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The Debt Brake Is the Target of Criticism – But It Supports Sustainable Fiscal Policy

Criticism of the debt brake enshrined in Germany's Basic Law is growing. In view of the downturn, more and more politicians and economists are arguing that the debt brake stands in the way of reasonable economic policy and is an obstacle to public investment. What should we make of these accusations?

It is right to ask, ten years after the introduction of the debt brake, whether this instrument is outdated. But the criticism is overblown. The hopes that some people pin on an end to the debt brake are unrealistic. And the debt brake by no means prevents policymakers from taking economic countermeasures in the event of a crisis.

The German economy is weakening, but current forecasts expect it to stabilize in 2020. Only if, contrary to expectations, the downturn were to worsen would it be worth considering a debt-financed stimulus package. Then the government could take countermeasures by improving depreciation for investments and moving up the planned abolition of the solidarity surcharge from 2021 to 2020.

Criticism of the Debt Brake Is Unconvincing

The debt brake does not stand in the way of this. While it is true that the German federal deficit must not exceed 0.35 percent of gross domestic product (GDP), this applies to the cyclically adjusted deficit figure. Under the current financial plans, the federal government would be allowed to borrow around EUR 10 billion in 2020. If the economy were to collapse, this sum would increase. So there is room for maneuver.

If necessary, the deficit limit can even be exceeded in the short term. Policymakers are to note excessive deficits in a control account for subsequent reduction in line with the cyclical condition of the economy. The statistical procedure for cyclical adjustment is often criticized as inadequate. But that calls only for a change in the procedure, not for throwing the debt brake overboard.

The second point of criticism of the debt brake – that it allegedly prevents more investment – is also wide off the mark. It is possible at any time to finance more investments by reallocating expenditure in the budget. Whether politicians want to do that is another question. In recent years, there was no need because falling interest rates and bubbling tax revenues meant that more money was available than could be spent sensibly. Since 2014, the first year with a balanced federal budget, public investment has grown about twice as fast as GDP.

Investment gaps do exist in some municipalities – but these municipalities are not subject to the debt brake. To date, municipalities have been able to finance investments with debt, and they are permitted to do so in the future. The federal and state governments can also continue to engage in debt-financed investment. Where this goes beyond the debt limits, however, they must organize it outside the regular budgets, for example in public companies such as the railways.

New Conditions Do Not Make the Debt Brake Superfluous

Of course, the world has changed in recent years. Yields on German sovereign debt have slipped into negative territory, and the public debt ratio has fallen below the European ceiling of 60 percent of GDP. Low interest rates mean that debt-financed government spending has become more attractive from a macroeconomic perspective. This has lessened the urgency of a debt brake.

But that doesn't mean it should be abolished. What would be the consequences? We cannot assume that additional scope to take on debt would be used primarily to promote investment. There are many calls to increase consumption expenditure, raise social benefits, and lower taxes. The most likely outcome would be a mixture of higher government final consumption expenditure, tax cuts, and more public investment. Hopes that a move away from the debt brake could improve the sustainability of public finances are therefore too optimistic. More debt-financed consumption does not have to be a disadvantage, as consumption brings benefits. But this leads to less, not more sustainability.

The sustainability of public finances also depends on implicit debt. In recent years, the implicit national debt has expanded as a result of political decisions, such as introducing the maternal pension and making the old-age pension available from age 63 onwards. This, too, is an argument in favor of placing limits on explicit government debt.

Fundamentally, constitutional rules that limit leeway are never helpful if policymakers always make optimal decisions. But that is precisely what they do not do. In the political process, short-term considerations often prevail over long-term concerns. That is why the political decision-makers themselves introduced the debt brake. It forces policymakers to set priorities in the interests of sustainable fiscal policy. Since then, the sustainability of public finances has improved – but not to the extent that the debt brake could now be dispensed with. The price of this rule is indeed that some opportunities for useful expenditure or tax cuts may be missed. But that isn't too high a price.

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