



REPORT ON THE ECONOMIC SITUATION

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Regional economic policy – What needs to be done now

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Gradually, the German government is realising that the economic problems in Germany can only be solved by improving the local environment. Accordingly, the federal minister for the economy has suggested corporate tax relief and also lobbied the CDU/CSU for their approval. His goal was to add a debt-financed fund to the Basic Law in order to create the budgetary leeway for this initiative. This proposal was rejected by the federal finance minister, who once again proposed the cancellation of the solidarity surcharge. Corporate revenues account for about half of the revenues generated by the remaining solidarity surcharge, therefore the cancellation of this tax would mean a significant reduction in the tax burden for this sector. The Chancellor's office, on the other hand, was not very enthusiastic about this proposal, because it is not keen to make adjustments on the spending side: Another EUR 12 billion would be added to the approximately EUR 20 billion in savings in the 2025 federal budget that have been banded about.

Notwithstanding the political disputes between the government and the opposition, or within the government coalition itself, there is no question that action is needed. Companies in Germany face an unfavourable investment environment. Companies invest if their investments result in profits (after taxes), i.e. if capital costs are positive. The sales opportunities for their products and production costs are relevant factors in this context. For the German economy, which is highly export-oriented, it is the international sales opportunities that matter the most. It is primarily the cost situation that is responsible for the sluggish investment activity.

Germany 'offers' investors extremely high energy costs, high labour costs, one of the highest corporate tax burdens, and the highest regulatory costs worldwide. The high energy costs are the result of a misguided energy policy. While the energy transformation enacted by the Merkel government plays a part in this development, so does the inability of the current government to delay the shut-down of nuclear plants over a transition period. No major cost reductions are expected in the future, given the expected increases in CO2 pricing as part of the climate policy. But a certain reduction could be achieved with the accelerated expansion of renewable energies. This means that approval processes must also be accelerated greatly.

Unit labour costs in Germany have increased again since the year 2015. On the one hand, this is due to the weak productivity trend. On the other hand, real

wages have increased significantly (excepting the years with high inflation). The containment of inflation is accompanied by once again rising real wages. Besides the current collective bargaining, the pressure on labour costs will probably remain high, as the labour market experiences labour shortages due to demographic developments. This shortage creates pressure on wages. Mitigating effects could be achieved with more net immigration. But similar to energy costs, the expected cost relief will be limited.

This leaves two major areas in which the government could reduce the costs for companies: taxes and regulations. However, tax policies are in a state of gridlock. Consensus for real corporate tax reform is not expected from within the government. The Growth Opportunities Act offers structural improvements, as long as the states in the Bundesrat agree, but it will not provide enough momentum volume-wise.

The federal government could make real progress in reducing the cost of red tape. At least this target is included in the coalition agreement. However, there has not been a noticeable improvement; rather, things have deteriorated. In its most recent report, the national regulatory control council found that since the current coalition came to power, the on-going cost of complying with regulations has increased, mainly because of the Building Energy Act (Gebäudeenergiegesetz), the minimum wage and the All-Day Support for Children of Primary-School Age Act (Ganztagsförderungsgesetz). The further tightening of existing regulations, e.g. due to the European supply chain directive, can still be prevented. But what about deregulation?

At the end of the day, Germany is home to two political blocks - one side that wants to manage the economy through subsidies and regulation, and another side that wants to rely on market principles. As long as the conflict between these two sides is not solved, there is no improvement in sight.

Sincerely yours

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