Luiss
School of European Political Economy

European fiscal capacity: the example of the German special funds

Carlo Bastasin

Policy Brief 1/2023

LUISS

January 12, 2023

European fiscal capacity: the example of the German special funds

Carlo Bastasin

The debate on the reform of European rules risks neglecting the importance of integrating the rules governing national fiscal policies with a centralized fiscal capacity. A current example of the use of off-balance sheet special funds comes from Germany.

Ever since the European rules were conceived, Germany has represented the benchmark for all the other countries of the euro area. The 3% ceiling for government deficits, for example, was calibrated to the historic level of public investment in post-war Germany (reflecting what economists call the "golden rule"). The Stability Pact was written in 1997 on a desk of the old Finance Ministry in Bonn and then communicated to the partners. The debt brake, enshrined in the German constitution in 2009, was transposed into European regulations two years later. Several times old Wolfgang Schäuble replied to German ministers who asked him to loosen the purse strings that made Germany a good example for other countries so that the latter would not find excuses for indiscipline.

As is known, the rules – still in force, although their application is currently suspended – have not worked well. During the crisis of 2010 they aggravated the difficulties of weak countries. In the following years, ever more detailed rules oscillated between unrealistic requirements (rapid debt reduction) and specious exceptions. Overall, the rules have not prevented the area from being divided into high-debt and low-debt countries; their sanctions have never been applied (except formally) and their credibility has suffered to the point of requesting multiple redesign efforts, still ongoing. In this obstacle course, the exemplary role of German public finance has also been lost sight of.

Thus a transformation that could have been an inspiration for the euro area has gone unnoticed. Starting with the response to the pandemic crisis, the German Parliament suspended the internal rules to curb public debt. It has ordered large spending measures to counter an exceptional crisis, orchestrated a support plan in favor of weak European countries by accepting the issuance of common debt and above all it has set up special funds, *Sondervermögen*, i.e. debt practices outside the federal budget which have assumed enormous dimensions.

Special funds have been a historical instrument of German public finance since 1952 (*Lastenausgleich*) and 1953 (Marshall Plan). They were used for reunification in 1990 and 1995 and then in the financial crisis of 2008. Recently, they were activated for the floods of 2013 and 2021. A stabilization fund was created in 2020 to fight the post-pandemic recession and in 2022, with the unspent resources, 60 billion were allocated to finance the digital transition and the fight against climate change. In February, Chancellor Scholz set up a 100-billion-euro special fund to finance the modernization of the country's defense systems. Finally, in the autumn, a further 200 billion was allocated to a stabilization fund to combat the energy crisis. The nominal value is often overestimated, and the use has so far been partial. But these enormous resources remain at the disposal of the government in case of need, without appearing in the debt-to-GDP ratio except with respect to their cost of financing. This cost has sometimes been negative thanks to the country's exceptional credit standing and low interest rates.

The German experience with special funds

Since World War II, Germany has had recourse to around 27 special funds. Each special fund must be anchored in legal requirements which refer directly to the Basic Law. For the necessary two-thirds majority, the current coalition, for example, also needed the votes of the opposition. On March 23, 2022, parliamentary group leader of the Christian Democratic Union (the largest opposition party) Friedrich Merz made the approval of his parliamentary group conditional, among other things, on the fact that the expenditure of the special fund should actually be for an investment in the Bundeswehr: "for nothing else, only for the Bundeswehr". However, as was the case with the pandemic funds, the resources set aside and not used were invested in programs that had nothing to do with their original destination. In this sense, it is possible to say that the special funds represent a true "off-budget budget" to which the government can have recourse in emergency conditions with a speed that normal parliamentary procedures would not guarantee. The Federal Statistical Office speaks of "extra budgets" in its national accounts, but they are commonly referred to as secondary budgets or shadow budgets.

Special funds are set up in times of upheaval and crisis, or for events that arise suddenly and are beyond the government's control. The first funds were set up for post-war reconstruction (Burden Equalization Fund 1952, ERP Special Fund 1953), followed by those linked to German reunification such as the German Unity Fund 1990 and the Inheritance Redemption Fund (of former East Germany 1995). Immediately after the outbreak of the financial market crisis, the Financial Market Stabilization Fund was established in 2008 and the Investment and Redemption Fund in 2009, while in 2020, at the beginning of the pandemic crisis, the Economic Stabilization Fund was launched.

According to a definition[1] by the German Parliament's analysis services, these special funds are "separate parts of the federal assets which are intended exclusively for the fulfillment of limited individual tasks of the federal government and are therefore administered separately from other federal funds." The special funds require autonomous economic and accounting management, representing a derogation from the constitutional principle of the "unity of the budget", and can only be established on a legal basis.

[1] https://www.bundestag.de/dokumente/textarchiv/2022/kw16-sondervermoegen-890232

The special funds are in fact governed by Article 110 of the Basic Law which prescribes that "All revenues and expenditures of the federal government must be included in the budget; in the case of federal companies and special funds, only additions or deliveries need to be suspended. The budget must be in balance in terms of income and expenditure." Until August 1, 2009, the Basic Law allowed special funds to be exempted by federal law from the then debt rule under Article 115 paragraph 1, according to which the indebtedness may not exceed the estimated investment expenditure . This was no longer possible after the amendment of Article 115 and after the introduction of the debt brake (*Schuldenbremse*) in the 2011 financial year. Since then, the upper limit for net debt applies not only to the federal budget but also to special funds with their own credit authorization established after January 1, 2011 (Article 143d of the Basic Law).

In fact, a distinction is made between special funds with their own credit authorization, including the recently created special fund for the army (*Bundeswehr*), and those whose revenues come from the federal budget. The special funds with credit authorization are currently the Financial Market Stabilization Fund (FMS), the Economic Stabilization Fund (WSF), the Investment and Redemption Fund (ITF) and the Restructuring Fund (RSF). These are four of the 27 "special and trust funds" listed by the Federal Ministry of Finance in its federal budget. In 2021, the "Aufbauhilfe 2021" special fund was added to rebuild flood-destroyed infrastructure in four federal states.

As a German Parliament factsheet[2] indicates, the control of special funds is the responsibility of the Bundestag, the Bundesrat and the Federal Court of Auditors (Article 114 of the Basic Law). Article 113 of the Federal Budget Code provides that the Federal Court of Auditors examines the budget and the economic management of the special funds.

Over the past two decades the biggest role has been played by the FMS since 2008 and the WSF since 2020. The FMS with a credit authorization of over 100 billion euros aimed at stabilizing the financial market by helping companies in the financial sector to overcome liquidity bottlenecks and to strengthen the shareholding base of the banks made fragile by the crisis that erupted on Wall Street in September. The Pandemic Crisis Stabilization Fund (WSF), on the other hand, had a credit authorization of over 200 billion euros in order to ensure the survival of companies and to prevent negative effects on the security of supply and the job market.

The 2021 federal budget accounts showed that the FMS was the most indebted special fund at the end of 2020 at 55.17 billion euros and with assets of 31.82 billion euros. For the WSF, debt and equity coincide.

In its 2021 comments on the federal budget and economic management (20/180), the Federal Court of Auditors highlights the problems that arose with the special ITF fund, which was set up in 2009 to cushion the consequences of the financial market crisis. At the time it was supposed to finance the

[2] https://www.bundestag.de/dokumente/textarchiv/2022/kw16-sondervermoegen-890232

federal government's economic stimulus package up to an amount of 20.4 billion euros and had received a credit authorization of 25.2 billion euros. The government's goal was to pay off the debts of the ITF as quickly as possible in better times, write the Bonn auditors. "Despite good fiscal results in the years 2015 to 2019 with a total surplus of 48.2 billion euros, however, no continuous reduction of liabilities has been carried out so far." According to the court, the ITF is "further evidence that secondary budgets in the form of special loan-financed funds entail permanent additional burdens."

The evaluation of the oldest of the special funds, the "ERP Special Fund", which the Bundestag established in 1953, is quite different. The European Recovery Program is nothing more than the US Marshall Plan for the reconstruction in Europe. Since the end of the reconstruction phase, ERP funds have essentially been used to promote investment projects in German industry, especially in medium-sized companies. According to the federal budget for 2020, the ERP's assets still amount to 21.74 billion euros, which makes it third among the special funds. In contrast, the Ministry of Finance estimates the debt at just 585.2 million euros. The Federal Court of Auditors says that, "Because the assets significantly exceed the equivalent value", the Federal Ministry of Economic Affairs "has markedly overfulfilled the legal mandate to preserve the assets."

As the aforementioned analysis of the German Parliament's research office reports, the Federal Minister for Marshall Plan affairs, Franz Blücher (FDP, 1896–1959), presented the bill on the administration of the special ERP fund to the Bundestag (01/4283) towards the end of the first legislature. It was adopted on July 3, 1953, as amended, "against the votes of the communist group". In the report submitted to the steering committee for ERP issues, CDU Deputy Herrmann Pünder recommended a change to paragraph 2 of the bill that has relevant implications even today. "The special fund serves to rebuild and promote the German economy in accordance with the provisions of the Agreement on Economic Cooperation between the United States of America and the Federal Republic of Germany of December 15, 1949." From this the commission concluded: "The special fund is used exclusively for reconstruction and promotion...". The adverb 'exclusively' has been the subject of evaluation over the decades by the German constitutional judges.

This old tradition of German financial management has been rediscovered with great enthusiasm in recent years. There are political reasons that push the current composite government coalition to resort to these tricks: the liberal finance minister wants to avoid expenditure in the budget in order to be able to reduce taxes; the Greens can finance extra-budget the environmental transformation of the economy without clashing with their partners; the chancellor can present a public budget that converges towards a balance (the beloved *Schwarze Null*). This is a controversial practice because parliament must approve the appropriation, controlling its use only ex-post; the Länder do not participate in the allocation of funds and citizens do not have a clear indication of the state's debt level. However, the use of structural funds to counter exceptional events is a need justified by the technological, social and geopolitical transformations that concern not only Germany, but all European countries.

Precisely for this reason, it is surprising that the German example is not providing inspiration for the reform of the governing rules of the European economy. The term "government" is not accidental: in order to identify European emergencies of a strategic nature, typical functions of an institution that knows how to select priorities, finance interventions and respond to the results are needed. The German example indicates the advantages that the euro area would obtain from the establishment of its own fiscal capacity. It also indicates the problems to avoid, starting with the relative irresponsibility of the competent institutions of the fund subject to ex-post controls but not to ex-ante approval procedures in the specific use of the funds.

The importance of considering a fiscal capacity in addition to the European rules

Proposals for a CFC had been made in the academic literature and in the policy debate even before the euro came into existence, by Padoa-Schioppa[3] in 1987 among others. At the time, however, as an ECB discussion paper[4] remarks, the belief prevailed that macroeconomic stabilization would be achieved through market mechanisms and that EMU by itself would lead to more business cycle synchronization within the euro area (EA)[5]. This lack of completeness of EMU emerged soon after its take-off, aggravated by the fact that cross-border private risk-sharing remained limited. The "Four Presidents' Report"[6] envisaged the gradual creation of a CFC, while the "Five Presidents' Report"[7] discusses a euro area stabilization function that rules out permanent transfers through the convergence of economic structures beforehand, so as to encourage governments to follow sound fiscal policies. In its reflection paper[8], the European Commission sketched options for a euro area macroeconomic stabilization function, such as a scheme to protect investment during downturns and an unemployment reinsurance scheme. Although the RRF was a timely response to the Covid-crisis, it remained temporary.

More recently, Buti and Messori[9] have convincingly argued that a central fiscal capacity – or vertical coordination – is a way to improve the efficiency of the current governance. They correctly point out that the level of trust among the member state is currently insufficient to set up the new policy instrument. This observation, however, should encourage taking a larger perspective on the reform of European governance and on the institutions presiding over it.

The request to establish a fiscal capacity has recently been raised by the ECB and the ESM, and should be considered complementary to the reforms of the fiscal rules: having special funds to be used in an emergency would make the request for rigorous fiscal policies in the ordinary management of national

3 Padoa-Schioppa, T. (1987). Efficiency, stability and equity: A strategy for the evolution of the economic system of the European community. Oxford University Press.

4 https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2666~170f00add8.en.pdf

5 Allard, C., Brooks, P., Bluedorn, J., Bornhorst, F., Christopherson, K., Ohnsorge, F., & Poghosyan, T. (2013). Toward a fiscal union for the euro area (IMF Staff Discussion Notes No. 09). IMF. Washington, D.C.

6 Van Rompuy, H., Barroso, J., Juncker, J.-C., & Draghi, M. (2012). Towards a genuine economic and monetary union (Policy Note). European Council. Brussels

7 Juncker, J., Tusk, D., Dijsselbloem, J., Draghi, M., & Schultz, M. (2015). Completing Europe's economic and monetary union (Policy Note). European Commission. Brussels.

8 European Commission. (2017). Reflection paper on the deepening of the economic and monetary union (Policy Note).

9 https://cepr.org/publications/policy-insight-113-euro-area-policy-mix-horizontal-vertical-coordination

budgets more justified. It would also make national public debts, which would not be burdened by unpredictable emergencies, less risky. Record debt levels in euro-area countries expose many countries to risks originating from factors beyond their control, and economic cycles are characterized by deeper recessions and milder recoveries than in the past, indicating the need of structural interventions.

There exists in the literature devoted to European economic governance a substantial volume of proposals dealing with many different types of fiscal stabilization capacities of the euro area. The proposals can be grouped into three big categories: insurance funds, rainy-day funds and revolving funds. They differ in the degree of risk sharing and/or mutualization, as well as the mix of grants and loans in dealing with shocks, although the distinction is not always clear between one and another fund model. Many recent proposals are based on some form of European unemployment benefit scheme (those involving direct transfers to the unemployed or national reinsurance schemes with transfers to the government). Proposals can be further distinguished according to their activation conditions - conditions that trigger payments and pre-emptive eligibility to access funding - and whether the funds are intended for a specific purpose. It is foreseeable that the significant financial commitments linked to the future reconstruction of Ukraine offer the opportunity for the activation of a special fund, bringing the issue of centralized fiscal capacity back to the table of the European Council.

The traditional division between fiscally solid and fragile countries - whose positions may not coincide in the face of the proposal for a new shared fiscal instrument - seems to be overcome in view of the assessment in favor of the establishment of a centralized fiscal capacity expressed recently by the European Central Bank. In an important communication[10] of December 2021, the ECB clearly expresses its opinion in favor of the establishment of a common fiscal capacity for the purpose of macroeconomic stabilization: "Completing Economic and Monetary Union remains essential to strengthen the euro area's shock-absorption capacity. This includes the completion of the banking union and capital markets union. In addition, a permanent central fiscal capacity, if appropriately designed, could play a role in enhancing macroeconomic stabilization and convergence in the euro area in the longer run." It is reasonable to deduce from this that special funds dedicated to overcoming exceptional circumstances beyond the control of these members are even more justified by the common monetary authority.

The recognition of exceptional circumstances and targeted (and possibly conditional) support from a special fund provide the link between the stabilization function and budgetary rules. For this reason it is to be hoped that the ongoing debate on fiscal rules also takes into consideration the preparation of a centralized fiscal capacity. As an ESM research publication[11] notes, "Funds from a fiscal stabilisation function due to exceptional circumstances would mean that the European Commission and the European Council could consider a breach of the 3% budgetary deficit rule exceptional, such that it would not trigger an excessive deficit procedure and might also justify suspending the primary balance rule guiding debt reduction (...) Similarly, when a member state is already subject to an excessive deficit

[10] https://www.ecb.europa.eu/pub/pdf/other/eurosystem_reply_commission_eu_economy_after_covid_implications_economic_governance211202~d2eeec68dc.en.pdf
[11] https://www.esm.europa.eu/publications/eu-fiscal-rules-reform-considerations

procedure, the European Commission and the European Council may issue revised recommendations granting longer deadlines – one more year usually – to meet their deficit targets when exceptional economic circumstances hamper the country's ability to achieve them. At the same time, a country's past track record of sufficient compliance with the rules would be an important determinant to access the funds, also supporting fiscal discipline in normal times."

The availability of a fiscal capacity to supplement the rules, therefore, appears to be of considerable importance. The trend decline in the equilibrium real interest rate, if it proves to be persistent after the exceptional inflationary episode of 2022-23, would imply that the effective lower bound (ELB) on nominal rates interest will more frequently constrain the conduct of monetary policy. In such circumstances, the stabilizing role of fiscal policies would be more important, given their greater effectiveness close to the ELB. Countercyclical fiscal policies require determined action during major recessions to prevent the economic shock from having overly severe or long-lasting consequences, but they also require, crucially, the rebuilding of reserves once the economy is firmly back on track so as to ensure debt sustainability. For this to be possible, national fiscal policies and central European fiscal capacities need to be integrated.

Finally, from an institutional point of view, having resources for shared and strategic purposes would require the EU to take on the capacities of analysis and choice, which are lacking today and which represent a poor alibi for inertia.