

## German Experience with Fiscal Rules: Lessons for the US Budget Process

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I greatly appreciate the opportunity to testify before this Committee during its consideration of multiyear budgeting processes and possible biennial budgeting reforms in the United States. In particular, I would like to commend the Committee for taking an international perspective on the pitfalls and potentially useful practices involved in setting fiscal policy from a long-term perspective. There are more policy options available than can be usefully considered either on the basis of US experience or theoretical argument alone. As the House of Representatives faces the current mounting US Federal budget deficits and long-term commitments to expenditure, reflecting both domestic and security needs, it is worth examining the possibility that new budget processes could exert constructive discipline on US fiscal policy.

Germany is an extremely relevant case for comparison with US budget processes. Like the United States, Germany is a lively democracy, with a federal system of government, a high-level of national wealth, and extreme trust in its financial stability and creditworthiness. Like the United States, Germany has seen a rapid rise in national (public) debt in recent years despite an absence of significant political or institutional change. And like the United States, the lower house of the national legislature (the *Bundestag*) has within its powers to shape the budget process, in hopes of constraining the executive branch as well as future parliaments. Thus, in both countries the source of budget indiscipline has the recurring desire to bind its own hands with rules to produce better policies, even though there is little threat of outright fiscal crisis.

That said, there are two fundamental differences between the German and American political contexts for fiscal policymaking. First, Germany has a completely different form of exposure to international pressures on budgets than the United States—where the United States is dependent upon capital flows from abroad to finance its deficits, but has no external political influence on its

decision-making, Germany is more than able to fund its current and projected deficits domestically, but is at least legally answerable to the European Union’s (EU) Council of Ministers for its adherence to the budgetary strictures of the European Union’s Stability and Growth Pact (SGP). Second, Germany is governed under a parliamentary system, which gives the majority party direct control of the executive branch, and simultaneously generally weakens the role of the *Bundestag* in budget (and other) decision-making. In short, where the US House faces some real economic constraints from abroad but political autonomy with respect to the budget, Germany has the opposite situation.

## **Multiyear Budgeting in the Federal Republic of Germany<sup>1</sup>**

Since the passage of the Law on Budget Principles in 1969, German government budgets, at both the Federal and State (*Länder*) level, are subject to a mandatory, standardized framework. The Federal budget is required to take into account “the requirements of macroeconomic equilibrium (stable prices, a high level of employment, and external balance accompanied by steady and adequate economic growth). [Article 109(2) *Grundgesetz*.] Borrowing may not exceed the total expenditure set for “investment,” except under conditions of “sustained disturbance of macroeconomic equilibrium” (i.e., a prolonged, deep recession). This prominent emphasis on the macroeconomic implications of budget policy is forward-looking and encourages identifying at an early stage the fiscal impact of new spending and taxation measures, as well as the putative limits on fiscal policy action in the medium-term. To my mind, this top-down vantage point on the importance of budget policy is highly salutary, especially given the natural tendency in wealthy countries without immediate credit constraints to have fiscal policy come out as the sausage at the end of everyone adding ingredients.

German budget management is to be based on a financial plan covering a five-year period, the current fiscal year, the draft budget for the next fiscal year, and forecasts for the following three years. The five-year medium-term plan rolls forward with each fiscal year—every time a new draft budget is prepared, the following three years’ forecasts are updated. The plan is released to the public, along with the legislature, although expenditure figures are not broken down in full detail (roughly 40 general categories are presented, rather than the 5,300+ line-item expenditures; similar restraint in the service of transparency is exercised by aggregating the 1,100+ revenue items in the full budget).

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<sup>1</sup> Useful references on this topic are published by the German Federal Ministry of Finance, including “Medium-term Financial Planning in the Federal Republic of Germany” and “Accountability and Control: Federal Republic of Germany,” available from [www.bundesministerium.de](http://www.bundesministerium.de).

In the words of German Finance Ministry, “the financial plan has become a useful tool for fending off excessive demands on the budget.” Note, however, that this tool is employed in much the same role our Office of Management and Budget (OMB) plays in the US budgeting process, that is in forcing the proposals of various executive departments (in Germany, ministries) to show some consistency with an overall budget picture—it is not a tool for the leadership in the legislature to enforce discipline on various members’ proposals.<sup>2</sup> In fact, the financial plan is negotiated and revised line-item by line-item with the various ministries. While the summaries of the main categories of revenue and expenditure are submitted to the *Bundestag* and *Bundesrat* (upper house of Parliament) together with the government’s draft budget for the next fiscal year, there is no requirement for the financial plan to be adopted (or voted on) by either house. Again, this reflects the parliamentary system in Germany in contrast to the US separation of powers.

Beyond Ministry of Finance officials, coordinated by the Budget Directorate-General within the Ministry, and their counterparts in the other ministries, other groups are involved in the financial planning process (even if the *Bundestag* is not directly consulted when the plan is formulated). The Financial Planning Council, a coordinating body at the ministerial level includes the finance ministries of all the *Länder* as well as representatives of associations of local-level government, meets twice a year to coordinate budgetary policy across the levels of government. Representatives of the Deutsche Bundesbank (the German central bank) are allowed to participate. Germany shares with the United States some predilection for unfunded mandates and programs involving co-funding between federal and state level. This makes such a formal coordination mechanism all the more useful, especially since in Germany as in the United States it is the combined state, local, and federal government budget positions which determine the fiscal stance and overall public (dis)saving.<sup>3</sup>

There is also a “Working Party on Tax Estimates” that includes representatives from the Finance Ministry and their *Länder* level counterparts, independent (non-profit) economic research institutes, the Federal Statistical Office (analogous to some parts of the Bureau of Economic Analysis [BEA] and Bureau of Labor Statistics [BLS] here), the Bundesbank, Council of Economic Advisors (independent of the executive in Germany, not part of the Office of the President as in the United States), and representatives from other local government associations. This working party’s estimates of tax revenues are the ones included in the multiyear financial plan. Revenue projections are

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<sup>2</sup> In fact, in Germany there is nothing analogous to the US appropriations process under the direct control of the *Bundestag*. It is the Finance Ministry that has the right to withhold funds from unapproved spending.

<sup>3</sup> The German *Länder* are legally autonomous and independent of each other—and of the Federal government—in setting their own fiscal policies, as are the states in the United States. This is part of the reason having a coordinating mechanism provides a useful purpose, though it is admittedly easier with one fourth as many *Länder* as there are US states.

obviously dependent upon macroeconomic forecasts, particularly of the labor market. In the German system, a full forecast is made for the first two years of the planning period (i.e., current and next fiscal year), but the remaining years of the medium-term projection “deliberately makes no allowance for fluctuations in the level of economic activity,” that is, the trend is projected but neither policy nor events are forecast. This reflects a different approach than that available to US policymakers, given the existence of the Congressional Budget Office (CBO), although it shares with the CBO process a concern for avoiding making partisan calls on the likely impact of current policies beyond the immediate term.

Amidst all this detail, it is important to recognize what medium-term budget planning in Germany is not: It is not a binding fiscal rule setting limits on future budgets; it is not a process for explicitly linking together expenditure and taxation decisions (as in, for example, Paygo in the US context); and it is not a means of expediting budget decision-making or streamlining the process, since the entire budgeting procedure is begun anew every year (albeit by the Finance Ministry doubling as the German OMB, rather than by the *Bundestag*). What the Medium-Term Financial Planning process in Germany does offer—in contrast to the current arrangements in the United States—is threefold:

1. an explicit recognition of the macroeconomic implications of overall fiscal stance (and thus a reminder of the idea of medium-term constraints on budgets);
2. greater coordination between Federal- and State-level financial officials, particularly on expenditure, taking the overall situation and mandates into account;
3. enhanced transparency in the budget process, both by giving experts from civil society a voice in formulating tax revenue estimates and by annually announcing five-year projection for major fiscal categories.

## **German Compliance with the European Union’s Stability and Growth Pact<sup>4</sup>**

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<sup>4</sup> For a broader discussion of the SGP on which this section draws, see Adam S. Posen, “Can Rubinomics Work in the Eurozone?,” in Adam S. Posen, ed., *The Euro at Five: Ready for a Global Role?* (IIE, 2005). The European Commission’s view on the recent reform of the SGP is clearly set out in Klaus Regling, “The Reform of the Stability and Growth Pact: View from the Commission,” mimeo, the ECB and its Watchers VII Conference, Centre for Financial Studies, University of Frankfurt, June 3, 2005.

German budget officials are forced to confront medium- and long-term constraints on its fiscal policy at the European level as well, given the country's obligations under the Maastricht Treaty among EU members. Thus, to focus on the domestic German multiyear budgeting process alone would leave out a significant part of the story. Germany is subject to international review of its budget plans for the coming fiscal year, with an eye to multiyear trends, in light of a budget rule. This rule in theory should be more strictly binding over the course of the multiyear business cycle, albeit only on the topline budget numbers, than the domestic budget planning process. In practice, however, it has not worked out that way.

The Maastricht Treaty, signed in 1992, and its subsequent amendments and implementation, was designed primarily to ready EU member countries for participation in the eurozone (the currency union of EU states adopting the euro). The basic concern was that high-debt countries or countries with a proclivity to public deficits—a group not thought to include Germany—would “free-ride” upon entry into the currency, taking advantage of the expected drop in interest rates on their respective debt, and issue significantly more bonds. It was feared this would result in a weakening of price stability in the eurozone and of confidence in the euro itself. As a result, the Maastricht Treaty included an annex that set up the SGP that stated that member states had to keep annual budget deficits to 3 percent of national GDP, and had to work to reduce public debt to and/or maintain total public debt at 60 percent of GDP. Countries that violate these limits are legally subject to review, warnings, and ultimately the possibility of fines (on the order of several tenths of a percent of GDP) by the Council of Ministers, the European Union's ultimate policymaking body.

Germany, along with other Eurozone members France, Portugal, and more recently Italy, has been in repeated violation of these rules. German budget deficits have exceeded 3 percent of GDP for each of the last five years (counting FY2005), and in the current multiyear financial plan are expected to do so again at least in 2006. Accordingly, German public debt levels have risen well in excess of 60 percent of GDP in recent years and are continuing to increase (a trend in contrast to the medium-term fiscal discipline seen even in the aftermath of the expenses of German reunification). Germany has of course suffered from a prolonged recession and historically high unemployment since 2001, which has put significant pressure on fiscal policy. The criticism widely leveled in Europe, including in German legislative discussion, of German budget policy and the SGP's failure to impose discipline is two-fold: first, that Germany did not (and was not forced by the SGP to) consolidate budgets and run surpluses in the good years of the cycle, so that there would be more room for fiscal stimulus in the downturn without exceeding the 3 percent limit; second, that the German

government did not take seriously (and the Council of Ministers did not enforce punishments for) violating the SGP limits.

In fact, the first claim is largely without merit. My own analysis shows that the introduction of the euro (and attempts to enforce the SGP) had no impact on the counter-cyclicality of euro zone members' fiscal policy compared with the pre-1992 responses of their budgets to the business cycle. Even during the run-up to euro membership covering a time of expansion for most EU economies, budget positions did not improve more than the usual pro-cyclical factors would account for, but they did in fact improve. German budgets specifically were indeed more countercyclical in 1992–2003 than expected from a forecast based on past behavior, but was so *symmetrically* on both the up and down cycles. For reference, France and Italy followed much the same pattern. France became more countercyclical since the adoption of the euro in 1999 than expected based on past behavior, but again in *both* directions, not simply towards ease. Italy's fiscal behavior post-Maastricht is fit well by an estimated reaction function for the entire post-1960 period, only deviating towards surplus in 1997, as one might expect with one-off privatization measures to show motion towards the Maastricht debt level target.

The second claim shows the difficulty of enforcing budget rules when the government in question is part of the enforcement process (a phenomenon analogous to the common failure of peer review and constraints on pork barrel spending within a Congress of equal members each with districts to represent). For these governments, unwillingness to adhere to the SGP or to undertake major fiscal consolidation is a rational, if not optimal, response to economic realities. On the one hand, Germany had the most to lose from giving up fiscal stabilization policy, because it is the European economy in which such policy would be most effective. There is a strong positive correlation between a developed economy's size and its fiscal responsiveness to business cycles, and a strong negative correlation between developed countries' openness and their fiscal responsiveness. In short, the countries most likely to benefit from fiscal policy rather than see its impact spill abroad are the ones that use fiscal policy the most.

On the other hand, Germany is not a candidate for a Rubinesque virtuous circle from fiscal consolidation to investment booms to growth back to budget surpluses (a la the United States in the 1990s). For such an expansionary consolidations (as economists call them) to work, several factors are required. Interest rates must respond strongly to fiscal consolidation, which usually requires a high initial debt-to-GDP ratio and/or significant foreign-held debt. Business investment must respond strongly to interest rate reductions, which usually involved forward-looking and flexible

corporations. Growth in productivity and employment must respond strongly to the increases in investment. And, to complete the cycle, government revenue must respond strongly to the increase in growth. (A little accompanying monetary accommodation does not hurt, either.)

Though these attributes did characterize the United States in the 1990s, they did not and do not characterize the large continental European economies, particularly given their well-known structural problems. The initial debt conditions in Germany were sufficiently benign that it already had low interest rates and thus little to gain on that front from euro entry. And without any obvious near-term growth benefit from fiscal consolidation, the yielding of monetary sovereignty by the Bundesbank to the European Central Bank made the loss of national fiscal discretion to the SGP more costly and increased Germany's output volatility.

The European Commission and the EU Council of Ministers have recognized that the credibility of the SGP as an enforceable set of budget rules have been damaged, and moreover that the conflict between countries attempting to stabilize their economies in recession and the strictures of the SGP was a major source of the shortfall. Accordingly and commendably, earlier this year the SGP was reformed to enhance the national "ownership" of the budget rules, by increasing the scope for countercyclical fiscal policy, taking better account in particular of when member economies are growing below trend, giving greater attention to longer-term debt and sustainability issues when evaluating a member country's policies, and improving the equality and transparency of fiscal policy reporting among member states. The SGP has however remained unchanged on certain matters of discipline, keeping the fundamental reference values at 3 percent for budget deficits and 60 percent for public debt, and not excluding any particular expenditure categories from calculation (to limit budgetary excess by classifying certain expenditures as "investment," a possibility left open in the German among other members' budget processes).

In summary, the SGP reforms reflect the fact that threats of fines and such for rule violations are not credible when in contradiction of countries' macroeconomic balance, and that the main fiscal discipline device is the transparent release of information on the medium-term implications of today's budget decisions—principle already enshrined in the national-level Medium-Term Financial Planning process in Germany. This is unlikely to revolutionize budgeting or even significantly affect current debt trends in the eurozone including Germany, but it is likely to deliver better performance over the long-run.

### Three Principles for US Budgeting Reform Based on German Experience

I would like to suggest three takeaways for the Committee from the German experience with its domestic and European multiyear budgeting processes of relevance to budgetary reform in the United States.

The first is one already well known to members of this Committee and this House, but which has been amply demonstrated again by recent events in Europe with the SGP. *Strict budgetary rules do not work without political leadership and will to enforce them—they are at best tools that can be used by legislators who already are committed to achieving budget discipline.* The declared existence of a rule itself does not become self-enforcing, whatever the claims about reputational or long-term effects, if the incentives are not present.<sup>5</sup> Bond markets alone cannot be the enforcement mechanism of fiscal rules, for if those markets' sanctions, such as increases in interest rates in response to budgetary laxity, were sufficiently scary to the governments, there would be no need for the rule in the first place. To use a currently relevant analogy, one may set the thermostat to air conditioning when one wants to be cooler, and the air conditioning does help one stay cool, but one will turn up the thermostat whenever one feels too cool—the air conditioning cannot force one into keeping the temperature set at 72 degrees (outside of US government buildings that is).

The second principle is one demonstrated doubly by the German experience, both by its inclusion in the budgeting process at the German national level and by the consequences of it being previously underappreciated at the European level. *The assessment of the country's overall fiscal stance, in terms of both short-term cyclical and medium-term trends in revenues and expenditures, and that stance's macroeconomic implications should be at the forefront of budget discussions.* It would be naïve to suggest that such concerns should be the starting point for multiyear budget planning, given the pressures for ongoing programs and departmental interests to build budgets from the bottom up; starting there might also lead to excess belief in the power of short-term fiscal stabilization resulting in a repeat of some of the macroeconomic policy mistakes of the 1960s and 1970s. Nonetheless, neglecting the importance of the macroeconomic perspective can have equally destructive effects on national well-being, on budgetary credibility, and on political viability of fiscal policy. This is if anything all the more true for the United States than for Germany, given our dependence upon significant inflows of foreign capital to fund our budget deficits in the short-term.

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<sup>5</sup> As quoted on this Subcommittee's website, the CBO notes "experience under the BEA—and with the budget process in general—suggests that no procedures to control deficits or impose budgetary restraint will be effective in the absence of an overall political consensus to achieve those goals." See [http://www.house.gov/rules/108\\_hear\\_bug1.htm](http://www.house.gov/rules/108_hear_bug1.htm).

The third and final principle is in some sense the implication of the first two. *Coordination between federal and state-level budget planning is beneficial, especially over the medium-term.* A country's overall fiscal stance is determined by the total fiscal impulse generated by its various public budgets. As was seen in discussions of the response to the downturn of 2001 in the United States and of the various tax proposals made in this House at the time, as well as in the more general problem of unfunded mandates shifting budgetary burdens, lack of coordination or of at least planning to take into account state level fiscal response can noticeably diminish the effectiveness of federal fiscal policy and any fiscal discipline at the federal level.

Strictures or processes imposed at the federal level that do not also provide incentives—or build up political will for discipline—at the state level will not have the full desired impact on the US economy. Attempts to impose a national rule while ignoring state-level factors and incentives in the face of macroeconomic pressures will lead to unintended overall fiscal laxity and even breakdown (in the extreme as in Argentina). An example of this failure is what brought on the breakdown of the European Union's Stability and Growth Pact. Meanwhile, an example of the benefits of such coordination is given by Germany's overall successful budgetary management of the costs of German reunification in the early and mid-1990s, despite huge political pressures for budgetary excess. In the United States there might seem to be less need for such coordination given the combination of bond-market discipline and balanced-budget rules constraining the states' budget processes. This is a valid point, but not one that removes the need for coordination—as the pressures over unfunded mandates and state tax differences continue to constrain US support for critical infrastructure and homeland security needs at the state and local level, this will become apparent. There also were better ways to undertake the tax cut stimulus of the 2001–03 period in terms of sustainable bang-for-the-buck had the federal-state system been better utilized. The real issue is feasibility of making such coordination work given the legal independence and the sheer number of our state governments. That is something this Committee may wish to explore in future.