A Concept for a New Budget Rule for Germany

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With Germany having finally overcome its long economic stagnation in 2006, its public finance has also become much more favourable, showing a fiscal surplus in 2007 for the first time since German reunification. Additionally, the debt ratio was reduced to 65 percent after having reached almost 68 percent in 2005. Nevertheless, neither the Federation *(Bund)* nor a large number of *Länder* (states) had managed to comply with the respective – and quite generous – limits of net borrowing laid down in the constitutions in the years before. The deficit had been in excess of the 3 percent deficit ceiling of the European Stability and Growth Pact (SGP) from 2002 for four years in a row. Annual interest payments have reached around 15 percent of the expenditures of the federal budget in recent years. Having such a high public indebtedness narrows the scope for manoeuvre of fiscal policy and poses a heavy burden to future generations, especially under the conditions of an ageing society and implicit debt.

As the current budget rule in the Federal Constitution has not been able to prevent the accumulation of debt – which increasingly confines the government's capacity to act – the political discussion has recently focused on the introduction of a new budget rule. The first "practical" task started in the Federal Ministry of Finance in late spring 2006. This work has led to a central goal of the "Stage 2" of the Federalism Reform in Germany, carried out by the Committee on the Modernisation of the Financial Relations between the Federation and the states. The central goal is to enact a more effective budget rule than the current one. Since then the Federal Ministry of Finance has been involved in the conceptual task aimed at developing a new budget rule, and presented – in the name of the federal government – a proposal for a new budget rule to the aforementioned Committee at the end of February 2008 (Kommission zur Modernisierung der Bund-Länder Finanzbeziehungen 2008). The proposal has been approved and its economic and political aspects have been tested against the competing models such as the net-investment model of the Council of Economic Experts (CEE). At present, there is a lively discussion both inside the parties of the Grand Coalition and in the states, since a new budget rule enjoys – besides the development of an early warning system in order to prevent a budgetary crisis – the highest priority on the agenda of the Committee.[1] A draft bill should be finalised by the end of 2008.

In this article we will firstly deal with the *status quo* of the existing budget rule and the resulting problems. In the next section the two main concepts of how a new budget rule can be designed are discussed, followed by our own proposal for a reform. The final section concludes.

Status quo and problems of the existing budget rule

The current budget rule was implemented at the end of 1960s – the heyday of Germany's Keynesian fiscal policy fine-tuning. According to Article 15 of the German Constitution net borrowing in the proposed budget is limited to the amount of (gross) public investment. Exceptions to this rule are only allowed in the case of an emerging "disturbance of the macroeconomic equilibrium". Art. 109 II of the German Constitution has another similarly imprecise obligation stating that the Federation and the states must take the macroeconomic equilibrium into consideration when approving their budgets.

The economic and general institutional framework has changed, however, since the implementation of the current budget rule, which makes the rule obso-

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[1] For an overview of competing proposals and their key characteristics, see Groneck and Plachta (2008).

lete in some aspects. Globalisation has reduced the power of the instrument that once was seen as a global controlling mechanism. Secular decline of potential growth rates accompanied by demographic changes has led to conflicts in the social security system regarding the intergenerational distribution of financial burden. Last but not least, besides the Federal Constitution (and the respective state constitutions) the guidelines introduced by the European Stability and Growth Pact (SGP) must now also be adhered to.

On the other hand, such changed general environments may also have contributed to the increase in public debt at the federal level. As the constitutions of many states have similar – in some cases even the same – rules as the Federation does, this may also be true on the state and municipality levels since 1970, particularly exacerbated in the years after German reunification when the public debt increased much more strongly than GDP.

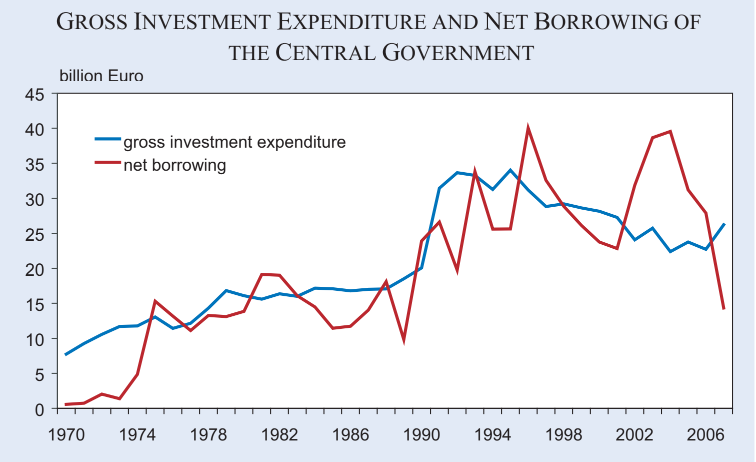
One of the major problems of the existing budget rule is that it reacts asymmetrically over the business cycle. In situations of a disturbance of the macroeconomic equilibrium, net borrowing is not limited at all. But there is no corresponding rule for the opposite case: there is no obligation to reduce net borrowing (or to create a surplus) if economy is in "good" shape with a positive output gap. For instance, in the past, public expenditures rose and revenues decreased in bad economic years, while there was no comparable (opposite) development recorded in those favourable periods.

Second, the exception clause, i.e. the disturbance of the macroeconomic equilibrium, is not clear enough and therefore it has always been difficult to decide, before applying this rule, whether the macroeconomic equilibrium is really disturbed or not. There have been two judgements by the Federal Constitutional Court regarding this matter: one in April 1989 about the budget in 1981 and the other in July 2007 on the budget in 2004. In 1989, for example, the Federal Constitutional Court did not make a precise definition of the exception but stated that the legislator had a scope for judgemental evaluation in this question. The only obligation was that the assessment of the situation had to be based on economic data and backed by statements of the legitimated, financial and economic advisory institutions (e.g. Financial Planning Council, Business Cycle Council, CEE and *Bundesbank*). In addition, the assessment had to be traceable and justified by the perceptions of economic theory and public economics. Ultimately, in case of a dispute, it is the Federal Constitutional Court itself that must examine and evaluate the question of whether the assessment of the legislator was traceable and justifiable.

In general such an exception rule also made it relatively easy to face political or economic pressure by increasing structural debt behind the veil of "macroeconomic equilibrium" and "intergenerational burden sharing". In recent decades, for example, this rule was repeatedly used to "finance" German unification, without fully recognising major negative (mid- to long-term) impacts of a growing debt on the economy. But also at the beginning of this century, this track has not been abandoned.

In the proposed budgets of the Federation from 2002 to 2004 and even that for 2006, net borrowing exceeded the limit defined by the investment expenditures, and this was also true for some states in recent years. In 2002 and 2003, net borrowing of the Federation exceeded investment expenditure only in the "supplementary" budget, while the excess took place already in the "original" budget for the year 2004. In all cases such an excess was officially justified by a disturbed macroeconomic equilibrium. The opposition parties at the time – CDU/CSU and FDP – reasoned that there was no disturbance of the macro-

Figure 1



Source: Federal Ministry of Finance.

economic equilibrium, and filed an action against the 2004 budget law at the Federal Constitutional Court. In 2005 the federal government, which did not have to prepare a supplementary budget, protected the net borrowing excess again in terms of a disturbed macroeconomic equilibrium, because it still had credit authorisations from former years that had not been utilised. Finally, in 2006 the government again justified the excess in the same manner, although there had already been some signals that the economy was recovering. But also in the years before 2002, the exception rule was used without having a clear-cut knowledge about whether the macroeconomic equilibrium was really disturbed or not. In almost half of the investigated period since 1970, net borrowing of the central government was higher than its gross investment (Figure 1). Moreover, a clear correlation between the budget rule (as a type of golden rule) and investment could not be observed.

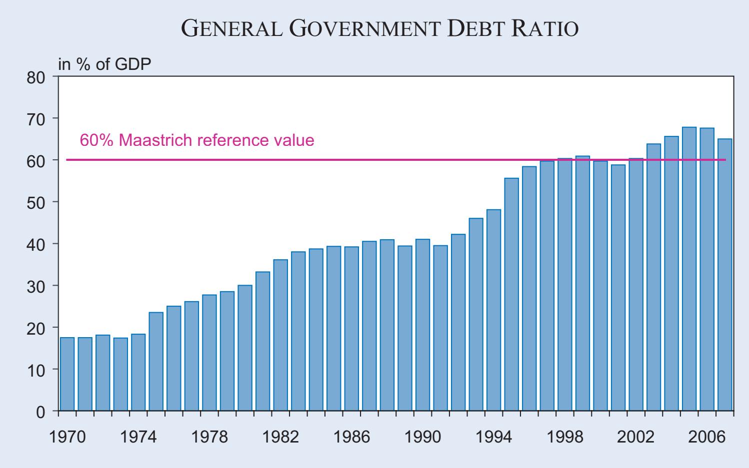
The marked increase in the general government's indebtedness from 17.5 percent relative to GDP in 1970 to 65.0 percent in 2007 could not be prevented (Figure 2). The increase above the Maastricht reference value of 60 percent of GDP was interrupted only by small and non-sustainable decreases in the years around 2002. Furthermore, the rapid growth of interest payments reduced the fiscal policy scope dramatically.

Besides, Article 115 of the German Constitution turned out to be incompatible with the SGP, although the deficit was below the 3 percent criterion in 2006 and therefore well in line with the rules prescribed in the SGP. Yet net borrowing still exceeded gross investment that year. Beyond this, the existing budget rule accompanied by rising public debt is not in line with the budgetary objective of long-term sustainability. Another problem is that the so-called "investment concept" relates to gross investment expenditure as the limiting factor. By neglecting depreciation of the public capital stock, the limit for net borrowing is therefore set too high, without any significant economic implication.

On July 9, 2007, the Federal Constitutional Court again dismissed action against a budget violating constitutional principles – this time for the year 2004. The Court acknowledged that the reasons and actions of the former federal government had been traceable and justifiable. But the Court also stressed that the existing budget rule was in need of reform, without mentioning any details about what a reformed rule should look like. In contrast to the decision made in 1989, the Court gave neither any further guidelines nor set any time scope required for the reform.

As a consequence of the growing public debt and the non-conformity with the SGP, the increased consciousness about the necessary consolidation that should (and could) not be postponed any more, as well as the judgment of the Federal Constitutional Court, a vivid discussion started in public about a reform of the existing budget rule. As already mentioned above, the formulation of a new budget rule was chosen as one of the prior goals of the Committee on the Modernisation of the Financial Relations between the Federation and the states, established by the Presidents of the *Bundestag* and the *Bundesrat* in March 2007. Given the economic and fiscal situation of Germany and the current majority in Parliament, chances for a binding decision for a reform – which requires a constitutional change – together with a fixed date of implementation are favourable. The current economic upswing has led to a cyclical improvement of the fiscal stance and consequently to compliance with the existing budget rules (German Constitution and SGP). This also appears to have led to a structural improvement of revenues in the medium term by substituting one-off measures (e.g. privatisation gains) with tax revenues. Such favourable conditions additionally provide broad acceptance of a new budget rule by the public.

Figure 2



Source: Federal Statistical Office.

Concepts of a new budget rule: Golden rule versus balanced budget in the medium term

Firstly some suggest that the chance for reforming the current budget rule could also be used to change the target orientation from a deficit level to an expenditure path (see Horn et al. 2008; Vesper 2008). Yet in the case of such a system transfer, there would be no enforcement mechanism that works in the direction of sustainable public finance. More precisely, the option with an expenditure path would not solve the problem of increasing deficits. Since there is no any correction mechanism for those policy measures that are not (or insufficiently) financed by revenues, it would not offer an adjustment mechanism to different revenue paths in the future, and it would certainly increase incentives to circumvent the expenditure path via "creative" measures on the revenue side, e.g. via tax expenditures or tax allowances.

If one keeps to the principle of a budget rule aiming at maintaining a certain deficit level, two different concepts basically exist. The idea of the golden rule of fiscal policy is to limit public net borrowing to the amount of *net* public investment. In contrast, the SGP approach aims at a balanced budget which mandates that net borrowing be (close to) zero in the medium term but permits the so-called automatic stabilisers in the short term (see below).

The idea behind the golden rule is classical and based on the following economic assumption: public investment is accompanied by an asset accumulation which is also of use for future generations. For this reason it is justified that the future generations also bear a share in the costs arising in the financing. The underlying rationale is that productive public investment raises potential output per capita in the future. While Germany follows a "modified" type of golden rule where gross public investment is the restraining factor, the United Kingdom, Australia and New Zealand apply a golden rule oriented to net public investment. Other countries like Belgium, the Netherlands and Sweden, which introduced the golden rule in the 1950s and 1960s, gave up the system in the course of time. Another difference between Germany and, for example, the United Kingdom is that, while the limit of the budget has to be observed every year in Germany, the rule in the United Kingdom has to be followed over the medium-term financial planning only. In order to ensure sustainable public finance, a so-called sustainable investment rule exists in the United Kingdom in addition to the rule stating that the public debt ratio must be kept below 40 percent of GDP.

Theoretically, a golden rule can be optimal for several reasons. It can be optimal (1) if – compared to a regime where public debt is prohibited – public investment is below the social optimum level, and (2) if there are – in the presence of political or institutional restrictions – incentives to cut productive public investment. Another argument often used for the golden rule is that intergenerational redistribution should favour today's generations and at the expense of future generations. Without really knowing what the social optimum level of public investment is, Figure 1 shows a clear downward trend of gross public investment expenditure since German reunification despite the existence of a golden rule. One of the reasons is that this type of public expenditure is the easiest to cut. Even worse, the reduction of public investment was accompanied by an increase of public debt, punishing future generations.

The golden rule is criticised not only because of this experience. One of the major problems associated with such a rule is the problem of how to define investment. In practice, it turns out to be technically difficult to determine the precise depreciation rate. In addition the determination could be subject to manipulation, as there is an incentive to underestimate these rates. In Germany, an additional problem emerges because government's investment grants for the private sector or transfers for other countries are also recorded as investments. In both cases, however, a (direct) net wealth increase does not take place at the government level. Moreover, some types of public expenditures are presently classified as "consumptive" but have investment characteristics, e.g. expenditures for R&D or education. A golden rule that fails to include these kinds of expenditures as investment would provide incentives to reduce them to a level below the socially optimal one.

Since education in Germany is a matter of the states, this question is not of much relevance for a budget rule on the Federation level. But counting all education expenditures as investment would widen the deficit limit for the states considerably. On the level of the Federation this would amount largely to the non-investitve transfers of funds to the states aimed at supporting research institutions of the so-called Blue List (Scientific Community Gottfried Wilhelm Leibniz, an association of German research institutes of different specialisations) as well as stimulating R&D activities of private firms within the public innovation promotion policy.

The difficulty arising with the inclusion of education expenditure is that in order to calculate net investment correctly, one has to be able to compute the depreciation of human capital. This is an extremely difficult task. The research that has attempted to tackle this problem suggests a rather high depreciation rate (see examples given in Sachverständigenrat 2007, 130). Together with the extremely low correlation with the outcome resulting from educational expenditures,[2] this fact suggests that inclusion of the education expenditure into the public investment concept and thereby increasing the tolerable level of net borrowing can occur only in a very restrictive manner. These and other difficulties led the Advisory Council to the Federal Ministry of Finance (1980) as well as the Federal Constitutional Court in its judgement about Article 115 of the German Constitution (1989) to decide against such an inclusion.

An imminent danger – which again creates a political incentive to spend for "good reasons" – involved with the question of the correct definition of the investment term is that it might open the floodgates to a discussion of including other non-investment public expenditures in the health sector, for childcare or for security reasons, as they could be interpreted as investment in the future and preconditions for economic growth. Another problem with the golden rule is that – though it follows the principle of intertemporal equivalence – it is accompanied by a growing sustainability gap in the face of demographic changes witnessed in many industrial countries including Germany. In this respect, a golden rule does not adhere to sustainability principles in an ageing society.

All these aspects that argue against a golden rule have to be seen together with the robust result of economic theory that holds that deficit financing of public expenditure – no matter whether this is used for consumption or investment – burdens future generations and leads to lower growth. This is true at least for the plausible case in the long run when the interest rate is greater than the secular shrinking of the potential growth rate. Desired redistribution effects to the detriment of future generations are then the only justification for public expenditures financed by the long-term debt. These effects, however, are counteracted in an ageing society by the burden that future generations have to bear in the face of the demographic change – especially in a social security system that is based solely on a pay-as-you-go principle.

Aside from the intergenerational problem, a golden rule neglects the productivity of private investment as a substitute to public investment. Though public investment may encourage private investment and increase its productivity, the opposite effect is possible as well, depending on the kind of investment and the existing capital stock. In this case the waiving of public investment, together with less debt and less future tax burden, may lead to more productive private investment. Finally, the analogy to the private sector concerning return on investment is limited. While the economic profitability of an investment project of a private enterprise has to show up at least in the long run in financial returns, public investment does not have to.

In the face of all these problems with the golden rule, there are a number of arguments in favour of a structurally balanced budget in order to guarantee sustainable public finance and to limit net borrowing. While a golden rule allows net borrowing at the amount of public investment, according to a structurally balanced budget rule net borrowing is allowed only for cyclical reasons (automatic stabilisers) and there must be additional saving efforts in the case of a cyclical upswing. The consequence is a reduction of public debt in relation to GDP. Even a budget rule that is less restrictive but still in accordance with the SGP – e.g. the "close to balance"-rule which prescribes for Germany a minimal structural deficit of 0.5 percent of GDP – would be much more advantageous than the current rule. Finally, the quality of public finance is also guaranteed in a structurally balanced budget rule. It may be even superior to the golden rule, as it does not have a bias towards "physical" capital formation. This rule would prescribe the legislator to shift the expenditures to those of "high quality types (education and R&D)" that are viable for the future, regardless of whether they are classified as investment or consumption expenditures. Here the new deficit regime meets or is even part of the "Quality of Public Finance" agenda, now being developed at the EU level and its members, including Germany.

[2] Empirical studies find no or at best a very weak relationship between the amounts invested for education and the outcome (see the zero or even negative correlations between the PISA results and education expenditure in Sachverständigenrat 2004 and Hanushek 2002).

Criteria and proposal for a new budget rule

Regardless of its design, a budget rule has to fulfil certain indispensable criteria. First, there should be an effective limit for (structural) net borrowing. Second, the rule should lead to stabilisation over the business cycle and guarantee sustainability of public finance in the long run. Moreover, the budget rule must be compatible with the SGP. Additionally, it must have an enforcement mechanism requiring not only *ex ante* control, i.e. with the establishment of the budget, but also after execution of the budget. Finally, the viability of the rule has to be guaranteed by an exception clause in case of emergencies. These essential criteria must be embedded in a budget rule that is technically and legally feasible. As a special problem of Germany's federalism, federal aspects also have to be considered.

As shown in the previous section, there are a number of arguments against a budget rule that relies on the golden rule concept. This holds especially for the case of Germany where a necessary new definition of the investment concept involves serious problems. This is one of the main differences to the proposal of the German Council of Economic Experts (CEE) published in its Spring 2007 expertise commissioned by the Federal Minister of Economics and Technology. Entitled "Limiting Government Debt Effectively" (Sachverständigenrat 2007) it defends the (net) investment concept. A prominent supporter of deviating from the golden rule is the Advisory Council to the Federal Ministry of Finance, which advocated its position in a letter to the Federal Minister of Finance in July 2007 (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2007). Besides relying on the investment concept, the CEE also introduced in its proposal a component for cyclical adjustment close to the so-called debt brake in Switzerland, which was proposed in 2000 (Schweizerischer Bundesrat 2000) and realised in 2002.

In our view, a new budget rule should be compatible with the "close to balance or in surplus" approach of the SGP, which also shows some similarities with the Swiss debt brake. The following principles must be followed. First and as the main principle, the budget must be balanced in general in terms of revenues and expenditures without net borrowing. Second, the new rule should play a stabilising role for budget policy over the business cycle. Allowing automatic stabilisers to work assures that the budget rule reacts symmetrically over the business cycle. Therefore, in case of divergences from potential output, cyclical adjustments in net borrowing should be allowed. A cyclically induced increase in net borrowing (or a lower surplus) should be possible with a negative output gap, while net borrowing ought to be reduced by cyclically caused excess revenues or reduced expenditures (or a fiscal surplus has to be realised) in a situation with a positive output gap. This symmetry over the business cycle provides additional room for net borrowing in bad times, which leads to a systematic increase in public debt in the long run. The symmetrical consideration of the business cycle was also demanded by the Federal Constitutional Court: "it is necessary to develop mechanisms that guarantee the necessary balance of the budget over several fiscal years. The choice and institutionalisation of rules that counteract conveniently the incentive to postpone balancing burdens on future legislations is the task of the legislator, who is able to change the Constitution" (Bundesverfassungsgericht 2007).

Cyclical adjustment has already been used in the application of the SGP, which aims at controlling and evaluating (1) the medium-term objectives (MTO) of the budget, (2) the adjustment steps leading to the MTO, and (3) the recommendations of the European Council to the Member States made for correcting excessive deficits and the required time span.

While in the concept of the CEE, as in the Swiss model, the cyclical component is calculated with the Hodrick-Prescott filter, we propose following the SGP and applying the production function approach in order to estimate potential output. This is the reference method agreed by the European Council on 12 July 2002.[3] However, as potential output is an unobservable variable, there is neither a single correct estimation approach nor a clear result. The Hodrick-Prescott-filter method is a purely statistical one, while the production function approach is based more strongly on economic theory. In general these and other computation methods lead to similar results, although the output gaps may differ even in sign in certain periods. All methods also have the problem that values for former periods are usually revised, which may eventually change even the sign (+ or –) of the output gap.

Cyclical adjustment is applied as follows. The cyclical component of the fiscal balance is calculated as the

[3] Cyclical adjustment is stipulated by law in Council Regulation (EC) No 1467/97 (OJ 1467/97, OJ 1056/2005) on speeding up and clarifying the implementation of the excessive deficit procedure.

product of the budgetary sensitivity and the output gap. Budgetary sensitivities, i.e. the elasticities of the budget deficit on a change in the output gap, have been derived for the European Commission by the OECD in a sophisticated approach (André and Girouard 2005). Cyclical components of the budget according to the SGP are tax revenues, social security contributions and labour market expenditures. The result for Germany has been evaluated also in a separate work by the Ifo Institute (Büttner et al. 2005), which confirmed a general government budgetary sensitivity for Germany of 0.5 as obtained by the OECD. This empirical analysis also showed that about 50 percent of the cyclical component can be attributed to the federal budget and the rest to the budgets of the social security system, the states and municipalities. Subtracting the cyclical component from the fiscal balance leads to the cyclically adjusted fiscal balance, which means, for example, that an output gap of – 1 percent generally results in a cyclical component of the budget deficit of 0.5 percent of GDP.

Third, the medium-term objective of the SGP has to be observed. Therefore, net borrowing must be limited to the medium-term objective of the SGP ("close to balance or in surplus") which tolerates a maximum structural deficit of 0.5 percent of GDP for the general government. In addition, in order to be compatible with the Maastricht definition, this amount should be corrected for net financial transactions (mainly privatisation gains). This aims at guaranteeing durably sustainable public budgets and therefore full compliance with the Code of Conduct of the revised SGP, which states: "Member States should achieve a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in periods of economic recovery, with the objective to avoid pro-cyclical policies and to gradually reach their medium-term objective, thus creating the necessary room to accommodate economic downturns and reduce government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finance. The presumption is to use unexpected extra revenues for deficit and debt reduction".[4]

Since the Federation takes nearly 70 percent of the total public debt, we propose an interjurisdictional distribution of a net borrowing share of 70 and 30 percent between the Federation and the states. This would mean 0.35 percent of GDP for the Federation, i.e. a tolerated Maastricht deficit of about € 8½ bn at present. Subsequently the allowed net borrowing ceiling (or the required minimum fiscal surplus) amounts to the cyclical component of the budget subtracted by the sum of 0.35 percent of GDP and net financial transactions.

Because in the long run public debt as a share of GDP is expected to be reduced to far below 60 percent, our approach – as well as that of the CEE – takes intergenerational justice and future viability into consideration. Debt reduction can be used to cover implicit liabilities, which, in turn, makes an important contribution to long-term sustainability of public finance. A decreasing public debt ratio also opens room for manoeuvre so that expenditures can be shifted towards tasks relevant to the future. This improves the quality of public finance. An exception clause to the general rule should be formulated only for specific emergency cases. In order to overcome an extreme crisis, e.g. a natural disaster coupled with a severe economic downturn, a two-thirds majority or an even higher quorum of the *Bundestag* may provide extra scope for net borrowing.

In terms of enforcement, there is a need for monitoring and setting incentives not only for the establishment but also for the execution of the budget. Deviations from the allowed expenditure ceiling (or the minimum fiscal surplus) defined by this budget rule will be put on a special account, the so-called control fund, which acts as "memory and buffer" if non-compliance with the rule is established *ex post*.

Deviations of the actual from the minimum fiscal balance are accumulated over the years in the control fund. However, the minimum fiscal balance may change over the course of the fiscal year compared to that forecasted at the time of the budget approval due to different unforeseen economic, i.e. cyclical developments. This will be taken into account in a pragmatic approach by correcting the cyclical component by the deviation of the actual growth rate of GDP from the forecasted one. A similar approach is chosen in the assessment of the excessive deficit procedure for Germany. This would mean, for example, that with a forecasted real GDP growth of 2 percent, but a realisation of only 1 percent, the one percentage difference between these two rates would be multiplied by the budgetary sensitivity and the share

[4] See European Commission (2006), Specifications on the Implementation of the Stability and Growth Pact and Guidelines on the Format and Content of Stability and Convergence Programmes, 2006, ec.europa.eu/economy_finance/about/activities/sgp/codeofconduct_en.pdf.

of the Federation. The same is true for the opposite case if the forecasted GDP growth is more pessimistic than the realisation. This so-called *ex post* additional cyclical component will then be added to the *ex ante* cyclical component and either reduces or increases the minimum fiscal balance that is not relevant for the control fund. The target-performance comparison will be made as soon as there are preliminary results for the budget and GDP growth of the fiscal year.

Nonetheless, in cases when the debit side is in excess of a defined threshold level possible policy measures have to be introduced as soon as an excess is observed. Consolidation measures have to be implemented in a way that the debit side falls below the threshold level again within a specified time scope. The threshold amount could be set at above 1 percent of GDP, for example. A backward simulation of this rule to the years 2000 until 2007 shows that this level would never have been exceeded on the debit side. This simulation was done under the assumptions that the allowed net borrowing is bailed out *ex ante*, i.e. at the time of budget approval. Deviations between targeted and actual net borrowing equal the actual deviations in the past (taking net financial transactions into account).

As pointed out above, the opportunity to introduce a new budget rule should be exploited now. And as the general government budget will be balanced in 2011 according to the current budget plan, it seems unnecessary to consider an adjustment path until the new budget rule can work. The new rule would become effective when the budget is balanced. As the SGP demands budget discipline for the general government and the Federation takes the responsibility vis-à-vis the EU, it might be politically desirable to have a budget rule that covers not only the central governmental level but also the state level. (In principle all municipalities should have a balanced budget.) Basically there is no technical problem to translate the budget rule to all levels of government, though there is no need for fiscal policy to do so. As tax revenues among the states are equalised to a large extent by the fiscal equalisation scheme between the federal government and the states, there is no close relation between regional GDP and regional tax revenue. The cyclical component therefore could be divided according to the distribution of tax revenues after fiscal equalisation, which corresponds to the split made based on the share of the population.

But a translation of the proposed budget rule to the states could cause some problems, since the starting conditions and, consequently, the time path to a structurally balanced budget differ from one state to another. While some of them have a balanced budget or are even in surplus, others have a distressed budget: the eastern German states, for example, additionally receive special equalisation payments from the federal government. The main task of the states is merely to introduce a preventive measure in order to avoid financial distress of the individual states, which was also demanded by the Federal Court of Justice. This could be, for example, an early warning system. In this context a stability council sets a time path for those states lacking a balanced budget, formulates a concept of financial restructuring for a state in distress, controls the state's adherence to it, and decides on possible sanctions if the consolidation program fails.

Conclusion

A reform of the existing budget rule is inevitable in Germany. Economic and fiscal conditions as well as the political environment of a grand coalition are favourable for a reform and such an opportunity should be fully exploited. The reform of a budget rule is one of the main topics of the Committee on the Modernisation of the Financial Relations between the Federation and the states at present – a task additionally triggered by the Federal Constitutional Court.

Although the need for a new budget rule appears to be clear, the question, however, about its format remains. The link of the budgetary process to the business cycle is not new. What is new is the application of econometric methods in budget policy making. Another innovation would be the introduction of a link between the establishment and the execution of the budget in the form of the control fund. The Swiss experience shows that this is technically and politically feasible.

Beyond the necessary political commitment, there are, of course, some questions about the technical realisation to be solved if the budget rule is reformed in the sense outlined above. A particular concern is about the design of the control fund and how it should work. The formulation for the Constitution also poses a challenge. But we think that all these are manageable. The gain of a credible commitment to sustainable public finance should by far outweigh its costs.

Last but not least, all this has to be realised in a manageable way for the daily work of preparing, executing and controlling the budget. Parliamentarians of all parties now seem to accept that Germany needs a new stricter deficit rule which will also diminish or self-restrict ministers' and minister presidents' power to spend on the federal and the state level, respectively. Moreover, it is a paradigm change, more "economic" than the old rule to which everybody is accustomed. So it will take time to overcome the existing scepticism related to implementing a new system. Nevertheless, we are convinced that this new model will gain political and public acceptance due to its positive impact on public finance, and, consequently on growth and sustainability of German economy.

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