Germany's debt brake: surveillance by the Stability Council

Since 2016, Germany's debt brake has limited the Federal Government's structural net borrowing to 0.35% of gross domestic product (GDP). From 2020, Germany's federal states will be generally forbidden from taking on new debt. The federal states have implemented this provision of the Basic Law in very different ways thus far. The key point is that debt ultimately remains limited in future. Furthermore, the debt brake also aims to ensure compliance with European budgetary rules for general government.

Comprehensive and transparent fiscal surveillance is a key factor in the binding force of budgetary rules. In Germany, the Stability Council is to carry out this surveillance, i.e. chiefly the Federal Minister of Finance and the state ministers of finance. From 2020, the Stability Council will also review the extent to which central government and the individual state governments are adhering to their debt brakes. In this context, the budgets are to be assessed against uniform criteria and the results of these assessments are to be published. At the same time, the Stability Council is tasked with ensuring that there are no conflicts with European budgetary rules. These are linked not to budgetary data, but to the budget balance according to the national accounts. Overall, the intention is to set up a new early warning system for breaches of budgetary rules. As the Stability Council is not an independent supervisory authority, a transparent and goal-oriented surveillance procedure is essential.

In December 2018, the Stability Council finalised its review criteria for monitoring the debt brakes. However, it is uncertain whether it will always be able to detect potential clashes with European budgetary rules, especially as deficits cannot be derived within the relevant definition. Moreover, it is not required that the agreed indicators be defined in an entirely harmonised manner, which makes it more difficult to draw comparisons between federal states. Together with the complex steps in the procedure, this also has an impact on transparency. Furthermore, it is intended that the results of the review will be published only with the consent of the relevant government entity.

Overall, the review process appears to be inadequate for assessing and comparing the respective financial situations and outlooks. It is difficult to ascertain whether a clash with the general government deficit ceiling is on the horizon. In order to gain a comprehensive and meaningful picture, it would be advisable, amongst other things, to use harmonised indicators that are closely oriented towards the rules of the national accounts. Alongside the off-budget entities that are to be taken into account, this also affects the delineation of deficit-relevant events. In any case, the results and their derivations should be made available to the public in full.

Current fiscal surveillance by the Stability Council

Debt brake requires surveillance with early warning signal

The debt brake was adopted in 2009 and will also apply to the federal states from 2020. Article 109(3) of the Basic Law sets out general rules for the debt brakes. The core point is that net borrowing is forbidden with only few exceptions. For the Federal Government, Article 115 stipulates additional key points that include repayment obligations if the rules have been breached. The federal states are requested to enshrine their debt brakes in state rules. Constitutional courts can review whether the requirements have been met. However, above and beyond this, it is crucial that unwelcome developments are detected and counteracted in good time. For this to happen, budgetary situations and developments must be assessed as comprehensively and – not least for the benefit of the general public – as transparently as possible.

Fiscal surveillance by Stability Council comprised of ministers

The Stability Council was created alongside the debt brake with the aim of monitoring German public finances. Instead of an independent body, the Federal and state finance ministers who sit on the Stability Council are responsible for their own supervision. Thus far, the Stability Council has reviewed whether the Federal Government or the individual states are at risk of a budgetary emergency. Furthermore, it assesses whether the federal states receiving consolidation assistance – Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein – are adhering to their agreed deficit reduction paths. It also checks compliance with the general government deficit ceiling according to EU rules and, if necessary, makes proposals for corrective action. In order to take account of the European Fiscal Compact, the Stability Council is assisted by an independent advisory board.[1] This advisory board publishes its evaluations of the Stability Council's projections.

Considerable weaknesses in current surveillance

Harmonised, meaningful and up-to-date figures on budgetary situations and prospects are decisive for effective fiscal surveillance. Transparency in this regard also makes it easier for the general public to work towards sound government finances.[2] This is especially important if those responsible for the budgets are also responsible for their own supervision. With this in mind, the current fiscal surveillance by the Stability Council exhibits considerable weaknesses. One example of these is the agreed indicator system for emerging budgetary emergencies.[3] In this context, high alert thresholds and the major importance attributed to the sluggish debt level prevent early warning signals that would facilitate gentler countermeasures. Furthermore, government entities that are off the core budget are not included. In addition, relatively old planned budget figures are used instead of current forecast figures in some cases.

Future surveillance of the debt brakes

Review based on the relevant requirements

Details of review not made public

In December 2018, the Stability Council decided to monitor the debt brakes using a new, two-step process from 2020.[4] In the first step of this process, the Stability Council conducts its review based on the criteria of the debt brake for the Federal Government or for the relevant federal state. The specific details of this step in the review process have not been made public.

Key differences in cyclical adjustment, application of national accounts rules and target variables

The majority of the federal state debt brakes aim, at the very least, to balance the cyclically adjusted budget outturn. In this regard, however, the rules differ in a number of areas. This applies not only to the variety of procedures used for cyclical adjustment.[5] Shifts in financial

1 Amongst others, an expert delegated by the Bundesbank sits on the advisory board. For more information on the independent advisory board, see: www.stabilitaetsrat.de/en.
2 See Deutsche Bundesbank (2018a), pp. 32-37.
3 See also Deutsche Bundesbank (2011).
4 See Stability Council (2018).
5 See Deutsche Bundesbank (2017).

assets (financial transactions) that do not affect the balance are also defined in different ways. Furthermore, the target variables differ. For the most part, they are not closely oriented towards the budget balance in the national accounts, which is essential to the general government deficit ceiling. In addition, withdrawals from and payments into reserves are often treated as revenue and expenditure, respectively. This means that the reported result changes even though the overall financial situation of the relevant government entity has remained the same.[6]

Review according to relevant rules presumably of little benefit

Overall, there are concerns that these reviews of the respective debt brakes will not be especially beneficial.[7] The information provided by each subject regarding its planned budget figures is expected to be highly difficult to verify and interpret in some cases. This applies especially to federal states that update their target figures on a comparatively infrequent basis. Up-to-date and transparent forecasts would be vital for effective supervision, however. It could also be helpful for the Stability Council to analyse any discrepancies between the results and the previously submitted forecasts.

Harmonised review with regard to European requirements

Mandate: harmonised review of federal states based on European requirements

The review of the federal state debt brakes is important. However, it does not allow for meaningful comparisons between states. For this to be possible, there need to be uniformly defined budgetary indicators that also take account of government entities that are formally off the budget. The statutory provisions indicate that the second step in the review process should fulfil these requirements (see the adjacent overview). In addition, it appears that the

6 For more information on reserves, see Deutsche Bundesbank (2016) and (2018b), pp. 71 f.
7 For more information on important elements of suitable fiscal surveillance, see also Deutsche Bundesbank (2018a), pp. 34 ff.

Legal background to surveillance pursuant to the Stability Council Act

Section 5a of the Stability Council Act *(Stabilitätsratsgesetz):* reviewing compliance with the constitutional debt rule

(1) In the autumn of each year, the Stability Council shall conduct a regular review of the Federal Government's and each individual federal state's compliance with the debt rule set out in Article 109(3) of the Basic Law for the previous, current and following year.

(2) The monitoring pursuant to subsection (1) above shall be based on the requirements and procedures for compliance with budgetary discipline as contained in legislation based on the Treaty on the Functioning of the European Union. A uniform cyclical adjustment method shall be used as a basis. The decisions and reports shall be published.

Explanatory statement in the draft law (Bundestagsdrucksache 18/11135): number 2 (amendment to Section 5)

The newly introduced Section 5a specifies the expansion of the Stability Council's tasks under number 1. Accordingly, in the autumn of each year, the Stability Council shall conduct a regular review of the Federal Government's and each individual federal state's compliance with the debt rule set out in Article 109(3) of the Basic Law for the previous, current and following year. The surveillance is based on the provisions and procedures set out in statutory instruments on the basis of the Treaty on the Functioning of the European Union to ensure compliance with budgetary discipline. This expands the Stability Council's tasks also with regard to Germany's obligation to comply with the provisions of the preventive arm of the European Stability and Growth Pact as well as the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact).

European requirements are intended to be the key criteria. In this context, the national accounts are the main reference framework, which should then also govern harmonised surveillance by the Stability Council. This is significant with regard to two aspects in particular: first, in terms of delineating sectors, i.e. selecting the off-budget entities that are to be taken into account (all off-budget entities); second, in terms of how budgetary events are specifically recorded, especially which transactions are to be recognised as being neutral to the balance.

Assessment variables agreed upon

The Stability Council agreed upon a number of anchor points for its harmonised review, which are described in greater detail below. The following have been determined:

- the underlying target variable;
- the reporting requirements regarding off-budget entities in the government sector;
- the events to be defined as financial transactions;
- the determination of cyclical effects.

In addition, the Stability Council decided on a threshold value which, if exceeded, will be used as an early warning signal for federal state budgets that deviate from a structural balance.

Transparency necessitates publication

The derivations and outcomes for a federal state are to be published only with that state's consent. However, it is not clear as to why the information should be withheld from the general public: transparency towards the public is an important component of budgetary surveillance. This is all the more applicable in this case as the members of the Stability Council are essentially responsible for their own government budgets and, to this extent, cannot constitute an independent surveillance authority. Transparency would also facilitate broader public discourse on budgetary trends – both for individual entities as well as when drawing comparisons between federal states.

Up-to-date estimates with ex post checks are more informative than planned budget figures, which are susceptible to distortion and sometimes outdated

The foreseeable differences in the quality of the data are also likely to have a negative impact on transparency as well as comparability. For example, planned budget figures may also be submitted for the budget assessment for the current and following year. However, planned budget figures may, for instance, include extensive global cuts in expenditure or increases in revenue in order to avoid revealing any breaches of the rules. To the extent that the budgetary relief does not materialise, the requirements would then be unfulfilled without any prior warning signal. Moreover, the planned budget figures of different federal states are typically based on different data vintages. This is especially important if different tax estimates are used as the basis or if changes in tax legislation that were only adopted at a later point in time are taken into account in different ways. For a meaningful comparison, the measures included but not yet adopted would need to be reported transparently including the relevant amounts. Measures that have since been adopted but not yet taken into account would likewise need to be reported with the relevant amounts. In general terms, a comparison of current forecasts of budgetary trends against the upper limit would be objectively warranted. In order to ensure the robustness of the estimates, regular ex post checks by the Stability Council would be worth considering.

Net borrowing as target variable

Net borrowing as target variable permits deficits provided reserves are available

The Stability Council specified that net borrowing should be the harmonised target variable for surveillance. Central government's debt brake is also based on this variable, as are the debt brakes of most federal state governments. It is, however, of limited use for monitoring the structural national accounts deficits, which are bound by the European rules. This is because resorting to (the currently high) reserves would reduce net borrowing in the budget, but not in the national accounts balance, as withdrawals from the reserves merely represent a regroup-

ing within the government sector.[8] At any rate, changes in the reserves must be stated for the harmonised review. If the data are published, the (planned and actual) national accounts balances can be inferred to this extent.

Inclusion of off-budget entities

Structural deficits not evident due to off-budget entities with no borrowing authorisation

If the relevant deficits are to be calculated, all government entities must be included in full in surveillance. However, the Stability Council includes dependent off-budget entities[9] alongside core budgets only if they received their own borrowing authorisations after 2011. As these entities will usually be banned from net new borrowing going forward, they are likely to play a negligible role, at least in the longer term. Meanwhile, the excluded off-budget entities with no borrowing authorisation, into which surpluses were ploughed in recent years, could become significant. The reserves formed there may be used to reduce the net borrowing relevant to the debt brake. However, like withdrawals from reserves, resorting to such reserves does not lower the deficit in the national accounts relevant to the European rules. Unlike withdrawals from reserves, such transactions are not evident from the specified data: neither financial flows between the core budget and these off-budget entities nor the planned fiscal balances for these special funds need to be reported.

Adjusting budget balances for financial transactions

Progress towards recognition of calls on guarantees in line with national accounts rules …

For the harmonised review, net borrowing is adjusted for the financial transactions “new borrowing and repayments” as well as “acquisitions and sales of participating interests”. This is in line with the rules specified in most federal states’ debt brakes. In a departure from the current procedure (in the surveillance of federal states receiving consolidation assistance), expenditure on calls on guarantees is in future to be recognised in the balance. In this respect, notable progress has been made.

… but discrepancies remain in terms of, for instance, capital injections and …

However, in other instances, the definition of financial transactions continues to differ considerably from the European (national accounts) definition. For instance, capital injections are always recognised as financial transactions, meaning that they are not included in the relevant budget balance. This is not the case in the national accounts, however, if the capital injection is not used to acquire recoverable assets. If, for example, losses incurred by public transport companies are covered, a deficit-increasing capital transfer is booked there. Unlike under the EU framework, non-cash transactions with financial assets are also generally disregarded. For instance, the harmonised review ignores debt relief and debt assumption although they lead to a deterioration of the asset position and weigh on the national accounts balance. Harmonised fiscal surveillance by the Stability Council ought to follow the national accounts approach, also in order to produce a realistic picture of the budgetary situation. At the very least, deviations from reporting pursuant to the national accounts should be listed, which is not something that the Stability Council requires, however.[10]

… interest expenditure

Budgetary interest expenditure should likewise be adjusted for financial transactions in order to bring the figures more into line with the European accounting rules. This is true both of derivatives transactions and discounts and premiums when issuing debt instruments. However, under the harmonised review, no such correction is made, nor is the relevant information reported.

8 One way of integrating changes in the reserves into the European rules in line with their objective is described in Deutsche Bundesbank (2019), pp. 82 f.
9 Unincorporated state enterprises and special funds are dependent entities. Public-law entities, corporations (such as special-purpose associations) and foundations are therefore not included.
10 For a similar demand in relation to the surveillance of the general government deficit limit, see Independent Advisory Board (2018), p. 2.

Cyclical adjustment[11]

Federal states have extensive options despite calls for harmonised cyclical adjustment

According to Section 5a of the Stability Council Act, harmonised surveillance should include a uniform cyclical adjustment procedure. According to the Stability Council decision, central government is to apply its customary procedure, which is based on the EU approach. The overall review will therefore cause no alarm for central government as long as it adheres to its own rules. Several federal states obviously wanted their valuations to be closely based on their own rules. For instance, under the harmonised procedure, the states were granted options in terms of the cyclical adjustment procedure. A federal state may, for example, opt for the adjustment method used to monitor the federal states receiving consolidation assistance. The cyclical effects recognised can therefore deviate substantially from what is recognised under the central government procedure. The reason is that, under the consolidation assistance procedure, forecast errors are attributed solely to cyclical factors (where the budget spans two years, this may even be the case across several years). Several federal states' debt brakes allow net borrowing only when economic performance is extremely weak and only subsequently demand that such debt be repaid during an economic boom. These states have the option of not being flagged if they do not plan to repay debt despite the statistics indicating favourable cyclical factors. For this to be the case, a specific control account must show no increase in debt since the debt brake was implemented. Under this option, the harmonised method consequently also allows higher cyclical tax revenue to be spent rather than sending an alarm signal. In sum, all these options considerably limit both comparability and suitability as a tool for monitoring compliance with EU regulations. The results after cyclical adjustment as per the EU procedure should be stated at least as a memo item.

Tolerance

Compensation component not convincing as loosening for all federal states

Despite the leeway, outlined above, that the federal states have to mask budgetary shortfalls, the Stability Council does not wish to send an alarm signal every time it identifies structural new borrowing. In fact, a tolerance ("compensation component") of 0.15% of gross domestic product was agreed for the state governments as a whole. The amount is distributed across the federal states based on their population. For North Rhine-Westphalia, for instance, tolerated structural net new borrowing works out to just over €1 billion, while the figure for Hesse is almost €½ billion. This is justified mainly by specific issues in local government financial equalisation schemes. For instance, delays in final settlement are not reflected in cyclical adjustment. However, it would be possible to properly neutralise the effects through loans. The loosening of the actual budget target agreed in the form of the compensation component is therefore not convincing.

Premiums for population growth should be combined with discounts when population shrinks

The additional compensation component for above-average population growth agreed by the Stability Council is a sensible idea. Additional tax revenue as a result of population growth is, in the first instance, classified as cyclical, for instance when conducting cyclical adjustment using the consolidation assistance procedure. This means that it may not be used to cover additional expenditure. It should, however, be immediately available to cover the additional needs resulting from population growth. For city states, a population growth-related premium on the compensation component was agreed for this purpose. It is not logical why this should apply only to city states and why there should be no equivalent discounts for below-average population growth.

The debt brake does not apply to local government. However, the local government level is automatically included for city states. For this

11 For a general overview, see Deutsche Bundesbank (2017).

Compensatory premiums for city states in case of higher local government debt not plausible

reason, city states are, according to the Stability Council decision, to receive a premium on the new borrowing limit if local government debt in the non-city states has risen. This rule is not symmetrical, however, as a drop in local government debt in the non-city states does not mean higher requirements for city states. It would, in fact, be better for higher local government deficits in the non-city states to be recognised there than for them to justify additional leeway for city states. Ultimately, the impression conveyed is that the premiums aim to ease the budget rules for the already very highly indebted city states.

Conclusions

Monitoring the respective debt brakes unlikely to be very effective

In December 2018, the Stability Council decided how it would meet its legal mandate to monitor the debt brakes from 2020 onwards. This task is rendered more difficult by the fact that the federal states look set to have very different debt brake rules. The surveillance of the federal state-specific borrowing limits planned in the first stage of the review is ultimately not likely to provide enough information value. In particular, it will not allow comparisons between the individual states.

Harmonised monitoring does not meet requirements for independent surveillance and comparability

Though a more uniform review checklist was agreed for a second review step, it is fairly non-transparent and, moreover, the outcome is not required to be published for every federal state. Ultimately, therefore, it too fails to ensure that comprehensive comparisons can be made. This appears to be a major shortcoming, in particular as no independent body is tasked with monitoring the debt brakes. Surveillance is therefore likely to be non-transparent for the public.

Major weaknesses: deviation from national accounts rules and lack of harmonised cyclical adjustment

The standardised review checklist has a number of shortcomings. In particular, it is not possible to adequately assess whether the European rules are set to be breached. For instance, there is no way of deriving structural deficits on the basis of these rules. This is because the debt brake surveillance rules do not consistently follow the classification requirements for transactions pursuant to the national accounts, which are key for the European budget rules. Unlike in the national accounts, some important off-budget entities at the state level are not captured, either. Various options for cyclical adjustment further severely limit comparability among federal states. On top of that, there is no requirement to update budget estimates for the budget years, meaning that these may be based on very different data vintages. Targeted remedial action would be recommendable in relation to these issues.

Inclusion of local government important when monitoring general government deficit

A general government structural deficit above the European limit may also emanate from the local government level. This level was left out of the debt brake on account of data and planning problems.[12] However, the Federal Government will continue to present an estimate for local authorities in aggregate in order to be able to calculate a general government deficit. It would have been desirable in this context for the federal states to forecast the financial results of their local governments. This could improve the aggregate Federal Government forecast, as the federal states have an information advantage. For instance, they manage important municipal tasks as well as large-scale transfers to their local governments. Furthermore, they set out, and are able to ensure compliance with, budget rules for local government. In addition, the federal states are likely to have to shoulder at least some of the burden of over-indebted local governments. Overall, it would therefore be appropriate for developments in local government finances to be included in fiscal surveillance at the federal state level.

Reporting of one-off effects advisable

In addition, the European budget rules correct for any larger one-off effects that could mask the underlying trend. Last year saw quite a number of such special effects at the federal state level: Lower Saxony and Bavaria were paid high fines by automobile producers, Ham-

12 See Deutscher Bundestag (ed., 2009), pp. 10 f.

burg and Schleswig-Holstein, by contrast, had to pay for losses on portfolios of HSH Nordbank. To be able to compare budgets without such distortions, any major one-off effects would have to be listed with the respective figures.

Looking ahead, boost transparency of surveillance and involve the general public

Overall, the agreed review criteria do not guarantee transparent and meaningful fiscal surveillance. Over time, these criteria are to be reviewed and modified as appropriate. It would be important to achieve progress in the aforementioned areas – not least in order to resolve the challenges presented by not having an independent surveillance authority. In any case, the federal states should make public the key data they calculate. These data should allow the public to correctly evaluate developments in the individual federal states. Sound public finances depend, not least, on public backing, which in turn requires comprehensive and transparent information on financial developments.

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