

The right combination of monetary and fiscal policy

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After the federal cabinet approved the federal budget for 2024 last week, criticism came from all sides. This is not surprising. With fewer financial resources and the resulting need to set priorities, some will interests have to take a backseat. It is understandable that this is not popular in some circles. But do the budget policies of the federal government actually make sense?

After two quarters with negative GDP growth rates (Q4 2022 and Q1 2023), it seems more and more likely that Germany is in a recession. Not much growth is expected for the remainder of 2023, and the situation is not likely to change too much in 2024. It is a major economic policy principle that governments should not be starting to save as the economy starts to falter. However, financial policies in Germany are starting to do exactly that, i.e. they are becoming more restrictive.

This apparent dissonance dissolves against the background of a more comprehensive analysis of the macroeconomic situation. The economic environment in German, Europe and the US is stagflationary. High inflation leads to weaker economic growth - on the one hand because higher prices dampen private consumption, and also because interest rate increases by the central banks have a negative effect on private investment activity. The latter is particularly relevant to industries that are more responsive to interest rates, such as the construction sector. The higher inflation is the result of government policies during the COVID-19 crisis, and it is exacerbated by the impact from the war in Ukraine. Expansive monetary and fiscal policies maintained economic demand during the COVID-19 crisis, while aggregate supply remained limited for a variety of reasons. Now demand and supply must find an equilibrium again. The current more restrictive monetary policies are reducing demand. Fiscal policy cannot counteract this with an expansive demand-oriented policy. It would only have an inflationary effect.

But not just fiscal policy - the entire economic policy must be supply-oriented in this situation, i.e. focus on expanding the aggregate supply. The general framework must be designed in such a way that it pays for private households and investors to work, to invest

and to take on risks. With regard to the expenditure side of governments, this means a shift from transfers and government consumption to government investments. Tax increases are a no-go on the income side; rather, what is required is a reduction in the tax burden. Moreover, the efficiency of the tax system should be improved; therefore, tax breaks (or rather, tax subsidies) should be removed.

The federal budget certainly has a lot of room for improvement with regard to the above requirements. At the same time, there has been a shift in budgetary policy in that direction. One example is parental benefits. The entitlement thresholds are being lowered: Now, only private households with a taxable annual income of up to EUR 150,000 are eligible for parental benefits (instead of EUR 300,000). Contrary to some allegations made in the media and social media, empirical studies on higher-income households have not found that parental benefits have a robust significant effect on fertility. It would be surprising if that was the case, because higher-income earners are able to afford child care even without government help, and they do not need to make the desire to have children dependent on parental benefits. On the other hand, it has been proven that especially well-educated women return to the labour market earlier because of parental benefits. This is likely a favourable outcome in terms of equality. Having said that, many other government measures, particularly the expansion of child care, work in the same direction.

The example of parental benefits demonstrates how the federal government is gradually moving from state transfers to state investments. Investments by the federal government are rising - in the core budget in connection with the special assets. But it will still require a lot of work to achieve the transformation towards a supply-oriented fiscal policy.

Sincerely yours



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