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Experiences with Budget Rules in Switzerland and Germany

The Swiss debt brake served as a model for the new German budget rule. The two tools share the long-term goal of rendering fiscal policy sustainable by stabilising nominal debt as well as the short-term goal of smoothing the economic cycle. Debt brakes thus act as an automatic stabiliser within the economic cycle, but their effect can be impaired over the long term if government spending falls as debt is reduced.

At the end of 2014, public debt in the euro area amounted to nearly 95 per cent of its GDP. The level of public debt in Germany at the same time was 75 per cent of GDP. Switzerland, by contrast, had a debt-to-GDP ratio of just 35 per cent, a figure that had steadily fallen despite the global economic and financial crisis. The country's sinking national debt contributed decisively to this development.

It therefore comes as little surprise that the Swiss debt brake, which in 2013 had been in place for ten years, has been met with considerable interest abroad and served as a model for the German debt brake. By stipulating that the federal budget must be balanced, however, the Swiss debt brake is significantly more restrictive than the German one, which permits a structural deficit of 0.35 per cent of the GDP. In addition, the compensation account in Switzerland permits economic output-related deficits on only about half the scale allowed by the corresponding German one. The aim of this article is to compare the regulations in Switzerland and in Germany.

The Swiss debt brake

Fiscal policy in Switzerland has undergone a transformation in recent decades. Whereas a Keynesian fiscal policy took precedence in the past, the dominating idea today is that a government's fiscal policy should smooth economic fluctuations and at the same time contribute to sustainable development.[1] This paradigm shift can be seen in the budget figures of communes and cantons, but it is above all evident at the national level. In the past, the Swiss federal budget tended to display an economically asymmetric pattern in which the deficits accumulated during recessions were not compensated by corresponding surpluses while the economy was booming.[2] The result was a permanent rise in public debt, which increased from CHF 11 billion in 1970 to CHF 108 billion in 2000. Over the same period, the federal debt-to-GDP ratio increased from 11.6 per cent to almost 26 per cent.[3] A large share of this greater debt was used to finance accumulated deficits or to restructure old debts in the second half of the 1990s, for example those stemming from the renovation and refinancing of the Swiss national railway.[4]

The introduction of the debt brake in 2003 marked a transformation in Swiss fiscal policy, the core element of which became the aim of maintaining a balance between sustainability and economic support. This turning point can be seen particularly in the primacy of the passive anti-cyclical stability policy, in which automatic stabilisers are given precedence over active anti-cyclical

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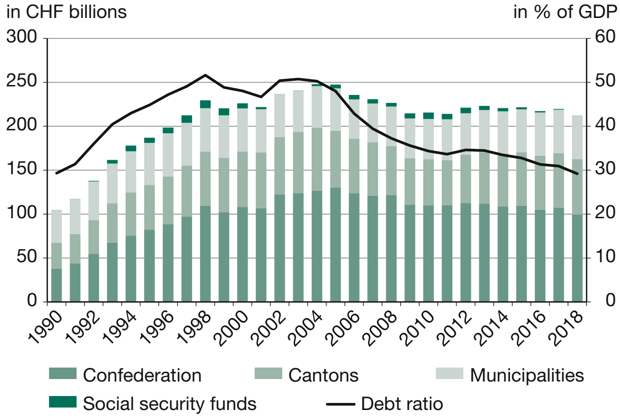
1 R.L. Frey: Finanzpolitik des Bundes seit 1960. Bericht im Auftrag der Kommission für Konjunkturfragen, Center for Research in Economics, Management and the Arts, Basel 2007, p. 5.

2 T. Beljean, F. Zurbrügg: Die Stabilisierungsmassnahmen des Bundes vor dem Hintergrund der Schuldenbremse, in: Die Volkswirtschaft. Das Magazin für Wirtschaftspolitik, No. 2009/7-8, pp. 15-17, here p. 15.

3 Swiss Federal Council: Bericht über die Schuldenentwicklung der öffentlichen Haushalte, Bern 2006, pp. 4ff.

4 Ibid., pp. 10ff.

Figure 1
Swiss gross debt, 1990-2016



Source: EFD – Eidgenössisches Finanzdepartement: Entwicklung der Staatsfinanzen: Resultate 2012 und Prognosen 2013-2018, Bern 2014, p. 10.

interventions.[5] This ensures that the automatic stabilisers can take full effect. By contrast, discretionary measures deviating from the basic rule of the debt brake are limited to exceptional cases in accordance with Article 15 of the Swiss Financial Budget Act and the provisions of the supplementation rule. During the recent economic crisis, a progressive procedure was also chosen for the governmental economic programmes, and great reliance was placed on fiscal policy measures.[6]

In 2014 the debt ratio of public budgets in Switzerland was below 35 per cent – significantly lower than the Maastricht debt ceiling of 60 per cent. Since 2003, when the ratio of gross debt to GDP in Switzerland was just under 54 per cent, the debt ratio has been continuously reduced (see Figure 1).[7] The prediction is that it will be further reduced to around 29 per cent by 2018,[8] since the debt reduction trend is expected to continue in all sectors.[9]

This welcome reversal in the development of Switzerland's public finances is particularly reflected in the federal budget figures. In 2013 public debt amounted to CHF 112 billion and had thus fallen by almost CHF 20 billion since peaking in 2005.

While fiscal limitations in the form of debt brakes and financial referenda have been in place at the canton level in Switzerland for some time now, a debt brake for the Confederation was only proposed in 2000.[10] In the referendum held on 2 December 2001, the debt brake for the Confederation was accepted by 85 per cent of voters. It thus replaced the interim provision for the 2001 budget target at the constitutional level (Article 126 of the Federal Constitution). The debt brake was first applied in the 2003 budget. Contrary to original assumptions, however, the debt brake was not introduced on the basis of a structurally balanced budget, which is why additional debt relief programmes were adopted.[11] With the 2003 debt relief programme, the Swiss Parliament approved cuts totalling around CHF 6 billion. Relief measures on the expenditure side had a considerable effect on the six major task areas of the Confederation: social welfare, transport, national defence, education and basic research, agriculture, and foreign relations.[12] In addition, the 2004 relief programme for the federal budget, which also significantly affected the expenditure side, was adopted.[13]

Goals of the debt brake

"In the debt brake, the Confederation has introduced a tool whose goal is to connect matters of economic sustainability […] with anti-cyclical fiscal policy."[14] Accordingly, two specific goals of the debt brake can be identified:[15]

- The short-term goal consists of smoothing economic fluctuations. With surpluses being formed while the economy is booming and deficits being allowed to accumulate during recessions, fiscal policy is prevented from becoming pro-cyclical. Instead, the debt brake

5 T. Beljean, F. Zurbrügg, op. cit. p. 16.
6 F. Zurbrügg: Schweizer Schuldenbremse – Wirtschaftskrise als Bewährungsprobe, in: E. Baltensperger, D. Niepelt, B. Zürcher (eds.): Wirtschaftspolitik nach der Krise, Conference proceedings, Gerzensee Conference, 19-20 November 2009, Study center Gerzensee, 2010, pp. 27-36, here pp. 30ff.
7 The debts concerned are the explicit debts of public budgets, including social security, in line with the Maastricht definition set out by the EU. The calculation is based on the IMF's Government Finance Statistics Model.
8 EFD – Eidgenössisches Finanzdepartement: Entwicklung der Staatsfinanzen: Resultate 2012 und Prognosen 2013-2018, Bern 2014, p. 10.
9 A. Brülhart: Die öffentlichen Finanzen der Schweiz, in: Die Volkswirtschaft. Zeitschrift für Wirtschaftspolitik, No. 2013/5, pp. 51-54, here p. 53.
10 Swiss Federal Council: Botschaft zur Schuldenbremse vom 5. Juli 2000, Bundesblatt No. 35, 5 September 2000, Bern, pp. 4653-4726.
11 M. Himmel, A. Geier: Erste Erfahrungen mit der Umsetzung der Schuldenbremse, in: Die Volkswirtschaft. Das Magazin für Wirtschaftspolitik, No. 2004/2, pp. 5-9.
12 Swiss Federal Council: Botschaft zum Entlastungsprogramm 2003 für den Bundeshaushalt (EP 03), Bundesblatt No. 32, 19 August 2003, Bern, pp. 5615-5802.
13 Swiss Federal Council: Botschaft zum Entlastungsprogramm 2004 für den Bundeshaushalt (EP 04), Bundesblatt No. 5, 8 February 2005, Bern, pp. 759-884.
14 R.L. Frey, op. cit., p. 28.
15 R.L. Frey, op. cit., p. 26; C. Colombier: Eine Neubewertung der Schuldenbremse, Working Paper No. 2 der Eidgenössischen Finanzverwaltung, Bern 2004, p. 11; T. Beljean: Schuldenbremse – konjunkturverträgliche Stabilisierung des Bundeshaushalts, in: Die Volkswirtschaft. Das Magazin für Wirtschaftspolitik, No. 2001/11, pp. 34-37.

has an automatic stabilising effect on economic development.

- In the medium to long term, the aim of the debt brake is to guarantee that fiscal policy is sustainable by helping to render the federal budget structurally balanced and thus to stabilise the federal debt. In the event of continuous economic growth, the debt ratio will decline over time. The medium-term goal of the debt brake is not therefore to reduce the level of debt, but to stabilise the nominal federal debt. "The Federal Council and Parliament reserve the right, however, to pursue 'more ambitious' goals in budgeting and financial planning" in order to reduce debt.[16]

Key elements of the debt brake

In order to achieve these goals, the debt brake comprises the following four key elements:[17]

Basic rule. The debt brake was conceived as a rule that manages expenditure by linking it to revenue in order to ensure that expenditure does not exceed revenue, controlling for the economic cycle. However, exceptions to this basic rule are permissible under the Financial Budget Act with a qualified majority vote in the National Council and the Council of States "because it is impossible to lay down adequate guidelines in advance for expenditure for all non-taxable eventualities such as severe recessions, natural disasters, wars and other specific developments".[18] The debt brake is thus a fixed rule with discretionary scope.[19]

Cyclical adjustment rule. The economic situation is taken into account in the debt brake by the cyclical adjustment factor. This economic factor corresponds to the quotient from the estimated real GDP in accordance with a smoothed trend over the long term and the expected real GDP in the budget year. Expressing both figures in real values ensures that only the cyclical fluctuations of the real economy are taken into account and not the cyclical fluctuations of the GDP deflator, which would reflect a distorted real economy situation.[20]

If the real trend GDP is greater than the actual real GDP, the economic factor will be larger than one, which indicates that the economic situation is weak. According to the basic rule of the debt brake, this will lead to the expenditure ceiling exceeding revenue and budget deficits will arise. The opposite is true if the real trend GDP is lower than the actual real GDP. In this case, the cyclical adjustment factor is smaller than one and a surplus is generated.[21]

The problem with determining the cyclical adjustment factor, however, is that the real trend GDP must be estimated by the observed time series being smoothed in order to derive a trend from it that is independent of the economic cycle. Originally, the Hodrick Prescott (HP) filter was used for this purpose.[22] However, problems with this filter soon became apparent, such as the establishment of the smoothing parameter and particularly the low degree of stability in the marginal values.[23] A modified HP filter is now used,[24] which gives less weight to the figures at the upper and lower ends of the observed time series when the trend components are determined than the traditional HP filter does.[25]

Compensation account and sanction rule. In order to prevent the debt brake from being undermined, a compensation account exists outside government accounting. This compensation account is debited with that part of the actual total expenditure that exceeds the permissible expenditure ceiling. Likewise, funds that remain below the expenditure ceiling are credited to the compensation account. A key cause of such deviations is the fact that errors in the calculation of revenue tend to be underestimated during upturns and overestimated during downturns. "Crediting and debiting the compensation account thus follow a cyclical pattern, with the account assuming the function of a buffer to a certain extent because these

16 Swiss Federal Council: Botschaft über die Ergänzungsregel zur Schuldenbremse vom 19. September 2008, Bundesblatt No. 42, 21. October 2008, Bern, p. 8491-8540, here p. 8501.

17 F. Bodmer: The Swiss Debt Brake: How it works and what can go wrong, in: Swiss Journal of Economics and Statistics, Vol. 142, No. 3, pp. 307-330; A. Geier: The Debt Brake – The Swiss fiscal rule at the federal level, Working Paper of the FFA No. 15, Economic Analysis and Policy Advice (EAPA) Division, Bern 2011, pp. 12ff.; K.H. Hausner, S. Simon: Die neue Schuldenregel in Deutschland und die Schuldenbremse in der Schweiz. Wege zu nachhaltigen öffentlichen Finanzen?, in: Wirtschaftsdienst, Vol. 89, No. 4, 2009, pp. 265-271.

18 Swiss Federal Council: Botschaft zur Schuldenbremse vom 5. Juli 2000 . . . , op. cit., p. 4694.

19 C. Müller, J. Hartwig, A. Frick: Eine Schuldenbremse für den deutschen Bundeshaushalt. Ein Vorschlag zur Reform der Haushaltsgesetzgebung, Gutachten im Auftrag der Bundestagsfraktion Bündnis 90/Die Grünen, Eidgenössische Technische Hochschule – Konjunkturforschungsstelle, Zürich 2007, p. 27.

20 Swiss Federal Council: Botschaft zur Schuldenbremse vom 5. Juli 2000 . . . , op. cit., p. 4689.

21 T. Beljean, op. cit., p. 34.

22 R.J. Hodrick, E.C. Prescott: Postwar U.S. Business Cycles: An empirical investigation, in: Journal of Money, Credit and Banking, Vol. 29, No. 1, 1997, pp. 1-16.

23 C. Colombier, op. cit., pp. 24ff.; German Council of Economic Experts: Staatsverschuldung wirksam begrenzen, Expertise im Auftrag des Bundesministeriums für Wirtschaft und Technologie, Statistisches Bundesamt, Wiesbaden 2007, pp. 136ff.

24 T. Beljean, F. Zurbrügg, op. cit., p. 16.

25 P.-A. Bruchez: A modification of the HP filter aiming at reducing the end point bias, Working Paper of the Group of Economic Advisers No. 3 of the Swiss Federal Finance Administration, Bern 2003.

deviations are offset over time."[26] As far as the reduction of debits in the compensation account is concerned, no fixed rule has been imposed, leaving Parliament maximum scope for action. Article 17 of the Financial Budget Act only stipulates that a deficit in the compensation account will develop over several years due to the lowering of the expenditure ceilings. These deficits only have to be cleared within the following three years if the deficits are very high, exceeding six per cent of the total expenditure of the previous budget year.

Supplementary rule. The supplementary rule was subsequently introduced on 1 January 2010. Up to that date, the debt brake had merely ensured that the ordinary budget was structurally balanced, while extraordinary expenditure was not taken into account in the calculation of the expenditure ceiling. Such extraordinary expenditure always leads to a rise in the federal debt, however, if it is not offset by extraordinary revenue or structural surpluses in the ordinary budget. In order to meet the constitutional requirement, both the ordinary federal budget and the extraordinary budget must be balanced.[27] This is now ensured by the supplementary rule, the basic idea of which is to "compensate deficits in the extraordinary budget with the ordinary budget over the medium term".[28] This is initially done by crediting or debiting extraordinary revenue and expenditure to the newly introduced amortisation account in accordance with Article 17a, paragraph 1 of the Financial Budget Act.[29]

Several principles have been formulated in the Federal Budget Act on how deficits in the amortisation account are to be dealt with. Firstly, they must generally be compensated for during the following six accounting years by making reductions in the expenditure ceiling and thus by means of structural surpluses in the ordinary budget. This obligation to reduce extraordinary deficits only applies, however, when the compensation account is at least balanced. This subordination clause is crucial to ensuring the economic compatibility of the supplementary rule. As deficits on the compensation account are particularly likely during phases of economic recovery on account of overestimations of revenue, deficits on the amortisation account remain initially untouched.[30] A forward-looking financial policy should ensure, however, that such deficits in the amortisation account do not arise in the first place, which is why the Financial Budget Act also urges cautious spending cuts to be made by lowering the maximum levels for the expenditure ceiling in advance if there are foreseeable deficits ahead, allowing them to be more easily covered by means of the ordinary budget.

Evaluation of the Swiss debt brake

It was partly due to the debt brake that the Swiss Confederation's gross debt could be reduced from a peak of around CHF 130 billion in 2005 to CHF 112 billion in 2013. The medium-term goal of a structurally balanced federal budget already led to the implementation of the relief programmes of 2003 and 2004 to clear the existing structural deficit.[31] In the following boom years, the debt brake also had a disciplinary effect by directing the high tax revenue towards accumulating surpluses rather than towards additional expenditure.[32] The debt brake faced its largest test to date during the recent economic crisis, in which the exemption rule rendered it possible, among other things, to consolidate UBS's equity capital base without jeopardising the government's ability to fulfil its ordinary tasks. The compatibility of the rule with the momentum of the economy has also prevented government expenditure from being cut and has, in addition, created scope for stabilisation mechanisms.[33]

The Confederation's budget figures show that the debt brake has proved adequate for weathering any storm.[34] Ordinary financial accounting even recorded a surplus in the crisis years of 2008 and 2009. 2012 saw a surplus of CHF 1.262 million, consisting of an economic deficit of CHF 756 million and a structural surplus of CHF 2.018 million. The year-on-year increase of at least CHF 300 million in the economic deficit can be attributed to the comparatively stronger overall position of the Swiss economy as a result of the strength of the franc and the weakening of the international economic dynamism. It also reflects the expansive effect of the automatic stabilisers. The amortisation account currently has a positive balance of CHF 46 million, while the compensation account has now been credited with CHF 19.4 billion, mostly due to the high structural surpluses of the past few years.[35]

26 T. Beljean, F. Zurbrügg, op. cit. p. 16.

27 M. Himmel, M. Schuler: Ergänzungsregel – Stärkung der Schuldenbremse, in: Die Volkswirtschaft. Das Magazin für Wirtschaftspolitik, No. 2009/9, pp. 49-53, here p. 50.

28 Swiss Federal Council: Botschaft über die Ergänzungsregel ..., op. cit., p. 8492.

29 Article 17a, paragraph 2 of the Federal Budget Law, however, stipulates that earmarked extraordinary revenue and thus covered extraordinary expenditure shall not be debited to the amortisation account.

30 Swiss Federal Council: Botschaft über die Ergänzungsregel ..., op. cit., p. 8519.

31 Swiss Federal Council: Botschaft zum Entlastungsprogramm 2003 ..., op. cit.; Swiss Federal Council: Botschaft zum Entlastungsprogramm 2004 ..., op. cit.

32 T. Beljean, F. Zurbrügg, op. cit. p. 17.

33 EFD – Eidgenössisches Finanzdepartement: Die Schuldenbremse – eine Erfolgsgeschichte, Bern 2012, p. 4.

34 EFD – Eidgenössisches Finanzdepartement: Staatsrechnung, Bericht zur Bundesrechnung 2012, Bern 2013, p. 18.

35 Ibid., pp. 18ff.

In structural terms, strains on the federal budget have recently been eased, particularly by the decline in interest payments and by debt management. While the Confederation had to spend CHF 4 billion on debt interest in 2006, it was only half that amount in 2012, a development that can be attributed to both the low interest level and the decline in debt.[36]

It is not least because of its contribution to debt reduction that the debt brake still enjoys a high level of acceptance among the Swiss people. According to the financial monitor survey conducted in the summer of 2012, 64 per cent of the respondents said that the debt brake had proved to be a success, and 83 per cent of those surveyed wanted to keep it.[37]

Nevertheless, there is criticism of the debt brake, even in Switzerland.[38] This criticism concerns not only technical aspects, such as the method by which revenue is estimated, but also its fundamental design, with the risk of a decline in public investments often being emphasised.[39] The Swiss Federal Council is currently re-examining proposals for the enhancement of the debt brake. Its report is expected before the end of this year.

Ultimately, however, the success of the Swiss debt brake can be seen not only in Switzerland but also abroad, where it served as the model for the German debt brake.[40]

The new budget rule in Germany

As early as 1969, the grand coalition in power at the time introduced a national debt ceiling as part of a major financial reform. Article 115, paragraph 1, sentence 2 of the German Basic Law (as amended) stipulated that "revenue from borrowing shall not exceed the total expenditure for investment provided for in the budget estimates; exceptions shall be permissible only to avert a disturbance of macroeconomic equilibrium". However, in the 42 years since Article 115 came into force, up to and including 2010, federal net borrowing exceeded federal expenditure for investment a total of 18 times, thus reducing the law to the level of absurdity.

In March 2007, the Joint Commission for the Modernisation of Federation-Länder Financial Relations (Federalism Commission II) was established with the aim of preparing legislation to simplify the financial relations between the Federation and the *Länder*. At the end of February 2008, the German Federal Ministry of Finance proposed a new budget rule, which was to be introduced at the federal level in 2011.[41] In February 2009, the Federation and the *Länder* agreed on a new budget rule which came into force on 1 August 2009. The new rules in Articles 109 and 115 of the Basic Law were first applied in the fiscal year 2011. The Federation and the *Länder* are required to have balanced budgets beginning in 2016 and 2020 respectively.

Table 1
Federal structural deficit, 2011-2016

Year	2011	2012	2013	2014	2015	2016
Deficit reduction target[1]	1.89	1.59	1.28	0.97	0.66	0.35
Structural deficit[2]	0.85	0.31	0.23	+0.07	+0.03	+0.04

[1] Maximum permissible structural federal deficit as a percentage of GDP.
[2] As from 2014: target figures.

Sources: Federal Government Benchmark decision on the federal budget draft for 2015, the budget schedule for 2014 to 2018 and the "Special Energy and Climate Fund" established in March 2014.

Components of the budget rule

The main features of the German budget rule are similar to those of the Swiss debt brake, consisting of a structural and a cyclical component of debt, a control account, and exceptions.

Structural debt component. The structural debt component is intended to limit the total public budget deficit to 0.35 per cent of GDP by 2016. A gradual reduction of the deficit was to begin in the fiscal year 2011 (see Table 1). Due to the robust economic development in Germany, the actual federal structural deficits were considerably lower than the targets in 2011-2013. The Federal Ministry of Finance expected surpluses beginning in 2014.

The *Länder*, on the other hand, are as a rule not supposed to run up any new debt as of 2020. In the transition period from 2011 to 2019, the poorer *Länder* will be provided

36 Economiesuisse: Schuldenbremse: nachhaltig erfolgreich, Dossierpolitik 18, Zürich 2012, p. 4.
37 Ibid., p. 9.
38 C. Colombier, op. cit.
39 B. Kislig: Das Erfolgsmodell Schuldenbremse weckt Begehrlichkeiten, in: Berner Zeitung, 4 January 2011.
40 Economiesuisse, op. cit., p. 9.
41 Federal Ministry of Finance: Modell einer neuen Schuldenregel, Kommissionsdrucksache 96 der Föderalismuskommission II, Berlin 2008. Other proposals came from bodies such as the German Council of Economic Experts: Staatsverschuldung wirksam begrenzen ..., op. cit. or from the Academic Advisory Council of the Federal Ministry of Economics and Technology: Zur Begrenzung der Staatsverschuldung nach Art. 115 GG und zur Aufgabe des Stabilitäts- und Wachstumsgesetzes, Bundesministerium für Wirtschaft und Technologie, Berlin 2008.

support in the form of consolidation assistance on the order of €800 million per year to enable them to stay within the debt limits without having to rely on any other outside help. Berlin will receive €80 million, Bremen €300 million, Saarland €260 million, Saxony-Anhalt €80 million and Schleswig-Holstein €80 million per year.

In return, the federal government and the *Länder* will each forego €400 million of revenue from the value added tax every year; this money will instead be paid into a fund managed by the Federal Ministry of Finance. Bremen and Saarland have agreed to abandon the claims they have filed with the Federal Constitutional Court for further federal budgetary assistance. A new stability council made up of the finance ministries of the federal government and the Länder as well as the Federal Minister of Economics and Technology is to act as an early warning system for matters of fiscal policy.

Cyclical debt component. In addition to the structural debt component, a cyclical debt component will be introduced. A favourable economic situation will result in a lower maximum borrowing ceiling and the generation of a surplus. An economic downturn, on the other hand, will lead to the scope for debt being increased to let the automatic stabilisers take effect.[42] This should stimulate or restrain demand and thus help to "automatically" keep the economic cycle steady, i.e. without any additional legislative or discretionary measures. In addition, the manner and extent to which the automatic stabilisers work depend on the specific features of the tax and transfer system. A more progressive tax system, more generous social transfers and higher government expenditures increase the impact of automatic stabilisation.[43]

Furthermore, the short-term connection between revenue and demand for goods and services influences the effect of the automatic stabilisers. If the financial administration classifies the revenue shock as temporary and bases the government's current demand on the long-term revenue position,[44] the effort to stabilise current revenue will fail and the influence of the automatic stabilisers on demand will drift towards zero. It is more likely, however, that some of the *Länder* will bring their expenditures in line with the revenue currently available due to borrowing restrictions, myopic expectations or greater precautionary saving.[45] In these cases, the stabilisation of revenue will cause a stabilisation of the demand for goods, the effect of which is usually delayed.

The cyclical debt component must be offset beyond a complete economic cycle. Structural and cyclical debt components are based on the close-to-balance ceiling of the European Stability and Growth Pact and thus on the concept of a budget that is almost balanced over the economic cycle.

Control account. The function of the control account is to monitor compliance with the budget rule. Even when a budget is prepared in accordance with regulations, an unplanned borrowing requirement may arise if, for example, tax regulations are estimated wrongly. These non-cyclical deviations between budget preparation (target) and budget execution (actual) are debited to the control account and have to be balanced later. The Federalism Commission II has agreed on a ceiling of 1.5 per cent of GDP for the control account, although if the account exceeds 1.0 per cent of GDP, the scope for a structural debt increase is to be reduced by the excessive amount, but by no more than 0.35 per cent of GDP. This automatic debt reduction only becomes effective, however, in the event of a positive change in the output gap, in order to avoid pro-cyclical effects.

Exceptions. In the future, the borrowing limits established under the Constitution may only be exceeded in the event of natural disasters or extraordinary emergency situations. Such an exceptional situation must be beyond governmental control. This will probably also apply to banking and financial crises if they impair the government's financial situation significantly and the state's capacity for action has to be secured.

A high parliamentary hurdle must be overcome, however, before such an exception can be implemented, so as prevent the political players from interpreting the rule too liberally. While the Federal Ministry of Finance initially proposed a 3/5 or 2/3 majority of parliamentarians, the Federalism Commission II lowered the hurdle, stipulating that only a qualified majority was necessary to approve an exception.

42 For more information on the effects of the tax and transfer system as automatic stabilisers, see S.F. Franke: Steuer- und Transfersystem als automatischer Stabilisator – wie, wann und warum funktioniert das?, in: M. Held, G. Kubon-Gilke, R. Sturn (eds.): Lehren aus der Krise für die Makroökonomik, Jahrbuch Normative und institutionelle Grundfragen der Ökonomik 11, Marburg 2012, pp. 105-131.

43 German Council of Economic Experts: Die Finanzkrise meistern – Wachstumskräfte stärken, Jahresgutachten 2008/09, Statistisches Bundesamt, Wiesbaden 2008, p. 246.

44 For more information on the permanent revenue hypothesis, see M. Friedman: A theory of consumption function, Princeton 1957, Princeton University Press.

45 M. Dolls, C. Fuest, A. Peichl: Wie wirken die automatischen Stabilisatoren in der Wirtschaftskrise? Deutschland im Vergleich zu anderen EU-Staaten und den USA, in: Perspektiven der Wirtschaftspolitik, Vol. 11, No. 2, 2010, pp. 132-145, here 133.

Evaluation of the budget rule

The frequency with which Article 115 of the Basic Law has been bypassed and the continuous rise in public debt helped to prepare the ground for a national budget rule in Germany. The budget rule adopted by the Federalism Commission II concerns the budgets of the federal government and the *Länder*, but in contrast to the Swiss cantons, the German *Länder* do not have any notable financial autonomy. Instead, they are dependent on the tax pool shared with the federal government. The rule limiting the scope of the *Länder* to accumulate debt is an encroachment on the budgeting autonomy of the *Länder*, which necessitated an amendment to the German Basic Law. It was only on account of the consolidation assistance agreed for the poorer *Länder* that they were prepared to agree to this. On the whole, the budget rule that was adopted represents a further limitation of the scope of the *Länder* to influence the expenditure side, while their barely existent powers on the revenue side were not extended. This aspect, in addition to questions concerning the liability for public debt or the restructuring of the *Länder*,[46] is reserved for a Federalism Commission III.

A key advantage of debt brakes derives from the institutional rules with which discretionary fiscal policy is translated into rule-bound fiscal policy. What is more, the due consideration taken of the economic situation by means of the economic factor or cyclical debt component shows positive results. The economic situation leaves clear marks above all on the revenue side of the government budgets. In order to prevent debts from increasing beyond the economic cycle, surpluses must be accumulated during economic upturns, but this is difficult in practice on account of politico-economic factors and fiscal asymmetries. Budget rules act as institutional "restraints" that tie expenditure to revenue while consolidating the budget in an economically compatible way by means of the economic factor. Without cyclical adjustments, rules for limiting public debt would run the risk of reinforcing cyclical fluctuations instead of smoothing them.

However, inadequate functioning of an institutional debt-limiting mechanism during economic cycles could be a problem. Estimates of the effects that Germany's budget rule will have on the real economy differ greatly. On the one hand, the German Ministry of Finance forecasts that the new budget rule "leaves enough scope to respond flexibly to cyclical fluctuations and unexpected borrowing requirements that arise at short notice".[47] On the other hand, the Macroeconomic Policy Institute anticipates a pro-cyclical financial policy and extremely restrictive effects during economic downturns.[48] These differences in the ratings result mainly from the question of how accurately tax revenue can be forecast and how high budget sensitivity, i.e. the reaction of public budgets to changes in the GDP, is estimated to be.

Ultimately, when strict rules are imposed on expenditure to regulate the level of overall spending, there is the risk of government cuts on the expenditure side being a burden on investment spending and a benefit to consumer spending. Such a development would undoubtedly run counter to the goal of rendering fiscal policy sustainable. It is therefore not without reason that the golden rule of fiscal policy that was enshrined in Article 115 of Germany's Basic Law (as amended) exists. Germany, however, also offers an example of how this rule can be diluted and bypassed, not least because it is difficult to clearly define the term investment. This explains the fact that the golden rule of fiscal policy is no longer mentioned explicitly in the German budget rule.

Comparative evaluation

The quality of a debt brake must be measured by the help it provides in stabilising public debt in the long term. As there is no clearly defined limit to what is "acceptable" public debt, some fear that the debt brake may be too strict.[49] The most-cited reason for this is that the postulated balancing of the budget beyond the economic cycle will lead to nominal public debt being stabilised, while real public debt and the debt ratio will each decrease over time. Viewed from this perspective, both the Swiss and the German regulations, with their explicit aim of reducing the debt-to-GDP ratio, are considerably more restrictive than the widely accepted debt ratio stabilisation guideline. However, the coming demographic challenges, for example, may justify such a comparatively strict arrangement. The German structural debt component of 0.35 per cent of GDP per year, as proposed by the Federalism Commission II, is less strict than the Swiss debt brake, which demands that the federal budget be structurally

46 Questions of liability have been discussed in detail in the context of the Federalism Reform II. See C.B. Blankart, E.R. Fasten: Wer soll für die Schulden im Bundesstaat haften? Eine vernachlässigte Frage der Föderalismusreform II, in: Perspektiven der Wirtschaftspolitik, Vol. 10, 2009, No. 1, pp. 39-59; B. Jochimsen: Staatsschulden ohne Haftung – Eine Option für deutsche Bundesländer?, in: Wirtschaftsdienst, Vol. 87, No. 8, 2007, pp. 518-524; and K.A. Konrad: Vorschläge zur wirksamen Verschuldungsbegrenzung der Länder, in: Wirtschaftsdienst, Vol. 87, No. 9, 2007, pp. 581-585.

47 C. Kastrop, M. Snelting: Das Modell des Bundesfinanzministeriums für eine neue Schuldenregel, in: Wirtschaftsdienst, Vol. 88, No. 6, 2008, p. 382.

48 Macroeconomic Policy Institute (IMK): Die Schuldenbremse – eine Wachstumsbremse?, Report No. 29, 2008, pp. 11-12.

49 Ibid.; C.C. von Weizsäcker: Die Notwendigkeit von Staatsschulden, in: Wirtschaftsdienst, Vol. 90, No. 11, 2010, pp. 720-723.

balanced. The German budget rule would nevertheless also lead to a total public debt reduction of approximately 20 percentage points within 20 years of its entry into force.[50] This calculation, however, is based on long-term nominal GDP growth of 3.25 per cent, which is rather optimistic. The Federal Ministry of Finance expects the German debt ratio to fall from 78.4 per cent in 2013 to 65 per cent in 2018.

In Switzerland, there is criticism that the compensation account is too small, meaning that deficits must be eliminated even when the economic situation does not support this. The ceiling envisaged for the planned control account in Germany is 1.5 per cent of GDP, i.e. approximately €40 billion at present. Applying the Swiss rule to Germany would result in a maximum deficit of only €17.8 billion (six per cent of the overall federal expenditure of €296.5 billion in 2014). This makes the Swiss debt brake much more restrictive than the German model.

It should also be pointed out that neither the Swiss debt brake nor the planned German budget rule can comprehensively guarantee sustainable financial policies on their own, as they both only focus on explicit public debt. Long-term payment obligations and financing gaps, for instance in the area of social insurance, are not reflected in the budget. When this implicit public debt is taken into account, Germany's effective public debt rose to 241 per cent of GDP for the base year 2012.[51] The European Commission calculated that German public debt would be 261 per cent of GDP by the year 2050 if no fundamental reforms of the pension and healthcare systems are enacted.[52] On this premise, the German Council of Economic Experts predicts that the debt-to-GDP ratio will be 250 per cent by the year 2060.[53] The generational balance, an intertemporal accounting system that records cash flows between generations via the state, gives an indication of these debts accumulated for future generations. A national budget rule that only applies to explicit public debt is thus necessary but not sufficient to ensure sustainability in financial policy.

Summary

It is difficult to compare two mechanisms when one of them has not yet been fully implemented. Nevertheless, the experience with the Swiss debt brake since 2003 can be described as positive throughout. The public debt ratio has decreased by 19 percentage points from 54 per cent in 2003 to 35 per cent at present, despite the global financial crisis. By contrast, the German debt ratio has increased by 14 percentage points from 63 per cent to 77 per cent over the same period, although this was primarily due to the government rescue of failing banks. Nonetheless, over the last few years, at least at the federal level, Germany has experienced a quite remarkable decline in new debt, especially in light of the European sovereign debt crisis. The structural federal deficit, for example, was only 0.23 per cent of GDP in 2013, which means that it hit not only the agreed federal deficit reduction target (1.28 per cent of GDP for 2013; see Table 1), but also the budget rule target of 0.35 per cent of GDP, which does not become mandatory until 2016.

This policy is not uncontroversial, since an investment gap has arisen, especially in the areas of education and infrastructure. A decade of belt-tightening has starved Germany of much-needed investment, and public investment has not kept pace with depreciation.[54] However, the longstanding goal of no government borrowing is popular with German voters, the majority of whom regard deficits as dangerous, ineffective and probably immoral. So despite this trade-off between adequate public investment and a balanced budget, the German government maintained its policy goal of balancing the budget in 2015.

Furthermore, a focus on infrastructure spending would not actually violate the German debt rule, as there is significant room for manoeuvre. The German Institute for Economic Research forecasts a surplus of 0.1 per cent of GDP in 2015 and 0.4 per cent of GDP in 2016 for the public sector.[55] The federal government could increase public investment by 69 per cent (0.66 per cent of GDP) in 2015 and 36 per cent (0.35 per cent of GDP) in 2016 compared with the currently projected spending levels without contravening the debt rule.[56] In addition to projects such as repairing bridges and completing roads, this money could be used to help the cash-strapped *Länder* and munici-

50 Federal Ministry of Finance, op. cit., p. 7.

51 S. Moog, B. Raffelhüschen: Alte Gewinner und junge Verlierer – Ehrbarer Staat?, Die Generationenbilanz, Update 2014, Stiftung Marktwirtschaft, Berlin 2014, p. 6. The German Council of Economic Experts calculated that the implicit public debt for the year 2011 was 159 per cent, meaning that the effective public debt was 239 per cent of GDP. See German Council of Economic Experts: Herausforderungen des demografischen Wandels, Expertise im Auftrag der Bundesregierung, Statistisches Bundesamt, Wiesbaden 2011, p. 184.

52 European Commission: The long-term sustainability of public finances in the European Union, European Economy 4, Luxembourg 2006.

53 German Council of Economic Experts: Mehr Vertrauen in Marktprozesse, Jahresgutachten 2014/15, Statistisches Bundesamt Wiesbaden 2014, p. 304.

54 M. Fratzscher: Die Deutschland-Illusion – Warum wir unsere Wirtschaft überschätzen und Europa brauchen, München 2014.

55 K. van Deuverden: Finanzpolitik: Handlungsbedarf erkennen – Maßnahmen ergreifen!, in: DIW Wochenbericht, No. 51+52, 2014, pp. 1310-1317, here p. 1313.

56 Calculation based on Bundesministerium der Finanzen: Finanzbericht 2015, Berlin 2014, pp. 13, 15.

palities which together account for two-thirds of public infrastructure spending.

Focusing on investment would also boost Germany's long-term growth prospects. The rates of return on public investment in education or infrastructure are likely to be higher than current German bond yields, which are at record lows of less than one per cent. A conservative estimate suggests the return on government investments in e.g. early childhood education is between three and eight per cent.[57] It remains to be seen whether the *Länder* will put up with the extensive infringement on their financial autonomy resulting from the ban on new borrowing or whether some of them, as in the past, will claim that budgetary emergencies exist for which the federal government will have to at least partly step in.[58] While the ban on new borrowing will apply to the *Länder* directly beginning in 2020, they have already found several ways of bypassing the brake, by e.g. "sale and lease back" of public buildings, the provision of public infrastructure in public private partnerships, or the outsourcing of certain services.[59]

It remains up to the *Länder* to decide whether and to what degree they want to impose a limit on borrowing in their own constitutions. Saxony was the first federal state to do so, approving a ban in July 2013 that already applies to the fiscal year 2014. While exceptions are allowed for budgetary emergencies, the high hurdle of a two-thirds majority in the state legislature must be overcome for such an emergency to be declared. Bavaria also approved via referendum the inclusion of a debt brake in its constitution. However, it is much less ambitious than the one in Saxony and indeed practically superfluous, as it in no way departs from the regulations that are included in the German Basic Law and that will apply to all the *Länder* beginning in 2020.

57 K.H. Hausner, R. Stölner: Bildungsspezifische Problemstrukturen in Deutschland und Österreich sowie Lösungsansätze aus ökonomischer und fiskalischer Sicht, in: Theorie und Praxis der Sozialen Arbeit, No. 3, 2010, pp. 225-230.

58 Mecklenburg-Western Pomerania and Saxony were the only Länder that were able to generate a budget surplus in 2011. See Cologne Institute for Economic Research (IW): Konsolidierungscheck 2012 – Die Schuldenbremse in den Bundesländern, IW, Köln 2013, p. 13.

59 C. Fuest, M. Thöne: Durchsetzung der Schuldenbremse in den Bundesländern – Kurzstudie des Finanzwissenschaftlichen Forschungsinstituts an der Universität zu Köln im Auftrage des Bayerischen Staatsministeriums für Wirtschaft, Infrastruktur, Verkehr und Technologie, Köln 2013; J. Pinkl: Umgehungsgefahren für die neue Schuldenbremse – Auslegung der Ausnahmetatbestände, Sondervermögen und Nebenhaushalte, Belastung der Kommunen, in: C. Hetschko, J. Pinkl, H. Pünder, M. Thye (eds.): Staatsverschuldung in Deutschland nach der Föderalismuskommission II – eine Zwischenbilanz, Bucerius Law School Press, Hamburg 2012, pp. 103-144.