The case for putting a public investment clause into the German debt brake

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Abstract: In this article, I explore the need for reform of the German debt brake to incentivize public investment. I approach the issue from multiple angles: assessing elite support for debt brake reform among policymakers and economists, examining empirical evidence on the impact of fiscal rules on public investment, exploring the conceptual basis for prioritizing public investment within fiscal rules, and presenting a reform proposal put forth by the Scientific Advisory Board of the German Ministry of Economic Affairs and Climate Action.

1. Introduction

The German debt brake limits the federal government's new debt to 0.35% of GDP and has faced intense scrutiny since a ruling by the German constitutional court in November 2023. Although the decision pertained to the budget act of 2021 and the correct application of the debt brake's escape clause, it subsequently sparked public division. Opinions vary from maintaining the debt brake in its current form, a stance favored by supporters of right-of-center parties as well as Finance Minister Christian Lindner, to advocating for its abolition, a position endorsed by many on the left. Intermediate perspectives suggest that reforming the debt brake to encourage more public investment is necessary. Concerns about the overstretched state of German infrastructure, such as highways and the rail network, are widely acknowledged (Wissenschaftlicher Beirat, 2020). However, there is debate about whether the German debt brake is a causal factor or a prerequisite for addressing these challenges.

In this article, I explore the need for reform and propose a specific reform option for the German debt brake. I approach the issue from multiple angles: assessing elite support for debt brake reform among policymakers and economists, examining empirical evidence on the impact of fiscal rules on public investment, exploring the conceptual basis for prioritizing public investment within fiscal rules, and presenting a reform proposal put forth by the Scientific Advisory Board of the German Ministry of Economic Affairs and Climate Action.

2. Support for Flexible Fiscal Rules: Survey Evidence

Elites play a significant role in policymaking due to their influence and understanding of complex issues, particularly those involving economists in the context of fiscal rules. A survey conducted in late 2023 among 187 German economists revealed overwhelming support for maintaining the debt brake, with only 6% advocating for its abolition (Fuest et al. 2024). However, economists were nearly evenly divided between maintaining the debt brake as is and reforming it (48% vs. 44% of all surveyed). Among those favoring reform, 44% proposed exempting net investment from the debt limit.

The support for the debt brake in Germany may in part be explained simply by its long adherence to it. Studying over 1200 economists from 109 countries, a study by Gründler and Potrafke (2020) finds that the presence of fiscal rules in one's country influence attitudes towards such rules. Experts from countries with fiscal rules typically believe that such regulations effectively reduce public debt, promote economic growth, and do not negatively impact public investment. Strong support for the debt brake in Germany is thus unsurprising.

Support for the debt brake is even higher among state parliamentarians in Germany (Blesse et al. 2020). A survey conducted in the spring and summer of 2020, during the early phase of the Coronavirus pandemic when the debt brake's escape clause was invoked, found that 68% of the 557 respondents favored returning to normal debt brake operations. Additionally, 56% supported reform by incorporating a public investment clause.

Elite support for debt brake reform does not inherently validate its efficacy. Therefore, I proceed to examine empirical evidence regarding the effects of fiscal rules on public investment and fiscal performance.

3. Empirical Evidence on Fiscal Rules and Public Investment

In a recent analysis, Blesse et al. (2023a) evaluate and summarize the empirical literature on the impact of fiscal rules on public investment. It is crucial to distinguish between the effects of general fiscal rules and those with specific provisions targeting public investment such as a so called "golden rule", under which debt-financed public investment does not count against a fiscal rule's deficit limit. Focusing first on the former, 12 out of 18 studies found no effect on public investment, while 4 reported a decrease and 2 observed an increase. Similarly, among those studies specifically examining the effects on public infrastructure spending, the effects vary, with some reporting no effect and others showing both positive and negative impacts.

Blesse et al. (2023a) also consider studies on more flexible rules, including those with specific provisions for public investment such as a golden rule. These studies generally yield more positive outcomes, as flexible rules reduce fiscal imbalances and increase public investment. However, the authors warn against potential pitfalls such as creative accounting, where increased investment may not genuinely enhance public capital but merely involve relabeling other expenditures. Additionally, there may be a trade-off between flexibility in investment provisions and commitment to deficit limits, affecting fiscal performance negatively.

A separate study by Blesse et al. (2023b) at the European level corroborates these findings, suggesting that a "golden rule" could boost expenditure but jeopardize fiscal sustainability. The latter finding seems a bit surprising because higher public investment may in the long run increase output and thus improve sustainability of public finances because higher output leads to more tax revenues and fewer transfers. However, the finding may be explained by the previous observation that accounting tricks may lead to a relabeling of public consumption spending as investment, in which case public finances deteriorate and no growth effect is induced.

The empirical evidence, while nuanced, does not negate the argument for debt brake reform. To understand why, it is necessary to consider the conceptual underpinnings.

4. Conceptual Considerations

While empirical evidence indicates that fiscal rules generally do not harm public investment, it is essential to examine the rationale behind introducing such rules. Fiscal rules address present bias in budgetary processes, where policymakers prioritize short-term goals for reelection over long-term considerations, leading to excessive debt levels. In other words, there is a distortion between current and future government spending, where public debt serves as an instrument to shift resources from the future to the present. However, alongside this distortion, there exists another (for given deficits): an inefficient allocation of government spending favoring current consumption over investment, because the latter yields benefit only in the longer term. Therefore, excessive debt and inadequate infrastructure result from the same underlying bias.

This insight does not imply that a public investment clause into the debt brake can easily be done in practice, which I will discuss in the next section. Rather, it is the conceptual point, making clear that excessive debt and bad infrastructure are the two sides of the same coin.

Moreover, at first glance the above insight seems to contradict the empirical evidence from the literature on fiscal rules, as discussed above, which found no systematic negative effect of fiscal rules on public investment. However, a fiscal rule without specific provisions for public investment does not address the bias towards current consumption spending. Only a "golden rule" that limits debt while incentivizing investment can effectively tackle both distortions. Since only very few studies have empirically examined the effects of golden rule type fiscal rules, there is no apparent contradiction.

5. A Specific Reform Proposal

The Scientific Advisory Board of the Federal Ministry of Economic Affairs and Climate Action has proposed a reform known as the Golden Rule Plus (Wissenschaftlicher Beirat, 2023). This rule allows for debt-financed net public investment, providing an incentive for increased investment while ensuring fiscal sustainability. The option of financing net investment through debt provides an incentive to invest more, as depreciation of existing public capital needs to be funded from concurrent revenues. In the long run the amount of public debt is backed by the stock of public capital. At the same time, however, the amount of additional public debt to be taken appears moderate.[1]

To prevent abuse such as creative accounting, an independent agency would monitor the implementation of the investment rule. The “Plus” stands for the requirement of independent monitoring. The agency would scrutinize the government’s proposed investment expenditures and challenge those deemed incompatible with genuine investment objectives. If the expert panel rejects the investment character of an expenditure, the agency must have means to protest. This could influence the government’s decision by creating publicity. As this might not be strong enough it would be even better if a negative vote by the agency forced the government to act, either in the form of a revised proposal or by forcing it to explain itself publicly. This mechanism is known as the "explain or comply principle" in the context of European fiscal surveillance. An even stronger mechanism would be created by granting a veto right to the agency against the planned investment

[1] In recent decades, the public net investment ratio has fluctuated around 0 percent, and in many years net public investment was even negative (Wissenschaftlicher Beirat 2020). The new rule would provide more incentives to invest and hence the level of investment under the existing rule is probably a lower bound for new debt to be expected.

spending by the government. This ultima ratio must be considered with care as it may conflict with parliament's budgetary rights.

Examples of independent bodies overseeing fiscal matters already exist in Germany, demonstrating the feasibility of implementing such reforms. The Joint Economic Forecast (“Gemeinschaftsdiagnose”) reviews the Federal Government's macroeconomic forecasts on the basis of the Forecasting Act (EgVG). The projections are important for the federal government's budget and financial planning as well as for compliance with German and European fiscal rules. Another example is the Advisory Board to the German Stability Council (Beirat des Stabilitätsrats) which issues statements on Germany’s compliance with the European Fiscal Compact since 2013.

6. Conclusion

In this article, I have argued for the incorporation of an investment clause into the German debt brake. Elite support for reform, empirical evidence suggesting potential benefits, and theoretical considerations highlighting the need to address biases in policymaking all underscore the case for reform. The proposed Golden Rule Plus offers a concrete solution to incentivize investment while maintaining fiscal discipline, with mechanisms in place to prevent misuse and ensure accountability.

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