Restart and Reform Strategies after the Covid-19 Crisis

Many European economies are gradually recovering from the corona pandemic, although it is not yet over. National governments are using the breather to assess the effectiveness of their less-conventional and short-term crisis-prevention measures. This is important because they must prepare to return to their long-term economic and fiscal priorities. These include strategies to ensure a smooth structural transformation supported by an adequate supply of skilled labor. They are also looking for a plan on what investments they need to undertake in digitization. They also want to answer the question of how they can manage the energy transition and how they can achieve the goals of climate policy. What is needed are financing concepts that keep public debt within reasonable limits and do not place an undue burden on the welfare state. As if that were not enough, the EU member states must simultaneously develop a clear and new vision for the future of the EU and define its role in a globalized world. In doing so, it is important to maintain a balance with national needs and priorities, among others, in recovering from the crisis. This edition of the CESifo Forum offers systematic insights into these critical and urgent policy issues in selected European countries.

Clemens Fuest

Germany's Economic Restart after Covid-19: The Role of Fiscal Policy and Taxation

ECONOMIC CHALLENGES IN THE COMING YEARS

Germany faces considerable economic challenges in the coming years. The German economy has partially recovered from the corona crisis, but economic output has not yet returned to pre-crisis levels. At present, supply problems for many primary products are weighing on the economy, so the recovery remains fragile. In addition, the pandemic is leaving deep scars. Public debt has risen considerably in the course of the crisis. Many companies have lost customers, employees, and capital due to long closures. Young people in particular have been set back in their schooling and vocational training.

In addition, there are challenges to be met that existed even before the corona pandemic. Demographic change will lead to a decline in the number of people of working age in the coming years. The shortage of skilled workers, which has been noticeable for some time, will intensify. This reduces the potential for growth. The aging of the population will put considerable financial burdens on the public purse, especially in the social security funds. The pandemic has accelerated the digitalization of the economy and society.

The reduction of CO_2 emissions for climate protection and adaptation to climate change, digitalization, and other forms of technical progress are leading to deep structural change. Although Germany has a very well-developed welfare state, it is to be feared that economic disparities will increase in the coming years, partly because the shortfalls in schooling caused by the pandemic will hit children and young people from educationally deprived backgrounds harder than others. It will therefore be even more important to promote inclusion and equity.

Germany also faces major challenges at the European and international level. European integration is an important driver of prosperity, but Brexit has massively weakened the EU, and in important policy areas the EU is

Clemens Fuest

is President of the ifo Institute, and Professor of Economics and Director of the Center for Economic Studies (CES) of the University of Munich.

not playing the role it should in the interests of all Europeans. At the same time, protectionist tendencies and geopolitical conflicts are growing internationally, especially between China and the US. After the election of Joe Biden as US president, relations with the US have greatly improved, but it cannot be ruled out that in three years' time another politician of Donald Trump's ilk will be elected. It will not be easy to safeguard German and European economic interests in this environment.

This paper focuses on the area of fiscal policy and explains what measures the next German federal government should take to address the fiscal challenges ahead.[1] Fiscal policy in the next legislature faces significant tensions and trade-offs. On the one hand, it is crucial that fiscal policy supports economic recovery and a return to steady economic growth. This suggests that tax relief and more public investment are needed. On the other hand, public debt has risen considerably during the financial crisis, and fiscal rules need to be taken into account. Therefore, the room for maneuver is limited. In addition, some political parties are calling for greater redistribution through taxes, especially by introducing a net wealth tax. This, in turn, would discourage investors and hamper economic growth. Ultimately, the weighting of the various objectives is a political judgment call. In view of the challenges described above and the still fragile economic situation, however, there is much to be said for gearing fiscal policy primarily towards promoting economic growth.

What does that mean? Economic growth is primarily driven by the development of employment, and by investment and innovation. In both areas, efficiency and productivity play a central role, as do the current drivers of structural change. A growth-oriented fiscal policy should focus on promoting employment and investment in this sense. High employment and high productivity are also crucial for inclusion, i.e., broad participation in economic growth.

The rest of the paper is structured as follows. The next section discusses reforms which aim at fostering labor supply and productivity. The third section turns to the role of tax and fiscal policy for private and public investment, followed by the fourth section which discusses the restrictions implied by fiscal rules. In the fifth section, conclusions are offered.

REFORMS TO FOSTER HIGHER EMPLOYMENT AND LABOR PRODUCTIVITY

In the last two decades, economic development in Germany has been characterized by a steady increase in the number of people in employment, partly due to more women in employment and immigration. Unemployment declined and the baby boomer generation reached the peak of its productivity. This has boosted economic growth and eased the burden on government finances. However, this trend will reverse in the coming years. The labor force is aging and shrinking. A declining number of people in the labor force will go along with a growing number of retirees.

This has consequences beyond pension and healthcare spending. The shrinking and aging of the working population will also dampen economic growth. This will reduce the potential for prosperity in all areas of society. Contrary to what is often claimed, declining economic growth due to a shrinking working population also impedes the chances of successfully advancing environmental and climate protection, because this requires resources, especially innovations and investments.

Whether and to what extent economic growth actually declines, however, depends on the course set by economic and social policy. Important for the development of growth are not only the number and age structure of the workforce, but also the willingness and opportunity to participate in the labor market. Another decisive factor is the productivity of the workforce. Better education, training and health, automation and the provision of a modern capital stock, intelligent use of digital technologies, and functioning labor markets where employees are placed in the right jobs are all factors that have a significant impact on productivity. If improvements are made in these areas, this can at least partially compensate for the decline in the labor force. Fostering the immigration of skilled workers is another key factor.

Measures German policymakers should take here include:

– reforms of the Hartz IV regulations to eliminate the low-income trap,[2]
– an income tax reform in which marital splitting is replaced by real splitting, combined with transitional periods for existing marriages,
– a further expansion of childcare,
– promoting labor immigration, inter alia, by streamlining the visa process and appointment procedures, enhancing opti-employment opportunities during the job search (Poutvaara 2021),
– strengthening the participation of refugees already living in Germany in the labor market, and
– reforms at schools, universities, and in vocational education that promote inclusion and equal opportunities. These include Germany-wide intermediate and final examinations, structural changes for a more efficient use of resources in the education system, downstream tuition fees, and more certified continuing education (Wößmann 2021).

[1] The article is partly based on the economic policy reform program developed by the ifo Institute, which is presented in more detail in: "Wirtschaftspolitische Herausforderungen Deutschlands in der Post-Merkel-Ära – 10 Vorschläge des ifo Instituts für die kommende Legislaturperiode", *ifo Schnelldienst* 74(7), 2021.

[2] For details, see Blömer et al. (2019).

Through such a package of reforms, Germany could at least partially offset the growth-inhibiting effects of demographic change. These reforms only partly belong to the narrower area of fiscal policy, but they all have relevance for fiscal policy in that they have implications for public budgets.

SUPPORTING PRIVATE AND PUBLIC INVESTMENT

In addition to the measures described in the previous section to strengthen the supply of labor, private and public investment should be boosted. Important drivers for these investments are digitalization and climate protection as well as adaptation to global warming. What is controversial is what needs to be done to ensure that these investments take place.

Many companies face the challenge of making significant investments to reduce their CO_2 emissions or to seize opportunities in digitization. To enable and encourage this, the tax conditions for investment and research and development in Germany should be improved.[3] This requires tax relief, or at least avoiding major tax increases.

Public debates often give the impression that the investment required is primarily public investment. This is misleading. In fact, it is primarily a matter of creating the right conditions for private investment, in climate protection above all through a transparent and comprehensive CO_2 pricing mechanism. It is also necessary to supplement the price mechanism, where it does not work, with targeted state subsidies or regulation. Public investment is also important, but it is undoubtedly the smaller part in quantitative terms.[4]

Particularly in the crucial area of decarbonization and adapting to global warming, an important task for the coming German government is to find the right combination between creating good framework conditions for private investment, targeted intervention through regulation, taxes and subsidies, and public investment. This is not easy because many of the necessary investments lie on the border between the private sector and the state, for example in the case of Deutsche Bahn, in the energy industry or in the telecommunications sector.

The problems of delimitation become clear when one examines which investments are involved. A recent study by Agora Energiewende (Krebs and Steitz 2021), has calculated an additional need for public investment of 460 billion euros in the decade until 2030, which corresponds to 46 billion euros per year, or about 1.3 percent of GDP. In the period up to 2025, 80 billion euros are already included in the financial planning of the federal government. The total amount of 460 billion euros includes 200 billion euros for the subsidization of building insulation, i.e., a promotion of private investment. A further 140 billion euros is to flow into railways, "climate-neutral" social housing, district heating networks, and hydrogen networks. These are investments that appear to make sense, but for which there is likely to be some dispute as to whether the government should finance and manage them. This is certainly true for social housing, where models with private investors and appropriate subsidies and regulations are likely to be more efficient. In the case of hydrogen pipelines and district heating networks, at least partial private financing and control as well as risk assumption by private operators is possible. The same applies to investments in local public transport, which are emphasized by the study.

In all this, private financing is not an end in itself. It can even be counterproductive if private investors only provide financing that is usually more expensive than the government's financing costs, but do not assume any risks. The point is to achieve greater efficiency through private-sector incentives, especially in construction, but also among operators. This only works if the private investors bear at least part of the risk.

Regardless of how the roles of public and private players are assigned, another task for the coming federal government is to speed up the planning and approval procedures for investment projects in Germany. Here, too, policymakers must deal with difficult conflicts of objectives. The participation of the local population in decisions on infrastructure projects such as power lines or railway lines is a key asset in a democratic state with the rule of law. However, if the implementation of projects is delayed by years or even decades, this form of participation is not compatible with the ambitious transformation goals that policymakers are striving for, particularly in the area of climate protection.

FISCAL RULES: THE ROLE OF THE GERMAN "DEBT BRAKE"

An important question for fiscal policy in the coming years is whether and how demands for tax relief and more public investment are compatible with the requirements of the debt brake enshrined in the German constitution as well as the European fiscal rules.[5] European fiscal rules are not enforced very stringently, they offer a lot of flexibility, and they will likely be reformed in the coming years. The national debt brake is more binding and more difficult to change. The rules of the debt brake imply that the "structural budget deficit" of the federal government budget in Germany

[3] It is obvious that there are many other politically influenced location factors that are relevant here. These include, for example, a competitively priced and secure energy supply.

[4] In a recent study on public climate investment needs, Krebs and Steitz (2021, 2) point out that "public climate investments represent only a relatively small part of total climate investments."

[5] Feld et al. (2021) provides an up-to-date analysis of fiscal space in the coming years, taking into account the debt brake and European fiscal rules.

should not exceed 0.35 percent of GDP. This ceiling can be suspended in severe crises and it has been suspended for 2020 and 2021; it is likely that the suspension will also apply to 2022. In general, the deficit ceiling does not prevent higher debt for investments beyond the deficit limits, provided that these investments and their financing take place off-budget, for instance in public enterprises or other vehicles. One can criticize that these are "shadow budgets," but given the high level of public attention paid to major investments in the context of climate policy or digitalization, one can assume that these financial transactions are sufficiently registered and discussed in the political process.

Many critics of the rules are nevertheless calling for the debt brake to be reformed in order to expand the scope for debt contained therein. Much support has been given to the idea of returning to a variant of the "golden rule" that allows credit financing of public investment. An investment-oriented debt rule applied in Germany until the introduction of the debt brake in 2009, and it did nothing to prevent the marked decline in public investment in the years between 2000 and 2008 or the steady rise in the public debt ratio in the decades before that. Moreover, as mentioned above, the debt brake hardly restricts the credit financing of at least "classic" public investment, such as in the area of infrastructure, because there is the option of financing in public enterprises or special budgets. However, the debt brake does indeed limit the scope for a growth stimulus in the form of tax relief for companies and employees. This also applies to tax subsidies for private climate-protection investments such as the aforementioned thermal insulation of buildings. However, the introduction of an investment-oriented debt rule does not help here because it does not provide for credit financing for this expenditure either.[6]

Both the tax cuts and the subsidies for thermal insulation have characteristics of public investment in that they burden public budgets today and are hoped to bring benefits in the form of higher economic output in the future. This points to a crucial weakness of investment-based debt rules—distinguishing investment from non-investment spending is difficult.

In view of these difficulties, one could come up with the idea of abolishing the debt brake altogether. However, that would be a mistake. The debt brake represents an important anchor for medium-term fiscal policy in Germany, strengthening credibility and exposing policymakers to salutary pressure to set priorities. A less far-reaching intervention would be to define a transition path, similar to the years before 2016, which would temporarily open up additional financing leeway in the coming years (Feld et al. 2021). However, this would require a basic law amendment for which there is no majority in sight. Moreover, it would be unwise to negotiate a softening of the debt brake without a convincing and sufficiently concrete fiscal policy concept that convincingly justifies and limits the additional financing requirements. In my opinion, such a fiscal policy concept should contain the following elements:

1. A comprehensive tax reform for workers and businesses that improves incentives for labor supply, investment, and innovation. Elements of this reform could include the aforementioned reforms in the low-income sector and in spousal taxation, improved tax write-offs for investments,[7] and expanded tax loss offsets.
2. The solidarity surcharge will be abolished for all taxpayers, and the income tax scale will be redesigned in its place. Distribution policy objectives can be incorporated into this reform. In particular, the consequences for labor supply incentives and for investment incentives of partnerships subject to income tax must be taken into account.
3. A program for public investment and support measures for private investment in climate protection, adaptation to climate change, and digitalization. In the case of support measures for private investment, it should be borne in mind that investment incentives should primarily arise from CO_2 pricing and that support should only be considered if the effects of pricing are not sufficient or the price mechanism is not effective due to existing regulations or other market frictions.

Once a convincing fiscal policy concept for strengthening growth and managing the transformation to digitalization and climate neutrality is available, it can be discussed what fiscal effects this will have and in what proportion the necessary funds should be raised through spending cuts, tax increases, or the reduction of tax subsidies and borrowing. In this context, it would be important to check carefully whether part of the required spending can be financed by spending cuts in other areas. If priorities change, so should the structure of public spending. In this process it will be clarified whether the leeway offered by the debt brake is sufficient, or whether greater leeway is temporarily required. A possible approach to creating such leeway would be to "set aside" borrowing authorizations by creating a budgetary provision while the deficit ceiling of the debt brake is suspended. Of course, whether this will legally be considered as allowed, given that the suspension is justified by the Covid-19 crisis, is an open question.

[6] The scope for borrowing is increased to the extent that existing investments that have not been financed by borrowing are financed by borrowing in the future. Whether and to what extent this frees up funds depends, among other things, on whether the investment rule takes into account write-downs on the public capital stock.

[7] The economic and fiscal effects of accelerated tax depreciation are analyzed in Dorn et al. (2021).

CONCLUSIONS

Restarting the economy and achieving a strong and sustainable economic recovery is challenging, not only for Germany but even more so for many other countries, in particular those hit hardest by the pandemic. It is of key importance that countries individually do what is necessary to achieve this recovery. However, many of the economic challenges before us, in particular, climate change and geopolitical shifts, require cooperation and reforms at the European and the international level. Therefore, the key task of the incoming German government will be to contribute decisively to reforms of the EU with the objective of deepening European integration in policy areas where action at the EU level creates added value.

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