Before the G20 summit in Cannes: IZA researchers propose concept for a global debt brake

October 31 2011

A few days before the G20 summit in Cannes, economists from the Institute for the Study of Labor (IZA) in Bonn, Germany, have proposed a global consolidation strategy of public finances. In a new IZA Policy Paper entitled "A challenge for the G20: Globally stipulated debt brakes and transnational independent fiscal supervisory councils," Mathias Dolls, Andreas Peichl and Klaus F. Zimmermann recommend that political leaders of the G20 countries implement a global debt brake to push the process of consolidation of public finances and make it binding. To ensure this, the debt brakes should be fixed in national constitutions and enforced by transnational independent fiscal supervisory councils. The researchers point out that the debt brake is an important instrument for a long-lasting solution of the sovereign debt crisis.

The fiscal councils could be located at the European Stability Mechanism (ESM) and at the International Monetary Fund (IMF). They should conduct a regular evaluation of national budget plans in order to ensure that they meet the requirements stipulated by the debt brake. Through this global monitoring process, an early warning system could be developed to avoid sovereign debt crises and the resulting contagion risks among highly indebted countries in the future.

Klaus F. Zimmermann, Director of IZA: "The dramatic developments of the last weeks and months make clear that besides the emergency measures taken in the Eurozone and the debt deal in the United States, which only provide short-term relief, structural reforms to overcome the sovereign debt crisis are desperately needed. The G20 is the right place for the negotiation of global reform measures." The G20 does not only include representatives of countries with the highest debt levels (EU, US, Japan), but also the BRIC countries Brazil, Russia, India and China as well as large developing economies whose growth is particularly threatened by the sovereign debt crisis.

"It is not sufficient to negotiate at the G20 meeting in Cannes only emergency measures against the current crisis. A master plan is needed which puts the focus on the long-term challenges of the global sovereign debt crisis; if no convincing answers are found, financial market uncertainty will grow even further," said Zimmermann.

The sovereign debt crisis was already on the agenda of the last G20 summits in Toronto and Seoul. Political leaders agreed that budget deficits are to be halved by 2013. However, these commitments are not binding, and the state of the economy is much weaker today than it was hoped at that time. The same is true for the decisions made at the EU summit last week. They call for national debt brakes fixed in national constitutions, but fail to stipulate politically independent supervision. IZA Director Zimmermann: "This structure of fiscal supervision already failed in the Maastricht Treaty. We need a global solution which includes independent fiscal supervisory councils with the right to impose sanctions."

High sovereign debt is not only a problem in Europe, but also for other important world regions. At 233 percent, Japan has the highest debt-to-GDP ratio among industrialized economies. Almost half of the budget is financed by new credits. The United States will likely see a new record level of government debt this budget year. By the end of June 2011, the debt-to-GDP ratio already amounted to 98.6 percent.

The emerging markets are no uninterested bystanders in this debate. These countries and their vast populations feel that this is their time, and that a shadow that laid over them for centuries has been lifted at long last. If the Western countries now fail to get their fiscal acts together, there is a real danger of a new form of "colonialism," which would manifest itself in a very serious growth tax that would be imposed on the developing nations. This "tax" would take the form of a global economic collapse and a decline in development aid related to an unresolved Western debt overhang that may very soon prove unsustainable. Or it may take the form of high inflation, which would have the same effect on these countries, which are not only hoping for, but depend on, macroeconomic stability to execute their plan to move out from under the shackles of centuries of underdevelopment. For these reasons, imposing an irrevocable debt brake is not just a fair, but a very necessary quid pro quo if we want to have any chance to work off the public funds we are currently injecting into our economies.

More information: "A challenge for the G20: Globally stipulated debt brakes and transnational independent fiscal supervisory councils"
IZA Policy Paper No. 33 [ftp.iza.org/pp33.pdf](ftp.iza.org/pp33.pdf)

Provided by Institute for the Study of Labor (IZA), Bonn, Germany