# A Reform Proposal for the Cyclical Component of the Debt Brake

What is the cyclical component? Within the framework of the debt brake, the cyclical component allows for the increase or decrease of the maximum permissible annual net borrowing depending on whether the level of economic activity is below or above the 'normal level'. The cyclical component is calculated on the basis of the output gap, that is the difference between projected economic output (GDP) and an estimate of 'potential output' (which is how the concept of the 'normal level' is construed in economic terms) multiplied by the budget semi-elasticity. The budget semi-elasticity in turn determines how much more or less can be spent for each Euro of under– or overcapacity. An illustration of this mechanism can be found here, and a more detailed explanation is provided in the Compendium of the Federal Debt Brake of the Federal Ministry of Finance (in German).

Why is it problematic? In its current form, the cyclical component has several flaws. The inputs to the estimation of potential output are not sufficiently specified in the law. This omission is criticized by Korioth and Müller in their legal opinion. According to them, the legislature should not have left the definition of these inputs to technical experts. From an economic perspective, it is hard to define with any certainty when an economy has reached its potential, when, for example, its labour potential has been fully exploited. (The discretion that results from the uncertainty of these estimates is one of the reasons why Müller and Korioth consider delegating the task of defining the inputs to technical experts so problematic.) It is simply assumed that current potential output roughly corresponds to the cyclically adjusted output of the past. But even that is problematic as there is no way to unambiguously identify the impact of the business cycle. Hence one has to rely on statistical assumptions to determine which changes are merely cyclical in nature and which should be reflected in potential output. (More details can be found here. The US Federal Reserve has hence decided to no longer rely on the NAIRU, the estimated lowest possible level of unemployment without accelerating inflation (the US version of the NAWRU), one of the key inputs of the potential output calculation. Instead, the Fed now targets 'maximum employment'. Beyond that, estimating potential output involves deeply political judgments. Answers to questions like "How many women will be working in the future?" very much depend on what kind of policy is pursed after all. In addition, the answer has a huge impact on the estimate of potential output and therefore on the amount of permissible net borrowing. Korioth and Müller conclude: *"It is therefore the task of the parliamentary legislator to determine the factors concerning the assumptions to be made. § 5 G-115 is insufficient in fulfilling this task."*

## How does the reform proposal work?

In the short term, we propose three modifications to mitigate some of these shortcomings. Instead of defining the lowest possible level of unemployment, the potential participation rate (defined as the share of the population that participates in the labour market), and potential hours worked by extrapolating from their past trends we propose labour potential to be exhausted when: (1) long-term unemployment is no longer prevalent; (2) the labour market participation gap between women and men has been halved (equivalent to the level in Scandinavia), and (3) involuntary and unnecessary part-time work has been halved. To address the issue of legitimacy, the legislator should actively decide on the adjustment of these inputs. Such a reform would increase the coherence of fiscal policy as lawmakers would have a responsibility to realise the potential they themselves defined. Based on the European Commission's publicly available calculation methodology and on its forecast from Spring 2021, our proposal would raise the net borrowing limit for 2023 by close to €20 billion. These estimates, however, fluctuate significantly. To obtain a more precise estimate the calculation would have to be rerun based on the latest forecast from the German government and using the method of the Federal Ministry of Finance, rather than the one by the EU-Commission.

Why is our proposal fiscally sustainable? The greatest challenge to the sustainability of Germany's public finances is demographic: a declining working age population is confronted with more and more pensioners, and the demographic dependency ratio is expected to rise from 36% in 2019 to 52% in 2040. Nearly one-third of the federal budget (in non-pandemic years) already flows into subsidies of the public pension scheme. At the same time, the economic dependency ratio is at 62%. Too many people are unable to earn their own living despite working; more than 10% of the employed are only marginally employed. It therefore seems counterintuitive to, in the name of fiscal sustainability, extrapolate current labour potential from the past instead of striving to ensure that every working person can earn a living. After all, those with a good income pay taxes, save up for retirement and won't have to rely on social welfare. (More on a fiscal policy adapted to today's challenges can be found here.) Finally, our proposal still allows for a fiscal policy that doesn't neglect inflation, since the deficit is still derived from an estimate of economic potential.

Is our proposal legally feasible? Yes. Korioth and Müller find that the implementation of this reform doesn't require legislative change. But as mentioned above, they do they find the components of the debt brake currently specified in ordinary law to be legally problematic, and recommend clarifying in how far the cyclical adjustment method differs from that of the Commission. Hence they see it as preferable to have the described adjustment of the potential output calculation be accompanied by a change in ordinary law.  In addition, the *extent* to which parliament can make assumptions about the definition of potential output is limited. It cannot, for instance, simply declare its desired level of economic output to be the normal one. The desired level of potential output would actually have to be attainable. Hence the government would be responsible for actually translating the economic potential it has declared into real economic output, possibly through reforms. There would thus be a clear incentive to implement reforms. Korioth and Müller also state that there is a limit on net borrowing: if the deficit exceeds 1.5% of GDP it would have to be reduced in line with the business cycle.

Shouldn't the adjustment of the potential output estimate occur at the European level? The potential output estimate is also used for the implementation of European fiscal rules. (Here, however, the estimate is only included in a qualitative assessment). The answer to the above question mainly depends on political and possibly economic considerations. It would also be possible to adjust the inputs to the calculation only in Germany, where an adjustment in ordinary law would be desirable. In addition, minor adjustments to the calculations can be approved under the European procedure. On the other hand, all member states are affected by the same problem within the framework of the Stability and Growth Pact, since potential output is estimated for each member state. Finally, the question is relevant for the European fiscal rules simply because it is clear that the Stability and Growth will have to be adapted to face new challenges.

Does this proposal solve all the problems of today's fiscal policy? No. With its focus on full capacity utilization, it can help to (1) ensure that the debt brake actually renders public finances sustainable in the long term (as envisaged in the original explanatory memorandum to the law), and (2) reduce the lack of legitimacy inherent in the current estimation method. Furthermore, long-term investments in Germany are dearly needed, especially at the municipal level and especially for the process of decarbonization. To this end, a separate investment fund that provides funding over a medium-term period is more suitable.