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Financing government tasks: Challenges and recommendations for a sustainable fiscal policy

*Scientific Advisory Board at the
Federal Ministry for Economic Affairs and Climate Action*

bmwk.de

At several meetings, most recently on 13 October 2023, the Scientific Advisory Board at the Federal Ministry for Economic Affairs and Climate Action dealt with the topic of

Financing government tasks: Challenges and recommendations for a sustainable fiscal policy

and arrived at the following statement

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I. Occasion

Fiscal policy in Germany is facing major structural challenges: the population is ageing, the digital and ecological transformation must be promoted and defense and foreign policy must be realigned. Public infrastructure must become efficient again and be further expanded. Decisions on priorities and how to finance them need to be taken.

These tasks have taken a back seat during the crises of recent years because households and companies had to be relieved and the negative distributional effects of the crises had to be mitigated. This was accompanied by massive borrowing, amounting to around €460 billion in the federal budget alone in the years 2020–22. This borrowing was possible because the capital market was prepared to finance this debt thanks to a good fiscal starting position before the crisis, on top of what the European Central Bank was already doing so through the Pandemic Emergency Purchase Program. In addition, the emergency clause of the debt brake came into effect, which allowed a temporary increase in debt. Since this year, however, the upper limit for net borrowing by the federal government of 0.35 percent of GDP, which the Bundestag had enshrined in the Basic Law („Grundgesetz") in 2009 for reasons of sustainable state finances, is once again binding. This necessitates adjustments to taxes and/or expenditure, partly because the economic conditions (e.g. lower GDP growth, higher interest rates) have changed compared to the time before the crises.

Fiscal policy has become less transparent: Expenditure was outsourced to extra budgets and expenditure in subsequent years could be financed quietly from reserves financed by loans taken out in previous years. However, this is only a temporary option, as the reserves will soon be exhausted and the loans taken out for this purpose must be repaid within a reasonable period of time in accordance with Article 115(2) of the Basic Law. This is another reason why fiscal policy must return to a normal mode.

In this report, the Scientific Advisory Board develops principles for a sustainable fiscal policy and makes proposals for a reform of German and European fiscal rules that simultaneously strengthen incentives for public investment. The Advisory Board sees a sustainable and prioritized fiscal policy as a central building block for successfully overcoming structural challenges.

Section II of this report discusses the economic principles of tax and debt financing of government spending and the political economy reasons for limiting government borrowing through fiscal rules. From an economic point of view, recurring permanent state tasks should be financed sustainably through taxes and not through debt. This creates leeway to react flexibly to future shocks, similar to the response to the coronavirus, by taking on debt and smoothing the additional burdens of these shocks over time. So-called special funds („Sondervermögen"), i.e. special debt funds to finance specific tasks, on the other hand, only make sense as an exception and for clearly defined objectives that are less controversial in terms of distribution policy.

Debt rules are a fundamentally sensible self-binding instrument, because in the political process there is always the temptation to shift the burden of financing to third parties through debt.

Section III of this report addresses existing disincentives under the German debt brake and presents proposals for reform. The debt brake can be seen in part as a response to the imperfections of the previous rule of the Basic Law, which was characterized by vague exceptions and only focused on budget planning, but not on implementation. As expected, the debt brake counteracts these weaknesses.

However, the debt brake does not eliminate the incentive to favor government consumption and transfer spending at the expense of government

investment. This problem can be solved in various ways. The Scientific Advisory Board makes two proposals: firstly, the establishment of investment promotion agencies (Wissenschaftlicher Beirat, 2020). Secondly, a "Golden Rule Plus" fiscal rule, under which debt-financed net investments are permitted, but an independent body checks whether an expenditure that the government classifies as an investment is recognized as such.

National fiscal rules in the EU are bound, at least in principle, by the Stability and Growth Pact (SGP). However, the SGP is criticized in various aspects and from various sides, e.g. due to their lack of enforcement in practice. The European Commission (2023 a,b) recently presented a reform proposal. Some elements of the proposal could be advisable in an ideal world, for example the focus on a multi-year (instead of annual) budget based on a debt sustainability analysis. However, the Council is concerned that, as in the past, the additional leeway this would give the European Commission would come at the expense of enforcing the rules. Greater involvement of the national fiscal councils and the European Fiscal Board, as well as the definition of clear numerical rules, could counteract this.

Section IV analyzes current fiscal policy issues, including the use of special funds and options for tax and spending policy. The federal government has created numerous special funds in recent years. As a result, the federal government's core budget does not adequately reflect its fiscal policy and core tasks are outsourced from the core budget. In addition, borrowing and the creation of reserves during the debt brake's emergency clause are used to finance expenditure in subsequent years, thereby de facto undermining the debt brake. This practice is not sustainable.

The transformation to a climate-neutral economy, the long-term safeguarding of defense capabilities and the management of demographic change are enormously costly government tasks that will arise at a time when pension and social spending will also rise sharply. Financing all these tasks solely through (additional) taxes and contributions threatens to overburden the economic actors in view of the level of expenditure involved. Taking this limitation into account, the political bodies legitimized by elections must decide where the fiscal policy priorities should be set. However, setting priorities is unavoidable.

In the final section, the Scientific Advisory Board presents its conclusions and recommendations.

II. The role of debt and taxes in financing government tasks

There is a consensus that productive government spending to improve infrastructure and defense capabilities is necessary in Germany today. There are basically four different ways of balancing the budget:

1. Reduced spending on other goods and services that the state purchases or provides itself.
2. Reduction of transfers and subsidies.
3. Increase in taxes
4. Debt.

Which of these options is preferable is an eminently political decision for parliaments. The decision also depends on a number of factors that have been discussed in the academic literature on macroeconomics and political economy. The principles of sustainable fiscal policy can be summarized as follows (for a more detailed presentation, including various references, see Box 1 – Macroeconomic foundations, and Box 2 – Political economy):

1. In order to minimize the excess burden of taxes over time, tax rates should be as stable as possible over time. It follows that a temporary need for additional expenditure should not be financed by temporary tax increases, but that the tax burden should be spread over time by means of debt. Conversely, permanent additional expenditure that is not offset elsewhere generally requires a congruent tax increase.
2. Debt financing does not result in an additional financial burden for citizens in the future if the debt service is financed in the future by a reduction in other government expenditure, i.e. there is not really an increased need for expenditure, but merely a shift in expenditures over time. In this case, it makes sense to consider the economic environment so as not to create additional difficulties for the central bank in ensuring price stability.
3. Compared to tax financing/transfer cuts, debt financing of temporary additional expenditure leads to an increase in overall economic demand if tax financing/transfer cuts would primarily burden poorer or illiquid households.
4. In the political process, taking on debt is a way of shifting financing to citizens who are not yet eligible to vote or have not yet been born. Debt rules are a means of avoiding this form of policy failure.[1]
5. Debt rules should be designed in such a way that they provide exceptions for extraordinary situations and prevent public investment from being neglected as a residual variable of government spending in favor of government consumption spending. Debt financing of public investments can be justified by the fact that the benefits will accrue to future generations, who should therefore participate in the financing.

1 For a detailed discussion, see the report Wissenschaftlicher Beirat (2020).

Box 1 – Macroeconomic fundamentals

Debt financing usually means that higher taxes will have to be levied or expenditure reduced in the future. In this respect, the question of tax or debt financing for a given current volume of government spending is first and foremost a question of the distribution of taxes and/or spending cuts over time in the future. Ideally, taxes should be distributed over time in such a way that their total excess burden is minimized, and a short-term overburdening of taxpayers is avoided. The excess burden refers to the efficiency losses associated with the avoidance behavior of taxpayers. A good public debt policy therefore ensures that effective tax rates remain stable and that temporary fluctuations in government spending or the tax base are minimized (Barro, 1979, Aiyagari et al., 2002).

A long-term increase in specific expenditure requirements, e.g. due to demographic changes, changes in geopolitical conditions or long-term technological trends, should be financed through taxes and not through debt. This is certainly true if government debt is to be stable in its real value (cf. Lucas and Stokey, 1983, Schmitt-Grohé and Uribe, 2004). Consequently, the question of the maturity of a change in expenditure and tasks is central to the assessment of whether debt financing is appropriate. Apart from political economy issues, this basic principle of public debt financing can be broken at two points.

Firstly, the savings motives of private households can be so pronounced that the equilibrium real interest rate for risk-free liquid assets is permanently below the real growth rate of the economy. This may be the case if households want to hedge strongly against ageing risks (Diamond, 1965) or income risks (Bewley, 1977, Imrohoroglu, 1989, Hugget, 1993, Aiyagari, 1994) by saving. In such a situation of so-called dynamic inefficiency, additional government debt does not necessarily lead to higher tax rates in the future. In such a situation, a permanently higher level of government debt in relation to domestic product can possibly reduce the government's remaining financing requirements. However, positive growth rate-interest rate differentials are only necessary for this, not sufficient. This is because the interest rates that the government has to offer for its debt increase with the level of government debt (Mian et al., 2022, Reis, 2022, Bayer et al. 2023a).

The second factor that can break through the perspective of intertemporal tax smoothing described above is the possible cyclical effect of government deficits. The traditional Keynesian view on this is that deficits have a positive effect on demand. If additional economic stimulation is desired, deficits are therefore expedient. However, whether a stimulus is necessary depends on whether the economy is in a recession and, if so, what type of recession it is. If weak demand is responsible for the recession (Keynesian underemployment) and monetary policy alone is not enough, stimulus makes sense. In a supply recession with stagflationary elements or even in a balanced economic situation, on the other hand, demand stimulation does not make sense because it would have an inflationary effect, or at least be less desirable (Barro and Grossman 1971, Sinn 1980, Acharya et al., 2023).

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The Keynesian view has no longer been generally shared since the 1980s, due to the work of Barro (1974) and Kydland and Prescott (1982). To understand the critics' argument, it is useful to understand the difference between debt financing and tax financing as a debt-financed transfer to those households that would have to pay the increased taxes without the debt financing. The transfer is equal to the tax increase that would otherwise be owed. Debt financing separates the time of expenditure and the time of financing. If the households spared the immediate tax liability in this way expect to pay the same amount of tax in the future, the debt financing does not change their net wealth position. Accordingly, the aggregate multiplier of a debt-financed transfer is typically zero (see also Christiano et al., 2005, Smets and Wouters, 2007, Ramey, 2019).

However, macroeconomic research in recent years has emphasized the function of government debt as an additional source of wealth in imperfect capital markets or for a situation in which households do not understand the intertemporal shift in taxation. This means that government debt itself can have a demand and thus an economic effect. However, the "for what" of a deficit remains decisive for the demand effect (McKay and Reis, 2016), i.e. who is spared from the direct financing of government spending. Accordingly, in the case of financing through tax increases or transfer cuts, the economic effect is also determined by which households the state levies financing contributions on. If debt financing spares households with a high propensity to spend (Campbell and Mankiw, 1989) or avoids cuts in social security systems (Bayer et al. 2023b, Hagedorn et al., 2019), debt financing has a stimulating effect. Debt financing that avoids taxes whose debtors would be wealthy households, such as deferring higher top taxes, has no significant aggregate demand effect.

Box 2 – Political causes of excessive government debt

Taking on higher debt often alleviates the struggle for political compromise because the ones who suffer are future generations who inherit a higher tax burden and whose weight in political decisions is lower as they are not yet eligible to vote. Other mechanisms have been examined in the literature on the political economy of public debt: Debts of individual countries – within a federal state or even within a confederation of states such as the EU – can burden other countries or states, for example, if in a monetary union the heavy indebtedness of one state results in a “bailout” by other states in order to avert the danger of a currency crisis. In political competition, there may also be an incentive to take on debt, in order to limit the political opponent’s future room for maneuver, see Persson and Svensson (1989), Alesina and Tabellini (1990) or Persson and Tabellini (2004). Empirically, this effect is particularly evident when there is a high probability that the incumbent government will lose the next election.

If the political compromise is repeatedly achieved by incurring debt at the expense of future generations, the result is a level of national debt that is too high and burdens everyone. Debt rules should serve to avoid this form of policy failure.

One possible cause of excessive public debt – and also of overdeveloped pay-as-you-go pension systems, which represent an implicit public debt – is the ageing society (see Jackson and Yariv (2015), Yared (2019) and Sinn and Übelmesser (2002)). The political preferences of older people are thus given greater weight in the political process. In an ageing society, the costs of explicit or implicit public debt for future generations carry less political weight, and the willingness to take on debt increases (Cukierman and Meltzer 1989 and Tabellini 1991). Empirically, this explanation is plausible insofar as the past decades have been associated with both higher government debt and an ageing society.

In the literature, the tendency towards excessive debt is attributed to the problem of a lack of self-commitment in the political process, see Kydland and Prescott (1977). Such problems arise when political measures provide short-term benefits but have long-term costs and too much weight is given to short-term benefits out of political opportunism.

Optimally designed fiscal rules counteract the tendency towards excessive debt. However, they must also take into account the fact that, as explained above, there are good reasons for debt financing of government spending, such as the intertemporal smoothing of the tax burden or an appropriate distribution of the financing burden of future investments over several generations. An optimal rule strikes a balance between the need to avoid excessive debt and maintaining flexibility in spending policy (Amador et al. 2006, Yared 2019).

The pattern underlying the explanations of excessive government debt can be applied to the government's investment activities. Taking on debt is a form of revenue policy, the burdens of which will only be felt in the future. Public investment is expenditure whose benefits will be felt primarily in the future. The mechanisms that lead to the neglect of future burdens when shaping revenue policy can also explain the neglect of future benefits when shaping expenditure policy. Excessive debt and dilapidated infrastructure are then two sides of the same coin.

III. Debt brake and European fiscal rules

1. Debt brake: challenges and disincentives

Since the 1970s, federal debt has risen sharply in several stages (Federal Ministry of Finance (no year, compendium on the debt brake). Before the introduction of the debt brake, the provisions of the Basic Law at the time (Art. 115 GG old version) provided for a limit on net borrowing. There was also an emergency clause if the overall economic balance was at risk.[2] This clause was used several times, but it was not linked to precisely defined circumstances and was not subject to any review that was independent of the government.

The regulations of the Basic Law at the time permitted debt up to the amount of public investment (based on the so-called Golden Rule). However, this rule was conceptually problematic in that the concept of the Golden Rule refers to net investment, i.e. the increase in public capital stock, whereas the German rules allowed gross investment to be financed by debt. Another weakness of the rule was that it was only applied in budget planning, but not in implementation. Such a rule can be undermined by an overly optimistic budget projection, which weakens the effectiveness of the rule. In addition, the boundary between public consumption and public investment was not clearly defined, which invited abuse of the rule.

The current debt brake was included in the German Basic Law in 2009. It limits net borrowing by the federal government to 0.35 percent of GDP from 2016 and does not permit borrowing by the federal states. Although cyclical and one-off factors are excluded when calculating the deficit, no other consideration is given to the type of income or expenditure. For example, public investment does not have a special status compared to public consumption. In contrast to the previous regulation, non-cyclical deviations from budget planning are recorded in a control account under the debt brake.

The debt brake was introduced in 2009, shortly after the outbreak of the Lehman crisis, because there were fears in the eurozone of a general softening of the debt limit of the 1996 Stability and Growth Pact, which also makes no distinction between public investment and consumption expenditure and generally stipulates an upper limit of 3 percent of GDP for new government debt. Germany wanted to set an example for the other EU countries and thus indirectly protect itself from the liability risks that it saw in the general demand for a softening of the states' budget restrictions.

The new German debt rule of 2009 is not completely rigid and provides for a suspension of the deficit ceiling in the event of an emergency. The exceptional circumstances were also formulated more clearly in comparison to the old version of Article 115 of the Basic Law. The debt brake that exists today can therefore be seen in part as a response to the imperfections of the regulation that existed before 2009.

The first-time application of the emergency clause in 2020 was justified by the unexpected coronavirus pandemic. It is disputed whether the clause made it possible to combat the crisis effectively and whether it had a counterproductive effect as an expansionary fiscal policy measure (during the supply-side shortage caused by the pandemic) and sowed the seeds for today's inflation (Sinn, 2021, p. 351 ff). The pandemic was also referred to as justification for the application of the emergency clause in 2021. With the development of effective vaccination

2 The old version of Article 115(2) of the Basic Law stated: "The revenue from loans may not exceed the sum of the budgeted expenditure for investments; exceptions are only permitted to avert a disturbance of the overall economic balance."

protection and the widespread vaccination of the population in 2021, an emergency situation for 2022 was no longer evident at the end of 2021. In the German government's projection from fall 2021, real economic growth of over 4 percent was expected for 2022. However, the energy crisis in 2022 gave rise to new challenges, which was also used to justify the application of the emergency clause for 2022.

The debt brake limits an intertemporal shift in financing at the expense of future generations. However, it does not prevent the political process from favoring government consumption spending at the expense of government investment spending. This argument regarding the short-term orientation of policy concerns both aspects (Wissenschaftlicher Beirat 2020), as also described in Box 2 in Chapter II. The returns from government investment spending benefit future generations, which is given too little weight in the political process compared to government consumption spending. Debt financing of net public investment would counteract this distortion. A golden rule that excludes debt-financed net public investment from the calculation of the deficit can be justified by the principle of equivalence of taxation.

In line with the comments in section II, debt financing of investments also makes economic sense if it is intended to cover a temporary need to catch up and there is no risk of inflation. Maintaining public infrastructure is a permanent task and should therefore not be financed through debt. However, infrastructure has been neglected in many areas in Germany for years, meaning that there is now an increased need that goes beyond regular maintenance.[3] In addition, the energy transition requires an expansion of infrastructure, for example in the area of rail transport. In this respect, debt financing can be justified here under certain conditions.[4]

Finally, debt financing of additional investments is also justified if public investments generate additional tax revenues in the future, for example through increased output or productivity effects in the private sector, because even with given future tax rates, the debt can be repaid with a lower additional burden than would be possible today by increasing tax rates. This corresponds to the argument of tax smoothing, as explained in section II.

It is sometimes argued that we do not know which investments future generations will want to see realized today and that the resulting uncertainty cannot be used to derive a preference for investments in the design of fiscal rules, for example through a golden rule. This is contradicted by the experience that many of the infrastructure measures carried out in Germany since the 19th century (railroads, energy industry, locks, bridges) have made long-term growth-promoting development possible in the first place.

If infrastructure expansion is financed by the state and there is no risk of inflation, debt financing can therefore be economically justified. However, a golden rule that excludes debt-financed public investment in infrastructure from the calculation of the deficit ceiling could be abused because it is often difficult to distinguish investment from consumer spending in economic terms (Deutsche Bundesbank 2019). A government could declare government consumption expenditure as investment expenditure and thus undermine the deficit rules. If the definition of public investment in the

3 In its report on public infrastructure (Wissenschaftlicher Beirat 2020), the Advisory Board presented an analysis of the quality and performance of key infrastructure providers in Germany.

4 This logic must not be misused as a justification for repeated neglect of public infrastructure. Ensuring this is the basis of the Council's recommendations listed below.

national accounts is used instead, which is based on investments in fixed assets (including physical capital and intellectual property, see Federal Ministry of Finance 2021) and financial assets, there is less scope for manipulation, but this comes at the expense of an economically meaningful definition of future-related expenditure: Education expenditure, for example, has an investment character, even if this is not recorded as such in the statistics.

A further demarcation problem arises from the determination of net investments, as only these increase the capital stock and justify debt financing, while reinvestments (to make up for depreciation) must be financed from the current budget (Deutsche Bundesbank 2019). Net investment is calculated by deducting depreciation from gross investment. In the national accounts, depreciation reflects the loss in value of assets through use, which is not identical to wear and tear in the production process and does not necessarily correspond to current replacement costs due to technical progress (Grömling et al. 2019). As the federal government does not report its assets on the balance sheet, the capital stock of public infrastructure would first have to be determined in order to calculate depreciation.

2. Reform of fiscal rules and incentives for public investment

The problems described above can be reduced through a better governance structure. The Scientific Advisory Board proposes two approaches: Investment promotion agencies (see also Wissenschaftlicher Beirat 2020) and a Golden Rule Plus.

Investment promotion agencies

Investment promotion agencies („Investitionsfördergesellschaften“, IFGs) are newly created institutions that have binding contractual or statutory entitlements to constant allocations of funds over a period of several years in order to guarantee the continuity of investments in public budgets. The agencies pass on the funds to those to be funded, such as local authorities. The stabilization of allocations creates planning security for those involved. The framework is similar to the agreements between the federal government and the German railway company DB AG (“Leistungs- und Finanzierungsvereinbarung”, LuFV). The governance structures play a decisive role in the internal relationship between policy makers, agencies and funding recipients (Wissenschaftlicher Beirat 2020).

A good governance structure includes, on the one hand, the relationship between the IFG and the funding recipients, whose autonomy in submitting applications and deciding on implementation and organization must be ensured. Since autonomy and the application process lie with the funding recipient, the incentives for a sensible use of the funds are maintained. At the same time, the legislator must define criteria for the allocation of funds, which are then applied by the IFG based on objective criteria. A review of this process by an external institution would make sense, e.g. in the form of certification of the investment character of the measure. However, the IFG must be able to monitor misuse during planning, awarding of contracts and project implementation.

Secondly, in the relationship between the IFGs and parliament and government, it must be ensured that the democratically legitimized institutions set upper limits for the financing of IFGs, e.g. as part of a multi-year financing agreement, which would make borrowing by the IFGs themselves superfluous.

This would keep the overall burden on public budgets transparent.[5] The IFGs' ability to borrow is particularly problematic if no user fees are generated by the projects that would enable interest and principal payments to be made. Financing through the state budget is then unavoidable.

Golden Rule Plus

The Golden Rule Plus is based on the old Golden Rule but corrects it in two key respects. Firstly, only *net public investment* may be debt-financed. In recent decades, the public net investment ratio has fluctuated around 0 percent, and in many years net public investment was even negative (Wissenschaftlicher Beirat 2020). The option of financing net investment through debt would provide an incentive to invest more. At the same time, however, the amount of debt to be taken on would be manageable.

Secondly, it must be ensured that the Golden Rule is not abused by declaring public consumption expenditure as investment. The "Plus" stands for the fact that the implementation of the investment rule is monitored by an independent body of experts, alternatively the Federal Audit Office. This body would have to check the government's planned investment expenditure for compatibility with the investment character. The calculation of depreciation could also be reviewed by such a body in order to correctly determine the net investment.

If the expert panel rejects the investment character of an expenditure, there are various options for how to proceed: the vote of the expert panel could prevent misuse simply by creating publicity. It would be stronger and better if a negative vote by the panel forced the government to act, either in the form of a revised proposal or by forcing it to explain itself publicly (the so-called "explain or comply principle"). A hearing in the German Bundestag could also create publicity and activate parliament. An even stronger mechanism would be created by granting a veto right against the classification of a specific project as an investment if the independent body does not believe that the conditions for such a classification are met. Care must be taken to ensure that a veto does not conflict with parliament's budgetary rights.

There are already examples of independent bodies that review government measures or decisions. The Joint Economic Forecast ("Gemeinschaftsdiagnose") is prepared by an independent body that reviews the Federal Government's macroeconomic forecasts on the basis of the Forecasting Act (EgVG). The projections are important for the federal government's budget and financial planning as well as for compliance with German and European fiscal rules. The Advisory Board to the German Stability Council has been involved in compliance with the European Fiscal Compact in Germany since 2013. It supports the Stability Council in monitoring compliance with the upper limit of the structural general government financing deficit in accordance with Section 51 (2) HGrG pursuant to Section 6 of the Stability Council Act.[6]

5 Krebs et al. (2021) propose financing public investments by transferring equity to public companies (similar to Deutsche Bahn) and allowing them to take out their own loans. DB is a cautionary example of this idea, as the governance structures in the relationship between the federal government and the railroads are problematic (see Wissenschaftlicher Beirat 2020). There are very good reasons why the state should stay out of direct control of companies (political influence on investment and personnel decisions, soft budget constraints, lack of cost discipline). However, this presupposes that, unlike in the case of the railroads, the governance structures provide sensible incentives. Borrowing can lead to a lack of transparency regarding the level of government debt. Compatibility with European fiscal rules is questionable, depending on how it is structured.

6 Similar bodies and tasks were made mandatory by the Fiscal Compact in all signatory states and have contributed to compliance with fiscal rules and sound finances in Europe.

3. European reform debate

A reform of the debt brake in Germany cannot be seen in isolation from the European debate. Emergency clauses were also used at European level during the coronavirus and energy crises. A legislative process to reform the fiscal rules of the Stability and Growth Pact is also taking place currently.

To this end, the European Commission presented proposals for a new set of rules in April 2023 (European Commission 2023a,b), which include changes to the preventive and corrective arm of the Stability and Growth Pact. The deficit limit of 3 percent of GDP and the debt limit of 60 percent of GDP are enshrined in the Maastricht Treaty and therefore cannot be changed simply, but several elements of the Commission's proposals imply a significant change to the rules.

Firstly, net expenditure is to be used as the new monitoring target instead of the structural (cyclically-adjusted) budget deficit. Net expenditure includes all government expenditure except interest expenditure. A correction is also made by deducting the fiscal effects of government tax policy measures (such as a tax reform) and cyclical expenditure to support the unemployed.[7] The switch to this fiscal policy indicator is explained by the difficulties encountered when using the previous indicator, which was based on the cyclically adjusted budget deficit. It is difficult to determine this deficit in real time, above all because of the need to separate structural and cyclical factors when calculating the output gap, the size of which is necessary for calculating the cyclical part of the budget deficit. As a result, the application of the fiscal rule can lead to a procyclical fiscal policy.[8] In addition, the calculation of the cyclical factor is complex, and the method used in the EU to estimate the potential is controversial. In contrast, (corrected) primary expenditure is easier to control through policy. However, in order to calculate the corrected primary balance, the revenue effects of tax policy measures must be estimated, which is also methodologically problematic, especially when it comes to the dynamic incentive effects of tax changes. In this respect, the added value of the new regulation is not as great as some claim.

A second element of the proposal concerns the period and the indicators of the fiscal adjustment path. The corrective arm of the Stability and Growth Pact, which is now primarily intended to deal with the correction of excessive budget deficits (Art. 126 TFEU), provides for the abolition of the 1/20 rule on debt reduction, which was retroactively introduced during the euro crisis with the so-called "six-pack" in 2011. This rule requires that the debt level above the limit of 60 percent of GDP (on a three-year average) is reduced by 1/20 per year.

If the debt limit or deficit limit is exceeded, the EU Commission wants the debt situation of a member state to be assessed using a debt sustainability analysis instead. This type of analysis, which is used by several international institutions such as the IMF and the European Commission (see Debt Sustainability Monitor, European Commission 2023), forecasts the debt level as a proportion of gross domestic product based on various assumptions, including those on interest rates, GDP growth and demographic trends. The German side (German technical

7 This is intended to ensure that tax-reducing reform measures are accompanied by reductions in expenditure in the European fiscal monitoring framework (European Commission, 2013).

8 In its analysis, the European Fiscal Board (2019) assesses the procyclicality of fiscal policy in the countries of the European Union. Procyclical fiscal consolidation took place in Europe in 2012/3, among others. In addition to fiscal rules, this may have been caused by other factors such as pressure from the financial markets. However, the two-pack and six-pack reforms of the Stability and Growth Pact, which led to a tightening of European fiscal rules, fell into this period.

non-paper, 2023) criticized the debt sustainability analysis tool because the results depend heavily on assumptions. In the Scientific Advisory Board's view, this is not a fundamental problem, as the debt sustainability analysis makes the assumptions transparent and must do justice to the complex relationships between growth, interest rate trends and risks in the assessment. The decisive factor is rather who makes the assumptions. It makes a difference whether the IMF prepares this analysis and grants loans to countries on this basis or the EU Commission.[9]

The Commission proposal also provides for medium-term financial planning (instead of annual balances). On the basis of a multi-year path (at least 4 years) proposed by the Commission for the net expenditure, the Member State proposes a corresponding budget plan as part of the new preventive arm of the Stability and Growth Pact. This is therefore a country-specific adjustment path. According to the Commission proposal, adjustment periods of up to three years longer are possible at the request of the member state if these are justified by reform measures and public investment.

However, this approach entails the risk that the correction mechanism will only take effect too late in the event of an unsound fiscal policy. The procedure for reducing excessive deficits (Art. 126 TFEU) remains in place. However, the previous system of sanctions in the corrective arm of the Stability and Growth Pact has not functioned adequately, as evidenced by the fact that the rules have frequently been breached.[10] It can be assumed that there will be considerable political pressure on the Commission to approve slower adjustment paths in the multi-annual budget. This will give the Commission even greater discretionary leeway than before, as the multi-annual adjustment paths are individually tailored to each Member State.

Compliance with the adjustment paths and possible reasons for deviating from them are to be assessed by the national independent fiscal councils. However, the Commission proposal does not grant the fiscal councils any specific rights of co-determination or veto, so that the potential for independent control is not strengthened. In addition, the European Fiscal Board, which already monitors the uniform application of fiscal rules in Europe and has identified various violations (see the EFB's annual reports), is not assigned a formal role in the monitoring system. Overall, the Commission proposal therefore does not strengthen bodies that are independent of the Commission and government and that can contribute to a more effective enforcement of fiscal rules. Instead, the EU Commission is expanded as the central supervisory authority. The Scientific Advisory Board is against a stronger role for the Commission and instead advocates a stronger role and increased independence for bodies such as the EFB and the national fiscal councils in complying with and enforcing European fiscal rules.

If the focus is on net expenditure as a target figure, as proposed by the Commission, expenditure on public investment would be treated like other expenditure, even if the Commission includes public investment in its assessment of the fiscal situation and as part of budget monitoring. This could lead to the problem of favoring public consumption expenditure described above not being addressed precisely and only on a discretionary basis.

9 Even with a standardized method in the budgetary framework in the EU, there is still room for maneuver in its application. For example, the unemployment of refugees who came to Germany in 2015 and 2016 was assessed by the EU Commission as cyclical, while the German side considered it to be structural, primarily due to the refugees' lack of language skills. The Commission therefore saw more fiscal space than the German government (see also Advisory Board to the Stability Council 2015).

10 The European Fiscal Board (EFB) reports breaches of the numerical budget rules in its Compliance Tracker, which is available on the EFB website.

A rule-based inclusion of public investment, such as a Golden Rule Plus, would be preferable.

Another problem for Germany arises from the coexistence of the German debt brake and European regulations. So far, compliance with the debt brake can be seen as a far-reaching guarantee of compliance with European requirements.[11] If Germany were to stick with the current debt brake or switch to a golden rule plus, a situation could arise more frequently in which compliance with a heavily reformed Stability and Growth Pact would be possible while at the same time violating the German rules, or vice versa.[12] This would make it (even) more difficult in a federal state like Germany to manage public budgets in compliance with general government deficit ceilings (as under the Stability and Growth Pact). The problem is already virulent due to the existence of the Fiscal Compact.[13] Against this backdrop, it is important that Germany supports proposals in the European debate that are compatible with German fiscal rules.

11 One exception is the use of reserves, for example, as this reduces the government's net borrowing under budgetary law, which makes it easier to comply with the debt brake, while the national accounts deficit is not affected by this under European rules. On the compatibility of German financial statistics and ESA, see Deutsche Bundesbank 2018.

12 There may already be tensions between the debt brake and the European rules. A release of reserves reduces net borrowing, which is the target figure of the debt brake. The EU regulations are aimed at the general government deficit on the basis of the national accounts, which is not positively influenced by the release of reserves, see Deutsche Bundesbank (2018).

13 The European Commission's proposal (2023a, recital 32) provides for the substantive content of the fiscal treaty to be transposed into European law. However, the problems arising from the coexistence of two targets (structural budget deficit vs. corrected primary expenditure) are not addressed in detail.

IV. Challenges of financial policy and possible solutions

This section discusses current fiscal policy issues, including the role of special funds, tax increases and social security reforms. The discussion builds on the principles and considerations set out in Section II.

1. Special funds

The federal government has recently set up a number of special funds, including the Climate and Transformation Fund ("Klima- und Transformationsfonds", KTF), the Special Fund for Reconstruction Assistance 2021, the Special Fund for the Federal Armed Forces („Bundeswehr"), the Economic Stabilization Fund („Wirtschaftsstabilisierungsfonds", WSF) and the Special Fund for Digital Infrastructure. Special funds can be set up to finance extensive, multi-year measures for a very specific purpose and exist outside the core budget. In addition to allocations from the core budget, they can have their own income and – depending on the legal structure – also income from their own loans. Special funds can be a useful vehicle for pursuing specific economic policy objectives in a targeted manner. However, the recent practice of using and structuring special funds appears problematic in some respects.

The planned expenditure of the special funds in the current and coming years is considerable and amounts to more than 10 percent of the core budget (Bundesrechnungshof 2022, Fig. 1). This expenditure is sometimes not made clear in the presentation of the federal government's financial policy, see e.g. Federal Ministry of Finance (2023). The reporting on the extra budgets in the Stability Council is also not transparent in this respect (Advisory Board to the Stability Council 2023). The importance of special funds is also reflected in borrowing, as some special funds have their own borrowing authorizations, e.g. the WSF with EUR 200 billion and the Bundeswehr special fund with EUR 100 billion. The expected general government deficits of 4¼ percent and 1¾ percent of forecast GDP in 2023 and 2024 are primarily driven by the WSF (Advisory Board to Stability Council 2023). The federal government's core budget therefore paints a distorted picture of federal fiscal policy.

This is particularly problematic when it comes to government activities that could just as easily be funded from the core budget. For example, the compensation payments to households and companies in the WSF due to higher energy prices are pure transfer payments which, like many other transfers, could just as easily be made from the federal budget. It is not relevant to the nature of the transfer whether it is justified by energy or social policy.

In addition, a considerable amount of unused credit appropriations in recent years, including in the special funds, have been transferred to a reserve, which will then be used to finance current expenditure in subsequent years, e.g. as part of the WSF (StFG Section 26b (4)), the Climate and Transformation Fund or previously in the asylum reserve. The reserves of the most important special funds (excluding the WSF) of the federal government amounted to around EUR 100 billion at the end of 2022 (Deutsche Bundesbank, 2022). The use of reserves reduces net borrowing under the debt brake in subsequent years, which makes compliance with the debt brake considerably easier or even possible in the first place (Deutsche Bundesbank, 2023). As a result, the construction and financing of the WSF conceals the fact that higher expenditure in the federal government's core business is financed by borrowing at times of the emergency clause in conjunction with the creation and release of reserves.

Another problem in dealing with special funds lies in the reallocation of their purpose. In 2021, unused credit authorizations amounting to 60 billion euros in the Coronavirus Fund were transferred to the

Climate and Transformation Fund (KTF). This was originally intended to combat the consequences of the coronavirus crisis. However, the KTF serves a prima facie different purpose in order to manage the energy transition and the transformation to a climate-neutral economy. The legal admissibility of the transfer of the credit authorization, which is justified by the failure to invest during the coronavirus crisis, has not yet been clarified (see proceedings before the Federal Constitutional Court). Economically, almost any reallocation of the purpose appears justifiable, as macroeconomic crises such as the coronavirus crisis leave their mark on almost all areas of the economy. However, the fact that the KTF funds are now to be used to initiate environmentally friendly investments, a measure that makes sense in itself, shows that it is no longer about cushioning the general consequences of the coronavirus crisis, but that the use of the funds is subordinated to current political priorities. However, this makes the link to the original intention of the loan authorization fragile.[14]

The Bundeswehr special fund plays a special role, allowing borrowing authorization of up to EUR 100 billion. Borrowing in this special fund does not count towards the net borrowing of the federal government within the framework of the debt brake (Art. 87a GG 1a). An outsourcing to a special fund can be justified by the fact that it is intended to cover the backlog in equipping the Bundeswehr over several years and should be reported separately from the core budget precisely because it does not count towards net borrowing under the debt brake. Permanently higher defense spending after the expiry of the special fund should, however, be financed from taxes as part of the core budget, as explained in Section II.

The Scientific Advisory Board criticizes the fact that the Bundeswehr Special Fund has so far been misused to relieve the core budget instead of serving its actual purpose. More than a year after its establishment, the credit authorizations in the special fund of the Bundeswehr are still little used and are expected to amount to 8.4 billion euros in 2023 (Bardt 2023). The special fund is intended to achieve NATO's 2 percent target. As defense spending in the core budget will stagnate in the years 2023–2027 (in contrast to the increase between 2018–2022), it will only be possible to achieve the 2 percent target through a sharp increase in funding from the special fund. This combination will result in de facto relief for the core budget, as the additional leeway can be used for purposes other than defense (Dorn and Schlepper 2023). The strengthening of Germany's defense capability is less than was intended with the special fund and indirectly undermines the debt brake, as the Bundeswehr special fund, which is not subject to the debt brake, is used to pursue other political goals.

The practice is also unsustainable, as once the special fund expires (at the end of 2026), there will be an even bigger gap to the 2 percent target. Closing the gap will require massive budget adjustments in the coming legislative period. Alternatively, there is a risk of missing the 2 percent target. A further burden results from the interest payments to service the loans of the special fund, which must be paid from the federal budget and further restrict the scope there. This example makes it clear that financial planning needs to be oriented beyond medium-term financial planning in order to keep an eye on the sustainability of public finances over a period of 5–15 years.

14 It is to be feared that the practice described will continue to grow. As reported by Handelsblatt (23.6.2023), the KTF is to be used to pay a subsidy to Intel for the construction of a chip plant in Magdeburg. This is primarily intended to improve Germany's security of supply in chip production. A link to the original intention of the loan authorization has been lost.

Shadow budgets and special funds also play a role at European level and in the federal states. The Next Generation EU program (NGEU) is a special fund existing at European level with a debt framework of over EUR 800 billion, of which the Federal Republic of Germany is likely to account for just under 24 percent or EUR 190 billion, excluding joint and several liability.[15] In addition, there are special funds of the federal states, including those recently established or planned in North Rhine-Westphalia, Saarland and Berlin. The proliferation of special funds is therefore not limited to the federal level and highlights a general problem that reduces the transparency of public budgets.

Special funds can make a meaningful contribution to achieving economic policy goals. The Scientific Advisory Board is concerned about the practice of recent years because it has led to less transparency, indirectly undermining the debt brake and shifting problems to future legislative periods. The Advisory Board urgently recommends abandoning this practice and instead returning tasks and expenditure to the core budget and linking them to longer-term financial planning.

2. Subsidy cuts, higher expenditure, tax increases

The limited state resources force the state to prioritize its spending policy. Although the financial leeway can be increased by raising taxes (after exhausting the debt within the framework of the fiscal rules), the potential of this measure is limited due to behavioral responses on the part of the taxed. New geopolitical requirements and structural challenges such as the accelerated climate policy transformation have added new spending targets to the competing uses of federal financial resources that were already occurring before the crises.

Increased competition for funding increases the pressure to eliminate "unnecessary" expenditure or tax concessions.[16] Federal financial aid and tax concessions, as listed in the federal government's subsidy report, can fulfill useful objectives and therefore cannot be eliminated without loss. However, an in-depth analysis conducted by the FiFo Institute Cologne (Thöne 2019) of tax concessions amounting to EUR 7.4 billion in 2018 shows that subsidies worth EUR 1.8 billion only have a "weak" assessment, including some energy tax concessions. Further subsidies amounting to €2.9 billion were rated as "acceptable", meaning that there was a high potential for improvement. Against this backdrop, the Scientific Advisory Board recommends that all current federal financial aid, which incidentally accounts for a much larger volume than that examined in the study by Thöne (2019), be systematically evaluated in order to identify potential savings.

The federal government's subsidies to social insurance schemes already make up a considerable proportion of the federal budget. For example, the subsidy for statutory pension insurance amounted to around €109 billion in 2022. Added to this is the federal subsidy for statutory health insurance of €28.5 billion and for social long-term care insurance of €1 billion. In total, this amounted to 31 percent of the federal budget in 2022. Expenditure in the area of social insurance will continue to rise due to the ageing population and will take up an even higher proportion of the federal budget unless this is counteracted by reforms.

15 The future obligations for the redemption of this special fund are not included in any other statistics.

16 The assessment of a tax concession or financial aid as unnecessary requires an evaluation standard that can be set in different ways. The FiFo Institute's study evaluates the relevance of the purpose of the subsidy, the effectiveness of the tax concession, sustainability, instrumental suitability, transparency and monitoring.

The long-term financing of statutory pension insurance is particularly important due to its large volume. Plans such as the "double stop line" ("Doppelte Haltelinie") are going in the wrong direction because they imply considerable increases in expenditure. With a pension level of 48 percent and a limitation of the increase in the contribution rate to 23 percent, the double stop line would require an additional 10 percentage points of the federal budget as a subsidy to the statutory pension insurance in 2040 (Wissenschaftlicher Beirat 2021). If we take the development of benefit expenditure in statutory health insurance over the last 5 years as a benchmark, the subsidy for statutory health insurance would increase by around 80 percent to EUR 51 billion by 2030. Social long-term care insurance is also facing a considerable increase in expenditure. Expenditure per insured person is likely to increase by over 90 percent between 2020 and 2040, partly because the care rate in the population will increase by almost one and a half percentage points (Scientific Advisory Board 2022). If the government does not take decisive countermeasures with reforms to the social security system, such as those proposed in the aforementioned reports by the Advisory Board, then far more than half of the federal budget will be used to support the social security funds in 2040. There will then be no scope left for future investments in education, infrastructure and climate-neutral transformation.

In addition to an increase in federal subsidies, higher expenditure is expected in other important core areas of the federal budget. One of the reasons for the additional requirement is that the NATO target for defense spending of 2 percent of GDP will result in higher federal spending in the medium term (after the use of the special fund of EUR 100 billion). An increase in the defense budget of 0.5 percent of GDP currently corresponds to approx. 18 billion euros.

The federal government's interest expenditure is also expected to have a negative impact on the budget, rising from EUR 4 billion in 2021 to around EUR 30 billion in 2023 and remaining high in the long term.

In addition, there is the repayment of the federal loans taken out under the emergency clause in the years 2020–2022, which is linked to a fixed repayment schedule and is to take place in the period 2028–2058 (German Bundestag, 2022). The repayment of the loans for the Next Generation EU program from 2028 over a 31-year period will also be added.

The above list of new and additional expenditure makes it clear what longer-term challenges Germany is facing. Medium-term financial planning, which is common in budgetary policy and covers three years, is too short-sighted and cannot reflect the structural challenges. The Scientific Advisory Board therefore recommends planning that goes beyond medium-term financial planning and reflects the long-term challenges and financing problems.[17]

In times of high inflation, the state benefits in the form of higher tax revenues in real terms, in particular from bracket creep. In this respect, the increased expenditure is also offset by increased revenue in real terms. If this additional revenue is compensated for by adjusting the income tax rate, as was recently done in part by the Inflation Compensation Act of 2022, there will be no additional revenue in real terms. This is also shown by the adjustment of the tax revenue estimate from May 2023, which includes the Inflation Compensation Act of December 2022 and leads to a considerable downward adjustment in the estimate compared to November 2022. The government currently has no legal obligation to compensate for the effects of bracket creep, only an obligation to report on progression. In the Scientific Advisory Board's view, however, a "secret" tax

17 The Federal Government's sustainability report is used to assess the state's long-term ability to act. However, it is only produced once per legislative period and is therefore of little use as a budgetary management tool. For example, the last sustainability report is from 2020.

increase in an environment with an inflation rate above the inflation target of 2 percent is not a sensible source of government financing. An "open", discretionary tax increase that has to be justified in public is preferable to a secret one.

The German Council of Economic Experts recently proposed a temporary tax increase for high-income households to finance the relief packages, for as long as the state pays higher transfers for increased gas and electricity prices (German Council of Economic Experts 2022). This is consistent insofar as financing via increased debt does not alleviate the issue of burden sharing, but only shifts it into the future and thus burdens future generations. If politicians want to compensate lower-income households in particular with the relief packages, which also benefit higher income earners due to the design of the packages, a temporarily higher burden on these groups can be justified.[18] However, taxes are generally associated with additional burdens that result from the avoidance behavior of the taxed and increase disproportionately with the level of the tax rate. Excess burdens are efficiency costs of taxation that go beyond the tax liability to be paid.

The behavioral response of taxpayers is the reason why the tax revenue decreases from a certain point with a further increase in the tax rate and does not increase any further. There is therefore an empirically determinable upper limit for income tax revenue. In a previous report of the Scientific Advisory Board on pension reform, the potential for higher income taxes was narrowed down on the basis of scientific literature (Wissenschaftlicher Beirat 2021).[19]

A policy of redistribution after the crises faces the difficulty that income tax law is linked to annual performance, but not to the change in income caused by the crisis. A negative income shock leads to a lower income and therefore also to a lower tax liability. However, this may be seen as insufficient relief compared to those who have not experienced an income shock. An example of the latter is the group of civil servants who were not affected by unemployment and furlough during the coronavirus crisis. A more targeted distribution policy designed to cushion the burden on households affected by crises requires better instruments and better information on the relationship between individual crisis consequences and taxable income. The slow payment of energy lump sums of 200 euros to all students in Germany is an example of the lack of linked data at the federal level.

The possibility of a tax-financed increase in government spending is highly controversial among political parties and also within the federal government. This is partly due to the fact that proponents of a tax increase want to combine this with greater redistribution at the expense of higher income earners, while opponents of a tax increase reject precisely this, citing negative incentive effects, or see opportunities to reduce expenditure. In this situation, the visibility of the burdens associated with additional expenditure could be increased if, for example, these were shown in proportion to income tax payments or in proportion to the previous year's net income.[20] The former is similar in principle to the solidarity surcharge in its original form, which made the costs of German reunification visible.

18 The intended redistribution is partially, but not fully, achieved under a progressive income tax if the compensation payments have to be taxed.

19 Ayaz et al. (2023) examine in a calibrated model for five European countries, including Germany, how the debt burdens of the Covid 19 shock should be financed by adjusting the income tax rate if the tax rate observed before the crisis is the result of welfare maximization or reflects a political equilibrium (so-called inverse optimum approach). The authors show that the additional tax burden increases with income, but the distribution is regressive, as the increases in average tax rates fall with income. This is due to the relatively low tax rates for lower and middle incomes before the crisis, which thus offer more scope for tax increases before the avoidance behavior of taxpayers limits the revenue potential.

20 The burden distribution of the (income) tax system according to income percentiles can be calculated on the basis of the factually anonymized wage and income tax statistics (FAST) and the Socio-Economic Panel (SOEP), see e.g. Isaak et al. (2021) and Benoszka and Hentze (2021).

The latter would be neutral in terms of income distribution. The proposal to show the burdens is based on the presentation of the distributional effects of the parties' fiscal policy proposals in the election campaign by independent institutes. The aim of this proposal is therefore to make it clear that an increase in government tasks has financial consequences for citizens and to what extent. The political process must then decide which specific funding is chosen.

Box 3 The role of inflation

Since 2021, the problem of inflation has also had to be brought back into the discussion of government fiscal policy. Even if global inflation is now abating somewhat, it is still very high and currently stands at 5.3 percent in the eurozone (August 2023), well above the level generally regarded as the upper limit of tolerable inflation (2 percent). There is a risk of persistently high inflation. However, the reasons for and therefore the dynamics of price trends are of crucial importance.

After the global financial crisis of 2007–2008, measured inflation was low for a long time, often well below the inflation target of 2 percent. The low interest rates and the massive expansion of nominal assets held by households and companies would have led one to expect otherwise. This was presumably due to the fact that demand for nominal assets, especially those with low earnings risk, had risen significantly. As a result, a large part of the expansion in the central bank money supply hardly affected demand.

The massive expansion of central bank money has facilitated new government borrowing, especially during the coronavirus pandemic in 2020 and 2021. Government debt instruments were sold on the market to finance government support programs during the pandemic and subsequently bought up on a large scale by the ECB and national central banks without market interest rates rising.

The return of inflation since 2021 and the resulting reorientation of monetary policy have significantly changed the framework conditions for fiscal policy. The ECB ended the growth of its asset holdings in July 2022 and in March 2023 began to no longer fully replace maturing assets with new asset purchases. Moreover, the rise in interest rates since mid-2022 suggests that the costs of servicing government debt will be significantly higher again in the future than in the past decade.

In this context, changes in the real economic environment, which are closely linked to inflation, must also be taken into account. Some of the price increases since 2021 have resulted from changes in scarcity and competitive conditions. The associated price increases reduce the real incomes of consumers. If these incomes are low, this is a challenge for social policy.

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Another factor is the labor markets in Germany. In many professions, more people are leaving the workforce to retire than the number of young people entering the workforce. The demographic shift associated with an ageing society will mean that this trend will intensify and continue for several years. The relatively high wage increases this year can be explained partly as a reaction to the inflation that has already taken place and partly as an exploitation of the increased bargaining power of the employee side due to the changes in scarcity conditions.

One-off effects vs. self-sustaining inflation processes

When analyzing inflation, a distinction must be made between price increases that are based on one-off effects and price increases that are based on self-sustaining momentum. In the eurozone, the price increases since 2021 are largely due to cost increases, which in turn reflect the increases in freight rates in shipping and the rise in the price of gas, oil and grain. These are likely to be one-off effects. It takes a certain amount of time for the knock-on effects to be passed on, but then the system settles down again. This is reflected in the observation that measured inflation rates have fallen again since the end of 2022. The retirement of a cohort from working life can also be classified as a one-off effect. The fact that this effect is to be expected every year in the medium term is due to the age structure of society and is not due to the fact that one year's development fuels the next year's inflation. However, one-off effects can trigger self-sustaining inflationary processes. Whether this happens depends on the reaction of monetary policy, fiscal policy and wage policy.

Real economic limits of fiscal and monetary policy

Self-sustaining inflationary momentum regularly occurs when monetary policy or fiscal policy pursue unrealistic goals and react to their failure with new impulses that lead to new price increases. This poses a great danger for dealing with the upcoming upheavals and challenges in the real economy. A policy that believes it can disregard the real economic context by relying on the financial strength of the state can cause considerable damage, and it may not be possible to achieve the goals set.

When planning to convert heating systems in Germany to renewable energies, it should therefore be borne in mind that the market results depend not only on the demand side, but also on the supply side of the markets. However, the supply side is relatively inflexible, partly because there is already a shortage of skilled workers. A massive increase in demand for heating systems that work with renewable energies caused by government regulations and subsidies will presumably increase prices significantly without increasing the number of heating systems installed to the same extent as the increase in demand, whereby the impact on the national budget, government borrowing and subsequent inflationary effects due to increased nominal asset prices have not yet been taken into account.

The same applies to dealing with the real economic effects of the demographic shift. The above-mentioned wage increases caused by this shift will make goods and services more expensive and reduce the purchasing power of income and assets expressed in monetary units. With inelastic overall economic supply, attempts to offset these purchasing power effects for pensioners, for example, are doomed to failure and will cause further price increases unless other measures are taken at the same time to curb demand.

The simplest – and best known – cause of self-sustaining inflationary processes has not yet been addressed. This concerns the case where fiscal policy demands a real deficit due to the inconsistency of political goals with real economic conditions and the state realizes its demand for goods and services by crowding out other demanders through price increases. Borrowing provides private individuals with additional assets, which in turn increase their demand. Over time, the realization of the political goals set requires ever higher price increases and ever higher government debt or an ever greater conversion of government debt into central bank money.

The costs of such a process are usually not entirely clear at the beginning, as it takes some time for market participants to understand the inflation dynamics and adjust their expectations accordingly. However, it can be assumed that this will happen in the further course, as in the 1970s after the oil price increases of 1973. Once expectations have been programmed for inflation, the return to a regime with price stability is associated with unpleasant side effects, as market participants initially continue to attempt to increase prices and wages compared to previous prices and wages, which would not be feasible in a regime without inflation (and without exogenous inflation drivers), so that sales of goods and services and employment are adversely affected.

V. Conclusion and recommendations

The extensive crisis response over the past three years may have created the impression and expectation that the state can eliminate all negative consequences of crises through government measures. The solid state of public finances before the start of the crisis made extensive debt-financed relief packages possible during the crises without the creditworthiness of the federal government suffering as a result. This made it possible to support people and companies in emergency situations. Now, however, after the crises, it is a matter of shaping a sustainable financial policy with the aim of ensuring the financing of social security systems and the ecological transformation as well as the expansion of public infrastructure.

Fiscal policy has become more intransparent in recent years. The creation of special funds and the holding of extensive reserves, some of which stem from borrowing under the emergency clause of the debt brake, have contributed significantly to this. This makes it temporarily easier to finance increased expenditure in subsequent years. However, this policy is not sustainable and will force even greater adjustments as soon as the debt brake applies again, the reserves are used up and the additional debt taken on has to be repaid. In times of high inflation, it must also be borne in mind that a federal budget that has risen sharply compared to the pre-coronavirus period contributes to price increases in areas with scarce production capacities.

In order to return to a sustainable financial policy, it is therefore essential to set priorities in the federal budget instead of attempting to conceal the actual competition for resources through debt. In a series of reports, such as on statutory pension insurance, social long-term care insurance and public infrastructure, the Scientific Advisory Board has pointed out specific challenges and made proposals for overcoming them.

With regard to the financing of the public budget, the Scientific Advisory Board recommends

1. The federal government should develop a financial plan that extends beyond the medium-term financial plan and covers the period of the two subsequent legislative periods. This is necessary to ensure the sustainable financing of permanent state tasks. Regularly recurring government tasks must be financed through taxes. To this end, politicians must decide which tasks are permanent tasks and which are not, for example in connection with expenditure on national defense. If the 2 percent target is to be implemented after the expiry of the Bundeswehr special fund, this requires financing through taxes and not through debt.
2. Special funds can be a useful instrument of economic and financial policy in very limited cases. However, the practice of the past few years makes financial policy non-transparent and indirectly leads to the debt brake being undermined and to problems being shifted to future legislative periods. The Scientific Advisory Board urgently recommends abandoning this practice and instead returning tasks and expenditure to the core budget.
3. A debt brake is fundamentally sensible and necessary in order to counteract the short-term orientation of politics, in particular the tendency to shift the costs of current government spending onto future generations. However, the same short-term orientation also makes it more attractive to spend on public consumption at the expense of public investment. This is why a reform of the debt brake makes sense.
   A debt brake also makes sense because it counteracts the inflationary overstretching of production potential through public debt, provided that the repayment of debt is not fully anticipated by taxpayers. Political decision-makers should

be prevented from using debt to cover up the natural scarcity of resources required for investment. Instead, they should be forced to face up to unpleasant distributional conflicts and set priorities.

The Scientific Advisory Board makes two reform proposals that are not mutually exclusive.

a. The debt brake should be developed into a Golden Rule Plus. This would mean that net public investments that are debt-financed would not count towards the maximum net borrowing limit of the debt brake if their investment character is confirmed by an independent institution. In addition, the risk of triggering or reinforcing an inflationary process should be taken into account.
b. The Advisory Board proposes the establishment of investment promotion agencies that have binding contractual or statutory entitlements to constant funding allocations over a multi-year period in order to guarantee the continuity of investments in public budgets.

4. The expected sharp rise in government spending on social security must be counteracted. The older generation that is still working should contribute more to the costs of social security. The Advisory Board has made detailed proposals on this in its reports (Wissenschaftlicher Beirat 2021, 2022) on the reform of statutory pension insurance and social long-term care insurance. The overdue reforms have been delayed for a long time and must now be tackled quickly. Otherwise, future investments in education, infrastructure and the transformation to a climate-neutral economy will soon no longer be possible.
5. In many cases, tax increases only make limited sense when used to create scope for additional public investment. They are usually accompanied by efficiency losses, as the taxed actors adjust their behavior and thus limit the revenue effect of the increase. Transparency regarding the financial burden of additional government spending can be increased, for example by showing the burden of a tax increase for all households in proportion to their current income tax liability or the previous year's net income. Similar to the analysis of the parties' tax policy proposals in the election campaign, this makes the costs of providing state services transparent for the population.
6. The German government should insist that the European and German budget rules do not diverge too far. The European Commission's proposals provide for a new operational parameter for budget monitoring in the form of net expenditure. This concept differs from the concept of the structural budget deficit or net borrowing used in Germany, as provided for under the Fiscal Compact and debt brake. The emergence of two different target figures would make it considerably more difficult to comply with fiscal rules and manage budgets, especially in a federal state such as Germany.
7. The involvement of national independent fiscal institutions and the European Fiscal Board should be strengthened in order to improve the enforcement of European budget rules. The European Commission's proposals for the realignment of budgetary rules and surveillance within the framework of the Stability and Growth Pact include considerable discretionary leeway in the assessment of a member state's financial situation and the negotiation of country-specific fiscal targets. The Scientific Advisory Board fears that, as in the past, this structure will ultimately be at the expense of compliance with the rules. Independent institutions should therefore be used more for monitoring purposes.

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https://www.bmwk.de/Navigation/DE/Ministerium/Beiraete/Veroeffentlichungen-Wissenschaftlicher-Beirat/veroeffentlichungen-wissenschaftlicher-beirat.html

The roots of the Scientific Advisory Board to the Federal Ministry for Economic Affairs and Energy go back to the time of the Second World War. From 1943, some of the later members of the advisory board met under the chairmanship of Prof. Erwin von Beckerath to prepare Germany's economic future after the war. This so-called "Consortium Erwin von Beckerath" merged into the Advisory Board, which was founded at the beginning of 1948 and formally constituted on January 23, 1948 in Königstein/Taunus at the invitation of the Administrative Office of Economy, the predecessor of the Federal Ministry for Economic Affairs and Energy.

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