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Germany`s slowdown is a wake-up call for policy

by Michael Heise

The German economy is in a downturn. Business expectations have deteriorated, particularly in manufacturing, but also in trade and other service segments, and even in construction, albeit to a lesser extent than in the industry. Following much lower than expected economic growth of just 1.4% in 2018, many forecasters predict growth of less than one percent in 2019. Are they exaggerating, or unduly skeptical?

The weak growth in 2018 was mainly due to flagging exports and only modest expansion of domestic consumption. Export performance was affected by China's slowing economy and the fallout from lingering trade disputes. China should recover over the course of the year thanks to strong government stimulus packages; the US economy should also grow by at least 2%. This should reinvigorate German export activity. Consumer demand in Germany remains supported by high levels of employment and rising wages; exceptional effects which have impacted demand for vehicles are coming to an end. Higher pensions, the raising of the tax-free allowance, and increased child benefits will all play their part in significantly boosting disposable income in 2019. Hence, there is no reason to worry unduly in the short term.

Longer-term growth prospects for the German economy, on the other hand, are less favorable. They will remain subdued owing to the expected sharp decline in labor force potential and a very weak rise in workforce productivity over the last few years. The German economy is more dependent than any other on global economic performance. Heavy dependence on foreign demand has always been the Achilles heel of the German economy and, with an export ratio of almost 47 percent, its dependence has never been greater. Against the background of growing protectionism around the world, this currently poses a particular risk.

Although this analysis should be incontrovertible, for years little has been done in Germany to strengthen internal growth and make the country attractive for investment and high-growth innovations. Higher investment and better opportunities for innovative growth companies would not only allow higher incomes and greater scope for distribution, but also create more jobs to compensate for those that will be potentially lost to digitalization. Furthermore, Germany's foreign trade surplus would shrink if the financial surpluses generated by private households and companies were invested more in Germany than abroad.

Companies take investment and innovation decisions on the basis of the expected long-term return potential. Entrepreneurial risks must be counterbalanced by the prospect of appropriate returns. In a location where costs or taxes are too high, where infrastructure is lacking and skilled workers missing, investment projects will be shelved or carried out elsewhere. The German government plans to improve the tax treatment for research and development. While this is a sensible step, more initiative is also needed in the areas of education, training, and public infrastructure policies. Moreover, the government should effectively curb the rise in non-wage labor costs, energy costs, and the costs of bureaucratic procedures..

Tax policy, in particular, can produce quick results, as Donald Trump's policies in the US have shown. Germany last implemented tax reforms in 2000 and 2008. The country's tax ratio has in the meantime risen to a record level and the tax rate of around 30 percent on German

companies profits is again high compared to other countries. Small companies are often taxed by the income tax schedule, which includes the solidarity surcharge that has still not been abolished almost 30 years after German reunification. Corporate taxation is not only high by international standards, it also inhibits investment by giving a tax advantage to debt financed investments as opposed to investment financed through the substantial cash balances that companies hold.

A fundamental tax reform should no longer be a political taboo. Government spending today is around €280 billion higher than in 2010, when the financial crisis abated. Its investment budget, on the other hand, has only increased by €25 billion. These figures show that there has by no means been a lack spending capacity, an argument often used as a pretext for blocking tax breaks for employees and companies. The problem has not been an overly tight budget constraint, but rather an inadequate prioritization, with new expenditure always piled on top of existing expenditure. A tax reform introduced now would no longer be pro-cyclical, but just in time to cushion the downturn.

Tax reforms are an effective tool of industrial policy. They strengthen the competitiveness of companies, including smaller ones, and create better conditions for growth in promising, strategic industrial sectors such as information and automation technology, biotechnology, and environmental technology. High-growth sectors also need favorable financing conditions and a brave commitment by government to fundamental research.

These are absolutely essential if we are to turn the vision of a leading role for Germany and Europe in the fields of artificial intelligence and Industry 4.0 into reality. Other industrial policy measures, by contrast, such as subsidizing battery cell production or grandfather provisions for large companies, are far less promising. Protective measures can only be justified if they are there to create a level playing field. After all, fair competition is the best basis for progress and prosperity in the long term.