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We Must Not Undermine the Signaling Function of Price!

The German government's relief package is well-intentioned. But regulation and subsidies aren't a sustainable way to combat inflation.

Inflation in Germany remains high. The inflation rate reached 7.4 percent in April, mainly due to the 35 percent increase in energy prices over the year. Expensive energy has unpleasant consequences for a country like Germany, which has hardly any oil or natural gas reserves of its own. Domestic prosperity is falling, and the economy as a whole is becoming poorer.

Policy Response to Rising Energy Prices

In its latest relief package, the German government has therefore decided to cut gasoline tax by 30 cents per liter and diesel tax by 14 cents from June 1. Everyone who pays income tax will receive a one-off EUR 300 "energy bonus" (which is, however, taxable), while recipients of social welfare will receive EUR 200. There is an additional EUR 100 per child. In earlier relief packages, policymakers granted heating cost subsidies for housing benefit recipients and increased the commuting allowance for long-distance commuters.

What are we to make of these measures? In a country that is too small to influence global market prices for oil, politics cannot alleviate the burden on the national economy as a whole. It can only redistribute it or shift it into the future by borrowing.

In principle, there are three instruments for responding to rising energy prices. The first option is price controls. These have an economically counterproductive effect, as price caps exacerbate shortages. One example of this is the United States: the country introduced maximum prices for gasoline in the 1970s, which resulted in rationing and a supply crisis with long queues. In Germany, direct gasoline price regulations hardly play a role in public opinion – at least at present – and that is a good thing.

Questionable Distribution Effects

The second anti-inflationary policy option is to apply targeted subsidies or tax cuts that make energy cheaper. This strategy is administratively easy to implement, but it has several disadvantages. Again, the signaling function of price is eliminated. A falling fuel tax prevents the demand side from adjusting its behavior and saving energy. Moreover, a fuel tax cut only partially reaches consumers. According to current empirical analyses, about one-third of the tax relief would accrue to gasoline suppliers and oil producers.

Moreover, the distribution effects are questionable. The three-month reduction in gasoline tax relieves private households by approximately EUR 1.4 billion. Around 60 percent of this, i.e., EUR 840 million, will go to households with net incomes of more than EUR 3,600 per month, because they consume more fuel on average than low-income households. Households with higher incomes do not need this assistance; they can usually meet rising gasoline costs from their own resources.

A third conceivable reaction to rising prices is to provide general transfers to all or particularly affected households and companies, such as the energy premium. Here, too, the question is whether this makes sense for people with higher incomes. The government is taking on debt to pay the premium, and it will have to service this debt in the future. If, in return, policymakers increase income tax, part of the burden will fall on the very households now receiving the energy premium. After all, unlike the fuel tax cut, the premium does not disrupt the price signal or reduce incentives to respond to tight energy supplies. In this respect, this part of the relief package is preferable. This also applies to the child bonus.

Focus on Vulnerable Groups

One argument for credit-financed tax relief in the form of a lower fuel tax or direct transfers is that inflation reduces purchasing power, making it necessary to support demand. But this overlooks the fact that in a situation of high inflation, the economy suffers not because demand is too low, but because it is too high. Tax cuts exacerbate this problem.

One could counter that high energy and food prices at least weaken demand in other sectors. At present, however, prices are rising across the board (albeit not as sharply as in the energy sector), partly because many households built up substantial savings during the pandemic and are now channeling these into consumption. At most, the argument in favor of broad tax relief is that wage increases might be lower if real incomes rise as a result of tax relief. This would reduce the danger of a wage-price spiral.

Overall, policy should focus on helping vulnerable groups that are hit particularly hard by rising energy and food prices. For groups that can shoulder these burdens themselves, policy should not intervene. Rising energy prices serve as the best possible adjustment to scarcer resources. For that reason, they should be allowed to take effect.

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