



# REPORT ON THE ECONOMIC SITUATION

03/2023

## Financial policy in times of consolidation

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A dispute within Germany's government made headlines in the last few weeks: In a letter, Germany's Minister for the Economy Habeck asked finance minister Lindner to provide more budgetary leeway for the government departments, more specifically, to allow the ministries to spend more money (e.g. by improving the revenue side). The letter mentioned tax breaks, and tax increases and a circumvention of the debt brake (Schuldenbremse) are also in discussion. The finance minister rejected the demand and instead emphasised the binding effect of the debt brake under Germany's Basic Law.

In his essay on the crisis of the tax state, Joseph Schumpeter wrote the following in 1918: "The kind of people that make up a nation, the level of cultural progress, the social structure and what policy-makers try to do for businesses - all that and much more is also part and parcel of financial history.? He who hears its message hears the thunder of global history more clearly than anywhere else ." Financial policy is where the political projects of a government converge, because you cannot do policy without money.

Financial policy decisions have different effects on economic development. This is true in the short term with regard to economic activity and the impact on inflation. And it is true in the long term with regard to productivity developments and (especially) private innovation and investment activities. Finally, financial policy reflects the focus of defence, environmental, energy and social policies.

On the one hand, financial policy must avoid having an inflationary effect in the current stagflationary environment. If inflation is the result of the disintegration of the relationship between economic supply and demand (the latter kept high with expansive fiscal and monetary policies), then financial policy should reduce its expansionary impact. On the other hand, it must also improve the supply conditions for individuals to help reduce stagflation. Measures that damage innovation and investment should be avoided, while those

that promote them should be implemented.

Every financial policy measure has an effect on supply and demand. Therefore it depends on the mix of measures to reverse the trend towards a supply policy. Tax increases are the wrong method because they damage investment and innovation. This applies not just to corporate and trade taxes (the classic business taxes) but also to income taxes, flat rate taxes and the solidarity surcharge, because those apply to partnerships, independent professionals and sole proprietorships. Approximately half of the revenue from the remaining portion of the solidarity surcharge comes from business income. But: Removing a tax break, e.g. the reduced VAT rate for meals in restaurants, is not a tax increase, even though it is perceived as such.

These considerations lead to two requirements for financial policy in 2023 and 2024: First, the overall budget deficit should be lower than in the previous year. This applies in equal measure to both the core and the special budgets of the federal government, state governments, local authorities and social insurance agencies. Second, this result should be achieved without tax increases.

The debt brake under Basic Law helps with achieving these goals. A return to its regulatory threshold is essential for financial policy stability. Of course, that is not easy, particularly since higher expenditures for social transfers, debt service as well as wages and salaries in the public sector can hardly be avoided due to inflation. Therefore the budgetary leeway is additionally restricted. But that is what politics is for: Managing conflicting objectives particularly when times are tough.

Sincerely yours

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