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Germany and the Juncker Plan

IN FOCUS

3 Steps to Reconcile Fiscal Consolidation and Investment

January 2016

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Summary

Unsurprisingly even within the "Brussels bubble" economists cannot agree on the ultimate result of President Juncker's European Fund for Strategic Investments (Juncker Plan). The mobilisation of additional funding mechanisms – over and above agreed national and EU frameworks – has caused unease with those who have prioritised budgetary consolidation as an immediate policy imperative. In this debate Germany holds the most important role as Europe's strongest large economy in 2016. However, this note highlights that fiscal balance and increased investment are not mutually exclusive political actions, but rather form important elements of a sustainable economic policy framework. This is vitally important for all member states, but particularly for Germany, in light of its challenging long term economic outlook.

Invest in Germany for Germany, not for Europe!

Further investment in Germany, so the argument goes, would boost the economy, modernise an aging physical infrastructure system, help prepare Germany for its approaching demographic challenge and, perhaps most importantly of all, help stimulate economic activity across

the EU. These arguments are not just the preserve of Keynesian economists but are reflected across a broad spectrum of debate across Europe.

Structural investment in Germany would boost its economy, modernize an aging physical infrastructure system and help stimulate economic activity across the EU.

Voices across Europe have commented on the internal German debate. Dutch Finance Minister (and chair of the Euro group) Jeroen Dijsselbloem has explicitly called for Germany to invest more in infrastructure, research and education. *The Economist* has implored Chancellor Merkel to *"build some bridges and roads"*. The European Commission, in its opinion of German budgetary plans in late 2015, noted the scope available to tackle the backlog of public investment.

Publicly, the investment debate in Germany has increasingly focused on the issue of public expenditure on transportation infrastructure. Awareness of Germany's infrastructural needs is now part of mainstream media debate. The Organisation for Economic Cooperation and Development (OECD) highlights that during the 2005-11 period Germany spent significantly less on inland transportation infrastructure than key global competitors such as Japan and barely matches that of the United States. The German media has characterised Germany's ailing infrastructure as *"a nation slowly crumbles"*.

The official German response to these calls for further investment is measured. The German authorities stress that public investment has been rising consistently since mid-2000 lows. They also emphasise a three pillar approach to long term investment planning in Germany. These pillars comprise first, a credible public finance model based on a sustained consolidation of government expenditures and bound by constitutional rules on public debt (i.e. the debt brake). Second, an ongoing structural reform programme complemented by targeted investments in areas such as digital communications, education and childcare. Third, a continuing focus on creating an investment climate conducive to attracting private funds.

Long term challenges require long term investment

So, is there an investment gap in Germany? Analysis at a sectoral level within Germany itself highlights two clear conclusions. First, there is a relatively broad based agreement that levels of German public investment should increase. The recent German Expert Commission on Investment noted explicitly the requirement to increase public investment with a particular focus on maintaining existing public infrastructure. This is a view shared by the International Monetary Fund (IMF) and the OECD.

Second, private sector investment has been constrained by various aspects of government policy including issues regarding employment contracts, pension reform and energy reform. Although research in this area is mixed, net private investment in fixed assets remains low at approximately 2% of German GDP.

Germany achieved a budget surplus of over 12 billion euros in 2015. Although the German government has laudably allocated the bulk of these resources to deal with the rising costs of integrating newly-arrived migrants, the reluctance to embrace wider, multi-sectoral investment programmes runs the risk of unbalancing the wider economy. Can the benefits of investing to integrate thousands (if not hundreds of thousands) of non-German speaking migrants into the education system, really be maximised without further investments in other related areas such as university and vocational education structures, state and regional employment agencies, cultural industries and educational technology?

With a budget surplus of over 12 billion euros in 2015 mostly allocated to deal with the rising costs of integrating migrants, Germany runs the risk of unbalancing its wider economy.

Public investment, contrary to much prevailing debate, is about more than just physical transport infrastructure and meeting the migrant challenge. In addition to these issues, Germany faces key economic challenges that – if left unchallenged – will significantly reduce its potential to maintain its current level of economic activity. Dependence on emerging markets for a high proportion of exports, a rapidly aging population (notwithstanding recent migrant flows), an uncertain energy supply situation and an

increasing dual-market labour market model characterised by low female participation rates in full time jobs, all require a multi-dimensional policy response. A response which requires a mix of public and private investment, allied to a re-allocation of existing resources to more productive areas (and a challenging of existing policy norms). In effect, updating the social market economic model for the 21st century.

Public investment is not just about spending taxpayers' money. It is also concerned with accumulating public assets with the aim of achieving a rate of return in excess of the cost of capital. By utilising public funds to attract more significant private funds, seed public capital – such as the Juncker Plan – can help address real infrastructural gaps, boost research and development, increase opportunities for small businesses and help create the conditions necessary for jobs and growth.

On this basis, the following three steps are highlighted which offer the potential to reconcile the objective of fiscal responsibility with long term investment planning in Germany.

1. European Challenges Require European Levels of Investment

Germany is a global economy at the heart of the European integration process for over 60 years. Its exporters enjoy the benefits of the single market every day. To achieve key priorities in the fields of energy, capital and digital union long-term (and large scale) investments are required on a continental scale. Germany should more readily embrace the spirit of the Juncker Plan and actively work towards utilising permanent long-term, cross-border investment programmes as an important component of their approach to fostering economic growth. Proposals for a Franco-German investment axis already exist.[1] By reinforcing and strengthening the single

[1] Henrik Enderlein and Jean Pisani-Ferry, *Reforms, Investment and Growth: An Agenda for France, Germany and Europe*, 2014, pp. 22-33.

market, Germany will continue to improve its economic performance while simultaneously strengthening the process of European integration.

2. Everything is fine…until the music stops!

The attainment of budgetary balance in Germany is a significant economic achievement and acts as a sound basis for a sustainable fiscal policy in the future. However, if current investment levels do not ensure adequacy levels for existing assets this will only lead to an increase in eventual replacement costs and provide uncertain long term economic benefits.

Even in the medium term, the existing apparent health of the German model (i.e. full employment, large savings, declining state debt) will be challenged by the prevailing global business cycle. Full employment, a slowly expanding economy, relatively low productivity growth and zero interest rates mean the music may have already stopped for the German economic miracle. Perceptions lag economic reality. The uncertain outlook for key emerging economies such as China and Brazil, will have a direct (and probable negative) impact on German performance.

In this context, the German approach of achieving fiscal consolidation today in order to meet tomorrow's demographic challenges should be balanced by a pro-active policy approach recognising that smart fiscal consolidation does not preclude moderate increases in public investment and education.[2] On a practical level, it should be recognised that any future slow-down in economic activity, coupled with rigid implementation of the debt break, will increase pressure to further consolidate already sluggish investment expenditures. Here, German history from the early 1930s provides an obvious comparison.[3]

[2] Galina Kolev and Jurgen Matthes, *Smart Fiscal Consolidation: A Strategy for Achieving Sustainable Public Finances and Growth*, 2013.
[3] *Barry Eichengreen, Hall of Mirrors: The Great Depression, the Great Recession and the Uses and Misuses of History*, 2015, p. 138.

3. More Market, Less Social?

Notwithstanding Germany's current economic strength, the social market economy model which emerged in West Germany in the aftermath of World War 2 is struggling to adapt to the requirements of a 21st century global economy. For ordinary employees, Germany has become a high tax country servicing an expensive social security model; a contributory model based on the assumption of multi-decade full time employment. Germany's tax wedge (i.e. taxes as a proportion of labour costs) is the second highest in the OECD. Over 42% of Germany's central government spending is on social protection, nearly a third higher than the OECD average.

Yet, Germany also exhibits sluggish investment, around 20% of the labour market work in low paid "mini jobs" and its tax system stymies second earners in families with children. In this context, the social market economy model requires to be updated to reflect the impacts of increased job flexibility, multi-job working, technological change and low natural population growth. In effect, a relocation of resources is required to support investment in key strategic reforms which will boost Germany's long term growth prospects.

In particular, this note highlights the importance of reforms (and investment) which will improve female participation in the labour market, particularly with regard to full-time employment. Linked to this, is the requirement to reform a German university model which is currently characterised by the absence of binding time constraints and the lack of a meaningful student financial contribution. Both of which play key roles in the relatively late labour market entry age of German graduates. A trend which is directly impacting on Germany's demographic challenge. In this context, structural reform and increased investment should not be viewed as mutually exclusive political actions, but rather as complementary elements of a sustainable economic policy framework.