Advisory report

on

basic conditions to ensure sustainable public finances

addressed to the parliamentary Budget Committee

This report comprises the concluding audit findings issued by the Bundesrechnungshof in accordance with Article 96 (4), sent. 1 Federal Budget Code. The decision on its disclosure is reserved to the Bundesrechnungshof.

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Sustainably ensure public finances

In the medium to long term, the federal budget will have less fiscal space. Without consolidation measures, the targets of the constitutional debt rule and the intended purposes, especially the long-term sustainability of the public finances and ensuring the Government's ability to act, cannot be met. Already when making relevant legislative proposals, the Federal Government needs to inform about future fiscal pressures in a more transparent and comprehensive manner to provide and maintain fiscal space for future generations.

What is it all about?

In addition to the demographic challenges which have already existed for a long time and which will become more and more acute in the years to come, the effects of the COVID-19 pandemic and of the war in Ukraine will put additional pressure on the public budgets. All of these factors jeopardise the long-term sustainability of the public finances and limit the fiscal space for key projects of future parliaments and governments. Thus, the options of future generations to meet their own needs are also limited.

What needs to be done?

The constitutional debt rule provides an appropriate basis to ensure the long-term sustainability of the federal and regional government budgets. The debt rule is not an end in itself. In light of scarce resources, the debt rule requires governments to consider budgetary priorities. However, this requires additional information on future fiscal pressures that are already evident today. The Federal Government has to provide the required information in the annual budget preparation process and in relevant legislative proposals of vital importance for the public budget. The transparency measures recommended by us can contribute to better preparing Germany for – even unexpected – fiscal challenges.

What is the objective?

The objective is to maintain fiscal space for future parliaments and governments and thus also the Government's ability to act and the options of future generations to meet their own needs. Long-term sustainable public finances are key to meeting this objective. They boost the confidence in Germany's financial soundness in the European Union and on the capital markets.

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List of abbreviations

D

DESTATIS *Federal Statistical Office*

E

ESM *European Stability Mechanism*

G

GDP *gross domestic product*

J

Joint Rules *Joint Rules of Procedure of the Federal Ministries*

M

Ministry *Federal Ministry of Finance*

0 Summary

The Federal Government determined that the **government deficit**, the **structural deficit** and the **debt level** were relevant indicators for **sustainable public finances**. Their targets are in line with the European fiscal rules. The **Federal Ministry of Finance** (Ministry) has lead responsibility for ensuring that these targets are met. One of the Ministry's key tasks is to inform the budget legislator about future fiscal pressures in a transparent manner. For the budget legislator, this is the only way to create the framework conditions to cope with – even unexpected – fiscal challenges.

We reviewed whether and to what extent the fiscal space for future parliaments and governments is limited – at federal government level – and whether the fiscal space will be further limited in the long term. Subsequently, we examined how the Ministry could contribute to **long-term sustainable public finances**. This report takes into account the trends up to June 2022 and the Federal Government's comments on our draft report. We developed the following key findings:

0.1 By means of the **debt rule** implemented in 2009, the constitutional legislator created a basis to ensure the long-term sustainability of the federal and regional government budgets. Long-term sustainability is key to maintaining **fiscal space** for future parliaments and governments and thus also the options of **future generations** to meet their own needs. Furthermore, the debt rule sends a credible signal to the European Union and to the capital markets that Germany has its general government debt under control. Nevertheless, there have been calls for higher levels of public debt and a reform or abolition of the debt rule. Some reasons given include a low interest level and an allegedly poor level of public investments in Germany.

We do not share this point of view. We rather see the risk that the budget legislator will no longer be able to adequately respond to future crises if the debt rule is relaxed or even abolished. It would be more favourable to consistently align **budgetary priorities** with increasing public investments and other future expenditure. Furthermore, the **administrative and regulatory framework** in the general government should be quickly and consistently adapted to increase the effectiveness of public and private investments. (No 3)

0.2 In addition to the **demographic challenges** which have already existed for a long time and which will become more and more acute in the years to come, the effects of the **COVID-19 pandemic** and of the **war in Ukraine** will result in significant public spending. Public finances have already come under considerable pressure. The general government budget balance fell deeply into the red and will remain negative in the medium term. Along with the debt-to-GDP ratio which has risen sharply, there is considerably less financial leeway to enable public budgets to absorb unexpected events.

Therefore, without consolidation measures, the targets for sustainable public finances cannot be met in the long term. In the event of further crises or risks associated with **contingent liabilities** which the Federal Government has assumed in an amount of several hundreds of billions of euros, the public budgets would come under further pressure. As a result of an increasing debt-to-GDP ratio, the capital markets could demand higher interest rates for government borrowing. (No 4)

0.3 When **preparing the annual budget**, the Federal Ministry of Finance has only **limited leeway** to ensure the sustainability of the public finances. The federal budgets of the near future are committed and – figuratively speaking – largely "petrified". According to the Ministry, only about 10 per cent of a federal budget's spending volume is non-earmarked when the budget is prepared. Thus, these funds only could be reprioritised and reallocated. The Ministry is capable of balancing the budget in the short term, e.g. to deal with unexpected events. However, this usually results in an even lower amount of funds available. (No 5)

0.4 In the medium and long term, **financial pressures** are expected to **increase**. This concerns in particular **expenditure induced by demographic trends**, but also **interest rate and repayment obligations**. Without countermeasures – i.e. an increase in revenue or a spending cut elsewhere – these pressures would lead to an increase in net borrowing. Since this expenditure is earmarked, the "degree of budgetary inflexibility" is expected to increase further.

However, we note with concern an **increasing degree of budgetary inflexibility** since the principle of democracy risks to erode when the pressures on future budgets limit future parliaments' and governments' financial ability to act in such a way that they are *de facto* unable to implement own political projects. (No 6)

0.5 The legislator can much more effectively ensure sustainable public finances in **making decisions in the respective policy areas** than in the annual budget preparation process. This especially applies to drafting legislation which may give rise to claims against the public sector in the long term, thus resulting in long-term commitments of the public budgets. For this reason, it is key that the financial impact of an act be described in a complete and transparent manner prior to any legislative deliberation.

In particular acts giving rise to long-term social insurance claims require the Ministry to engage more in the legislative process. Above all, the Ministry has to ensure that the regulatory impact assessment shows any impact on public budgets **in a complete and transparent manner and for an appropriate period of time**. (No 7)

0.6 **The Federal Government needs to increase its efforts to address the progressing degree of budgetary inflexibility.** For this purpose, the Government has to create **transparency** about the pressures on future budgets in order to use this as a basis to increase fiscal flexibility and to maintain future parliaments' and governments' ability to act. Therefore, we recommend that the Government, in the annual budget preparation process, always be provided with

- a complete overview showing which funds are committed, earmarked or uncommitted and the respective time horizon;
- a long-term projection of the federal budget’s key spending areas provided that the policy laid down in the financial plan is continued; and
- clear information about how the general government budget develops in the long term and the associated need for consolidation to be able to consistently comply with fiscal requirements. (No 8)

0.7 In its comments, the Ministry stated that it was also of the opinion that the constitutional **debt rule** provided an **appropriate framework for a sound and growth-oriented fiscal policy**. The Ministry intends to restore compliance with the upper limit for new debts as from 2023.

However, the Ministry does **not** intend to **implement** our **recommendations** since the Ministry holds that it is difficult to accurately define uncommitted funds and that it is unnecessary to make an additional projection on the government budget trends. In addition to that, the Ministry states that such calculations are complex and forward-looking statements are subject to uncertainty. Furthermore, the Ministry referred to other overviews and instruments which were already available. According to the Ministry, these overviews and instruments are appropriate to ensure the long-term sustainability of the public finances. (No 9)

0.8 We acknowledge that the Ministry also considers the constitutional debt rule to provide an appropriate framework for a sound and growth-oriented fiscal policy.

However, any further statements of the Ministry are not convincing, especially since the Ministry often did not provide a reasonable justification. We concur that it is difficult to accurately define uncommitted funds and that forward-looking statements are subject to uncertainty – in particular when they cover several decades. Nevertheless, a sound fiscal policy requires the Ministry not to turn a blind eye to long-term challenges and to take them into account in its plans and decisions. As a matter of fact, our review has already taken into account the overviews and instruments to which the Ministry referred. They are not appropriate to ensure the long-term sustainability of the public finances. Therefore, we reiterate our recommendation that the Ministry implement the **transparency measures** we proposed. (No 10)

1 Preliminary remarks

In 2015, 193 member states of the United Nations adopted the 2030 Agenda. At the core of the Agenda are 17 Sustainable Development Goals[1]. In order to implement these Goals, the Federal Government prepared a new version of the German Sustainable Development Strategy[2] (Strategy) in 2016 and has regularly updated the Strategy since then, most recently in 2021.[3]

Sustainability as a key principle requires meeting the needs of today's generation without jeopardising the options of future generations to meet their own needs. This also applies to public finances. In this context, sustainability means that Parliament may not finance today's public spending by making excessive new debts which future generations have to repay.[4] The Strategy operationalises the Sustainable Development Goals of the 2030 Agenda by using key indicators. For each indicator, the Strategy determines quantitative targets including deadlines.

Subject matter of this report is public finances. The Strategy defines government deficit, structural deficit and debt level as relevant key indicators for public finances. These indicators relate to the general government budget covering federal, regional and local government, social insurance and all extrabudgetary activities. The targets correspond to the European fiscal rules which are binding on EU Member States and which are to be complied with each year up to and including 2030:[5]

- Government deficit: a maximum of 3 per cent of gross domestic product (GDP)
- Structural deficit: a maximum of 0.5 per cent of GDP
- Debt level: a maximum of 60 per cent of GDP

By means of the indicators, the Federal Government primarily focuses on **sustainable public finances**. This means that the Government is able to sustainably **cover all future expenditure including debt service** by means of **future own revenue** and **without making new debts**.[6]

Public finances are considered to be no longer sustainable when the debt-to-GDP ratio increases steadily. On the one hand, this may be due to the fact that annual expenditure regularly considerably exceeds the revenue. On the other hand, an increase in interests can

1 SDGs.
2 German Sustainable Development Strategy – Version 2016 was adopted by the Federal Cabinet on 11 January 2017.
3 Cf. Bundestag printed paper 19/27530 of 11 March 2021 (communication of the Federal Government), German Sustainable Development Strategy – 2021 update.
4 Cf. German Sustainable Development Strategy 2021, pp. 71, 231 (in the German long version only).
5 Cf. German Sustainable Development Strategy 2021, pp. 101, 230 et seq. (in the German long version only).
6 This rather "technical" definition of sustainable public finances needs to be considered as an aspect of a quality evaluation concept of sustainability. See Federal Ministry of Finance, Fifth Report on the Sustainability of Public Finances, March 2020, pp. 1, 7.

cause significant pressure on the expenditure side and result in a spiral of ever-increasing interest expenditure and debts. The result would be a loss of confidence of the capital markets in the government's solvency. The budget legislator might need to take serious countermeasures, such as reducing (social) security benefits or refraining from investments.

2 Basic situation and objective of the report

From 2012 to 2019, Germany generated financial surpluses each year and thus fully met the criteria for government deficit and structural deficit. Owing to the financial and economic crisis, the general government debt-to-GDP ratio peaked at 82.0 per cent of GDP at year-end 2010. Since then, the ratio has steadily declined. The ratio totalled 58.9 per cent of GDP at year-end 2019.[7]

As to federal finances, it can be stated that the positive trend of the indicators was mainly not based on own consolidation efforts of the Federal Government in the last decade. In fact, public finances have benefitted from very favourable conditions, a robust economy, record employment, increasing tax revenue and low interest rates on government debts since the end of the financial and economic crisis.[8] However, the economic upswing has already significantly slowed down in the last years prior to the start of the pandemic.

In 2020, the outbreak of the COVID-19 pandemic put an end to the economic growth period. The price-adjusted GDP dropped by 4.6 per cent compared with the previous year.[9] The far-reaching measures to cope with the impact of the pandemic halted the positive trend of the indicators for the time being: In 2020, for the first time since 2011, Germany had once again a government deficit amounting to 4.3 per cent of GDP (Figure 1a). The structural deficit of 1.8 per cent of GDP also clearly missed the target. The debt-to-GDP ratio has risen sharply until year-end 2020. The ratio amounted to 68.7 per cent of GDP (Figure 1b). Owing to the continuing pandemic-related burdens, the government deficit and the structural deficit were far too high also in 2021. They amounted to 3.7 per cent and 2.1 per cent of GDP, respectively. Because of the burdens, the debt-to-GDP ratio further increased to 69.3 per cent of GDP until year-end 2021. Federal government accounts for about two-thirds of the debts, regional government for 27 per cent and local government for 6 per cent.[10]

7 Cf. https://www.bundesbank.de/en/statistics/public-finances (accessed on 20 January 2022).
8 Cf. German Stability Programme 2019, p. 6.
9 Cf. https://www.destatis.de/EN/Press/2022/01/PE22_020_811.html (accessed on 28 January 2022).
10 Cf. https://www.bundesbank.de/en/statistics/public-finances (accessed on 26 April 2022).

Figure 1a

COVID-19 pandemic drives the general government budget balance sharply into the red

In 2020, for the first time since 2011, Germany once again had a government deficit and even considerably exceeded the deficit ceiling of 3 per cent of GDP.

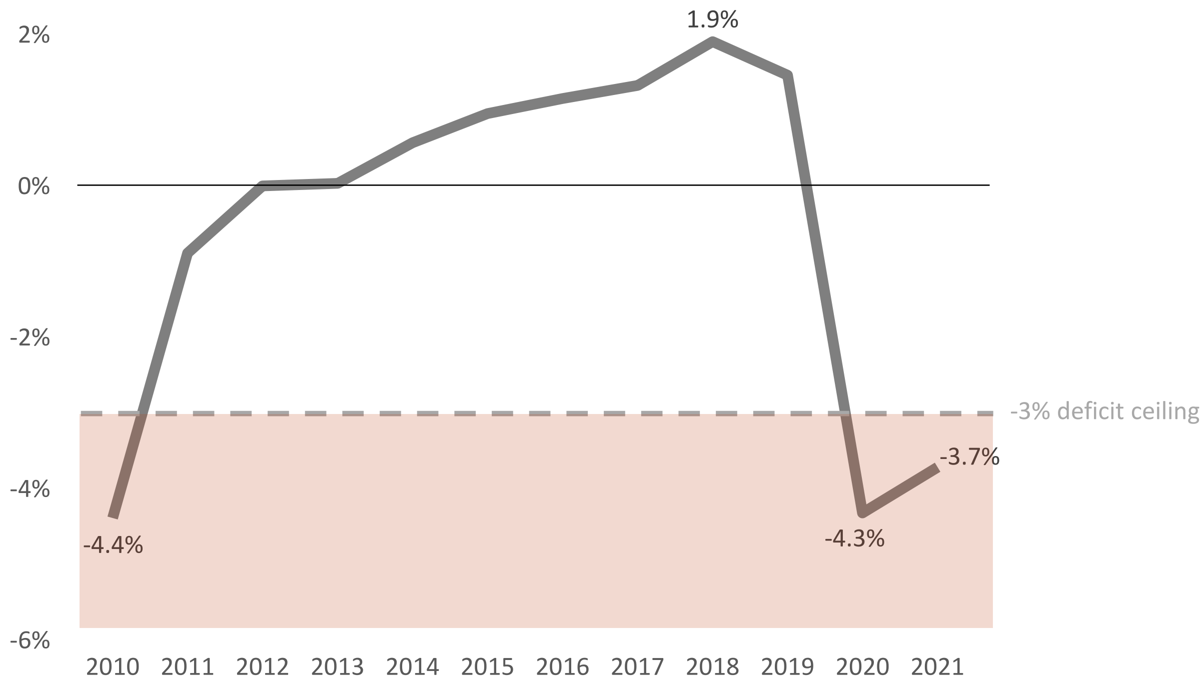

Chart: Bundesrechnungshof.

Source: Deutsche Bundesbank.

Figure 1b

New rise in debt-to-GDP ratio

The government deficits of 2020 and 2021 increased Germany's debt level. Since 2020, the debt-to-GDP ratio has been again above the limit of 60 per cent of GDP.

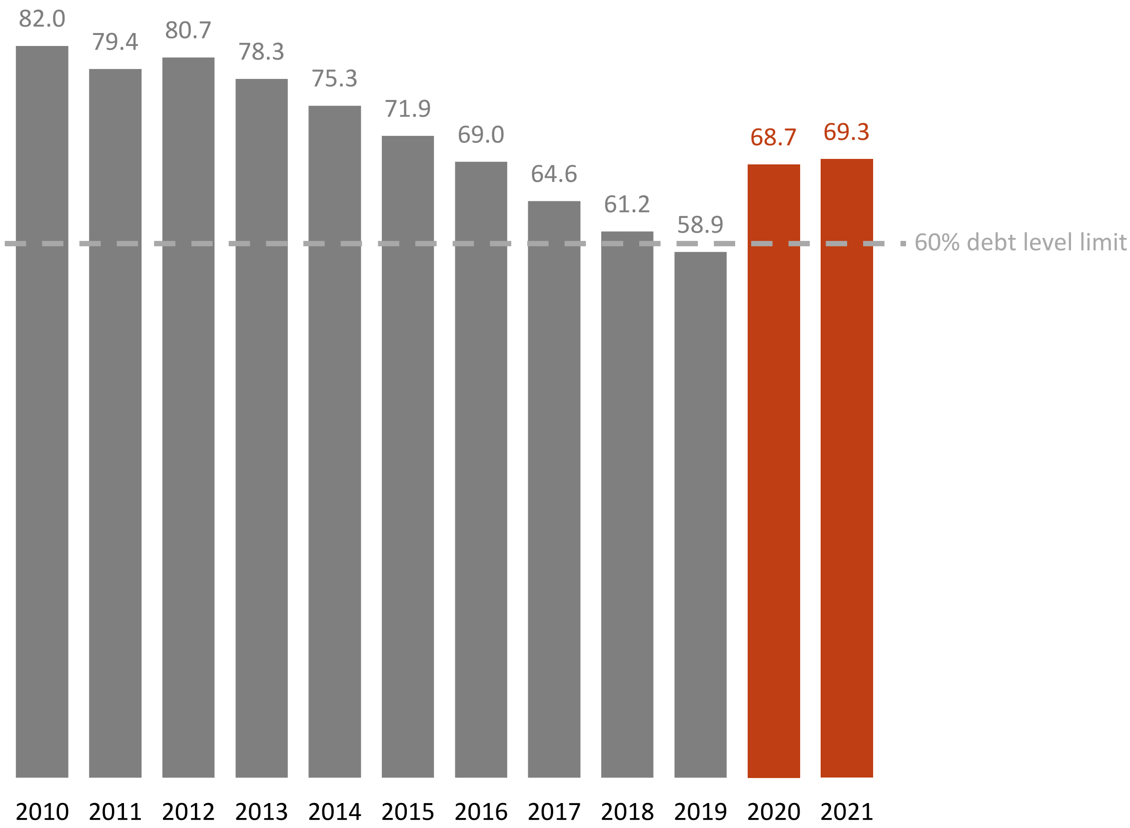

Chart: Bundesrechnungshof.

Source: Deutsche Bundesbank.

After the price-adjusted GDP could increase by 2.9 per cent in 2021, Russia's war of aggression against Ukraine abruptly slowed down the catch-up effect in February 2022. In its Stability Programme for the current year, the Federal Government expected a GDP growth of 3.6 per cent. However, the Government had to lower this expectation to merely 2.2 per cent in its spring projection. The Government expects the economic growth to stabilise at a level of 0.8 per cent annually in the medium term.[11]

[11] Cf. Federal Government's spring projection of 27 April 2022: https://www.bmwk.de/Redaktion/DE/Artikel/Wirtschaft/Projektionen-der-Bundesregierung/projektionen-der-bundesregierung-fruehjahr-2022.html (accessed on 29 April 2022, in German only). For the medium-term projection from 2024 to 2026, see German Stability Programme 2022, Table 11.

According to the Federal Government's projection in the Stability Programme, the government deficit of the current year will amount to 3.75 per cent and will thus miss the target again. The Government estimates that the debt-to-GDP ratio is to moderately decrease to 66.75 per cent of GDP until year-end 2022.[12]

The effects of the COVID-19 pandemic, the impact of the war in Ukraine and the changed security situation in Europe will continue to put pressure on the public budgets in the foreseeable future. In 2019, the Federal Government expected to be able to easily meet all fiscal challenges. Now, meeting the targets is unrealistic in the medium term.

Also in the long term, Germany will not be able to meet the targets for sustainable public finances without extensive reforms. Germany faces serious fiscal challenges which will remain relevant far beyond the financial planning period of five years. In order to overcome these challenges, a considerable amount of public funds will be needed. This includes, but is not limited to, additional expenditure for the transformation into an environmentally sustainable and digital society and increasing contributions in international cooperations and to the EU budget. Above all, however, the demographic trends will put considerable pressure on the public budgets as from the mid-2020s.[13]

Furthermore, the public budgets can generally come under additional pressure by exogenous shocks such as natural disasters or financial and economic crises unexpectedly at any time in the future. Past decisions also involve risks: For example, the extensive contingent liabilities which the Federal Government has assumed might put pressure on the budget.

Within the Government, the Federal Ministry of Finance has lead responsibility for ensuring that the targets for public finances enshrined in the Strategy are met.[14] The Ministry does not only focus on the short-term and medium-term perspective of the next federal budget and financial planning period of five years. The Ministry also assumes responsibility for ensuring long-term sustainable public finances.[15]

In this context, a key task of the Ministry is to achieve transparency on future financial pressures for the budget legislator and the general public. This is the only way for the legislator to create the framework conditions that serve to cope with future – even unexpected – fiscal challenges within the targets for sustainable public finances.

[12] Cf. German Stability Programme 2022, Tables 6 and 10.

[13] Cf. Federal Performance Commissioner, Analysis on the situation of the Federal Government's financial position, Opinion of 10 November 2021, p. 13 et seq.; German Stability Programme 2022, p. 50 et seq.

[14] Cf. 2021 departmental report on sustainability issued by the Federal Ministry of Finance, pp. 6, 12 (in German only).

[15] Cf. 2021 departmental report on sustainability issued by the Federal Ministry of Finance, p. 15 (in German only).

Against this background, this report is to

- make clear that compliance with the constitutional debt rule (**debt rule**) may not be up for discussion in light of the current critical situation of the public budgets (No 3);
- show to what extent the **fiscal space** for future parliaments is already limited now and will be further limited in the long term (No 4);
- examine the **role of the Ministry** with regard to the **sustainability of the public finances** (i.e. in the federal budget and in social insurance) beyond its key role in preparing the federal budget and the financial plan (No 5); and
- explore ways how the Ministry can contribute to sustainable public finances **by taking a long-term view** (No 7).

3 Constitutional debt rule: cornerstone for sustainable public finances

Adhering to the debt rule which has proven its worth even in times of crisis is key to the long-term sustainability of the federal and regional government budgets. The debt rule essentially protects Parliament's power over the budget that is fundamental pursuant to the constitution, maintains fiscal space for future parliaments and governments and thus helps next generations to maintain their fiscal decision-making authority and independence. Furthermore, the debt rule sends a credible signal to the European Union and to the capital markets that Germany has its general government debt under control. The debt rule substantially contributes to enabling Germany to continue to act as an anchor of stability in the euro area.

Nevertheless, there have been calls for higher levels of public debt and a reform or abolition of the debt rule. Some reasons given include a low or even negative interest level and an allegedly poor level of public investments in Germany. We do not share this point of view. We see the risk of lacking sustainability of the public finances if the debt rule was relaxed or even abolished. As a result, the budget legislator might no longer be able to adequately respond to future crises.

As a result of the deliberations on the second reform of the federal system, the constitutional provisions relevant to making new debts under Articles 109 and 115 of the German Constitution were amended in 2009. In doing so, the constitutional legislator ultimately responded to the various criticisms made to the investment-based debt rule – the “golden rule”[16] since this rule was not able to prevent “the strong increase in the federal and regional governments’ debt levels in the past”.[17]

According to the constitutional legislator, excessive debts would limit the Government’s scope for action in the long term and lead to losses in growth and employment. Furthermore, the legislator expected the public budgets to incur a significant amount of additional social security payments to tackle demographic change. These “implicit debts” required a readjustment of the intergenerational distribution of burdens.

By means of the (new) debt rule, the constitutional legislator intended to eliminate structural weaknesses of the golden rule and “improve the institutional conditions for ensuring the long-term sustainability of the federal and regional government budgets.” The very limited opportunities to make new debts were to ensure intergenerational equity and to focus spending on “high-quality measures”. This was not only to permanently enhance growth and sustainable development but in particular to benefit future generations without jeopardising the long-term sustainability of the public finances.[18]

Pursuant to Article 109 para. 3 of the German Constitution, the federal budget’s maximum structural net borrowing must not exceed 0.35 per cent of GDP when there is no crisis. The federal states are not allowed to make any structural net borrowings. If federal and regional governments consistently comply with the national debt rule, it can generally be assumed that the general government budget also complies with the requirements of the European fiscal rules for government deficit and structural deficit when there is no crisis.[19]

In recent years, critics of the debt rule reiterated that the rule hampered public investments. In particular in times of low interest rates, higher debts were acceptable to support the required investments in the green and digital transition. The debt-to-GDP ratio may not rapidly increase as long as the interest rate on current government debts is below the growth rate of nominal GDP (negative interest-growth difference). Furthermore, the critics argued that complying with the debt rule led to a very low debt-to-GDP ratio over time and unnecessarily limited the fiscal space for public investments. As a result, they considered

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16 The golden rule allowed for a net borrowing up to the limit of the investments estimated in the budget. This rule was based on the notion that capital spending should be (co-)financed by the future beneficiaries. A major weakness of this rule was, however, that the concept of investment was too vague. As a result, even consumption expenditure could be considered in the permitted amount of net borrowing. Furthermore, the loss of value by depreciations or sales has not been taken into account as gross investments were relevant for the amount of the borrowing powers and not net investments.

17 Cf. Bundestag printed paper 16/12410 (Draft act for amendment of the German Constitution) (Article 91c, 91d, 104b, 109, 109a, 115, 143d) of 24 March 2009, p. 1 (in German only).

18 Cf. ibid., p. 5 et seq.

19 The government deficit refers to the general government budget balance, while the debt rule of the Federal Government and of the constitutional states refers to the permitted amount of net borrowing of the respective federal and regional governments. Furthermore, different data bases have to be considered (European system of national accounts versus cash accounts). Therefore, budget balance and net borrowing are not to be put on the same level. It can generally be assumed, however, that the structural deficit will be below 0.5 per cent of GDP if the debt rule is complied with.

considerably higher public debts to not cause any problems and suggested managing public debt based on the interest-growth difference.

In line with this approach, public debt may increase until the amount of interest payments due corresponds to a certain share of tax revenue (interest-tax ratio).[20] The tax revenue trend heavily depends on economic growth.

We do not share the criticism to the debt rule.[21] History shows that the periods in which the interest rate exceeded the nominal economic growth and vice versa frequently alternated. In some cases, the two parameters changed significantly over the years.[22] If public debt is managed based on the interest-growth difference, this may lead to a pro-cyclical fiscal policy. In times of economic downturn associated with low economic growth and higher interest rates, the Government would have to save money and put additional pressure on the economy. As a result, the Government would have to either reduce expenditure or increase taxes to be able to pay the higher interest rates and to stabilise the debt-to-GDP ratio.

The objection that the debt rule would lead to a "too low" debt-to-GDP ratio from a macroeconomic point of view is not convincing:

- First, in 2021, the debt-to-GDP ratio at almost 70 per cent of GDP considerably exceeds the requirements of the European fiscal rules. Furthermore, the debt-to-GDP ratio of 60 per cent of GDP laid down in the European Treaties is defined as an upper limit and not as a target. A certain "safety margin" to this upper limit – i.e. a debt-to-GDP ratio below 60 per cent – would thus be desirable to not have to fear a loss of confidence on the capital markets in future crises. In the course of the global financial crisis in 2008/2009, for example, the debt-to-GDP ratio increased from 66 per cent to 82 per cent of GDP in 2010 within two years.
- Second, it will still take several years to lower the debt-to-GDP ratio from its current level again. According to a projection with an initial debt-to-GDP ratio of 70 per cent of GDP, a nominal GDP growth of 2.5 per cent and a government deficit of 0.5 per cent of GDP, it would take 10 years alone to fall again below the upper limit of 60 per cent of GDP.[23] It would even take 21 years to achieve a debt-to-GDP ratio of 50 per cent and thus a safety margin to the upper limit.
- Third, the debt rule creates the confidence required on the capital markets that public debts are sustainable at any time in spite of the high debt-to-GDP ratio and the long way to reduce the debts.

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[20] Cf. common paper of the employer-friendly German Economic Institute (IW) and of the Macroeconomic Policy Institute with links to the trade unions. Bardt/Dullien/Hüther/Rietzler, For a sound fiscal policy – Enabling public investments, IW Policy Paper No. 10, 2019 (in German only).

[21] See also: Federal Performance Commissioner, Analysis on the situation of the Federal Government's financial position, Opinion of 10 November 2021.

[22] Cf. German Council of Economic Experts, Dealing with structural change, annual report 2019, p. 258, chart 76.

[23] See footnote 19 for the differences between government deficit and net borrowing.

By means of the **debt rule**, the constitutional legislator enshrined a **targeted framework for federal and regional governments in the German Constitution**. The legislator thus established guiding principles required for a sustainable budget and financial policy since the debt rule makes it necessary to have political debates about priorities and also includes the interests of future generations.

Therefore, the debates on reforming the debt rule should focus on **strengthening** the **debt rule**. It is already clear that the federal budget, in particular, will have to face serious challenges in the coming decades. The demographic trends, for example, will cause increased expenditure. If fiscal policy is continued without priorities, focus and consolidation, the fiscal space of future budget legislators may be further limited. This might jeopardise the sustainability of the public finances in the long term.

We do not see any contradiction between complying with the debt rule and increasing spending for public investments and other future expenditure – as has been frequently requested. In normal times, this spending can be financed from the federal budget with total revenue of more than 10 per cent of GDP.[24] Furthermore, the budget legislator may flexibly use the maximum amount permitted for structural net borrowing. According to several institutions, the Federal Government should use the fiscal space exclusively for increasing the public capital stock (positive net investments).[25]

In essence, it is about consistently **aligning budgetary priorities** with **increasing public investments** and other **future expenditure**. Furthermore, the **conditions** for public and private investments to have any effect at all, i.e. the **administrative and regulatory framework** in the general government (federal/regional/local government), have to **be improved quickly and consistently**.[26]

4 Public finances under pressure

Owing to the pandemic and the war in Ukraine, the public budgets have come under considerable pressure. The general government budget will continue to show a deficit in the medium term after having fallen deeply into the red in 2020 and 2021. The debt-to-GDP ratio which has risen sharply is expected not to meet the target of 60 per cent of GDP until

24 The average government revenue ratio (without net borrowing) amounted to 10.2 per cent of GDP from 2010 to 2019.

25 Cf. Deutsche Bundesbank, European Stability and Growth Pact: individual reform options, monthly report April 2019, p. 77 et seq.; German Council of Economic Experts, Limiting national debt effectively, expert opinion for the Federal Government, March 2007, p. 45 et seq. (in German only).

26 Cf. Advisory opinion of the Board of Academic Advisors at the Federal Ministry for Economic Affairs and Energy, Public infrastructure in Germany: problems and need for reforms, June 2020, p. 51 et seq. (in German only); German Council of Economic Experts, Shaping the Transformation: Education, Digitalisation and Sustainability, annual report 2021, p. 155 et seq.

the end of the financial planning period. **There is considerably less financial leeway to enable public budgets to absorb unexpected events.**

In the coming decades, the **demographic change** will lead to a considerable increase in expenditure induced by demographic trends and will put pressure on the public budgets. Without consolidation measures, the targets for sustainable public finances cannot be met in the long term.

In the event of **further crises** or risks from **contingent liabilities** (sureties, guarantees and other warranties) which the Federal Government has assumed in an amount of several hundreds of billions of euros, the public budgets would come under further pressure. As a result of an increasing debt-to-GDP ratio, the capital markets could demand higher interest rates for government borrowing.

4.1 Hardly any fiscal space in the medium term

The Federal Government projections on the general government budget are based on the budget estimates of all government levels (federal, regional and local government, social insurance). The projections are modified when newer or updated estimates of the macroeconomic trends[27] and of tax revenue[28] are available.

In 2019, prior to the outbreak of the COVID-19 pandemic, the Government envisaged a balanced federal budget without new debts over the entire financial planning period up to 2023. The general government budget projection showed that the targets for sustainable public finances were easily met and even gave a certain leeway to absorb unexpected fiscal risks.[29] In order to cope with the serious impact of the COVID-19 shock, however, the buffers included in fiscal planning were not enough. Instead, the public budgets showed a government deficit of 4.2 per cent of GDP and thus fell deeply into the red in 2020.

For the current financial planning period up to 2026, the Federal Government provided a projection along with a scenario analysis by means of the Stability Programme 2022.[30] In the baseline scenario, the targets for the government deficit are met again as from 2023 and for the structural deficit as from 2026. The two indicators, however, will still remain in the red

[27] Every year in March/April and September/October, the Federal Government updates its macroeconomic forecast in the spring or autumn projection.

[28] On the basis of the updated macroeconomic forecast, the tax revenue estimates are adjusted by the Working Party on Tax Estimates in April and October each year.

[29] Cf. Stability Programme 2019, p. 8 and p. 31 et seq., especially Tables 5, 7, 8.

[30] Cf. German Stability Programme 2022, p. 40 et seq. The reference date for the projection is 31 March 2022. The projection is based on the Federal Government’s annual projection on macroeconomic trends of 26 January 2022 and on the second government draft of the federal budget for 2022 (without supplementary budget) adopted by the Federal Government on 16 March 2022, and the benchmark figures for the government draft of the 2023 federal budget and the financial plan up to 2026. The planned Bundeswehr Special Fund and the governing parties’ decision of 23 March 2022 on a “package of federal government measures to manage high energy costs” were also taken into account. Cf. ibid.

up to 2026. As from 2022, the debt-to-GDP ratio is expected to slowly decrease again from its temporary peak as a result of the pandemic. Nevertheless, the target of 60 per cent of GDP will still be missed at year-end 2026 according to the projection (Table 1).

Table 1

Federal Government projection on the medium-term trend of key indicators

	2021	2022	2023	2024	2025	2026
GDP growth in %	*2.90*	*3.60*	*2.30*	*0.80*	*0.80*	*0.80*
Budget balance in % of GDP (target: max. -3.0 %)	*-3.70*	*-3.75*	*-2.00*	*-1.75*	*-1.00*	*-0.50*
Structural balance in % of GDP (target: max. -0.5 %)	*-2.10*	*-3.50*	*-2.25*	*-2.00*	*-1.00*	*-0.50*
Debt level in % of GDP (target: max. 60 %)	*69.30*	*66.75*	*65.75*	*65.75*	*65.00*	*64.50*

Source: German Stability Programme 2022, Tables 6, 10 and 11.

Figure 2

Budget balance improves but remains negative in the medium term

According to the Federal Government projection, the budget balance will meet the target of a maximum of -3 per cent of GDP as from 2023.

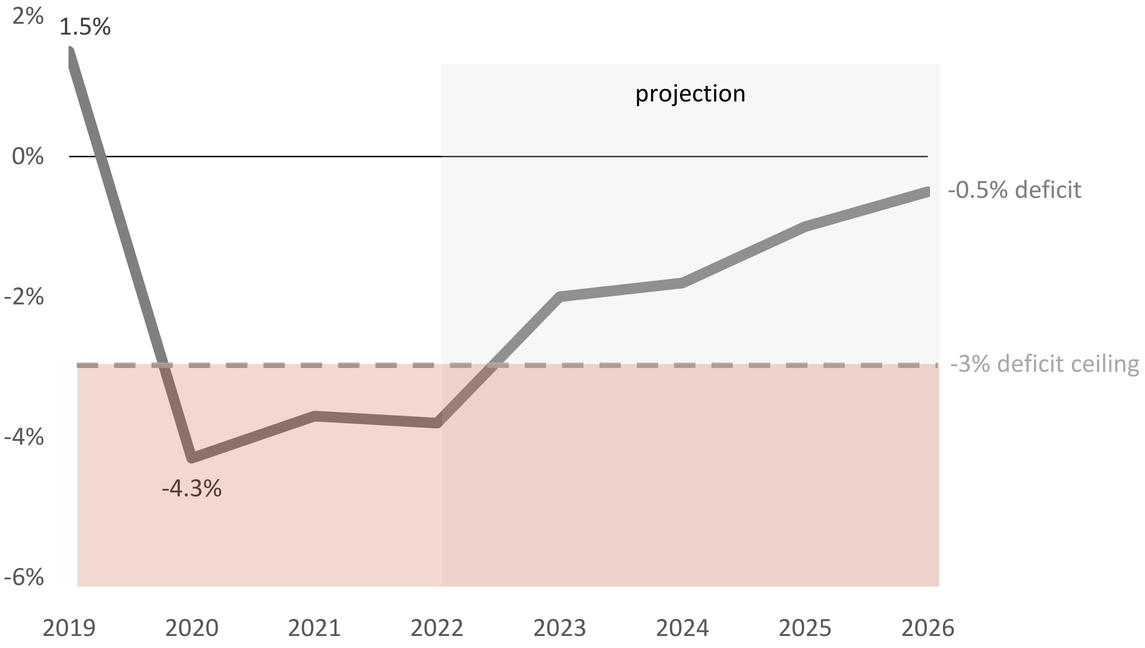

Chart: Bundesrechnungshof.

Source: German Stability Programme 2022.

The assumptions on future economic growth have a decisive impact on the projections. In a scenario analysis, the Federal Government modelled the budget balance trend based on the assumption that the GDP growth annually increases or decreases by half a percentage point compared with the baseline scenario pursuant to Table 1.[31] In the best-case scenario, the budget would be balanced in 2025 and positive again in 2026.

In the worst-case scenario, the budget balance would be at -1.75 per cent of GDP and thus still significantly negative in 2026. In this case, the debt-to-GDP ratio would hardly decrease. This seems quite likely in light of the current trends: In its spring projection, the Federal Government significantly reduced the expected GDP growth for the current year. Since the war in Ukraine puts considerable pressure on the economic recovery, the Government only expects a GDP growth of 2.2 per cent. This value is significantly below the assumption made in the worst-case scenario (3.1 per cent).

The fiscal space to enable public budgets to absorb unexpected events has reduced significantly since the outbreak of the COVID-19 pandemic. According to the current

[31] Cf. German Stability Programme 2022, chapter 4.4.

projections, the debt-to-GDP ratio will not meet the target of 60 per cent of GDP until the end of the current financial planning period. These projections have not even fully reflected the impact of the war in Ukraine. Should Germany face another exogenous shock in the medium term or should the German economy suffer even more as a result of the war in Ukraine, the debt-to-GDP ratio might increase again. This could lead to an increase in interest rates for public borrowing.

4.2 Demographic trends as a challenge for long-term sustainable public finances

Demographic trends in Germany are primarily characterised by an increasingly ageing population. These trends will put considerable pressure on the public finances in the long term. The baby boomers from 1955 to 1970 will retire one by one in the 2020s.[32] After the current "calm before the storm", the number of employees will decrease steadily as from the mid-2020s. Because of this decrease, the old-age dependency ratio[33] rises sharply up to 2038. Depending on the scenario of population trends, the rise will continue over the course of time.[34] According to the Federal Government projections, expenditure induced by demographic trends will increase considerably if the conditions remain the same, in particular in the areas of old-age provision (pensions) and health and long-term care insurance.[35]

The Federal Government regularly makes projections to estimate the impact of demographic trends on individual spending areas. This includes the pension report[36] projecting the trend in federal retirement benefits up to 2050.[37] The Government is also obliged to annually present the financial development of the statutory pension scheme including federal subsidy in the pension insurance report for a time horizon of 15 years each (Article 154 of Social Code Book VI). The current pension insurance report covers the period up to 2035.[38] According to the reports, the Government does not consider the financial stability to be jeopardised in any of the two pension schemes.[39]

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32 https://www.destatis.de/DE/Themen/Querschnitt/Demografischer-Wandel/demografie-mitten-im-wandel.html (accessed on 18 September 2021, in German only).
33 The old-age dependency ratio is the ratio between the population of retirement age – that is the group of potential recipients of benefits from the pension insurance scheme or other old-age security systems – and the people of working age.
34 Cf. Destatis, Assumptions and results of the 14th coordinated population projection, June 2019, p. 27 et seq.
35 Cf. German Stability Programme 2022, p. 60.
36 The Federal Government prepares the pension report once per legislative period, most recently in 2020. Cf. Federal Ministry of the Interior, Building and Community, Seventh pension report of the Federal Government, March 2020 (in German only).
37 Cf. Seventh pension report of the Federal Government, p. 80 et seq. (in German only).
38 Cf. Federal Ministry of Labour and Social Affairs, Pension insurance report 2021, November 2021.
39 Cf. Seventh pension report of the Federal Government, p. 13 (in German only); Pension insurance report 2021, p. 11 (in German only).

These long-term Federal Government projections, however, do not fully show the extent of the fiscal challenges induced by demographic trends. They each focus on specific areas only but are not embedded in an integrated overall analysis of budgetary trends. Furthermore, the projection period of 15 years is too short for the pension insurance scheme.[40] Major impacts, in particular in connection with the baby boomer effect, go well beyond 2035 – the year relevant to the last pension insurance report.[41]

The Federal Ministry of Finance makes a long-term projection of all public budgets in its **Report on the Sustainability of Public Finances**. The Ministry issues this report once per legislative period, most recently in March 2020.[42] This report models the hypothetical trend in the general government budget based on the assumption that the current legal situation (as of June 2019)[43] remains unchanged. The projection horizon up to 2060 extends far enough into the future to be able to also reflect the change in the population structure after the current "calm before the storm".

In order to show the possible scope of future trends in a long-term projection horizon, two baseline scenarios are calculated: A best-case scenario (T+) making positive assumptions on demographic and macroeconomic trends and a worst-case scenario (T-) making negative assumptions.[44] The scenario assumes that public revenue in relation to the current GDP remains constant and the deficits associated with increasing expenditure are balanced by additional debts.

Irrespective of the favourable economic situation in 2018 – the base year of the projection – the two baseline scenarios show that consolidation measures would be required to achieve long-term sustainable public finances. The **sustainability gap** quantifies the need for consolidation which would be required **as from the base year** to be able to cover all public expenditure including debt service by public revenue over an infinite time horizon.[45] The gap

[40] The Federal Ministry of Labour and Social Affairs stated that the impacts of the demographic challenges would not become sufficiently obvious in case of a projection horizon up to 2030 and expanded its projections on the statutory pension scheme up to 2045. Cf. Federal Ministry of Labour and Social Affairs, Old age security master plan, November 2016, p. 24 (in German only).

[41] Cf. Deutsche Bundesbank, The long-term outlook for the German statutory pension insurance scheme, monthly report, October 2019, p. 64 (in German only).

[42] Cf. Federal Ministry of Finance, Fifth Report on the Sustainability of Public Finances, March 2020. The Ministry commissioned economists of the ifo Institute, Munich, and of the Ruhr University Bochum to carry out the projections.

[43] For the pensions, this means: the retirement age will be gradually increased to 67 by 2031; current pensions are increased according to the applicable pension adjustment formula; until 2025, there is a "double backstop" for the net pension level before tax and the contribution rate; other elements of the pension reforms of 2018 and 2014 are also taken into account. The plans for a basic pension, however, have not been taken into account. As to the legal status, see Fifth Report on the Sustainability of Public Finances, p. 20 et seq.

[44] With regard to the assumptions on population trends, labour market and macroeconomic trends in the baseline scenarios, see Fifth Report on the Sustainability of Public Finances, p. 10 et seq., especially p. 19.

[45] The sustainability gap corresponds to the international common indicator S 2 and to the definition of long-term sustainable public finances used by the Federal Ministry of Finance; see also No. 1.

amounted to 1.49 (T+) and 4.1 per cent (T-) of GDP, respectively.[46] This means that the general government primary balance[47] needed to be improved **immediately and permanently** by 1.49 and 4.1 per cent of GDP, respectively.

Without additional and permanent consolidation measures, the general government budget balance would be below the target in the two scenarios over the course of time, in the worst-case scenario **already as from 2036**. Germany would thus not comply with the requirements of the Stability and Growth Pact.

Figure 3 illustrates the trend over the course of time. In consideration of the projected balances, the debt level would fall below the baseline at first but rise again as from the mid-2030s at the latest and increase to up to 73 (T+) and 185 per cent (T-) of GDP, respectively, by 2060.[48] Thus, the report contains – despite all uncertainties which cannot be avoided in the case of long-term projections – a clear warning that the sustainability of the public budgets could be jeopardised without additional consolidation efforts in the long term, even under best-case assumptions.

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[46] The values are based on the assumption of a consolidation "in a single step" in the base year. Cf. Fifth Report on the Sustainability of Public Finances, p. 36 et seq.

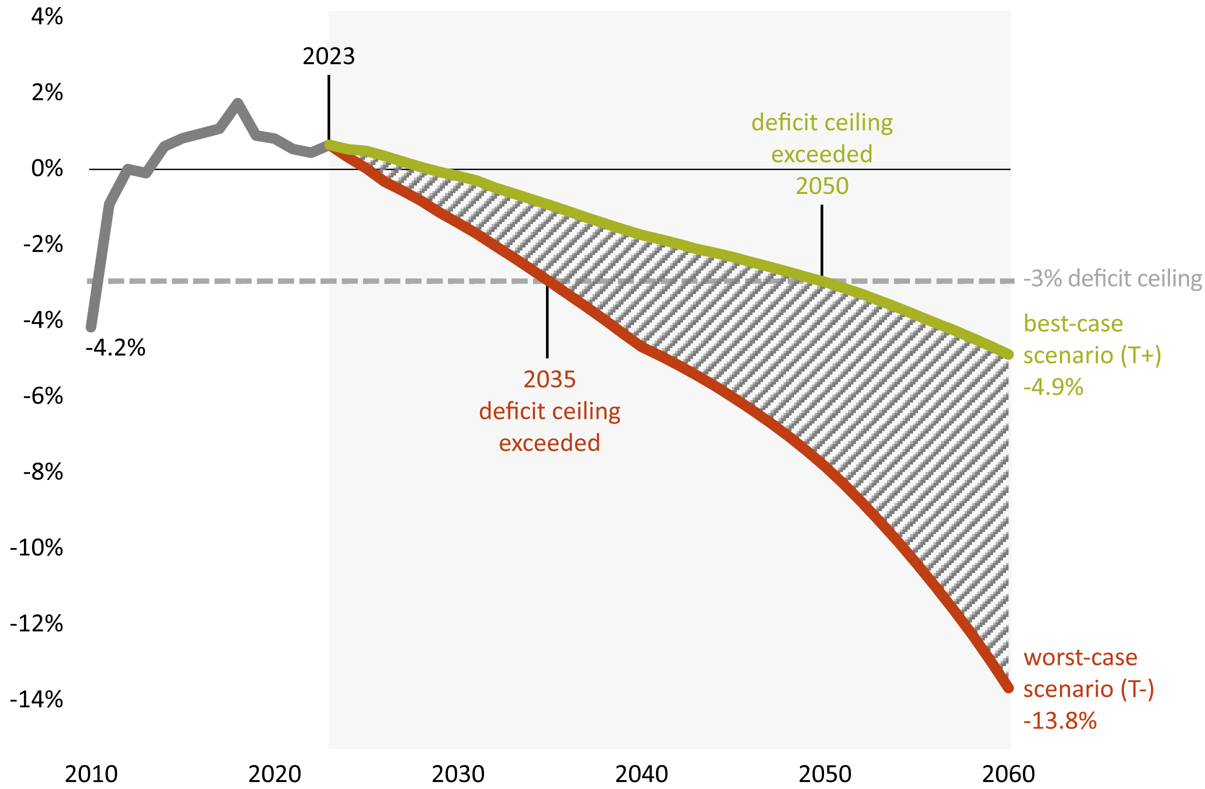
[47] The primary balance corresponds to the budget balance without interest payments.

[48] Cf. Fifth Report on the Sustainability of Public Finances, p. 29 et seq.

Figure 3

Public finances steadily deteriorate due to demographic change

Expenditure induced by demographic trends will steadily increase in the coming decades. Without appropriate increases in revenue or spending cuts, the general government budget balance (in % of GDP) will continue to deteriorate.



Explanatory note: The Fifth Report on the Sustainability of Public Finances could completely rely on actual data up to 2017. Up to 2023, the calculations are based on key data of the (at that time) current medium-term Federal Government projection. The projections do not diverge between the two base variants until 2023 (grey area).

Chart: Bundesrechnungshof.

Source: Werding/Gründler/Läpple/Lehmann/Mosler/Potrafke, Ruhr University Bochum, model calculations for the model variants T+ and T- taken from the Fifth Report on the Sustainability of Public Finances issued by the Federal Ministry of Finance.

In the case of the less ambitious target of complying with a debt-to-GDP ratio of 60 per cent in 2060, the need for consolidation would be more moderate but still at 2.27 per cent of GDP in the worst-case variant (T-).[49]

The Federal Ministry holds that the COVID-19 pandemic only has a minor impact on the dynamics of the projected trends in expenditure induced by demographic trends.[50]

[49] Cf. Fifth Report on the Sustainability of Public Finances, p. 37.

[50] Cf. German Stability Programme 2022, p. 52 et seq.

However, the debt-to-GDP ratio as a “starting point” of the projection has significantly deteriorated compared with the last report. The debt level of the base period is considered to be the “long-term memory” of fiscal policy and thus has a significant impact on the projection, in particular in the case of rising interest rates in the future.[51]

Current calculations on our behalf[52] provide evidence **that the sustainability gap has actually increased.**[53]

4.3 Risks from contingent liabilities

In order to hedge against uncertain future risks, the Federal Government assumes sureties, guarantees and other warranties in favour of third parties. The Government must not assume them if the Government has to expect that it is very likely exposed to financial liabilities.[54] Nevertheless, there is a certain likelihood that risks may arise and may lead to a budgetary burden in future years. These are therefore **contingent liabilities** which the Government might have to pay at any time.[55]

The **annual Budget Act** establishes the largest **volume of powers to grant guarantees**. Pursuant to Article 3, the Federal Ministry of Finance is authorised to assume guarantees for specific purposes, e.g. for exports or for the domestic economy. The volume of powers to grant guarantees initially adopted for the financial year 2020 of €465.2 billion was increased considerably to €821.7 billion in the course of the COVID-19 pandemic, primarily to stabilise the economy.[56] As at 31 December 2020[57], more than 66 per cent (€546 billion) of this amount was used.

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[51] Cf. Fifth Report on the Sustainability of Public Finances, p. 33.

[52] Cf. Baseline scenario in Werding/Läpple, Financial risks for the federal budget through the impact of demographic ageing on social insurance systems, FiFo Reports, No 31, 2022, Table 1 (in German only). See also advisory report on demographic trends: financial risks for the federal budget as a result of public shareholding in social security funding addressed to the parliamentary Budget Committee, to the parliamentary Committee on Labour and Social Affairs and to the parliamentary Committee on Health of 23 May 2022 (in German only).

[53] See also Potrafke, Statement in the framework of the hearing in the parliamentary Budget Committee on the draft of the Second Supplementary Budget Act 2020 (Bundestag printed paper 19/20000) and the draft of an Act on Accompanying Measures to Implement the Stimulus and Crisis Management Package (Bundestag printed paper 19/20057) on 29 June 2020, p. 5. Moreover, see Market Economy Foundation, 2021 Generational Balance Sheet Update: Rising debts, missed reforms, apathetic politics. Presentation for the press meeting on 12 August 2021, slides 5,7 (in German only).

[54] Cf. Administrative Rules No 5 on Article 39 of the Federal Budget Code (in German only).

[55] The contingent liabilities of the Federation and its off-budget funds are shown in section 5 of the federal capital accounts (liabilities). As they only represent a contingent burden in future financial years, they do not count as debts.

[56] Cf. Bundesrechnungshof, Background note to the Members of the parliamentary Budget Committee of 27 March 2020 (Ref. I 2 - 20 80 05), p. 3 (in German only).

[57] Exploitation of the volume of powers to grant guarantees as at 31 December 2020. See 2020 federal capital accounts, Table 24. The 2021 federal capital accounts have not been published at the moment this report was being drafted.

As a response to the COVID-19 pandemic, a new off-budget fund was established – the Economic Stabilisation Fund – that provides a guarantee framework of €400 billion. The volume of powers to grant guarantees for all **off-budget funds** thus doubled to €804 billion by the end of 2020, but largely remained unused. In December 2021, the guarantee framework of the Economic Stabilisation Fund was reduced to €100 billion.

The Federal Government assumed further guarantees outside the budgetary framework in connection with the **measures to stabilise the euro area**. This includes guarantees of €22.4 billion for loans of KfW, one of the world's leading promotional banks, to Greece assumed in 2010. Another guarantee of €91.5 billion was assumed in favour of the European Financial Stability Facility at year-end 2020. This Facility was part of the temporary rescue package established in 2010 that could grant stability support to Member States facing financial difficulties.

The **European Stability Mechanism** (ESM) established as a permanent rescue package in 2012 replaced the temporary package. Germany's share in the capital stock of the ESM amounts to €189.6 billion, of which €21.7 billion were paid into the Mechanism. The other €167.9 billion are to be paid when the ESM calls for them and thus have an impact on the budget.[58] In January 2021, the ESM Member States signed an agreement to amend the ESM Treaty in order to extend the possible uses of the ESM. We hold that, as a result, the risks to the federal budget will also increase considerably.[59]

Further Federal Government guarantees were added in connection with the **European response to the COVID-19 pandemic**. The EU Member States established the European Recovery Fund at year-end 2020. The Fund has a volume of €750 billion. Out of this amount, €390 billion are intended to be provided to the Member States as non-repayable grants and the remainder as loans. In order to finance the Recovery Fund, the European Commission uses EU bonds to borrow funds on the capital market. The EU bonds used for the grants are repaid using future EU budgets. The beneficiaries should repay the funds borrowed for the loans. All debts incurred for the Recovery Fund have to be repaid by year-end 2058 at the latest. The EU budget provides a guarantee for these debts. This means that, ultimately, the Member States are jointly liable for the debts incurred via their future contributions to the EU budget. Should a Member State be no longer able or willing to meet its payment obligations, the other Member States have to pay the respective Member State's share. For

[58] Apart from the ESM, the Federal Government is shareholder of further international banks and institutions. The financial obligations resulting from the callable capital are covered by the volume of powers to grant guarantees specified in the Budget Act under Article 3 para. 1 sentence 1 No 6, with the exception of the ESM and the EURATOM Supply Agency. See 2020 federal capital accounts, section 5.5 (in German only).

[59] Cf. Advisory report on the risks of a reform of the European Stability Mechanism (ESM) for the federal budget addressed to the parliamentary Budget Committee of 27 May 2019; Advisory report on the risks of the reform of the European Stability Mechanism (ESM) for the federal budget – here: agreement amending the treaty establishing the ESM addressed to the parliamentary Budget Committee of 26 May 2021 (in German only). The implementation of the agreement requires the ratification of the ESM Member States. In June 2022, the agreement had not yet been ratified by all ESM Member States.

this reason, the Government faces further liability risks running into billions – in addition to the regular proportionate repayment obligation.[60]

The European instrument for temporary support to mitigate unemployment risks in an emergency (SURE[61]) is also part of the response to the crisis. The instrument may provide loans of up to €100 billion to the Member States. The European Union finances these loans by borrowing funds on the capital market. In order to safeguard these funds, the Member States assumed guarantees. Germany's guarantees amount to €6.4 billion. However, the possible liability risk associated with future German contributions to the EU budget is considerably higher – as in the case of the Recovery Fund.

Overall, we note a **steady increase** in **the Federal Government's contingent liabilities** – starting with the financial and sovereign debt crisis as from 2010. In the course of the COVID-19 pandemic, the liabilities increased enormously both by national measures to stabilise the economy and by the European response to the crisis. All of these liabilities are now amounting to **several hundreds of billions of euros**. When contingent liabilities increase, **potential financial losses** also increase. **The public budgets which are already in a difficult situation would come under further pressure by such incidents.**

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[60] Special purpose report on the potential impact of joint borrowing of the member states of the European Union on the federal budget (Recovery Fund) of 11 March 2021.

[61] European instrument for temporary **s**upport to mitigate **u**nemployment **r**isks in an **e**mergency.

5 Short- and medium-term management at federal budget level

When **drawing up the budget**, the Federal Ministry of Finance only has limited fiscal space to ensure sustainable public finances. The federal budgets of the near future are committed and – figuratively speaking – largely **"petrified"**. It is possible to balance the budget in the short term, e.g. in the case of unexpected events. However, this regularly leads to less funds being non-earmarked. In the medium and long term, financial pressures increase, in particular expenditure induced by demographic trends, and interest rate and repayment obligations. Since this expenditure is earmarked, the "degree of budgetary inflexibility" might continue to increase.

When the inflexibility of the budget increases, there is a growing risk that future challenges or unexpected events might no longer be addressed within the fiscal targets. Furthermore, fiscal space for key projects of future governments will be further limited. The resulting loss of the opportunity to take political actions could jeopardise the sustainability of the public finances in the long term and, as a result, affect the Government's ability to act.

The Federal Government needs to take even more action against the increasing degree of budgetary inflexibility than before. In order to do so, the Government first has to create **transparency as to the pressures** of future budgets to use this as a basis to increase fiscal flexibility and to maintain future parliaments' and governments' ability to act.

5.1 Main features of the budget preparation process

On 1 August 2009, the **debt rule** pursuant to Article 109 para. 3 in conjunction with Article 115 para. 2 of the German Constitution entered into force.[62] In this connection, the Federal Government changed its internal government processes and started using a top-down approach for preparing the federal budget and the federal financial plan. For the first time, the new approach was used for drawing up the 2012 federal budget and the financial plan from 2011 to 2015.[63]

Key element of the top-down approach is the **benchmark figures decision of the Federal Government** that sets a ceiling for each government department that is then allocated to the budget items of the respective departmental budget. This means that already at the beginning of the budget preparation process, the overall budget and each departmental budget is fixed. The ceilings set for the departmental budgets must not be exceeded. This

[62] Act to amend the Basic Law of 29 July 2009, Federal Law Gazette I 2009, p. 2248 et seq (in German only). Under Article 143d para. 1 of the Basic Law (German Constitution), various transition periods have been created for the Federation, for off-budget funds already established and for the federal states.

[63] Cf. Letter of the Federal Ministry of Finance to the supreme federal authorities of 5 January 2011 – II A 1 – H 1105/10/10005:001, DOK 2011/0001373 (in German only).

also applies to individual arrangements in policy areas which merit particular attention. The benchmark figures decision thus takes the form of a target agreement within the Federal Government. The decision is intended to ensure a draft budget which is in line with the German Constitution. Within the Federal Government, the Federal Ministry of Finance is responsible for preparing the benchmark figures decision both in terms of content and organisation.[64]

In the budget preparation process, the Ministry has a prominent role – which is normatively approved. Pursuant to Article 28 para 1 of the Federal Budget Code, the Ministry prepares and takes responsibility for the draft budget based on the budget announcements made by the government departments. The Ministry's right to object laid down in Article 28 para 2 of the Federal Budget Code leads to the fact that, in practice, no federal budget has been adopted (by majority) by the Federal Cabinet so far without the approval of the Ministry. Due to this role, the Ministry exerts a profound and material influence on federal financial management and thus also on government actions.[65]

5.2 Pressures on future budgets

Future governments' political ability to act risks to erode if more and more commitments put pressure on future budgets since less and less funds will be available for new policy projects in the future.

In order to take countermeasures, the Ministry regularly limits the budget funds for **commitment appropriations** for subsequent years. For example, when drawing up the budget for the financial year *t*, commitments entered into per budget item may, as a matter of principle, not exceed 80 per cent of the estimated amount of the respective budget item in the following year *t+1*.[66] If these ceilings are to be exceeded in duly substantiated exceptional cases, approval of the Ministry's Directorate-General II: Federal budget is needed.

The commitments entered into are shown in the budget account. At year-end 2020, these commitments for subsequent years across all departmental budgets totalled €270.1 billion, including €61.2 billion in financial year 2021.[67]

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64 Cf.: www.bundesregierung.de/breg-de/aktuelles/bundeshaushalt-kurz-erklaert-1649006 (accessed on 6 September 2021, in German only).

65 Dittrich, Federal Budget Code, 58th edition, January 2020, item 2 on Article 28 of the Federal Budget Code (in German only).

66 For the subsequent financial years *t+2* or *t+3,* the rates of commitments entered into decreased to 60 or 40 per cent.
Cf. Federal Ministry of Finance, letter of 5 January 2021, Ref. II A 1 – H 1105/20/10002 :001, Guideline for preparing the 2022 budget and the financial plan up to 2025, No 5 (in German only).

67 Cf. 2020 federal budget account, Overview No 4.6.1 (in German only).

However, the commitment appropriations used do not reflect all pressures on future budgets since commitment appropriations do not have to be entered into for day-to-day operations of the administration.[68] This includes, but is not limited to, all staff-related expenditure of the Federal Government, i.e. total remuneration for employees and pensions for retired civil servants.[69] In the 2021 budget estimates, **staff expenditure and pension claims of former employees of privatised state-owned enterprises** totalled €49.8 billion.

Major commitments relate to **social security payments** of the Federal Government. In the 2021 budget estimates, social security payments account for almost 50 per cent even though the general government budget has been significantly increased and amounted to €572.2 billion due to the pandemic.[70] In addition to the payments to the statutory pension scheme, social security payments include in particular labour market expenditure, contributions to statutory health insurance, benefits for families and basic income support. All this expenditure is earmarked and thus hardly available in the short to medium term at least.

Example statutory pension scheme:

The Federal Government's allocations to the statutory pension scheme alone are budgeted to total €106.2 billion for the financial year 2021. This accounts for 18.5 per cent of the volume of expenditure and is thus the largest item in the federal budget. These allocations will continue to increase in the next years; on the one hand, due to benefit extensions in pension insurance, and on the other hand, due to demographic trends.[71] The allocations commit the budgets not only in the medium but also in the long term since key parameters may need long lead times to be changed.

The legislator's leeway to reduce the spending pressure for subsequent years by changing the statutory eligibility criteria (e.g. extension of the working life, increase in the qualifying period required to be eligible for pension payments, reduced pension amount) is tightly limited under constitutional law. In line with a ruling of the Federal Constitutional Court, accrued pension rights are in principle subject to the protection of property pursuant to

[68] Cf. No 3.1 on Article 16 in connection with No 5 on Article 38 of the Administrative Regulation of the Federal Budget Code (in German only).

[69] Cf. Special purpose report on the findings on trends in federal public finance of 22 October 2019, p. 63 et seq. (in German only).

[70] In the 2021 budget, social security payments were estimated at €284.7 billion. Cf. Federal Performance Commissioner, Analysis on the situation of the Federal Government's financial position, Opinion of 10 November 2021, p. 34, Table 4 (in German only).

[71] Cf. Bundestag printed paper 19/31501 (communication of the Federal Government) of 6 August 2021, federal financial plan from 2021 to 2025, pp. 15, 17. For the time being, benefit extensions in the statutory pension scheme increase the contribution rate – as soon as the sustainability reserve is used. This leads to a higher general federal subsidy in the subsequent year as the subsidy has to be in line with the trend in the contribution rate. Furthermore, a higher contribution rate implies smaller pension increases via the pension adjustment formula. Due to this mechanism, the burden of higher expenditure is allocated to the contributors (at present, this group has the largest burden), the Federation and the pensioners. The Federation can make a greater financial contribution in increasing the federal subsidy discretionarily (see No 7.2). A basic shift of burden-sharing would take place if the contribution rates amounted to 20 per cent.

Article 14 of the German Constitution. The legislator is not prevented from changing the conditions for entitlement to and the amount of the old-age pension. However, such changes are only possible without restrictions for future pensioners who will not reach retirement age until 10 years from the time the changes enter into force.[72] This means that changes in accrued pension rights which would significantly reduce the pressure on public spending might already be limited for the (baby boomer) generation reaching the retirement age up to the beginning of the 2030s.

In principle, it would be possible to relieve the Government of the burden of financing expenditure by the legislator reducing the allocation to the statutory pension scheme. The reduced government grant must be compensated by an increase in the contribution rate and lower pension increases. However, this is against the policy objective of avoiding overburdening contributors and pensioners. In 2018, the legislator implemented the "double backstop" which establishes two key determinants for the financial development of the pension scheme up to 2025 for the time being. For the period beyond 2025, the legislator has explicitly not yet established key determinants.[73] Nevertheless, the new Government seeks to stabilise the contribution rate and the pension level.[74] Depending on the specific details of future backstops, increases in expenditure could exclusively be a burden to the Federal Government in the long term.[75]

The majority of the commitments entered into – in particular due to social security entitlements – is specified in the relevant laws governing the provision of benefits. These commitments do not have to be covered by (additional) commitment appropriations and thus do not have to be disclosed in the budget estimates and in the budget account. If these commitments are also taken into account, the Federal Ministry of Finance states that, when a regular budget is prepared, more than 90 per cent of the spending volume is already earmarked or committed[76] (Figure 4). The Ministry could not provide reliable quantitative information on the exact extent of the budgetary commitments in the medium and long term.

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[72] On the constitutional protection of accrued rights and the constitutional requirements for transitional law, see Bieback, Zeitschrift für Sozialreform (Journal for Social Reform), 46th volume (issue 9, September 2000), pp. 779, 787 (in German only).

[73] Cf. Draft Act on Statutory Pension Insurance Benefit Improvement and Stabilisation, Bundestag printed paper 19/4668 of 1 October 2018, covering note, section B (in German only).

[74] "We will therefore strengthen the statutory pension and secure the minimum pension level of 48 per cent (…) in the long term. In this legislative period, the contribution rate will not rise above 20 per cent. There will be no pension cuts and no increase in the statutory retirement age. In order to safeguard this commitment in a way that is appropriate for the generations, we will enter into a partial capital cover (…) in order to stabilise the pension level and pension contribution rate in the long term." See Coalition Agreement 2021 – 2025 between the Social Democratic Party of Germany (SPD), Alliance 90/The Greens (BÜNDNIS 90/DIE GRÜNEN) and the Free Democrats (FDP), Dare more progress, Alliance for Freedom, Justice and Sustainability, p. 68 et seq.

[75] Cf. Advisory report on the financial development of the statutory pension scheme – here: proposals of the Pension Commission on a "reliable generational contract" addressed to the parliamentary Budget Committee of 18 September 2020, No. 5.3 (in German only).

[76] Our own analyses and calculations confirm this figure.

Figure 4

Substantial degree of budgetary inflexibility

The Ministry states that, when the budget is prepared, 90 per cent of the spending volume in the next federal budget is already earmarked or committed. Only 10 per cent of the funds are non-earmarked.

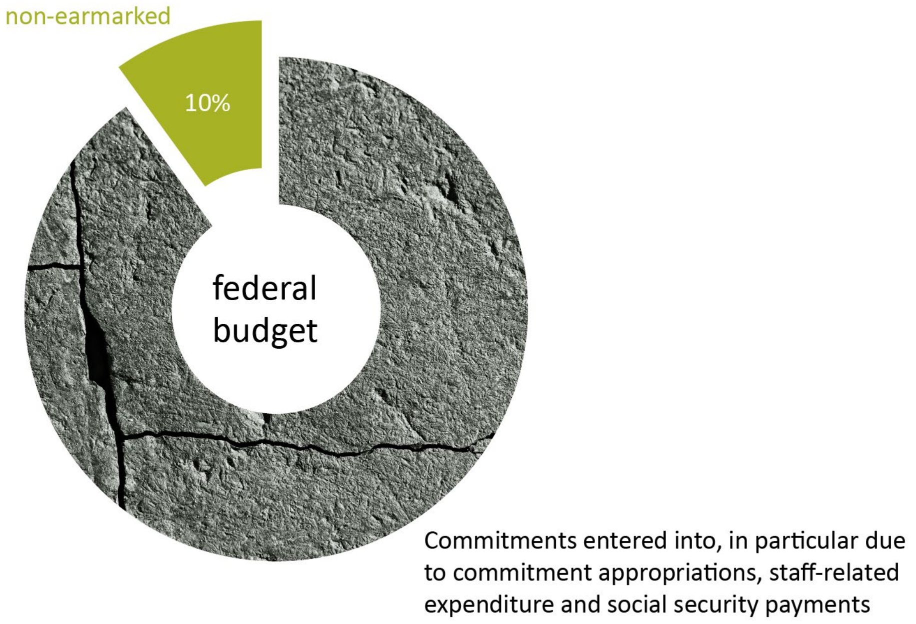

Chart: Bundesrechnungshof.

Source: Federal Ministry of Finance.

5.3 Limited control over the sustainability of the public finances in the budget preparation process

The Ministry states that, in the budget preparation process, it primarily ensures the financial sustainability of the federal budgets in the five-year financial planning period. In addition to complying with the debt rule, the primary objective is to avoid new debts under normal conditions in which there are no natural disasters or other exceptional emergency situations wherever possible.[77] The Ministry continues that this prevents the debt burden from increasing further and also contributes to ensuring sustainable public finances.

[77] Cf. Article 109 para. 3 sentence 1 and Article 115 para. 2 sentence 1 of the German Constitution, according to which the budgets shall, in principle, be balanced without revenue from credits. In cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to the state's financial capacity, these credit limits may be exceeded on the basis of a decision taken by a majority of the Members of the Bundestag. The decision must be combined with an amortisation plan. Repayment of the credits borrowed under the sixth sentence must be accomplished within an appropriate period of time (Article 115 para. 2 sentence 6 et seq. of the Basic Law).

This requires identifying funding requirements as soon as possible. Budget preparation is thus based on macroeconomic prospects and their impact on the federal budget and a projection of the requirements due to legal and actual obligations of the Federal Government in the financial planning period. For determining the benchmarks and preparing the financial plan, the Ministry states that it uses the latest findings on this matter. During the parliamentary procedure, it is common practice that the Ministry suggests changes to the draft budget of the following year when it has new findings by means of the settlement session document. As an alternative or in addition to the document, a supplementary budget pursuant to Article 32 of the Federal Budget Code could also be submitted prior to the completion of the procedure.

The Ministry also states that a funding requirement is taken into account in the draft budget and in financial planning, respectively, in case of compliance with the formal requirements for inclusion in the budget. In particular cases in which due to policy decisions, for example, it must be expected that the Federal Government faces payment obligations, departmental budget No 60 could also generally provide for these obligations. In case of compliance with the formal requirements for inclusion in the budget, however, such across-the-board appropriations are cancelled and the precise amount is included in the respective departmental budget. For example, the financial plan up to 2023 provides for the partial abolition of the solidarity surcharge since the coalition agreement for the 19th legislative period includes such an arrangement.

The Ministry continues that another option to prepare for expected payment obligations which are not yet in compliance with the formal requirements for inclusion in the budget is to create reserves. However, it is not permitted to build fiscal buffers to prepare for unexpected shocks. This would not be in line with the principle of validity. Within the framework of financial management, such events have to be absorbed. In order to cover unexpected funding requirements which occur in the course of the year, the Government could decide to freeze the budget, to make extrabudgetary and excess expenditure and to prepare supplementary budgets, for example. These budgetary control measures are subject to the constitutional limits of the debt rule.

After the outbreak of the COVID-19 pandemic, the German Parliament made use of the exemption laid down in Article 115 para. 2 sentence 6 of the German Constitution. Parliament declared an exceptional emergency situation for the financial years 2020 and 2021.[78] The amount of net borrowing permitted “under normal conditions” according to the debt rule was exceeded by €69.6 billion and €193.9 billion, respectively, in these two financial years.[79] In reference to the continuing exceptional emergency situation, net

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[78] Cf. Decision of the German Bundestag of 25 March 2020 (Bundestag printed paper 19/18108, 19/18131; Bundestag minutes of plenary proceedings 19/154). The decision has been confirmed several times, most recently by the decision of 27 January 2022 (Bundestag printed paper 20/505, Bundestag minutes of plenary proceedings 20/14) (in German only).

[79] Information provided by the Federal Ministry of Finance. €69.6 billion for 2021 result from the retroactive application of the accounting technique of budget balances of off-budget funds adopted with the second supplementary budget 2021.

borrowing is budgeted to again exceed the permitted amount by €115.7 billion in the financial year 2022.[80] Overall, (budgeted) additional net borrowing of the financial years from 2020 to 2022 totals €379.2 billion.

As in the case of the Recovery Fund, additional debts are to be repaid from 2028 to year-end 2058. Higher repayments are possible and reduce the period accordingly.[81] Should the budgeted amount of net borrowing be completely used in the financial year 2022, this would lead to additional pressures on the budget of €12.2 billion annually in the case of scheduled repayments over the period from 2028 to 2058.

6 Interim conclusions

By means of the debt rule, the constitutional legislator established guiding principles required for a sustainable budget and financial policy providing intergenerational equity. Complying with the debt rule is key for the long-term sustainability of the public budgets. The purpose of the debt rule is to prevent future parliaments and governments – and thus also future generations – from losing flexibility in their actions and decisions. In this way, the debt rule protects essential basic conditions of democratic action and decision-making procedures against material erosion and insignificance. Furthermore, the debt rule and complying with the rule send the credible signal to the capital markets that Germany has its general government debt under control. This substantially contributes to enabling Germany to continue to act as an anchor of stability in the euro area. **Maintaining and complying with the debt rule is thus not an end in itself but serves these key objectives – for the Government's ability to act.**

The Ministry has only limited powers to ensure the sustainability of the public finances when preparing individual budget estimates and financial plans. This is primarily due to the fact that the majority of the annual expenditure is already committed at that time. This concerns in particular the payment obligations based on laws governing the provision of (social) benefits which could only be changed by the legislator in the medium to long term. There is room for manoeuvre in less than 10 per cent of the spending volume in the short term. The budgets of the near future thus also lack flexibility.

In spite of a general government budget that has increased for many years and is expected to increase further, the Federal Government has limited **financial leeway** only to be able to cope with future challenges and respond to unexpected trends when implementing the

[80] Cf. Bundestag printed paper 20/1627 (recommendation for a decision of the Budget Committee) of 25 May 2022, p. 13 (in German only).

[81] Cf. Drafting guidance for a decision of the German Bundestag pursuant to Article 115 para. 2 sentence 7 of the German Constitution, Letter of the Federal Ministry of Finance to the head of the Federal Chancellery of 25 April 2022 - II A 1 - H 1120/20/10023 :008 (Cabinet item data sheet No. 20/08027), Annex 10 (in German only).

budget. There are several budget options to close funding gaps in the short term.[82] However, these instruments must also not exceed the upper limits of the debt rule as a matter of principle.

Furthermore, these instruments are mainly based on the funds available. Benefits stipulated by statute or by contract shall remain unaffected. The instruments extend the leeway in the short term only – if at all – and further limit the fiscal space in the medium to long term. In case of doubt, the Ministry would have to rely on precisely those funds which were expected to stimulate growth. Using those funds could in turn have a negative impact on future growth.

The funds may only exceed the limits of the debt rule in the short term in case of natural disasters or exceptional emergency situations. This has already been done in public policy most recently.[83] However, the Government is required to repay the additional borrowing within an appropriate period of time which reduces the funds available in the following years. The degree of budgetary inflexibility would be further increased.

When preparing and implementing the federal budget, the Ministry has instruments in place to respond to future challenges or unexpected events and to balance the budget again in the short term. However, using these instruments always reduces the funds available for other purposes or in future financial years.

In light of the dynamics to be expected in areas with committed or earmarked expenditure, the trend of an increasing degree of budgetary inflexibility is likely to continue. It is already clear that expenditure induced by demographic trends will increase significantly. The results of the Fifth Report on the Sustainability of Public Finances indicate that, even in the best case (T+), the expenditure induced by demographic trends will increase by about 2 per cent of GDP up to 2040.

Federal interest payments are currently at an all-time low level. However, we cannot expect the currently extremely favourable financing conditions for the Government to remain the same in the coming decades. In particular the geopolitical and macroeconomic trends have

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[82] This includes above all **blocks on expenditure** (Section 41 of the Federal Budget Code) and **across-the-board spending cuts**. However, these cuts may only be made up to 1 to 1.5 per cent of the budget volume. In the course of the year, the Federal Ministry of Finance may agree to **excess or extrabudgetary expenditure** pursuant to Article 112 of the German Constitution, Article 37 of the Federal Budget Code and, for example, Article 4 of the 2021 Budget Act. Pursuant to Article 37 para. 3 of the Federal Budget Code, these expenditures should be counterbalanced by savings on other expenditures in the same departmental budget. Thus, these expenditures are likely to further reduce the funds available.
A further possibility is to draw up a **supplementary budget**. This budget, however, would also be subject to the requirements of the debt rule. As a result, the Federal Government might rely on this instrument to a limited extent only, especially if the original budget estimates provide for net borrowing close to the constitutional credit limit pursuant to Article 115 para. 2 of the German Constitution.

[83] Cf. Decisions of the German Bundestag pursuant to Article 115 para. 2 sentences 6 and 7 of the German Constitution (Bundestag printed papers 19/18108 of 24 March 2020, 19/20128 of 17 June 2020, 19/22887 of 28 September 2020, 19/28464 of 14 April 2021, 20/505 of 26 January 2022 and 20/036 of 3 June 2022) (in German only).

implied a change since the beginning of 2022. When the war in Ukraine began, the yields on German government bonds significantly increased. Furthermore, the current high inflation rates in Germany and in the euro area give rise to the assumption that the interest rates will continue to increase. Simulations suggest that an average increase in interest rates by 3 percentage points would lead to increased interest payments of about 1 per cent of GDP up to 2040, even in the case of a constant debt-to-GDP ratio of 45 per cent of GDP which the Federal Government as the largest entity of the general government budget has at year-end 2020.[84] In order to better assess these figures: Total federal government revenue (without new borrowing) is at about 10 per cent of GDP.

Future repayment obligations put further pressure on the federal budget. On the one hand, emergency loans of an expected amount of €379.2 billion from 2020 to 2022 need to be repaid. On the other hand, the Government needs to pay its share to the grants of the Recovery Fund in an amount of more than €100 billion. In the two cases, the debts incurred are envisaged to be repaid from 2028 to 2058.

Figure 5 shows the growing pressures – already evident today – in the coming decades. These pressures are presented in expenditure equivalents of the financial year 2020 by adjusting them for effects of the assumed inflation and economic trends.[85]

Without timely countermeasures,[86] these pressures would lead to an increase in net borrowing which is expected to be in the same amount. Therefore, the Government would have to increase revenue or make spending cuts in other areas to compensate for these pressures.

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[84] Calculations retrieved from Feld/Nöh/Reuter/Yeter, From COVID-19-induced borrowing to re-compliance with the debt rule, perspectives of economic policy 22 (4), pp. 330 et seq. (in German only).

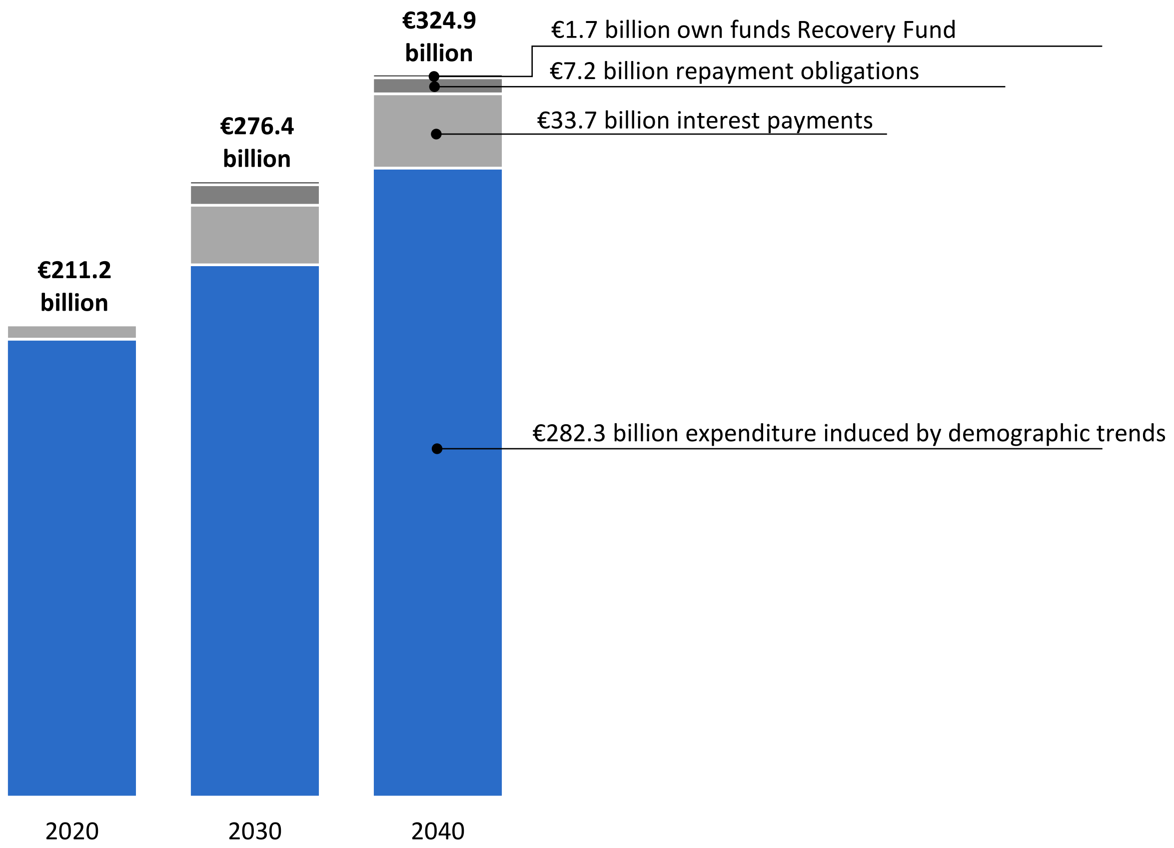
[85] In the sources which we used for our calculations, future pressures are mostly indicated in per cent of GDP of the respective year. For our Figure, we have multiplied the data for 2030 and 2040 by the nominal GDP of 2020. With regard to the **expenditure induced by demographic trends**, an increase of 2 per cent of GDP in the model variant (T+) of the Report on the Sustainability of Public Finances entails an increase in expenditure from €204.8 billion (FY 2020) to €282.3 billion in 2040. It is assumed that the additional expenditure induced by demographic trends put pressure on the federal budget only. In line with this calculation method, federal **interest payments** rise from €6.4 billion (FY 2020) to €33.7 billion in 2040. With regard to the **repayment** of the emergency loans taken up in the financial years from 2020 to 2022, the additional pressure decreases over time due to the inflation and economic trends. As far as the **EU Recovery Fund** is concerned, the Federal Government in addition has to proportionally pay interests for the EU bonds, which the European Commission will issue to finance the grants. These interest rates have not been considered in our calculations, among other reasons because this would have required a lot of additional assumptions.

[86] For example, a reduction of social security benefits or an increase in the contribution rate or tax increases or spending cuts in other areas.

Figure 5

Considerable pressure on future federal budgets

In the coming years, the Federal Government will have to increasingly use public funds to cover expenditure induced by demographic trends, to pay interest rates and to repay debts.



Explanatory note: The pressures on the federal budget in 2030 and 2040 are mostly indicated "in per cent of GPD" in studies. In order to calculate comparative figures for this Figure, the pressures were multiplied by the nominal GDP of 2020. The expenditure induced by demographic trends was taken from the 2020 federal budget account and the Fifth Report on the Sustainability of Public Finances issued by the Federal Ministry of Finance (model variant T+). The scenario for interest payments corresponds to an average increase in interest rates of 3 percentage points and a constant debt-to-GDP ratio for the Federal Government of 45 per cent of GDP. For the nominal GDP, an average annual growth rate of 2.5 per cent is assumed. There may be differences due to rounding.

Chart: Bundesrechnungshof.

Source: Feld et al. (see footnote 84), Fifth Report on the Sustainability of Public Finances issued by the Federal Ministry of Finance, 2020 federal budget account, Federal Statistical Office (DESTATIS) and own calculations.

Further pressures stem from the Bundeswehr (Federal Armed Forces) Special Fund. The Government may borrow up to €100 billion for this purpose. This is associated with further interest rate pressures and repayment burdens on the federal budget. We have not taken these burdens into account since a repayment schedule has not yet been set.[87] We also have not taken into account a possible long-term increase in defence spending in the federal budget in order to provide the resources for the applicable NATO capability targets after the Special Fund has been used.

Owing to the increasing degree of budgetary inflexibility, the risk grows that the Government loses its ability to act and may no longer be able to cope with future challenges or even serious exogenous shocks. Furthermore, this leads to reduced fiscal space for key projects of future parliaments and governments and thus also reduces the options of future generations to meet their own needs. The principle of democracy risks to erode when the pressures on future budgets limit future parliaments' and governments' financial ability to act in such a way that they are *de facto* unable to implement own political projects.

The budget preparation process thus does not provide the basis to ensure the long-term sustainability of the public finances. Especially in its current form – it primarily serves the purpose of allocating the available budget funds to the spending areas and government departments and of setting policy priorities within the limits of the funds available in the respective financial year. In order to ensure long-term sustainable public finances, landmark policy decisions would be required. These decisions could relate to expenditure trends in the pension scheme, for example. However, the individuals involved in preparing the benchmark figures decision do not have the mandate to make such decisions.

7 Long-term proactive management

The annual budget preparation process is not the right instrument to ensure the long-term sustainability of the public budgets. The legislator can much more effectively ensure sustainable public finances in making decisions in the respective policy areas. This especially applies to drafting legislation which may give rise to claims against the public sector in the long term, thus resulting in long-term commitments of the public budgets. **For this reason, it is key that the financial impact of an act be described in a complete and transparent manner prior to any legislative deliberation.**

In particular acts giving rise to **long-term social insurance claims** require the Ministry to engage more in the legislative process. Above all, the Ministry has to ensure that the regulatory impact assessment shows any impact on public budgets in a complete and transparent manner and for an appropriate period of time.

[87] Pursuant to Article 8 para. 2 of the Act on the Establishment of a Bundeswehr Special Fund, the loans taken up by the Special Fund have to be repaid within an appropriate period of time, as from 1 January 2031 at the latest, after full use of borrowing powers (in German only).

7.1 Sound regulatory impact assessments as a basis for sustainable public finances

The annual budget preparation process does not provide the basis to ensure the long-term sustainability of the public finances. The much more effective way is to intervene at a much earlier stage, i.e. when drafting legislation which may give rise to claims against the public sector in the long term, thus resulting in long-term commitments of the public budgets. Against this background, in 2000, the Federal Government committed itself to presenting the long-term financial impact of each act already when drafting it in a **regulatory impact assessment** in a transparent manner.[88]

This also includes the impact on the public budgets. The impact shall be allocated to each applicable five-year financial planning period of the federal budget.[89] According to the Federal Ministry of Finance, this is the rule. The Ministry states that a longer time horizon is chosen in individual cases of legislative proposals in which the significant financial impact does not take effect until a much later time. The statements on the financial impact of the legislative proposals of the government departments with lead responsibility are checked for plausibility and consistency by the respective shadowing divisions of the Ministry.

7.2 Example of a poor regulatory impact assessment: the 2014 retirement income package

By means of the 2014 retirement income package, the legislator extended the eligible child-raising periods for children born before 1992 by 12 months (known as “mother’s pension I”). At the same time, the legislator provided the possibility for people who have paid into the pension scheme for an especially long period of time and limited to individuals born in certain years to retire at the age of 63 with full benefits (known as “retirement at 63”). In addition to that, the package included improvements in the pension on account of reduced earning capacity and in rehabilitation services. The package entered into force on 1 July 2014.[90]

In return for the benefit extensions, the act stipulated the requirement to increase the general federal subsidy beyond the automatic increases by an annual amount of €0.5 billion in four steps as from 2019. As from 2022, the Federal Government pays about €2 billion annually more over the long term. This is to contribute to addressing the demographic trend

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88 Article 43 para. 1 No 5 in connection with Article 44 para. 1 sentence 3 of the Joint Rules of Procedure of the Federal Ministries, Joint Ministerial Gazette 2000, p. 526 (in German only).

89 Article 44 para. 2 of the Joint Rules of Procedure of the Federal Ministries.

90 Act on Improving the Benefits Provided by the Statutory Pension Insurance System of 23 June 2014, Federal Law Gazette part I of 26 June 2014, p. 787 et seq. To gain an overview, see Advisory report on the financial development of the statutory pension scheme – here: limitations and extensions of benefits since 2000 addressed to the parliamentary Budget Committee of 2 September 2020, No. 4.1 et seq. (in German only).

and to funding benefits not covered by contributions including additional benefits for raising children.[91]

In the statement of legislative intent, the Government estimated the following **additional expenditure** in the **statutory pension scheme** caused by the package (Table 2):[92]

Table 2

Estimated additional expenditure in the statutory pension scheme due to the 2014 retirement income package

	2014	2015	2016	2017	2018	2019	2020	2025	2030
	in € billion								
Mother's pension I	3.3	6.7	6.7	6.6	6.6	6.6	6.6	6.5	6.1
Retirement at 63	0.9	1.9	2.2	2.0	1.9	1.8	1.8	2.1	3.1
Other	0.2	0.4	0.5	0.6	0.7	0.9	1.0	1.4	1.8
Total package	4.4	9.0	9.3	9.3	9.3	9.3	9.4	10.0	11.0

Source: Bundestag printed paper 18/909, Reasoning – General part, Section V.2.A., Table 1.

The Government also projected the trends in contribution rates and the pension level before tax up to 2030. The Government expected that the measures would lead to higher contribution rates whilst having lower pension levels compared with the previous legal status.[93] The figures projected for 2030 of 22.0 per cent (contribution rate) and 43.7 per cent (pension level) were just within the limits set. So, the Government was not obliged to initiate any legislative action.[94]

The Government estimated the **impact on the federal budget** for the applicable financial planning period at that time. For the years from 2014 to 2017, the Government expected an increase in federal funds granted to the pension insurance scheme by about €1.4 billion annually.[95] The Government did not explain whether and to what extent the allocations from the federal budget would increase beyond 2017.

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91 Cf. Article 1 No 7 of the Act on Improving the Benefits Provided by the Statutory Pension Insurance System including reasoning (in German only).

92 On top of the additional expenditure shown in the table, the Federal Government expected contribution losses of €0.6 billion for 2030 due to the retirement at 63. Cf. Bundestag printed paper 18/909 (Federal Government Bill) of 25 March 2014, Reasoning – General part, Section V.2.A., p. 16 et seq. (in German only).

93 Cf. Bundestag printed paper 18/909, Reasoning – General part, Section V.2.A., p. 17 (in German only).

94 Pursuant to Article 154 para. 3 of the Social Code, the Federal Government has to propose adequate measures to the legislative bodies if the contribution rate exceeds 22 per cent by 2030 in the medium variant of the projections of the pension insurance report or if the pension level falls below 43 per cent by 2030 (only in German).

95 Cf. Bundestag printed paper 18/909, Reasoning – General part, Section V.II.B., Table 3 (in German only).

7.3 Fully reflect the regulatory impact in the long term

We hold that the regulatory impact assessment in our example was not adequate, by its very nature, to make the long-term impact for the public budgets transparent.

On the one hand, the **time horizon** for the regulatory impact assessment – in particular with a view to the sometimes very long-term financial impact – is **too short**. The impact of the reform on the statutory pension scheme reaches far beyond 2030. The youngest mothers who gave birth before 1992 will retire in the mid-2030s. As from this time, the Federal Government expects the additional expenditure for "mother's pension I" to decrease since there will be no more new beneficiaries.[96] Nevertheless, we have to assume that these age cohorts will receive a pension for more than 20 years on average. The average pension period of women recently stood at more than 21 years after consistent increases.[97] We therefore expect mother's pension I to have an impact up to the 2050s.

As to the "retirement at 63", the regulatory impact assessment shows an increase in expenditure at the end of the period under review. The transitional arrangement of old-age pension for people who have paid into the pension scheme for an especially long period of time favours the birth cohorts from 1950 to 1963, although the benefits are gradually reduced as from the birth year 1953.[98] The last beneficiaries might benefit from this special arrangement in 2028. Thus, the impact will last up to the 2050s also in this case.

In addition to that, the "baby boomer effect" will be far from showing its full impact on the statutory pension scheme by 2030 (No 4.2). An impact assessment limited to the period up to 2030 thus does not take into account all pressures arising from extending the benefits. The assessment obscures the associated increasing need for Parliament and Government to take further action with regard to the pension level and the contribution rate.

Furthermore, there could be no doubt that the 2014 retirement income package would put pressure on the federal budget far beyond 2017. The increases in the general federal subsidy induced by the reform are not only automatically updated.[99] As from 2019, there are also gradual increases in the federal subsidy that sum up to a permanent base amount of €2 billion up to 2022. The Federal Government did not make the impact of the burden

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96 Cf. Bundestag printed paper 18/9513 (reply of the Federal Government) of 2 September 2016, reply to question 3b) (in German only).

97 Cf. German Pension Insurance, 2020 pension atlas, p. 18 (in German only).

98 Cf. Bundestag printed paper 18/909, Article 1 No. 8 (on Article 236b Social Code Book VI). Pursuant to this Article, the retirement age for unreduced pension benefits will rise again in steps of two months starting with people born in 1953 until the retirement age of 65 years (which has been valid since 2012) will apply for the long-term insured people born in 1964 (in German only).

99 Pursuant to Article 213 para. 2 of the Social Code Book VI, the general federal subsidy changes in the same proportion as the average gross pay of the year before the last year to last year and – if the contribution rate changes – additionally in relation of the contribution rate in the reference year to that of the year before.

transparent by just describing the impact on the federal budget with regard to the applicable financial plan at that time and by not updating it in 2017.

In light of the long-term impact of the 2014 retirement income package up to the 2050s, the Government should have presented the trends in the relevant parameters – additional expenditure of the statutory pension scheme, contribution rate, pension level and federal subsidy – in the regulatory impact assessment beyond this time horizon.[100]

In addition to that, the Government made an isolated representation of the additional expenditure in the different sectors – without a transparent reference to the situation of the public budget in the financial year concerned. This is not appropriate for managing sustainable public finances. The cumulative burdens and possible interdependencies are thus not clear. In fact, the financial impact in the individual sectors has to be embedded in an integrated projection of the general government budget. This is the only way the legislator is able to understand a legislative proposal's long-term impact on the Sustainable Development Goals – based on the key indicators.

This report provides an example of such a calculation for the 2014 retirement income package. The calculation is based on the projections for the Fourth Report on the Sustainability of Public Finances.[101] For the best-case base scenario T+, a hypothetical alternative option without the retirement income package is modelled and that way the impact of this measure on the budget balance is isolated mathematically (Figure 6).[102]

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[100] See, for example, the reform proposals in our advisory report on demographic trends: financial risks for the federal budget as a result of public shareholding in social security funding addressed to the parliamentary Budget Committee, to the parliamentary Committee on Labour and Social Affairs and to the parliamentary Committee on Health of 23 May 2022 (in German only) and the table in Werding/Läpple, Financial risks for the federal budget through the impact of demographic ageing on social insurance systems, FiFo Reports, No 31, 2021, Table A.2 (in German only).

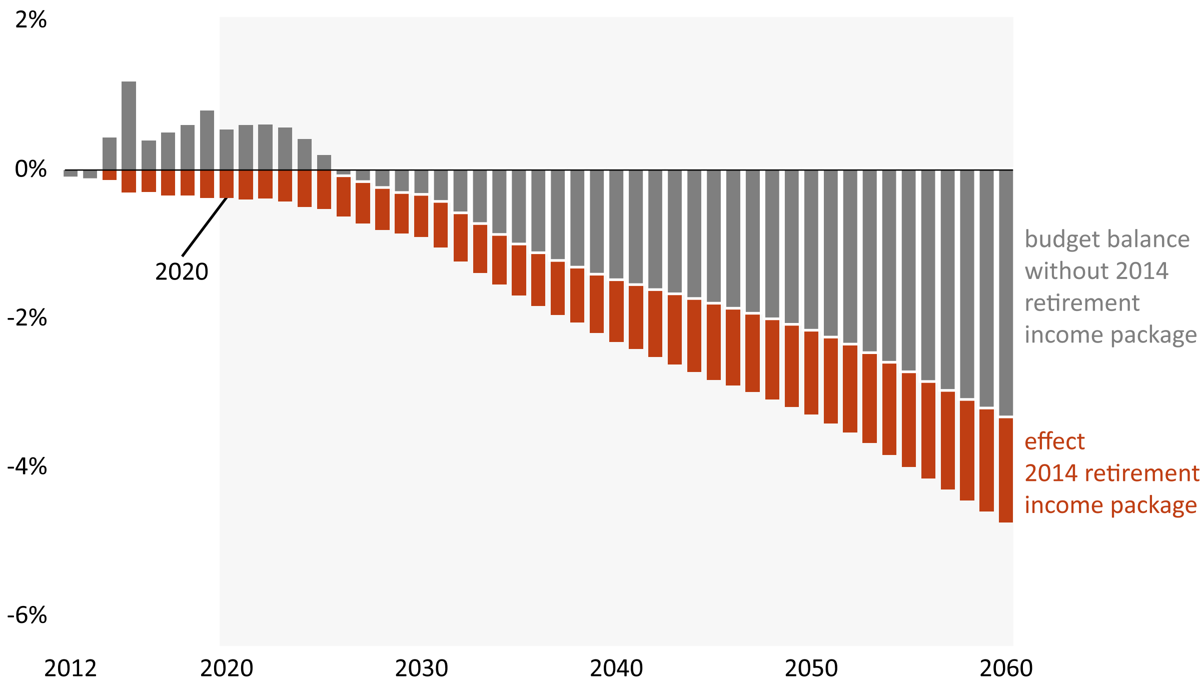
[101] Cf. Federal Ministry of Finance, Fourth Report on the Sustainability of Public Finances, February 2016. 2014 is the base year of the Fourth Report on the Sustainability of Public Finances. This report has been chosen as a benchmark for the calculation so that it is possible to fully reflect the impact of the "2014 retirement income package".

[102] Explanatory note: The projection is based on the assumption that the general government revenue ratio remains constant over time. As a consequence, higher contribution revenue due to increases in the contribution rates in the statutory pension scheme, which results automatically by statute from the increases in expenditure due to the pension reform, is not taken into account. Hence, the deterioration of the general government budget balance in Figure 6 is overstated without changing the basic statement of the projection. The assumption of a constant general government revenue ratio is not mandatory for the calculation and can be dropped in future projections.

Figure 6

2014 retirement income package will put pressure on the public finances in the long term

The best-case scenario of the Fourth Report on the Sustainability of Public Finances has already indicated that the pressures arising from the 2014 retirement income package will result in a further deterioration of the general government budget balance in the coming decades. The already clear negative trend will be further increased.



Explanatory note: The Fourth Report on the Sustainability of Public Finances completely relies on actual data up to 2013. The calculations up to 2019 are based on key data of the (at that time) current medium-term projection of the Federal Government. Model calculations commence in 2020 (grey area). The budget balances are calculated based on the assumption that the general government revenue ratio remains constant over time. As a result, expenditure on the 2014 retirement income package leads to higher public debt.

Chart: Bundesrechnungshof.

Source: Martin Werding, Ruhr University Bochum, model calculation in the variant T+ taken from the Fourth Report on the Sustainability of Public Finances issued by the Federal Ministry of Finance.

The *grey bars* show the hypothetical budget balance in the best-case base scenario T+ without the 2014 retirement income package. The *red bars* show the impact of the reform in per cent of GDP: The 2014 retirement income package leads to additional pressures and increases the already clear negative trend in the general government budget balance. This isolated effect of the reform increases steadily over time and far beyond 2030. This very clearly illustrates that the time horizon in the regulatory impact assessment was far too short.

Against this background, it should be noted that, in principle, a regulatory impact assessment should cover the period for which key impacts are expected. Furthermore, the assessment should be extended to include an integrated overview in the case of long-term projects of vital importance for the public budgets. In order to do so, the assessment might, for example, rely on the indicators “budget balance” or “primary balance” – each in per cent of GDP. Such an overview directly links to the goals of the Sustainable Development Strategy. When the figures are shown in relative terms, the financial impact of a measure is also adjusted by the effect on pricing. We hold that such an analysis is appropriate to make the impact of a legislative proposal on the sustainability of the public finances transparent. This analysis thus provides a more reliable basis for decision-making.

8 Conclusions

By means of the debt rule, the constitutional legislator established guiding principles required for a sustainable budget and financial policy providing intergenerational equity. Complying with the debt rule is key to the long-term sustainability of the public budgets. The purpose of the debt rule is to prevent future parliaments and governments – and thus also future generations – from losing flexibility in their actions and decisions. In this way, the debt rule protects key basic conditions of democratic action and decision-making procedures against material erosion and insignificance. Furthermore, the debt rule and complying with the rule send the credible signal to the capital markets that Germany has its general government debt under control. This substantially contributes to enabling Germany to continue to act as an anchor of stability in the euro area. **Maintaining and complying with the debt rule is thus not an end in itself but serves these key objectives – for the Government’s ability to act.**

Owing to the COVID-19 pandemic, the impact of the war in Ukraine and the changed security situation in Europe, the public budgets have come under considerable pressure. The COVID-19 pandemic painfully revealed structural financial challenges which had already been in place before. There is considerably less financial leeway to absorb unexpected events. In the coming decades, expenditure induced by demographic trends will increase considerably and thus will become an increasing challenge for the sustainability of the public finances. The budgets may come under further pressure in the event of (further) exogenous shocks or risks associated with contingent liabilities which the Federal Government has assumed.

The federal public budgets of the near future are largely “petrified”, i.e. they lack flexibility, owing to commitments entered into. The Ministry is capable of balancing the budget in the short term, e.g. to deal with unexpected events. However, this results in an even lower amount of funds available.

It would thus be an important step to create and maintain fiscal space to avoid the erosion of future parliaments’ and governments’ ability to act. In contrast to the period after the financial and economic crisis, it may be appropriate not to use increasing tax revenue to expand consumption expenditure. Instead, any additional funds should be used to increase investment expenditure, to fund structural reforms of the social security systems and to thus make Germany more robust to crises.

The annual budget preparation process does not provide the basis to ensure the long-term sustainability of the public finances. The much more effective way in terms of sustainable public finances is to intervene at a much earlier stage, i.e. when considerable funds of future budgets are committed because of policy decisions – e.g. in a legislative process. In this case, the Federal Government has to create transparency on the long-term impact of a legislative proposal and embed the impact in the context of the general government budget. Therefore, we recommend that an **integrated long-term projection** be **added** to the **regulatory impact assessment** in legislative proposals whose financial impact

- reaches far beyond the financial planning period; and
- is of vital importance for the public budget.

This is particularly true for – but not limited to – legislative proposals in the area of social legislation that give rise to or extend long-term social security entitlements.

Furthermore, the annual budget preparation process has to provide more clarity about commitments and their impact on future budgets. Transparent information is key to being able to take proactive measures against further inflexibility. Therefore, we recommend that the Government, **in the annual budget preparation process**, **always** be provided with

- a complete overview showing which funds are committed, earmarked or uncommitted and the respective time horizon;
- a long-term projection of the federal budget’s key spending areas provided that the policy laid down in the financial plan is continued; and
- clear information about how the general government budget develops in the long term and the associated need for consolidation to be able to consistently comply with the targets for sustainable public finances. In order to do so, a time horizon of at least 40 years should be envisaged. The projection of the long-term trends could be based on the methods of the Report on the Sustainability of Public Finances.

We expect it to become transparent how legislative decisions have a financial and social impact across generations. Parliament and government could then focus their deliberations and decide on how to reconcile the impacts to deliver sustainable social benefits which provide intergenerational equity and to maintain the Government’s ability to act and confidence in the soundness of the public finances.

9 Comments made by the Federal Ministry of Finance

The Federal Ministry of Finance commented that the Ministry also considered the **constitutional debt rule** to provide an appropriate framework for a sound and growth-oriented fiscal policy. The Ministry intended to again comply with the upper limit for new debts as from 2023.

The Ministry stated that the **top-down process used to prepare the federal budget** had been complemented by **spending reviews** since 2015. Spending reviews were used to analyse whether selected measures, policy areas or horizontal tasks of the public sector achieved their objectives (effectiveness) and whether this took place efficiently (efficiency). The conduct of spending reviews gave the budget preparation process sharper substantive focus and enhanced the outcome-orientation of the deployed budget funds. The spending reviews improved the structure of the federal budget and could provide the basis for repriorisation or created new fiscal space.

The Ministry continued that the **overview of committed, earmarked and uncommitted funds** recommended by us only had limited informative value. The term “uncommitted” funds already was hard to define. In addition to statutory or legal obligations, the evaluation of departmental policy assessments and areas of focus as specified in the coalition agreement was subject to conditions.

Apart from that, the Ministry stated that the overview of commitment appropriations attached to each departmental budget provided a good basis of information about financial commitments for expenditure not stipulated by law over the entire time horizon. Furthermore, within the framework of the annual budget preparation process, the Ministry updated the financial plan in coordination with the government departments. The financial plan showed the revenue projection and the expenditure trends according to individual subject matters broken down by areas of responsibility for the three subsequent years.

The Ministry considers an additional **projection of the trends in the public budget** to be unnecessary. The Report on the Sustainability of Public Finances served as a key data basis for long-term management. The Report covered various subjects based on scientific knowledge and on broad data and also took into account the interest rate environment, for example. The Report might also serve as a basis for relevant legislative decisions or for the budget legislator. An additional projection of the general government budget would necessarily have less informative value and thus could not provide any additional insights that are key to decision-making.

The Federal Ministry of Labour and Social Affairs responded to our concerns about the **regulatory impact assessment of the 2014 rental income package** by stating that the assessment had been carried out pursuant to Section 44 of the Joint Rules of Procedure of the Federal Ministries (Joint Rules) and had been approved pursuant to Section 45 of the Joint Rules. With a view to presenting “actual long-term” pressures, the Federal Ministry of Labour and Social Affairs pointed out that the results of particularly long-term projections were subject to a very high level of uncertainty owing to the long time horizon and largely depended on the underlying assumptions.

As to our recommendation to add an **integrated long-term projection** to the regulatory impact assessment in the case of acts having long-term financial impacts, the Federal Ministry of Finance states that, pursuant to Section 44 (1) of the Joint Rules, the Ministry already has to show whether the legislative proposal’s impacts are in line with sustainable development, and especially what the long-term impacts are. The Ministry is required to present the specific financial impacts pursuant to Section 44 (2) of the Joint Rules for the financial planning period.

The Ministry continued that the methods used in the Report on the Sustainability of Public Finances took into account a range of possible trends in the calculations made and thus also accounted for the uncertainty in the case of long-term projections. Needs for action which arose from the different assumptions made could be deduced from such model calculations. The Report on the Sustainability of Public Finances thus provided a basis for relevant legislative decisions. However, such calculations should not be understood as projections or as part of a regulatory impact assessment since the results largely depended on the assumptions made.

This was in particular also true for the assessment of the long-term financial regulatory impact in a projection of the general government budget, e.g. by relying on the budget balance in per cent of GDP, as recommended by us. In that case, assumptions on all policy areas relevant to the budget would be added which would further increase the range of possible trends.

In order to address the uncertainty, it would be best to present the range of possible trends according to different assumptions. Such an approach was, in principle, not appropriate for a regulatory impact assessment. In particular in the case of long-term measures which are key to fiscal policy, this approach did not exclude to explore additional sources of information in individual cases. The Ministry stated that it could also carry out a long-term projection after having given due consideration to costs and benefits. The added value, however, depended on the specific legislative process and could not be taken for granted.

10 Final conclusions

We acknowledge that the Ministry also considers the constitutional debt rule to provide an appropriate framework for a sound and growth-oriented fiscal policy. However, any further statements of the Ministry are not convincing.

The **spending reviews** addressed by the Ministry are aimed at effectively and efficiently implementing selected measures, policy areas or administrative responsibilities. They can thus contribute to strengthening governance in selected areas and to expanding the fiscal space in individual departmental budgets in the short to medium term. Since the benefits provided by the Government are not up for discussion, it seems questionable, however, whether this may lead to a release of a significant volume of funds in the long term. In any case, spending reviews do not contribute to increased transparency of commitments entered into and their impact on future budgets.

The Ministry did not provide a convincing justification for stating that an **overview of committed, earmarked and uncommitted funds** only had limited informative value. We explicitly do not agree with the objection that such an overview already failed due to the definition of “uncommitted funds”. While it is true that, in addition to the statutory and contractual obligations which can be clearly defined, there is a certain volume of funds for which the assessment of the availability may depend on political priorities, the Ministry – in coordination with the budget legislator – is responsible for finding a clear definition to specify whether and to what extent priority policy measures which are ultimately discretionary contribute to the inflexibility.

As a matter of fact, other governments, e.g. the United States of America, already have such overviews of committed and uncommitted public spending. The United States of America already distinguish between mandatory and discretionary outlays and present the resulting consequences in detailed budget reports.[103] Mandatory outlays include, but are not limited to, Social Security and Medicare.

In any case, the standard sources of information referred to by the Ministry that are used in the budget preparation process are not really appropriate to create transparency on the commitments entered into and their impact on the budgets of the near future. Overviews of commitment appropriations are not complete since they do not cover statutory obligations to pay benefits – as the Ministry itself admits. However, they account for the majority of the commitments entered into. The financial plan, on the other hand, reflects the projection of the trends in revenue and expenditure for the three subsequent years. The financial plan does not show what funds are or can be made available to be able to implement new projects and to respond to unexpected events.

Ultimately, none of the instruments referred to in the comments made by the Ministry creates the transparency required to be able to take deliberate and active measures against an increasing degree of budgetary inflexibility. Therefore, we reiterate our recommendation that the Ministry inform in the budget preparation process to what extent funds are already earmarked or committed in the budgets of the near future. Based on such an overview of the degree of budgetary inflexibility, needs for action can be identified and informed decisions on areas of focus or on the (new) focus of measures and programmes can be made. We hold that debates might be needed to appropriately define spending categories. In any case, however, the benefit of gaining knowledge is expected to outweigh the costs, particularly as other countries – in which the challenge to distinguish between spending categories is expected to be similar – have already used this approach.

As to the **long-term management of the sustainability** of the public finances, we also consider the Report on the Sustainability of Public Finances to be an important source of information to show the long-term dynamics of expenditure induced by demographic trends to the budget legislator. However, the Report is only prepared every four years. As a result, current trends are not shown until a later point in time. After key events which significantly change the parameters or assumptions of the projection, the informational benefit of the quantitative key performance indicators of the Report on the Sustainability of Public Finances decreases considerably. In addition to exogenous shocks involving a strong increase

[103] Cf. Congressional Budget Office, The Budget and Economic Outlook: 2022 to 2032, May 2022.

in the debt level, also an interest rate turnaround or reforms of social security systems could qualify as such events.

Therefore, we reiterate our demand that the Federal Government regularly inform the budget legislator about how **the public budget as a whole will develop in the long term**. To do so, it would be best to regularly update the projections of the Report on the Sustainability of Public Finances. At least after disruptive events which change the bases of the projection, however, we consider such an update to be required. This update would enable the budget legislator to identify a possible need for consolidation when preparing the federal budget and the financial plan. Consolidation might be needed to ensure the sustainability of the public finances.

We do not deny that estimating the **financial consequences of legislative proposals** which have an impact for decades in the future is subject to high uncertainty. However, uncertainty does not provide a justification for ignoring and disregarding the financial impact. This would mean to lose the power of ensuring long-term sustainable public finances. The Federal Government is free to select another form of presenting the long-term financial impact if the Government considers another form to be more appropriate than the methods chosen in Figure 6. The Government is also free to show different scenarios to account for the possible range of future trends.

Apart from that, the point that statements relating to the future were subject to high uncertainty is qualified by the fact that the focus is placed on the isolated effect when a specific assumption is changed, i.e. the respective legislative proposal (red bar in Figure 6). Since the other assumptions, e.g. interest rate trends or demographic trends, remain the same, the financial consequences of the legislative proposal are subject to less uncertainty than the long-term projection of the aggregated values such as budget balance or debt level.

Furthermore, we do not consider it to be appropriate to limit the description of the financial impact for the federal budget to the financial planning period by referring to Section 44 (2) of the Joint Rules. Especially in the case of proposals in the area of social legislation having such a serious impact on the long-term sustainability of the public finances, such a short projection horizon is obviously too short.

We do not deny that a long-term projection of the financial impact increases the effort compared with the traditional method of carrying out a regulatory impact assessment. We do not recommend that a long-term projection be the standard instrument for regulatory impact assessments. We do not doubt that the additional information gained justifies the effort in the case of legislative proposals which may have financial implications amounting to billions for decades to come. Furthermore, the Federal Government can rely on enough expertise and established calculation methods especially in the area of social legislation. The Government has already used them for the pension insurance report and the Report on the Sustainability of Public Finances.

We hold that the Government's vague promise to explore additional sources of information in individual cases especially in the case of long-term measures which are key to fiscal policy is not enough. The Government must not be in a position to decide whether or not it provides the legislator with **relevant information for decision-making**. Therefore, we reiterate our recommendation that **a long-term projection be added** to the **regulatory impact assessment** in the case of legislative proposals which have financial implications far beyond the financial planning period and which are of vital importance for the public budget.