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Public debt and growth in German federal states: What can Europe learn?

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Abstract

While there is ample evidence on the linkage between public debt and economic growth for national economies, far fewer investigations have been carried out at the subnational level. In this paper, we therefore study the long- and short-term relationship between regional public debt intensities and economic output (growth) for German federal states between 1970 and 2010. We estimate dynamic error correction models, which account for heterogeneous transmission mechanisms among federal states and the presence of unobserved common factors such as global macroeconomic shocks. Our findings hint at a significantly negative relationship between regional public debt and per capita GDP in the long run. We further demonstrate that this negative long-term effect is not negligible for the interregional differences in per capita GDP levels. Linking our empirical findings to the current policy debate on fiscal consolidation, we show along the lines of the German case that the decision of enacting a constitutional debt brake for subnational governments to limit the degree of discretionary spending policies together with supplementary measures – such as joint capital market operations by the central and state-level governments to lower borrowing costs – may provide new stimuli for a European-wide debate on the feasibility of solid fiscal consolidation.

JEL classification: C23; R11; R50; E62

Keywords: Public debt; Fiscal budget rule; Economic growth; German federal states; Panel data

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1. Introduction

The causes and consequences of public debt on the economic performance of nations are one of the major political issues in the European Union, especially within the euro area. Triggered by massive public expenditures to fight the recent economic turmoil following the global economic crisis in 2007/2008 and the subsequent euro crisis, rising debt-over-GDP ratios of several European economies have raised worries among financial markets with regard to the sustainability of their public finances. To counter the threat of a negative spiral of further harming economic downturns and sovereign credit downratings, two fundamental political views have crystallized: While representatives of Northern European countries underline the importance of balanced budgets through "austerity" principles, government representatives of Southern European nations argue in favor of more "flexibility" with regard to public indebtedness to take into account the fragile economic growth within their countries.[1]

Compared to the intensive debate on public debt management at the national level, however, far less attention has been paid to the nexus between public indebtedness and economic growth at the sub-sovereign level as well as its potential interplay with the sovereign level. In a recent study, Jenkner and Lu (2014) showed for the case of Spain that credit risk premia paid for by the Spanish central government are significantly affected by its actions in supporting fiscally distressed Spanish regions. Hence, regional fiscal imbalances may – in the end – turn out to be a threat at the national level as well. A similar conclusion is drawn by Buiatti, Carmeci, and Mauro (2014) for Italy, who argue that the ultimate cause of the accumulation of public debt in Italy lies in the extraordinary fiscal imbalance of the southern regions.

The regional picture of public debt accumulation and management within EU countries is quite diverse (see, for instance, Ter-Minassian, 2007, for a comparison of fiscal rules in European countries). Germany, for instance, in its aim for fiscal consolidation has recently introduced a new constitutional debt brake (*Schuldenbremse*) that allows federal states (*Länder*) to have only a relatively low structural deficit starting from 2016 onwards. Further, federal states are bound to have structurally balanced budgets starting in the year 2020 (under the so called *zero deficit rule*). This debt brake, in fact, can be seen as an automatic fiscal budget rule to prevent excessive debt-financed public expenditures of single states at the expense of other states and the national government.

Besides the introduction of the German debt brake, which may provide valuable insights with regard to a strengthening of the European Stability and Growth Pact (SGP), the German system of public finances has two other features, which may be of importance for the European debate on the need for harmonizing economic policies and consolidating public finances after the crisis: Firstly, starting in 2013 the German central government and 10 federal states have coordinated their capital market operations and issued a joint *Bund-Länder Anleihe* (also known as *Germany-bond*).

[1] Although this ideological divide among European countries has been obviously intensified by the recent government change in Greece following the elections in January 2015, also prior to this event the French and Italian Prime Minister have already called for a "New Deal for Europe" including larger tolerance in terms of fiscal consolidation so that countries with budgetary deficits do not undermine their economic growth base. For further information on these topical issues, the reader is referred to the following *New York Times* articles titled "Greek Election Reflects a Deep Divide in Europe" (published 26th January 2015, for download at http://www.nytimes.com/2015/01/27/world/europe/greek-election-reflects-a-deep-divide-in-europe.html Last accessed 11.02.15) and "Europe's Anti-Austerity Duo" (published 16th December 2014, for download at http://www.nytimes.com/2014/12/17/opinion/europes-anti-austerity-duo.html Last accessed 15.01.15).