4 The abandonment of existing Golden Rules for public investment in Germany and the UK as a counterargument?

In the discussion about a Golden Rule for public investment it is sometimes argued that two prominent examples of Golden Rules, namely the ones in Germany and the UK, had only just failed in the recent past. It is true that the U.K. has suspended its Golden rule in 2008/9 and that Germany has even more dramatically changed its fiscal rules by introducing a constitutional ‘debt brake’. The usual reason given for these changes in both cases is, in fact, the perceived failure of the previously existing institutions. They are said to have failed in preventing an increase in government debt, because they left too much leeway for politicians and/or were not legally binding or enforceable (see SVR 2007: 62-72 for the German case and Dupont and Kwarteng 2012 for the UK). Therefore this section will take a closer look at both examples to see whether they can really damage the case for the Golden Rule of public investment.

4.1 The German ‘Golden Rule’ and its substitution by the constitutional ‘debt brake’

The German ‘Golden Rule’ had been written into the German constitution as part of the so called great reform of fiscal federalism in 1969. It has to be seen as closely connected with the stability and growth law of 1967 which called for an active, macroeconomic stabilization policy on the federal level and the level of the federal states in order to achieve price stability, adequate and steady economic growth, high employment and international balance of payments. The new rule at the time replaced the previous constitutional ban of budget deficits which allowed for deficits only if they were self-financing in the sense that their fiscal return was higher than the annuities that had to be paid on the debt. Its purpose was to loosen the deficit restriction for growth-enhancing investment while allowing for active cyclical stabilization (Dönnebrinck et al. 2010: 22-35).

The German fiscal deficit rule before 2009 was, strictly speaking, no Golden Rule in the sense of this study, at all: It was simply a constitutional budgetary rule for the federal level and the majority of federal states that was related to public investment (see SVR 2007: 57-72). It stated that government net borrowing should not exceed the level of gross government investment as represented in the government financial accounts (not the national accounts). However, gross investment did only serve as an upper limit for
the budget deficit in economically ‘normal times’. A transgression of the limit was possible if the government declared a macroeconomic disequilibrium that had to be reduced with the help of fiscal stimulus from a higher budget deficit. The term macroeconomic (dis)equilibrium had no clear operationalization but referred to the four basic macroeconomic goals that were formulated in the Stability and Growth Law, namely price stability, adequate and steady economic growth, high employment and international balance of payments. Much of the criticism of the former German rules for government debt was directed against the vagueness of this concept which was said to have led to an excessive usage of the exceptional clause.

Figure 6: General government gross fixed capital formation (ESA 1995), budget balance and output gap in Germany in per cent of GDP, 1970-2013

Source: Federal Statistical Office; European Commission (2014a); author’s calculations.

However, the case for an excessive usage is not too easily made. For illustrative purposes figure 6 shows general government gross investment, the government budget deficit and the output gap for Germany from 1970 to 2013. Obviously, transgressions of the deficit limit happened quite often: In 19 out of 44 years the budget deficit was higher than gross public investment. However, in 13 out of these 19 years the output gap was negative, which may be interpreted as evidence of a macroeconomic disequilibrium (Horn et al. 2013). In 3 out of the remaining 6 years the output gap was positive but declining which means that the economy was experiencing a downswing, which was

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5 See SVR (2005: 320-328) and Horn et al. (2013) for a general discussion of potential criteria to operationalise the exceptional clause and their application to concrete budgets.
plausibly the case in 1981, 2001 and 2002. Finally, in one year (1994) the transgression was negligible, and in another (2006) the strong upswing after a five year stagnation period had been difficult to predict. Following this interpretation, there was only one year (1991) with a clearly unjustified transgression of the rules.

Of course, this interpretation may be contested, because the analysis was based on data from the national accounts and the general government where in fact data from financial accounts as well as for the federal level and the relevant individual federal states should have been used. However, at least for the federal level a similar analysis with financial account data leads to comparable results (Horn and Truger 2007) and it is at least relevant information that the fiscal rules for the federal level and the federal states in Germany did not lead to obviously unjustified transgressions of the deficit limit when checked on an aggregate macroeconomic level with data from the national accounts.

Groneck (2008: 121-123) presents tables listing in which of the 15 years from 1992 to 2006 the federal level and each of the individual federal states transgressed the deficit limit. Unfortunately, however, Groneck does not even try to check whether the transgression might have been justified by the exceptional clause. This might have been rewarding, though: As suggested by the EU Commission’s November 2014 output gap data for Germany from figure 6, all of the federal level’s 7 transgressions occurred in years with a negative output gap (6 years) or during a downswing (1 year). Furthermore, transgressions on the level of the federal states were relatively less frequent (71 occasions for 16 states in 15 years, i.e. out of 240 potential occasions) which is consistent with the federal level taking stronger responsibility for economic stabilization. Finally, 63 of the lamented 71 transgressions occurred in years with a negative output gap or during a downswing. After all, it seems that German fiscal policy was not as lax with its fiscal rules as is often suggested.
Furthermore, there is some evidence that the investment related fiscal rules in Germany may have contributed to protecting and stabilizing government investment over the business cycle. Figures 7 and 8 show gross and net public investment in relation to...
GDP for the different levels of government.\textsuperscript{6} The federal level and the level of the federal states were submitted to the fiscal rule whereas the municipal level which undertook more than half of overall public investment, but is strictly regulated regarding fiscal deficits, was not. As can be seen in the figures and as is demonstrated by the variation coefficient, municipal gross and net investment is more volatile in general and – more importantly – its correlation with the output gap is much stronger than it is in the case of federal or federal state gross and net investment. Furthermore, the trend of federal and state investment did not decline as sharply as that of municipal investment and most of the substantially negative German net public investment (ESA 1995) was caused by the municipalities.

Nevertheless it is true that the previous German institutional limits to government deficits did not use an economically sensible definition of public investment and left much room for political interpretation. They did neither put an upper limit to transgressions of the deficit limit nor place a requirement to undercut the limit in economically good times. And due to the absence of strong sanctions the degree of enforceability was low (SVR 2007: 62-64). All of this may have contributed to the considerable increase of the German debt to GDP ratio from below 20 per cent in the early 1970s to its maximum of about 80 per cent in 2010. However, it should be noted that much of the increase occurred in economically bad times. And a very large part of the increase in German (federal) government debt relates to the economic and fiscal shock of German unification and later on the financial rescue measures taken during the financial crisis. The unification related debt piled up until 1995 in the federal special funds “Erblastentilgungsfonds” and “Fonds Deutsche Einheit” amounted to more than 290 bn. Euros or 11.3 per cent of 2010 GDP according to the Federal Finance Ministry. The debt related to the financial rescue packages from 2008 to 2010 amounted to 388 bn. Euros or 15.1 per cent of 2010 GDP according to Eurostat. All of this cannot be attributed to the German investment related deficit rules at the time.

However, if one believes the points mentioned to be important shortcomings then this is not an argument against the Golden Investment Rule as such. To the contrary, in fact, as already mentioned in section 3, to overcome the shortcomings of the old framework, the German council of economic experts argued in favour of a Golden Rule for net public investment which according to his preferences was to be embedded in a suitably strict institutional framework. In the end most of his recommendations as to the strict framework were put into practice in the design of the German debt brake. Unfor-

\textsuperscript{6} The figures show fixed capital formation according to the old ESA 1995 definition as this is closer to the relevant investment categories of the fiscal rules at the time.
fortunately, the net investment related part of his concept dropped out during the political process and was replaced by the requirement for the structural budget to be (almost) in balance allowing for a general government structural budget deficit of only 0.35 per cent.\(^7\)

### 4.2 The UK’s Golden Rule suspended in 2008/9

The Golden Rule in the UK was introduced under the Labour government’s Chancellor of the Exchequer Gordon Brown in 1997 and was practiced until the March 2008 budget. As a consequence of the budgetary repercussions of the global financial and economic crisis it was suspended in the pre-budget report in November 2008 and has not been practiced any more since the March 2009 budget. The rule stated that the government over the economic cycle would only borrow in order to invest and not to fund current spending. The Golden Rule was complemented by the sustainable investment rule according to which public sector net debt in relation to GDP would be held at a stable and prudent level over the cycle. This level was set at 40 per cent of GDP (Budd 2010: 34-35).

Two main reasons were given for the Golden Rule: First, it was to protect government investment from disproportionately large cuts during potential periods of budget consolidation. In fact, the absence of such protection was seen as a major reason for a decline in net investment and the public stock under the previous conservative government in the past. Second, it was justified by the well-known intergenerational equity considerations, namely that current spending should be financed by current tax-payers whereas public investment also benefitted future tax payers and should therefore be (partly) borne by future tax payers through the debt service. The sustainable investment rule was more difficult to justify because there is no way to determine the optimal debt level for an economy, but it was thought necessary to reduce the risks associated with high and increasing debt levels. Both rules were to be met over the cycle which meant that there was room for the working of automatic stabilisers and even for discretionary fiscal policy (Budd 2010: 35-36).

Except for the regular admission of discretionary fiscal policy – which would in combination with the need to balance the cumulative current budget over a precisely dated cycle later on prove to be its decisive weak point – the UK Golden Rule looked strikingly similar to the Golden Rule sketched in section 3. In fact, there were more similarities

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\(^7\) For a critical evaluation of the German debt brake see Truger/Will (2013).