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Abolishing the Debt Brake Is Not Worth It

The debt brake enshrined in Article 115 of Germany's constitution has been the subject of controversial debate since its introduction in 2009. Critics argue that in the event of major economic slumps, the maximum permissible deficit for the federal budget of 0.35 percent of gross domestic product (GDP) is too small, even when adjusted for cyclical effects. The debt brake also leads to an excessive reduction in government debt and creates incentives to neglect public investment. Moreover, interest rates are so low that significantly more government debt can be afforded.

Defenders of the debt brake point to the high implicit debt in the social security systems and the strain on public finances caused by demographic change. Moreover, they argue that Germany has a role model-function in Europe: if Germany abolished its debt brake, they fear would be no stopping other, more heavily indebted European countries.

In principle, twelve years after the introduction of the debt brake, it is justified to examine whether it has proved its worth and whether reforms are necessary in view of changed circumstances. However, on closer inspection, many of the counterarguments are not very convincing.

Scope for the Coronavirus Crisis

This applies above all to the criticism that the state has too little leeway to stabilize the economy in severe crises. The coronavirus pandemic has plunged public budgets in Germany deep into the red. In the crisis year 2020, there was a record deficit of EUR 131 billion; net borrowing of EUR 96 billion is planned for 2021. The government has responded to the crisis with massive aid for companies and employees.

This was possible because the debt brake provides for exceptions: the upper limit for the budget deficit can be temporarily lifted by a resolution of the Bundestag in the event of severe crises. However, for any additional debt taken on, policymakers must adopt a repayment plan that reduces the debt "in line with the economic cycle." For the debt taken on in 2020 as a result of the crisis, it was decided that it would have to be repaid over a period of 20 years from 2023. It is certainly debatable whether this plan is appropriate. But it cannot be argued that the state is incapable of acting during the crisis. The debt rule has passed this test.

The accusation that it causes an exaggerated decline in the debt ratio is also unconvincing. It is true that a constant deficit of 0.35 percent of GDP and a growth rate of, say, 3 percent would reduce the national debt to 11.7 percent in the long term. But the next crisis is likely to come long before that. In the coronavirus crisis, at any rate, the drop in the debt ratio to just below 60 percent, which was supported by the debt brake, was very helpful: it created the leeway to increase debt and support the economy without raising doubts about the soundness of the state's finances.

No Brake on Investments

There is also no evidence that the debt brake is having a negative impact on public investment in the federal budget. This was low above all in the years 2000 to 2008 – i.e., before the debt brake was introduced. Since 2014, the first year of the "black zero" in the federal budget, they have risen about twice as fast as GDP. It is true that the currently very low interest rates and spare capacity in the construction industry argue in favor of expanding public investment. However, if there is no scope for this in budgets, then state-owned enterprises such as Deutsche Bahn can be provided with public funds for investment.

Alternative Rule? No Silver Bullet

Even if the arguments in favor of abolishing the debt brake are weak, it is excessive to reject every demand for reform as an attack on the soundness of public finances. It is perfectly possible to argue that shifting debt-financed public investment to public enterprises weakens the transparency of fiscal policy and that – as in earlier times – a net investment rule would be better. However, the necessary demarcation between investment and consumption-related government spending would then become a contentious issue, as would the determination of appropriate depreciation.

All this argues in favor of ending the often ideologically driven dispute over the debt brake. Amending the constitution is unlikely to bring about a better debt rule. It is therefore much more important to use the financial leeway to expand public investment wisely. The deficit limit can be suspended by a simple majority in the Bundestag until the economy has recovered sufficiently from the coronavirus crisis.

This also shows that the debt brake is more cleverly constructed than many critics claim.

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