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| The Hague University of applied sciences | German Fiscal Policy used as a blueprint in other Eurozone Countries that need revision after the crisis |

# Executive summary

This thesis considers the extent to which German fiscal policy can be used as a blueprint in other Eurozone countries that need revision after the crisis. This thesis also aims to discover the negative and positive sentiments regarding a common fiscal union in Eurozone countries and what exactly the role of Germany is. Finally, it addresses the economic successes of Germany, which cannot be easily copied by other Eurozone countries. The main question that has been considered in this thesis is the following:**“To what extent can German fiscal policy be used as a blueprint in other Eurozone countries that need revision after the crisis?”**

The methodology examines the secondary data used in this thesis. In this context there has been used legal legislatives, economic working papers, and working papers funded by the European Union and by the *Deutsche* (German) Bank etc. This thesis employs a comparative analysis to explain the correlation between Germany and the other Eurozone countries with respect to fiscal policy.

The result of this analysis is that Germany differs from the rest of the Eurozone countries.

* Germany owes its economic success to domestic factors and to policies that include stabilizing consumption demand, keeping unemployment low during the crisis, and stabilizing fiscal policy.
* Observers argue over whether the German debt brake is the key to its success or whether Germany benefits from its position in the middle of Europe and to its exports within and outside Europe. In fact, the debt brake is perceived as an artificial limit in the German State.
* Eurozone countries have adopted the German debt brake and currently consider a closer European integration by implementing a “German” equalization system. This means that “poorer” Eurozone countries will be funded by “richer” Eurozone countries.

However, the Germans are not satisfied with the fiscal equalization in their own country; thus a fiscal equalization system in Europe will open new conflicts between Eurozone countries. Furthermore, this will mean that the implementation of a fiscal union will lead to greater unity between the Eurozone countries. Germany will be asked to relinquish its political sovereignty, as decision-making will be at the European level. However, it seems that Eurozone countries are not prepared to have a “European government”.

References

[Executive summary ii](#_Toc409031811)

[Introduction 1](#_Toc409031812)

[Chapter 1 The evolution of Fiscal Policies in Germany 3](#_Toc409031813)

[1.1 West Germany after the Second World War 3](#_Toc409031814)

[1.1.1 The Social Market Economy 3](#_Toc409031815)

[1.1.2 The Keynesian theory 4](#_Toc409031816)

[1.2 A shift towards a Keynesian approach 4](#_Toc409031817)

[1.2.1 The end of Keynesian theory 5](#_Toc409031818)

[1.3 Demand stimulation 5](#_Toc409031819)

[1.3.1 A new fiscal transfer system 6](#_Toc409031820)

[1.4 The creation of the Economic Monetary Union (EMU) 6](#_Toc409031821)

[1.4.1 Germany after the EMU 7](#_Toc409031822)

[1.5 The Euro crisis 7](#_Toc409031823)

[1.5.1 The crisis in Germany 8](#_Toc409031824)

[1.6 New fiscal rules in Europe 8](#_Toc409031825)

[1.7 Conclusion 9](#_Toc409031826)

[Chapter 2 Methodology 10](#_Toc409031827)

[Chapter 3 The German debt brake as a blueprint for Eurozone countries 12](#_Toc409031828)

[3.1 The division of power in Germany 12](#_Toc409031829)

[3.1.1 The impact of redistribution of revenues 12](#_Toc409031830)

[3.2 Germany as export-led-mercantilist 13](#_Toc409031831)

[3.3 The effectiveness of the debt brake 14](#_Toc409031832)

[3.4 Germany as example for Eurozone countries 14](#_Toc409031833)

[3.4.1 The implementation of the German debt brake in the Eurozone 15](#_Toc409031834)

[3.5 The interaction between monetary policy and fiscal policy 15](#_Toc409031835)

[3.5.1 The skepticism of a fiscal union 16](#_Toc409031836)

[3.6 A heterogeneous Eurozone 16](#_Toc409031837)

[3.6.1 Fiscal equalization scheme at European level 17](#_Toc409031838)

[3.7 Conclusion 17](#_Toc409031839)

[Chapter 4 Discussion 19](#_Toc409031840)

[Chapter 5 Conclusion 21](#_Toc409031841)

[References 23](#_Toc409031842)

# Introduction

Since the summer of 2007, the European Union (EU) has known the deepest and longest recession since the Great Depression of the 1930s. This recession started after the fall of the mortgage markets in the USA, which resulted in a debt crisis in the EU. European authorities have therefore been considering a common fiscal policy that could stop the Euro crisis. However, economists argue that, “The debate on the fiscal strategy in Europe seems at times like a war of religions” (Buti & Carnot, 2013, para.1). Some academics argue that the future of the Eurozone might be completed by a fiscal union, which can be thought of as an integration of the fiscal policy of nations in which individual countries share the same common budget. However, Andreas Peichl states that, “The Eurozone is as typical as an economic union because monetary policy is decided at central level while fiscal policy is mostly carried out at member state level” (Fuest & Peichl, 2012, p. 2).

Recently, observers argue about the level of heterogeneity in the EU with Germany in the lead. For instance, some observers argue about an emergence of a “German Europe”. Indeed, the current success of the German economy has enhanced the position of Germany in the EU. As a result, Eurozone countries prefer to copy the German fiscal policy in their own constitutions to combat the crisis. In fact, in 2012 the Eurozone countries were forced to introduce the debt brake (*Schuldenbremse*), which requires governments deficits no more than 0.5 per cent of the Gross Domestic Product (GDP) and a debt that does not exceed sixty per cent (European Commission, 2012, section 2).

The aim of this study is to analyze the evolution of Germany’s fiscal policies since post-war 1949 and to consider the extent to which the German debt brake has the same problems within the Eurozone countries. The research question that defines this thesis is as follows: **“To what extent can German fiscal policy be used as a blueprint in other Eurozone countries that need revision after the crisis?”**

This thesis is divided into five chapters. The first chapter describes Germany’s Social-Market Economy, the implementation of Keynesian theory, the Keynesian demand stimulation, the fiscal-equalization system, and the German debt brake. In describing these fiscal policies, this thesis seeks to explain the changing and developing constitutional environment in Germany from a historical perspective. This will help to understand why the postwar German Governments chose to implement fiscal policies at particular moments in history. The Euro crisis described at the end of this chapter explains the role of Germany during the crisis and the new fiscal rules that are implemented in the EU.

The second chapter discusses methods that have been used to answer the main question. In addition, it presents a comparative analysis. The comparison is between Germany and other Eurozone countries, and it is based upon a literature review of sources such as policies, academic articles, and laws.

The third chapter outlines the comparative analyses. Whereas Germany and Northern Eurozone countries regard as unnecessary the establishment of a fiscal union, Southern Eurozone countries prefer a fiscal union or even departure from the Eurozone. This chapter begins by analyzing the effectiveness of the German debt brake, and then considers whether it will cause the same problems as in the Eurozone countries. In addition, it will explain why German is against a common fiscal union.

The fourth chapter offers recommendations for further research. This thesis concludes that a fiscal union can only be implemented when there is a closer political integration. However, it seems that Eurozone countries are not ready to relinquish their sovereignty and prefer to act on national interests. Though Southern Eurozone countries prefer a fiscal equalization system like that found in the Federal Republic of Germany, it seems that the German fiscal equalization system is not as effective as it first appears. The question is therefore whether Germany will agree to a fiscal equalization system at the European level, and if such equalization will help to solve the Euro crisis. In addition, it appears that the German debt brake has different versions in the German States. According to the German States, the debt brake is based on artificial limits. The effectiveness of the debt brake in Germany is in doubt, which cannot assure the effectiveness of this in other Eurozone countries. In addition, Germany survives every crisis because, unlike other Eurozone countries, it is an export-led mercantilist.

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# Chapter 1 The evolution of Fiscal Policies in Germany

This chapter explains Germany’s historical experiences with fiscal policies. The following pages discuss how Germany’s post-1949 experiences with deficit spending have led to the implementation of different fiscal policies in the German Federal Government in order to stabilize macroeconomic imbalances. The themes that inform this chapter are the following:

1. The success of the social market economy;
2. The start and end of Keynesian Theory;
3. The new fiscal transfer system after the German unification;
4. The fiscal rules implemented after the European Monetary Union and the Euro crisis.

## 1.1 West Germany after the Second World War

After the Second World War, West Germany succeeded in designing a new political and social order that made West Germany a modern democratic industrial nation (Radke, 1995, p. 12). At that time two decisions were made: first, the Basic Law was implemented; second, the social market economy was adopted (*Soziale Marktwirtschaft*). On 8 May, 1949, the Basic Law was adopted in the Federal Republic of Germany (*Bundesregierung*). The Federal Republic of Germany (FRG) in West Germany was based on a federalist structure with a division of power between the German States and the central government (O'Dochartaigh, 2004, p. 23). The Bundestag (*National Parliament*) was elected by citizens, and the Bundesrat (*Upper House*) was represented by the German States. TheGerman States had veto power on taxation matters that directly affected the states. These rights were established in the German Constitution—also called the Basic Law—that came into force on the 23rd of May 1949 in West Germany (Pünder &Waldhoff, 2014, p. 44).

### 1.1.1 The Social Market Economy

Germany’s economic institutional framework was the social market economy. The economic theory was influenced by the Freiburg economists in the 1930s and implemented after the war by Konrad Adenauer, the German Federal Chancellor, and by Ludwig Erhard, the Federal Economics Minister (Konrad-Adenauer-Stiftung, 2008, p. 2). The fundamental idea of the social market economy is that it combines the principle of the freedom of the market with that of social security (Friedrich Wünsche, 1982, p. 65). In other words, social problems should be solved by social security policy. This means the redistribution of income (taxes), subsidies, pension schemes, and protection from unemployment (Konrad-Adenauer-Stiftung, 2008, p. 21). Furthermore, this theory would help to guarantee long-term economic growth based on rules for competition and infrastructure (Gross, 2009, para. 3). The principle of freedom of the individual is therefore important with respect to competition.

### 1.1.2 The Keynesian theory

Keynesian theory was developed by the British economist John Maynard Keynes. In the 1930s, Keynes wanted to overcome the Great Depression. He therefore developed a theory according to which increasing government expenditures and lowering taxes would stimulate demand. However, a more anti-Keynesian note was sounded by the West Germans after the Second World War. They saw the social market economy as an alternative to Keynesian theory (Imbeau & Petry, 2004, p. 39). The trauma of two periods of extreme inflation in the first half of the twentieth century led to a reorientation in the economic policies of the Germans. For this reason, the West German central Bank pursued inflationary policy instead of a Keynesian approach (Touffut, 2008, p. 33). The rapid economic growth reinforced the power of social market views in the minds of West-German policy-makers until the 1960s. As stated by Mark Marktanner, “The commitment to a normative social and economic order had helped Germany realizing its economic miracle after the Second World War” (Konrad-Adenauer-Stiftung, 2008, p. 29).

## 1.2 A shift towards a Keynesian approach

In 1967, West Germany faced its first post-war recession with inflation (Lindlar, 1997, p. 3). The social market economy that was used in the 1950s was replaced by a Keynesian influence in the 1960s (Funk, 2012, p. 13). In fact, Keynesian policies were popular during the period of Grand Coalition under Willy Brandt in 1966-1969.

Lothar Funk states that the West German ¨Law on Stability and Growth¨, which applied during 1966 and 1967, was the way to shift to Keynesian demand-side strategy (Funk, 2012, p. 13). At first, the law was passed to avoid future recessions, to formalize cooperation between governments, and to make fiscal intervention against macroeconomic imbalances (Scheider, 2014, p. 3). The purpose of this new instrument was price stability and a high level of employment.

In the 1970s, the finance minister, Karl Schiller, purposed to the German Federal Government that he can overcome the recession of 1967. Then in 1972, under Schmidt’s direction, there was a shift towards monetary policy, and stabilisation became priority (Paterson and Smit, 1981, p. 43). In addition, the German Federal Government realized that German economic policy had embraced Keynesian and monetarist elements and rejected social consensus, which was seen as an important element of an economic policy. As stated by William Paterson and Gordon Smit, “There was a tension between both elements, but each was derived from, or rationalised with reference to, the larger concept of the social market economy*”* (Paterson and Smit, 1981, p. 41). It could be said that strong belief in the effectiveness of Keynesian theory decreased in Germany in the 1980s. According to Henry Farrell, German monetary policy was always against Keynesian policy in domestic economy (Farrell, 2012, p. 24).

Thus, Keynesian theory did not last long in Germany. Funk argues that Keynesian theory cannot affect expansionary monetary and fiscal policies in the long term. It will affect the price level, but it will not affect the employment rate (Funk, 2012, p. 13).

### 1.2.1 The end of Keynesian theory

In fact, as stated by Stephen Gross, the Kohl government moved away from Keynesian theory and used the social market economy as a guideline in the 1980s (2009, para. 4). However, in 1982 there was still inflation and debt; therefore the Kohl government started to focus on stabilizing production and reducing the federal debt (Gross, 2009, para. 4). After the fall of the Berlin wall in 1989 and the unification of Germany in 1990, the Kohl government faced a change in fiscal policy that was highly expansionary (Louis, 2011, p. 34). Expansionary policy means increasing aggregate demand through government spending or decreasing taxes. It temporarily helped to insulate the newly unified Germany from global recession. The Bundesbank tightened the monetary policy because it was afraid that debt and inflation would increase. Unfortunately, Germany fell into recession, which led to an increased unemployment rate, deficits, and debts (Louis, 2011, p. 196).

## 1.3 Demand stimulation

During the German unification, the Germans implemented Keynesian demand stimulation policy. The idea behind Keynesian theory is that the macroeconomy can be in recession for a considerable time in order to overcome the lack of aggregate demand to reduce unemployment and increase growth (Pettinger, 2013, para. 1).

Facing the crisis, German politicians implemented demand-stimulus measures. Demand stimulus leads to an increase of debt, which leads to high costs, which threatens the sustainability of public finances. For instance, consumers cut spending because they expect that taxes and unemployment will rise in the future. Thus, the aggregate demand will reduce (Siebert, 2004, p. 35).

The reason Germans are against demand stimulation is because the high growth rates of 1990 and 1991 were caused by implementing the Keynesian demand stimulus in order to transfer money to East Germany (Siebert, 2004, p. 36). The federal government was transferring payments and infrastructural investment to the East. The Germans were expecting that the East would converge easily to the West. However, prices were rising, interest was high, and it eventually led to a recession in 1992 (Gross, 2009, para. 2).

However, implementation of Keynesian policy by the Germans was soon abandoned because of difficulties in extra expenditures by tax increases (Imbeau and Petry, 2004, p. 41). According to Harold Wattel, anti-Keynesian counter-revolutionaries disagreed with the destabilizing shocks, whereas Keynesians believed that observing the shocks in the market can offset them and eventually lead to stabilization (Wattel, 1985, p. 125).

### 1.3.1 A new fiscal transfer system

In order to create social security and economic stability, the Germans had to change their fiscal strategy. The recession in 1992 led to the decision by the German government to raise taxes, increase social security contributions, and cut spending (Bibow, 2012, p. 19). However, the reform in 1995 increased the role of payments to the East German States, which also included fiscal resources with respect to new supplementary grants for all East German States as well as the Bremen and Saarland (situated in the West) who were facing difficulties regarding the transition from the old equalization system (Hepp & Von Hagen, 2010, p. 8). Tax-revenue sharing between the German States and the federal government is known as the fiscal equalization system (*Länderfinanzausgleich*). During this time period, Germany experienced poor economic growth and further income improvements. Finally, the government of Gerhard Schroeder in 1998 did not encourage the implementation of Keynesian policy (Farrell, 2012, p. 24).

## 1.4 The creation of the Economic Monetary Union (EMU)

After many years of careful preparations, the EMU became the backbone of the European Central Bank on 1 June, 1998. This event was followed on 1 January, 1999, by the introduction of the official currency, the euro, in eleven nations. The nations were prepared to be a part of the Eurozone by replacing their nations’ currencies with a new common currency. In addition, the Stability and Growth Pact (SGP) entered fully into force on 1 January, 1999 (European Commission, 2012, section 1).

Germany, one of the largest members of the EMU, forced the creation of SGP that would give financial penalties for any country with a budget deficit of more than three per cent of the Gross Domestic Product (GDP) or a debt exceeding sixty per cent of its GDP. When Germany itself violated these conditions (Feldstein, 2012, p. 2), the Council of Ministers voted not to impose penalties, and the SGP was thereby shown to be inadequate.

On 1 January, 2002, the German Mark, The French Franc, the Italian Lira, the Portuguese Escudo, and the Belgium Franc were replaced by Euro banknotes and coins. According to Harold James, this initiative was driven by the political will to establish a stable monetary policy to promote closer integration (James, 2012, p. 373). Unfortunately, just the opposite happened. After the establishment of the EMU, many countries proved to have difficulties adjusting their economic policies to the demands of the single monetary policy (Monetary Policy Report, 2012, p. 10). Therefore, the experience of the EMU was perceived as a disappointment.

### 1.4.1 Germany after the EMU

Germany’s fiscal policy has deteriorated since 2001, and even exceeded the Maastricht limit of three percent of GDP three years in a row (Siebert, 2004, Greiner, Koeller, Semmler 2004). In addition, Horst Siebert argues that the budget consolidation and the confidence in fiscal policy has decreased, which raises the question whether fiscal policy is sustainable. However, the position of Germany differs from that of the other European countries with respect to the pace of reduction in fiscal deficits (Artus, 2010, p. 4). In 2006 and 2007, Germany was recovering from the crisis. In 2007, Germany achieved a budget surplus, which means that government revenues exceeded government spending. In other words, the budget was healthy and the government could pay off national debt. According to Stephan Gross, the surplus existed because of good business and a consequent increase in employment (2009, para. 6).

## 1.5 The Euro crisis

Problems on the US real estate market led to the beginning of the financial crisis in 2006/2007. The reason was the fall of Lehman brothers, which was a global bank. Its fall caused the euro crisis in late 2008 (The economist, para. 1). Unfortunately, Germany and the rest of the Eurozone countries were hit hard by the economic crisis in 2008. In 2008, the European Council approved structural reforms and fiscal measures of 200 billion euro to boost demand and help European countries out of the crisis (Roeger & In ‘t Veld, 2009, p. 1). In addition, as stated by Henry Farrell, ¨The European Commission sought to get Germany to commit to spend 1% of GDP to boost aggregate demand in advance of the European Council summit in December 2008*¨* (Farrell, 2012, p. 24). At first, the Germans were against this initiative; however, the majority of member states supported it. Therefore, the German government accepted the proposal.

### 1.5.1 The crisis in Germany

To overcome the crisis of 2008, the German Chancellor, Angela Merkel, and the Finance Minister, Peer Steinbrück, implemented the ¨fiscal stimulus” despite being strong opponents of the fiscal stimulus (Gross, 2009, para. 1). The aim of fiscal stimulus is to reduce taxes and increase government spending (International Monetary Fund, 2001, p. 18). In addition, it aims to increase the ¨aggregate demand¨. For example, when consumption shrinks during recession, the income of groceries and restaurants (etc.) decreases and the aggregate demand decreases. For this reason, governments boost the aggregate demand by cutting taxes and increasing government spending in, for example, infrastructure and social welfare to boost the GDP (Ning, 2009, para. 6). As a result of these practices, employees are able to spend again and consumer demand increases. After that, government spending decreases.

According to Louis Imbeau and Francois Petry, the German system was the only one that allowed the federal government to perform a Keynesian-demand-stimulation policy (Imbeau & Petry, 2004, p. 39). Stephan Gross argues that the reason the Chancellor and Finance Minister resisted the European Union-wide fiscal package is that they feared other European States would run deficits (2009, para. 7). Some German policy makers were sceptical about Keynesian theory. These were, according to Henry Farrell, the conservatives (*CDU*) and the social democrats (*SPD*), who were against the stimulus program (Farrell, 2012, p. 25).

The recovery of Germany began in 2009 by implementing a new fiscal rule—called the debt brake—which constrained the structural budget deficit to 0.35 per cent of GDP by 2016 for the federal government and for the German states by 2020. The debt brake led to a fast economic recovery in 2010 and 2011 (Detzer & Eckhard, 2014, p. 1).

## 1.6 New fiscal rules in Europe

The Stability and Growth Pact is one element of fiscal policy that is implemented by member states. Recently, the

SGP has been reformed, and is called the Euro Plus Pact. The Pact was implemented in 2011, which reflects competitiveness, employment, sustainability of public finances, and reinforced financial stability (European Commission, 2013, section 2). In addition, the Euro Plus Pact coordinated the policy areas beyond fiscal policy, and supervision was reformed in the Sixpack. The fiscal compact was also added, which implies new fiscal rules that oblige countries to balance budgets at the national level.

The six-pack strengthens the SGP by covering fiscal surveillance as well as macroeconomic surveillance.

The Fiscal Compact was also implemented to set new fiscal targets that entered into force on the first of January, 2013. The national budgets must be in balance or in surplus and shall not exceed 0.5 per cent of the GDP at market prices. In addition, it shall be in line with the medium-term budgetary objective as it is defined in the SGP (Council of the European Union, 2012, p. 3).

## 1.7 Conclusion

In short, various fiscal policies have been implemented in Germany to address the economic situation. It started with the social market economy in the 1950s that led to an “economic miracle”. Eventually, it shifted towards Keynesian policy in the 1960s, which was popular during the Grand coalition under Willy Brandt from 1966-1969. Keynesian theory contradicted the social market economy because it rejected the social consensus. In the 1980s, Keynesian theory lost its effectiveness. The fall of the Berlin Wall in 1989 and the unification in 1990 led to the implementation of expansionary fiscal policy. However, Germany fell into recession in 1992. Implementation of the new equalization system in 1995 helped to improve the economy of East Germany. After establishing the EMU, Germany again fell into recession from 2001 to 2003. After those years, Germany recovered from the crisis that lasted until 2008. The German Chancellor, Angela Merkel, implemented the fiscal stimulus despite being a strong opponent of this approach. In 2009, the German economy grew after implementing the debt brake. Eurozone countries that also fell into recession got help from the Germans. The next chapter will examine at Germany’s role with regard to the Eurozone countries.

# Chapter 2 Methodology

Having established the theoretical outlook of this thesis, this chapter will reflect on the methods that has been used to collect the evidence needed to support the arguments. The main question asked in this thesis is this: **“To what extent can German fiscal policy be used as a blueprint in other Eurozone countries that need revision after the crisis?”** This question implies comparative analyses between Germany and the rest of the Eurozone. This comparison was chosen because of the economic success of Germany, which observers perceive as exemplary within the Eurozone. This thesis therefore asks whether or not it is possible to adopt German fiscal policy in other constitutions. Additionally, it analyzes how the fiscal union is perceived by Germany and by other Eurozone countries.

The following sub-questions have also been asked:

1. **How did German fiscal policy evolve from post-war 1949 to the establishment of the EMU?**
2. **What was the condition of Germany after the establishment of the EMU?**
3. **What European fiscal rules were implemented after the establishment of the EMU?**

By summarizing changing fiscal policies in German history, this thesis shows that the German Federal Republic implemented fiscal policies to address the economic situation. The first framework considered was the social market economy. For instance, the working paper of Konrad-Adenauer-Stiftung and books of Siebert Horst have been used to explain the success of the social market economy. The sources used to explain the transition from the social market economy to Keynesian theory (and vice-verse) are from writers who treated the evolution of Keynesian theory in Germany. For instance, Henry Farell and Stephen Gross have written about the rise and fall of Keynesian theory in Germany. Furthermore, Lothar Funk discussed the change from Keynesian theory to fiscal stimulus in Germany. Additionally, Konrad-Adenauer-Stiftung and Siebert Horst have been cited. To explain legal changes in the European Union, there are used sources from the European Commission, the Council of the European Union, and the Monetary Policy Report.

The following chapter will address the success of Germany and the effectiveness of the German debt brake. In addition, it will consider the view of Eurozone countries regarding a common fiscal union in the future.

The analysis starts with the following:

1. **How effective is the debt brake in the German constitution?**
2. **How do Eurozone countries perceive the establishment of a common fiscal Union?**
3. **What is the current situation in Eurozone countries with regard to the fiscal policy?**

In particular, economic research papers have been used in this chapter. For instance, an economic research paper funded by the EU in order to observe the domination of Germany in Europe (Detzer & Eckhard, 2014, p. 1). Sources produced by the Deutsche Bank Research, the German Federal Ministry of Finance, and the International Monetary Fund are also used to explain the frameworks of the fiscal equalization system in Europe, fiscal union, and a heterogeneous Eurozone.

In short, though the research is based on secondary sources, it puts laws and parliamentary reports into perspective. With help from secondary sources, this thesis answers the main research question. However, one should keep in mind that fiscal policy is a complex topic. Thus, the conclusion does not give straightforward answers and recommends further research.

# Chapter 3 The German debt brake as a blueprint for Eurozone countries

The financial credibility of Germany increased after the implementation of the debt brake in 2009 because Germany managed to balance its budget and its economy was therefore growing. According to Wolf-Georg Ringe and Peter Huber, ¨Germany’s influence in drawing up the Fiscal Compact as part of a package of measures has driven forward the Eurozone members to adopt national debt brakes¨ (2014, p. 65). Nowadays, economists argue whether it is reasonable to adopt the national debt brake in their constitutions. Thus, the question is whether the Euro crisis is caused by unstable fiscal policy.

## 3.1 The division of power in Germany

Implementation of the SGP needed to correct the excessive deficits in the first years of the EMU in Germany and the rest of the Eurozone countries. However, Mark Buti and Van den Noord wondered whether Germany wanted to adopt the fiscal rules (Buti & Van den Noord, 2004, p. 1). According to Horst Siebert, the expenditures of the government involve three layers: the federal level, the German States, and the municipalities (2004, p. 4). The federal level uses forty percent of the government (2004, p. 4). This means that the federal government provides transfers to the German States and the German States provide transfers to the municipalities. According to Mark Buti and Van Noord (2004, p. 4), the federal level cannot influence the expenditures and the budget of the German States. In other words, to prevent excessive deficits, the responsibility has to be split into three layers of government. The fourth layer is the social security system, which is spending on social benefits and for social purposes. The social security system receives money from the federal level that comes from tax revenues (Siebert, 2004, p. 4).

### 3.1.1 The impact of redistribution of revenues

The federal government of Germany is actively using the fiscal-policy instrument. However, according to Louis Imbeau and Francois Petry, the system is limited in its effectiveness to stabilize the macroeconomy (Imbeau & Petry, 2004, p. 40) because the compulsory negotiation system raises transaction costs and makes compromises expensive for the federal government. For this reason, the division of power also comes from the redistribution of revenues to German States, which aims to harmonize the standard of living throughout the country. As stated by Imbeau and Francois Petry, ¨The federal government has difficulties to reduce expenditures that affect in one way or other the interests of subgovernments¨ (2004, p. 41). In other words, it is harder to reduce expenditures when there is a division of power in a country because German States need the resources of the federal government in order to implement federal programs.

Siebert Horst argues that the redistribution of revenues has a negative impact on the economy (2004, p. 6). There are still transfers to East Germany. This means that transfers are made from the federal government to the public budgets of the federal states in Eastern Germany, which is called ¨vertical revenue sharing¨ (Siebert, 2004, p. 21). Also, there is revenue sharing among the federal states, which is called ¨horizontal revenue sharing¨.

It should be noted that the federal government did not stop giving funds to the poorer states. In fact, the federal government was giving a greater share to poorer states (Ziblatt, 2002, p. 625). This contradicts with what is argued by Jeffrey (2002), who states that the relationship between the states and the federal government did not improve since stronger states did not want to share the funds to weaker states. For this reason, fiscal decentralization appeared in the political debate. In fact, stronger German States panicked about the slow economic growth, which affected revenue growth in stronger states (Ziblatt, 2002, p. 628).

Furthermore, governments are autonomous in their own expenditures. For instance, they have to full authority over legislation and tax administration (Gupta, Knight & Wen, 1994, p. 77). The result is that states within a country have some degree of autonomy. The fiscal equalization system could be seen as a shared solidarity pact and fiscal responsibility (Deutsche Bank Research, 2011, p. 1).

## 3.2 Germany as export-led-mercantilist

According to Philip Arestis and Malcolm Swayer, fiscal policy contributed to a weak domestic demand and therefore to Germany’s appearance as an ¨export-led mercantilist¨ in the years before the crisis (Arestis & Swayer, 2014, p. 215). They argue that the German constellation required fiscal deficits of around five percent of GDP. However, this was prevented by the regulations of the Stability and Growth Pact (SGP), which required fiscal deficits of three percent of GDP. In particular, during the recession from 2002 to 2004, the fiscal policies in Germany were restrictive. However, after 2004, the fiscal policies in Germany led to greater surplus.

Germany recovered fast from the crisis that started in 2007 and ended in 2009. According to Daniel Detzer and Eckhard Hein, this is because Germany is an “export-led mercantilist¨ regime (Detzer & Hein, 2014, p. 26). “Export-led mercantilist¨ strategy focuses on increasing export which leads to increasing demand for domestic output. It does so to improve import and thereby raise domestic income (Hein, 2014, p. 153).

However, Daniel Detzer and Eckhard Hein (2014, p. 6) argue that the years after the crisis—2010, 2012, and 2013—encouraged recovery by stabilizing the private consumption demand. According to Klaus Zimmermann, ¨the great recession ended in 2010 as GDP grew by 3.7 percent in Germany¨ (2010, p. 7). Germany recovered from the crisis thanks to their ¨export-led mercantilist¨ strategy.

## 3.3 The effectiveness of the debt brake

In 2009, Germany successfully implemented the counter-cyclical use of fiscal policy, also called the debt brake. In other words, recovery from the economic crisis required that the economy be stimulated. The debt brake was the solution agreed to by the federal government. According to Philip Arestis and Malcolm Swayer (2014, p. 223), the debt brake led to strict limits on structural government deficits. Even consolidation aid is still given for Berlin, Bremen, Saarland, Saxony-Anhalt, and Schleswig-Holstein. For this reason, Philip Arestis and Malcolm Swayer perceive the debt brake negatively. In their view it is like imposing artificial limits at the federal and state level (2014, p. 223). According to Armin Steinbach, ¨A problem with the German debt brake is that it changes nothing about the underlying incentive structure created by the shared liability between the central government and the regional state government¨ (Steinbach, 2014, p. 87). The German States need to balance their budgets by 2020. How they balance them, however, is up to them. Thus, every German State has a different local version of the debt brake. Therefore the German States doubt whether the debt brake is effective (Wolf-Georg Ringe and Peter Huber, 2014, p. 69).

## 3.4 Germany as example for Eurozone countries

Eurozone countries are copying the German model. However, it cannot be applied in other countries because of structural differences between Germany and other Eurozone countries. According to Patrick Artus (2010, p.1), Germany is able to reduce fiscal deficits and German products are well positioned inside and outside Europe. Furthermore, Germany is the largest contributor to finance in the European Union. Not every country can utilize an export-oriented growth model like Germany. The Germans like to implement supply-side-oriented measures to balance the budget; thus, the national fiscal policies have to be monitored and sanctioned in an effective way (Funk, 2012, p. 32). According to Patrick Artus (2010, p. 4), Germany refuses to transfer money from richer countries to poorer countries—as occurred in German federalism—though other European countries prefer a certain degree of federalism. The reason is that other European countries struggle with excessive fiscal deficits and public debts. The only way to overcome the euro crisis is for Eurozone members to find a way to renew the current system, which can overcome the crisis. According to Funk, Eurozone members have to start to balance the national economic autonomy and provide for the centralization of economic governance (2012, p. 31).

### 3.4.1 The implementation of the German debt brake in the Eurozone

Implementation of the debt brake would not be necessary if the Eurozone had an effective budget control. According to Armin Steinbach, the SGP was not sustainable enough; therefore the debt brake could be seen as a replacement of the SGP (2014, p. 74). However, the introduction of debt brakes is no guarantee that responsible fiscal policy will result. The Fiscal Compact is implemented because of the SGP’s failure to monitor the budget of the Eurozone members. Furthermore, Wolf-Georg Ringe and Peter Huber argue that, ¨Critics see that Germany’s problems over the debt brake with the German States sends warning signs about similar stresses within the Eurozone and Member States¨ (Wolf-Georg Ringe and Peter Huber, 2014, p. 69). For example, the German States are afraid of losing their autonomy, which is also happing in other Eurozone countries.

## 3.5 The interaction between monetary policy and fiscal policy

Monetary policy is decided at the European level. Therefore, the EU can be characterized as an economic union. Monetary policy is carried out by the Monetary European Union and by the Central Bank. The main task is to increase and influence the supply of money. According to Pettinger, monetary policy became more popular because of the declining influence of politicians, as monetary policy is set by the Central Bank. On the contrary, fiscal policy may have more supply effects on the economy. For instance, lower spending means higher income tax.

Though some economists place monetary policy above fiscal policy, it is nevertheless a fact that monetary policy goes hand-in-hand with fiscal policy: both policies are used to control inflation (Pettinger, 2011, section 3). These two tools are used by governments to achieve macroeconomic objectives. It can be concluded that these two policies interact with each other by observing that fiscal policy influences the output of the economy and monetary policy influences the money supply. For this reason, monetary authorities inject money into the economy, which leads to more spending and more jobs.

Fiscal policy and monetary policy used to be under the control of national governments. Nowadays, monetary policy has been formulated into the European Monetary Union, and the creation of the Stability and Growth Pact reformed the fiscal unions. Another difference between the EMU and fiscal policy is that the EMU is based on an arrangement of public finances between member states while fiscal policy is decentralised. However, the European Union implemented the Stability and Growth Pact (SGP), which can be seen as a way toward a common fiscal policy in the EU.

### 3.5.1 The skepticism of a fiscal union

Fiscal policy is carried out at the member state level. Thus, there is no question of a ¨fiscal union¨ (Fuest & Peichl, 2012, p. 9). According to Clemens Fuest and Andreas Peichl (2012, p. 4), the German Academic Advisory Board of the German Federal Ministry of Finance prefers to focus on financial sector reform and sovereign debt restructuring instead of on a centralized fiscal policy. However, according to Celine Allard *et al*. (2013, p. 5), a centralized fiscal policy will reduce the risk of idiosyncratic national policies and lead to better fiscal coordination. In addition, closer fiscal integration will lead to a more stable monetary union in the long term (Allen, Neate, & Davies, 2013, p. 27).

On the contrary, Fanceso Nicoli from the European Policy Centre argues that, “Any form of fiscal union must accomplish, regardless of its institutional shape, two basic functions: preventing the emergence of endogenous asymmetric crisis, and correcting acute economic and fiscal crisis” (Nicoli, 2013, para. 3). For this reason, he argues for a stronger European budget, for a strengthened coordination mechanism for national budgets, and eventually for an independent national budget. However, Anders Borg, who is Sweden’s finance minister, argues that the Eurozone is trying to push toward a closer fiscal integration while the EU is doing little to solve the debt crisis (Milne, 2013, para. 2). He is therefore skeptical about the idea of a fiscal union with respect to euro bonds and joint taxes. In other words, a fiscal union can only exist if Eurozone countries are prepared to reform their national fiscal policy towards a centralized fiscal policy.

## 3.6 A heterogeneous Eurozone

Observers argue that the creation of the EMU led to a divergence in the Eurozone between Southern Eurozone countries (Greece, Portugal, Italy, and Spain) and Northern Eurozone countries (Germany, The Netherlands, Finland, Austria, and Belgium) (Arestis & Swayer, 2012; Artus, 2010). According to these observers, the Eurozone is becoming heterogeneous with regard to the increasing macroeconomic imbalances in the Southern countries. According to Philip Arestis and Malcolm Swayer (2012, p. 221), the Southern countries decreased in international competitiveness after the establishment of the euro.

Thus, Social unrest in the South has inspired some to consider leaving the Eurozone. It can be concluded that south European member states prefer to have a fiscal union because of the excessive deficits. In 2012, the new proposal was implemented by the Academic Advisory Board of the Federal Ministry of Finance, ¨which places less emphasis on centralised fiscal policy coordination and instead focuses on financial sector reform and sovereign debt restructuring in the case of fiscal crises¨ (Fuest & Peichl, 2012, p. 1). According to Allard *et al*. (2013, p. 5), an approach to a fiscal union will strengthen the architecture of EMU and stabilize the Eurozone. In addition, they argue that centralized fiscal policy would lead to a better fiscal coordination because there would be more counter-cyclical tools available to prevent excessive restrictive fiscal stances during recessions. However, in order to implement this, Eurozone countries need to transfer some of their fiscal responsibility to the centre.

### 3.6.1 Fiscal equalization scheme at European level

The preference for implementing fiscal equalization scheme at European level is due to macroeconomic imbalances in some Eurozone countries. According to Clemens Fuest and Andreas Peichl (2012, p. 7), fiscal equalization schemes can only exist in union with a high degree of political integration and a strong central government. This means that member states have to relinquish political sovereignty for decision making at the national level. In other words, European institutions have to be fully developed at the European level, which can take an institutional leap towards a federal state. The fiscal union includes only transfers when Eurozone members fail to meet their obligations to repay their debts (Fuest and Peichl, 2012, p. 6). The current EU budget does not include transfers; however, it exists of one percent of the GDP, which is quite small. Anders Borg states that the Southern Eurozone countries need to improve their competitiveness because the transfers from the Northern Eurozone countries compensate the lack of growth. For this reason, some observers are against the fiscal union. But there are also observers who believe that a fiscal union is the only way to make a single currency. However, according to Hubert Gabrisch and Karsten Staehr (2014, p. 8), competitiveness appears to have no effect on capital flows in the short term in Southern, Central, and Eastern Europe, while it improves cost competitiveness in Northern Europe.

## 3.7 Conclusion

In short, issues of the debt brake in Germany are the following:

1. Compulsory negotiation system that is raising transaction costs and makes compromises expensive for the federal government;
2. The debt brake is imposing artificial limits at federal and state level;
3. The German States differ in how they balance the debt brake at the local level. This means that governments are autonomous in their own expenditures and prefer to have autonomy to some degree.

In addition, Germany’s economy grew because of the focus on increasing export. It seems that copying the debt brake in Eurozone countries is not the way to solve the crisis. Comparing the issues of the debt brake in Germany might also happen in the Eurozone countries. Furthermore, the Southern Eurozone countries prefer a fiscal equalization system at the European level. However, this is another point of debate, which only can exist when there is a closer political integration within the Eurozone.

# Chapter 4 Discussion

Research has tended to focus on Germany’s post-1949 fiscal policy experiences followed by analyses of Eurozone countries that use Germany as a blueprint for their own fiscal policy. After analyzing this topic, I conclude that it will be a long time before fiscal policy will be decided at the national level.

Academics are debating the future of the Eurozone that might be completed by a fiscal union. The difference between the EMU and fiscal policy is that the EMU is based on an arrangement of public finances between member states while fiscal policy is decentralized. However, the European Union implemented the Stability and Growth Pact (SGP), which functions as a fiscal discipline in the EMU. Nowadays, some Eurozone countries wonder if it is better to leave the Eurozone if there is no fiscal union. There is a fear that the process of fiscal policy governance in the Eurozone remains weak and ineffective.

The reason Germany agrees to the EMU but does not agree to a fiscal union could be the following: Germany’s social security, which is introduced into the social market economy, is the point of discussion with respect to equal distribution of wealth. The reason is that the market economy especially benefits the weak and the poor, because an unequal society where everyone—even the poor—are slightly better off is better than a society where everyone is equally underprivileged. It can be said that Germany has a system that places a high priority on the redistribution of revenues in order to create equality. The case in point is that Eurozone countries prefer to have a “social system” that creates equality in the European Union.

However, Germany would not agree to the fiscal equalisation system between countries, because that would mean that richer countries transfer money to poorer countries without knowing what is actually happening to it. In fact, Germany is different from the rest of the Eurozone countries. First, it is able to reduce fiscal deficits. Second, Germany is reliant upon net-exports as the engine for demand. In fact, Germany’s fast recovery is due to domestic factors: for instance, the stabilising effects of fiscal policy, stable consumption demand, and the low unemployment rate during the economic crisis. Thus, Germans are satisfied with the EU budget that includes approximately 1% of the EU-TOTAL GDP that is used for structural, regional funds, and agricultural policy.

Furthermore, in order to achieve a fiscal union in which there is equality between countries, the European Union should consider to closer integration. However, if there is debate about the fiscal equalization system as in Germany, then this might also open up new conflicts between Eurozone countries. In fact, an effective fiscal policy might be achieved by political integration. However, this would mean that member states have to relinquish political sovereignty, because national economic policies will be controlled and decisions will be made at the European level. However, this is not the case. Though Brussels is coming up with pacts needed to sustain fiscal policy in the EU, the process of fiscal policy remains weak. Otherwise, it would not be necessary to implement the Fiscal Compact and the Sixpack.

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# Chapter 5 Conclusion

The purpose of this thesis was to analyze the extent to which German fiscal policy can be used as blueprint in other Eurozone countries that need revision after the crisis. It appears that implementing the social market economy in the 1950s benefited the German economy. This practice has therefore has been used to guide the German Federal Republic in subsequent years. Domestic factors also played a role in the success of the social market economy in Germany. However, other Eurozone countries are still struggling at the domestic level. We may therefore conclude that each country needs to tackle its own structural problems before fiscal union can be established. As Germany faced its economic challenges, the Eurozone countries need face theirs. It appears that after the Eurozone crisis, financial solidarity became more important with respect to the stability of the Eurozone.

It appears that some of the Eurozone countries prefer to establish a “social model” in Europe because of structural unemployment. It is a fact that Southern Eurozone countries are more deeply affected by the crisis than is Germany (and Austria). Thus, the appearance of a Northern and Southern Europe suggests the failure of the European project. As a result, a social model in the EU will lead to a rising employment rate and perhaps a fiscal union in the future.

Discussion about a common fiscal union is motivated by the national competence of the Member States. On the contrary, social integration that builds on the foundation of employment will be supported rather faster than political integration. For instance, in order to implement a fiscal union, political integration should be supported by European citizens. Without a centralized fiscal policy, there is no need for responsible common public debt; therefore Eurozone countries act in their national interests. This could mean that Eurozone countries are not ready to deal with a “Eurozone government” at the European level. However, in order to achieve fiscal union, the political organization of the union should be changed, because political bodies that are implementing fiscal rules at the central level are mandated to do that according to the Pacts that are implemented by Brussels rather than by national interests. Unfortunately, this is the root of the problem because the problems exist at national level while solutions are fixed at the European level.

Moreover, European citizens prefer a social Europe over a fiscal union. The advantage of this is that a social economic market model will lead to the rise of employment in Europe and eventually to competiveness in the Eurozone.

The EU is a complex institution that consists of twenty-eight member States. It is hard to establish a common European Fiscal Union or a common Social Model because of the different traditions of each Member State. For this reason, there must be a consensus that will benefit every Member State. Also, it seems that Germany’s financial equalization system is only suitable for Germany and not so easy to apply at the European level.

It is recommended that the EU aim to achieve agreements on unemployment based on a social model. Fiscal centralism does not seem to be in favour; therefore it is recommended that adjustable measures be implemented to create social security based on the work of Ludwig Erhard that brought prosperity to Germany.

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