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INSTITUTIONS ACROSS THE WORLD

European Banking after the 2023 Crisis
Thorsten Beck

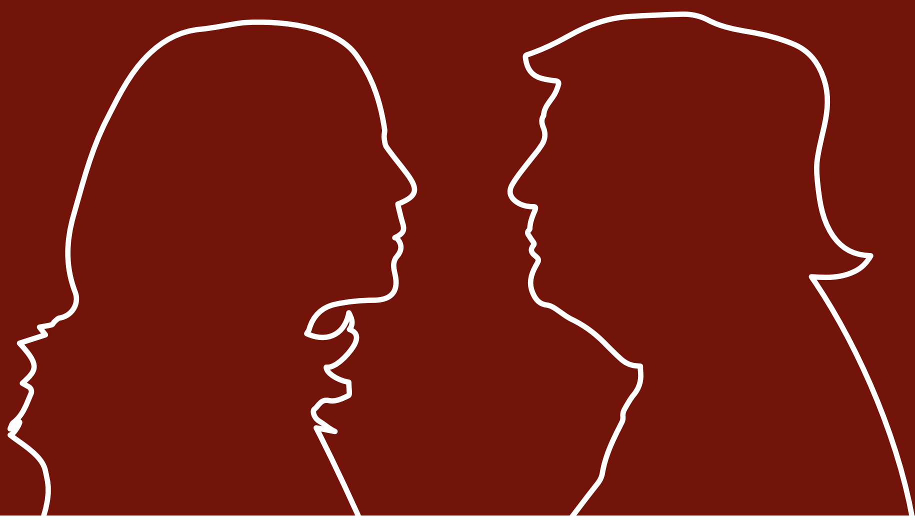
BIG-DATA-BASED ECONOMIC INSIGHTS

The Impact of Working from Home on the German Office Real Estate Market
Simon Krause, Andreas Trumpp, Tobias Dichtl, Susanne Kiese and *Alexander Rutsch*

POLICY DEBATE OF THE HOUR

US Presidential Election 2024: What's Next for Global Politics and the World Economy?

Barry Eichengreen, Anders Åslund, Kimberly A. Clausing, William McBride and *Erica York, Markus Jaeger, Andreas Baur, Lisandra Flach* and *Dorothee Hillrichs, Mark N. Katz, Valentino Larcinese, Pádraig Carmody* and *Paul S. Ciccantell*



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On November 5 this year, American voters will have a choice: will they support former Republican President Donald Trump? Or will they elect Vice President Kamala Harris, who was chosen as the Democratic candidate at short notice following President Joe Biden's decision not to run again? This US presidential election is likely to be one of the most important elections on the global stage. The world is currently suffering from wars, rising tensions between major powers, and other geopolitical risks. Nevertheless, most of these risks have not yet radically affected the outlook for economies and markets. However, many observers fear that this could change if the US returns to an aggressive "America First" stance. On the other hand, Harris is seen as a candidate of policy continuity who will maintain many of Biden's economic and foreign policy measures.

In this issue of EconPol Forum, our authors critically compare the economic, environmental, and foreign policy proposals of the two leading candidates. They assess the consequences of the different policy programs in the US, e.g., for the domestic economy and policy, and abroad. They suggest how Europe and other regions of the world could use their geoeconomic and geopolitical strategies to counter US protectionism and other discriminatory policies and help build a reformed and more legitimate international order.

In "Institutions Around the World," the authors draw important lessons from the turbulence in the banking sector in 2023: effective regulation and supervision is a moving target that must adapt to changing circumstances and banks' business models. In "Big-Data-Based Economic Insights," they examine how the constant shift to working from home, which is often a mixture of office and remote working, will reduce the demand for office space in Germany in the long term.

POLICY DEBATE OF THE HOUR

US Presidential Election 2024: What's Next for Global Politics and the World Economy?

INSTITUTIONS ACROSS THE WORLD

BIG-DATA-BASED ECONOMIC INSIGHTS

Introduction to the Issue on

US Presidential Election 2024: What's Next for Global Politics and the World Economy?

Chang Woon Nam

On November 5 of this year, American voters will have a choice between former Republican President Donald Trump and Vice President Kamala Harris, who was named the Democratic nominee after President Joe Biden's decision not to run for the presidency again. A record number of countries are holding elections this year, but this US presidential election is likely to be one of the most important due to the country's influence on the global stage. Although the world is currently suffering from wars, rising tensions between major powers, and other geopolitical risks, most of these have not radically affected the outlook for economies and markets in the short term. However, many fear that this could change if the US returns to an aggressive "America First" stance. On the other hand, Harris is seen as the candidate of political continuity who will maintain many of Biden's economic and foreign policy measures.

Domestically, Mr. Biden has increased investment in infrastructure and manufacturing, clean energy, and expanding job opportunities as part of "Bidenomics," which has led to strong growth during his presidency, but also to inflation and rising government debt. Mr. Trump, in turn, has blamed his successor's huge government spending for inflation and promised a return to lower taxes and less regulation. Aside from such differences in the fiscal policy priorities of the two candidates, of which change could also have multiple cross-border spillover effects, the 2024 US elections are seen more than ever as a pivotal moment in global politics and have the great potential to reshape international trade, climate policy, and the geopolitical landscape.

Democrats and Republicans agree on some issues, such as the strategic rivalry with China, the protection of domestic production, and access to strategic technologies. But the parties also disagree on issues that are of crucial importance to Europeans, such as climate protection, the war in Ukraine, and the United States' relations with its allies. The potential for a shift towards nationalist and populist rule (including in relation to migration issues), and the weakening of postwar institutions could also redefine international relations.

This issue of EconPol Forum contains nine articles on the impact of the upcoming US presidential election on global politics and the world economy. They not only critically compare the economic, environmental, and foreign policy proposals of the leading candidates, but also assess the potential consequences of their policy differences for the US domestic economy and politics, as well as their significant global spillover effects. The authors also make some policy suggestions on how Europe and other regions of the world should use their geoeconomic and geopolitical strategies to counter US protectionism and other discriminatory measures and help build a reformed and more legitimate international order.

In terms of future economic policy priority, *Barry Eichengreen* calls for the next US president to immediately tackle the country's chronic budget deficits and spiraling debt, while neither candidate is committed to free trade. Yet, Trump's trade policies will be driven by hostility towards China, while Harris's will be more influenced by climate and labor standards. One major difference between the two candidates is on climate policy, where Trump proposes to once again withdraw the US from the Paris Agreement, while Harris was a proponent of the New Green Deal in 2019. Trump promises to lower the cost of living by eliminating red tape and restrictions on oil and gas exploration and production, while Harris has promised to eliminate price gouging and provide subsidies for affordable housing.

Anders Åslund points out that the main differences between Trump and Harris also lie in the areas of immigration and taxes. Trump wants to deport all illegal immigrants, while Democrats want well-regulated legal immigration from the standpoint of limiting disruption to the US labor market, while controlling illegal immigration but offering illegal immigrants the opportunity to legalize their stay in the US. As for taxation, Trump supports billionaires, calling for minimal taxes on them and their businesses, while Harris wants higher taxes for corporations and the wealthy. Democrats talk a lot about the need for green energy, which is developing faster in Republican-led states because they don't insist on so many regulations.

Kimberly A. Clausing argues that to effectively address the enormous fiscal challenges caused by huge deficits and debt, spending cuts alone are not enough, but that the US needs to build a tax system that is better suited for this purpose. Candidate Trump and the Biden-Harris administration are very far apart on fiscal policy issues. The Trump campaign has proposed budget-damaging extensions of provisions of the Tax Cuts and Jobs Act in addition to new tax cuts; the proposed revenue increases (including tariffs) and unspecified spending cuts would not be enough to avoid a sharp increase in the deficit. In contrast, the Biden-Harris administration has proposed many potential tax increases to meet US fiscal needs without significantly burdening most Americans. The election will also have an impact on the distributional effects of key tax policy priorities: Trump's proposal for a tax policy shift that includes lower income taxes and higher tariffs would make the US tax system less progressive, while the Biden and Harris proposals emphasize tax policies that would increase its progressivity.

Instead of addressing the projected debt burden, which is unprecedented and unsustainable, *William McBride* and *Erica York* criticize that both candidates' fiscal plans will likely exacerbate the trajectory of US debt and slow economic growth. Harris's proposals of higher taxation of top earners and companies (including raising the corporate tax rate to 28 percent), and significantly greater redistribution via tax law would shrink the US economy by around 1.6 percent and fail to generate the revenue needed to cover increased spending. Trump's tax policy of making the 2017 tax cuts permanent and further lowering the corporate tax rate could boost growth, but his aggressive tariff strategy would damage the economy and would not be enough to pay for the tax cuts.

Markus Jaeger believes that foreign trade and macroeconomic policies under a Harris administration would offer broad continuity with the Biden administration, while policies under another Trump administration would have the potential to be highly disruptive. Although US national security-focused trade and investment policies will be further tightened in the context of US-China strategic competition, Trump's trade policies could prove highly destabilizing to the global trading system, seriously straining US-EU trade relations and leading to a full-blown trade war with China. The EU should use its new geoeconomic tools to prevent discriminatory measures by the US, while signaling openness to negotiations on how best to defuse the transatlantic economic conflict.

The US is Germany's largest trading partner. A simulation carried out by *Andreas Baur, Lisandra Flach* and *Dorothee Hillrichs* shows that German exports to the US and China will fall significantly in response to potential new tariffs announced by Trump during his election campaign – a 20 percent tariff on all US imports combined with a flat 60 percent tariff on US imports from China. However, the negative direct impact of these US tariffs will be partially offset by trade diversion in the form of increased trade between Germany and other countries, resulting in an overall 2 percent decline in German exports. Germany and the EU should not only work more intensively on new trade agreements to mitigate the risks of such protectionist measures by the US, but also strengthen their single market in order to remain an attractive trading partner for the US.

As for possible changes in American foreign and security policy, *Mark N. Katz* believes that Harris is likely to continue President Biden's foreign policy, and just as Biden continued former President Trump's foreign policy, a reelected Trump is likely to continue much of Biden's. Many see that Trump's criticism of NATO is aimed at getting European members to spend more on defense, not getting the US out of the alliance, and that he doesn't want Ukraine to collapse on his watch and fall into Russia's hands. Nevertheless, Europe should not only increase defense spending to encourage the US to maintain its NATO commitment, but also step up planning for an independent European defense in case the US commitment becomes unpredictable or wanes.

Valentino Larcinese emphasizes that the role of money in US politics has increased impressively in recent years and argues that reforming the campaign finance system is one of the most pressing challenges for the future of US democracy. Currently, money from individuals, corporations, and trade unions can flow to candidates without regulation, restriction or, in some cases, transparency, while there is growing evidence that such donations are increasingly influencing politicians and – through issue advertising – the political agenda as well as the prominence of particular issues in the public debate. This development, in turn, also tends to have an impact on economic policy in the US: wealthy donors are generally much more conservative on economic issues than the population as a whole.

The world is in a period of severe political and economic turmoil. *Pádraig Carmody* and *Paul S. Ciccantell* emphasize once again that the political outcome of the 2024 US presidential election has great potential to either accelerate the process of global disintegration or support the construction of a reformed and more legitimate international order. The way in which the competition between the US and China is played out appears to be the key to global stability and prosperity. Not only Europe, but also other regions of the world, including Asia and the Global South, need to prepare for shocks that a potential Trump victory could bring: the stakes are high for both the US and the world.

We hope you enjoy this Policy Debate of the Hour!

Barry Eichengreen

The Economic Policies of the Next US President

KEY MESSAGES

- **The next president of the United States will have to address the country's chronic budget deficits and spiraling debt. Unfortunately, neither candidate has a coherent plan**
- **Neither candidate is committed to free trade. Whereas Trump's trade policies will be conditioned by animosity toward China, Harris's will be shaped by climate and labor standards**
- **A dramatic difference between the two candidates is on climate policy, where Trump proposes to again withdraw the US from the Paris Agreement and to expand the use of oil and gas, whereas Harris was a proponent of the 2019 New Green Deal**
- **Trump promises to reduce the cost of living by eliminating red tape and restrictions on oil and gas exploration and extraction, while Harris has promised to eliminate price gouging and other anti-competitive practices and to provide subsidies for affordable housing**

Every US presidential election is consequential, but American voters will face an exceptionally weighty decision in November 2024. The outcome will have implications for US foreign policy, social policy, and the integrity of the political system.

And then there's economic policy. Vice President Kamala Harris is the candidate of economic policy continuity. While she lacks experience and a lengthy record of statements on economic policy issues, the best bet is that she will maintain many of the policies of President Joe Biden. Her opponent, former President Donald Trump, is a candidate of continuity as well – continuity with the low-tax, high-tariff, business-friendly policies of the Trump term from 2017 through 2020.

DEBTS AND DEFICITS

The next president, whomever he or she may be, is likely to inherit an economy with low unemployment, an inflation rate converging toward 2 percent, and a growth rate that is the envy of most any European economy. But he or she will preside over an economy with a large public debt (debt in the hands of the public on the order of 100 percent of GDP) and a budget deficit that the nonpartisan Congressional Budget Office projects, given no changes in current law, will approach 6.5 percent of GDP in 2025, down only marginally from 2024. Assuming a real interest rate of 1 percent and a real GDP growth rate of 2 percent, the primary (non-interest) deficit will have to be reduced by 2 percentage points of GDP to prevent the debt ratio from rising further. One respect in which the two candidates' economic policy positions are aligned is that neither has a realistic plan for closing this gap.

The CBO's projections assume that the 2017 Tax Cuts and Jobs Act will expire at the end of 2025, as scheduled under current law. That act, passed during the earlier Trump term, cut the corporate tax rate to 21 percent from 35 percent, reduced individual income tax rates, and increased the standard deduction available to income taxpayers who do not itemize deductions. Trump is unlikely to endorse higher taxes; on the contrary, he has indicated a desire to make his earlier tax cuts permanent. In his speech accepting the nomination at the Republican National Convention, he proposed reducing the corporate income tax rate further to 15 percent. In contrast, Harris would raise taxes on the well off, defined as households making more than USD 400,000 annually, increase the tax rate on capital gains, and impose a largely symbolic minimum tax rate on incomes of billionaires, all along the lines of the Biden Administration's earlier budget. The Biden White House's proposed budget for the fiscal year running from July 2024 through June 2025 would also have hiked the corporate tax rate from 21 to 28 percent, reversing out half of the rate reduction between pre- and post-Trump years, and the Harris campaign has signaled support for this idea. These and related proposals would reduce the deficit by USD 75 billion in 2025, according to independent estimates, where the overall deficit, again pace the CBO, is slated to be on the order of USD 2 trillion. The additional revenue, then, is what tax specialists politely refer to as a drop in the bucket.

Equally, there will be limited scope for the next president to reduce public spending. Some 59 percent of federal outlays are on pensions (Social Security), health care programs (such as Medicare for the elderly and Medicaid for low-income individuals), and other mandatory items. Another 13 percent of the

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budget goes to defense, and a further 14 percent pays interest on the debt. Basic arithmetic suggests that this leaves only a small fraction of the budget for forms of discretionary spending that might be cut. Trump has suggested sharp reductions in government employment and alluded to equally sharp reductions in defense spending. Whether domestic politics will permit the former, foreign politics the latter, is an open question, to put the matter in the most positive possible way.

Harris for her part has advocated in favor of Biden's programs providing subsidies for the domestic production of semiconductors and other advanced products on both national security and good-manufacturing-jobs grounds. She would implement so-called place-based policies that subsidize investment and small business operations in urban and rural communities that have fallen behind the rest of the country in terms of income and employment growth. She has proposed expanded tax credits for parents, paid parental leave, public spending on childcare, and more funding for education. She would add a USD 6,000 tax credit for newborns in their first year of life and make permanent the temporary pandemic-era tax credit for children that the Congress subsequently allowed to expire.

Recent research has pointed to positive returns from place-based policies, early childhood education, and reductions in child poverty (where such reductions make for better adult health and higher incomes). More precisely, it has pointed to positive returns when the policies and programs in question are well designed. Harris has emphasized this "return on investment" (her words); her campaign has suggested that many of these programs will pay for themselves. But appropriate design and high returns are not to be taken for granted. The experience of European countries that have similar programs in place suggests that these will have to be financed, at least in part, to avoid further widening the budget gap. Financing such programs will be no mean feat: making the pandemic-era tax credit for children permanent, by itself, would cost more than USD 1.2 trillion in revenues over ten years, according to the nonpartisan Committee for a Responsible Federal Budget. It is worth recalling, moreover, that all bills for raising revenue must originate in the House of Representatives and be passed by both Houses of Congress. The US president, of whatever party and inclination, cannot address the country's fiscal imbalance on his or her own. This is a reminder that November 2024 will see the election of not just the president but also one-third of the Senate and the entire House.

TRADE POLICY

Candidate Trump has also mused about a more radical fiscal idea, namely replacing the federal income tax in its entirety with a tax on imports, which he asserts will be paid in whole or large part by foreigners. Most economists will dismiss this idea out of hand. Replacing USD 2 trillion of individual and corporate tax revenue with taxes on USD 3 trillion of US imports would require an enormously high tariff, even assuming no decline in US import demand, no foreign retaliation, and no corollary damage to the US economy. Although Republicans in Congress no longer pledge allegiance to the Laffer Curve, even they will find it hard to deny that an import tax rate in excess of 67 percent will be on the wrong side of that relationship. Even the revenue-maximizing tariff, which is on the order of 50 percent given conventional assumptions about the elasticity of import demand, would replace barely one-third of existing individual and corporate tax revenues. As for the assertion that this import tax will be paid by foreigners, studies have shown that the largest share of the costs of Trump's first-term tariffs were passed through to US consumers and producers. Shifting from a graduated income tax to what would effectively be a de facto consumption tax would have the most dramatic negative effects on low-income US households, who devote the largest share of their incomes to consumption.

Alternatively, Trump has proposed a 10 percent tariff on all US imports and a 60 percent tariff on imports from China. The comprehensiveness of a 10 percent across-the-board tariff and the height of a 60 percent Chinese tariff would be escalations of policies followed in the earlier Trump term, when only certain imports were taxed and tariffs on imports from China ranged from 10 to 25 percent.

It is relevant here that Biden in his presidential term did not roll back Trump's tariffs in their entirety. Not only did he retain his predecessor's tariffs on imports from China, but he increased those duties on steel, aluminum, and clean-energy products, even quadrupling tariffs on Chinese electric vehicles. To be sure, in 2021 the Biden Administration negotiated an agreement with the EU suspending US tariffs on European aircraft and agricultural products and replaced US tariffs on European and Japanese steel and aluminum with a tariff-rate-quota system, where only imports above the designated quota are taxed. But, whatever the outcome, the 2024 election will not herald a return to free trade in the United States. The global trading system will remain under strain. Decoupling between the US and China will continue.

It is worth recalling in this context that Vice President Harris has stated that she would have voted against the 1992 North American Free Trade Agreement (NAFTA) and the proposed 2016 Trans-Pacific Partnership. While serving in the Senate in 2020, she voted against the successor to NAFTA, the United States-Mexico-Canada Agreement (USCMA). In explaining her opposition to NAFTA, Harris cited its failure to protect American workers from low wages and lax labor standards abroad. In voting against USMCA, Harris cited the agreement's inadequate environmental protections, and that free trade between the US and Mexico enabled dirty industries to operate freely south of the border. This suggests that under a Harris Administration future US trade conditions and agreements will be conditioned on labor and environmental standards.

CLIMATE POLICY

This observation points to what is perhaps the most consequential economic policy difference between the two candidates, namely their positions on climate policy. President Trump pulled the United States out of the Paris Climate Accord in 2019, while the US under President Biden reentered it. Trump has vowed to expand oil and gas production, and his campaign has stated that he would withdraw the US from the Paris Accord a second time if granted another term. In contrast, Harris supported the Green New Deal while serving in the Senate and investigated the oil industry while California Attorney General, securing a settlement from British Petroleum subsidiaries in compensation for underground gas tank ruptures and indictments against a Texas-based pipeline operator for an environmentally damaging oil leak.

Thus, under a President Harris the United States is likely to attempt to revive US-EU negotiations seeking to link trade and decarbonization. Those negotiations were suspended in early 2024, partly owing to seemingly irreconcilable differences between the negotiating partners, and partly due to the difficulty of passing a new trade agreement into law given a divided Congress and a US presidential election year. The fundamental difficulty lies in the two economies' very different approaches to limiting carbon emissions. Europe is putting in place a carbon border adjustment mechanism that will tax imports of emission-laden products at the same rate as domestically produced substitutes subject to the EU's cap-and-trade emissions system. The US Congress has blocked cap-and-trade, so US negotiators have instead proposed symmetrical subsidies for low-carbon production of steel, aluminum, and other products, together with the elimination of both Europe's carbon border adjustment system and US tariffs on steel and aluminum, and tariffs on imports from other countries that do not subsidize or otherwise move to low-carbon production. Whether a Harris Administration could reconcile these two different approaches is unclear. But it is likely to try. The alternative is more US-EU commercial tension and headwinds for the global trading system.

THE DOLLAR

Another issue for the next president of great consequence for the rest of the world is policy toward the dollar. Trump, his vice presidential running mate J. D. Vance, and his former trade negotiator (and prospective treasury secretary) Robert Lighthizer have complained that the high value of the dollar handicaps the efforts of US exporters. Given the limited resources of the Exchange Stabilization Fund of the US Treasury, it is unclear whether intervention in the foreign exchange market in pursuit of a lower dollar would succeed. Trump's advisors have suggested the possibility of tariffs on imports from countries that prevent their currencies from appreciating against the greenback, or alternatively a tax on foreign purchases of US treasury securities and other assets, purchases that have the effect of supporting the dollar on foreign exchange markets. The first measure could be destabilizing for the global trading system, since Trump's initial 10 percent tariff would itself push up the dollar, insofar as it did nothing to alter the balance between US saving and investment and therefore the current account balance. More tariffs would then make for a stronger dollar, and in turn still more tariffs, continuing without obvious end.

Alternatively, taxing foreign purchases of US treasuries would undermine the international and reserve currency role of the dollar. There being no adequate substitute for the dollar as a source of global liquidity, global finance as well as global trade would be at risk. Yet another possibility is President Trump pressuring the Federal Reserve to lower interest rates so as to weaken the dollar, Trump in the past having raised questions about the independence of the central bank. A serious challenge to the independence of the Fed would in turn weaken confidence in the integrity and stability of the dollar as an international currency, again with ominous implications for the global trade and financial systems. President Biden has adhered to the so-called "strong dollar policy" of US administrations since the 1990s – which mainly amounts to not commenting on the dollar. He has not questioned the independence of the Fed. Vice President Harris has not shown signs of departing from this line. As she put it in the late days of last summer, "The Fed is an independent entity and as president I would never interfere in the decisions that the Fed makes."

THE COST OF LIVING

The Federal Reserve notwithstanding, inflation is an issue is of great concern to American voters and hence to both presidential candidates. Trump has promised to bring down the cost of living – effectively, to reverse past inflation. He has not provided much detail on specific policies to achieve this, other than eliminating costly regulation and removing limits on oil and gas exploration and extraction. Harris has focused on food prices and housing costs. She proposes a federal ban on price gouging for groceries, a measure that seems somewhat redundant, since many states already have laws prohibiting predatory pricing in the wake of hurricanes and other natural disasters. Allusions to "new federal enforcement tools" to punish companies that opportunistically push up the prices of food are open to various interpretations. Best would be to simply use existing enforcement tools, such as the existing antitrust, pro-competition powers of the Justice Department and the Federal Trade Commission. Reassuringly, Harris alluded to this alternative as well, asserting in her maiden economic address in August that "We will help the food industry become more competitive because I believe competition is the lifeblood of our economy."

On housing, Harris would send up to USD 25,000 of down-payment assistance to qualifying first-time home buyers. (Who exactly would qualify is yet to be specified.) She would provide tax credits to companies that build starter homes, and direct USD 40 billion to local governments that encourage the construction of affordable housing. Increasing the supply of homes is an admirable goal in a country where, for many, housing is unaffordable. The USD 40 billion fund can be leveraged to counter local government resistance in areas where NIMBY ("not in my back yard") sentiment is strong. But down-payment assistance will only increase the demand for homes. Basic incidence analysis suggests that the benefits will accrue heavily to home builders and sellers, and not to first-time buyers, insofar as supply remains inelastic.

POLICY CONCLUSIONS

No question, the upcoming US election will have far-reaching implications for the global trading system, for US-EU economic relations, and for climate policy. It will determine whether there is regress, progress, or perhaps just stasis in redressing the imbalance in US fiscal policy. It could reshape the position of the dollar and more generally of the United States in the world economy. It will affect US-China relations and the fate of globalization. Clearly, much is at stake.

Anders Åslund

What to Expect from US Economic Policy after the Presidential Election

KEY MESSAGES

- **Both candidates, Kamala Harris and Donald Trump, favor protectionism, but Trump to an extreme degree**
- **The joint protectionism is mainly directed against Chinese technology**
- **Trump favors mass deportation of immigrants, while the Democrats want orderly immigration**
- **Nobody cares much about the unsustainable public finances, but the Republicans want to cut taxes, while the Democrats want to raise them for corporations and the wealthy**
- **The rhetorical differences over green energy are largely fictive**

The US presidential election stands between Vice President Kamala Harris and former President Donald Trump. Trump's policies are well known, while Harris is not all that well defined. She pushed a comparatively left-wing agenda in 2019 when she was a presidential candidate, but as Vice President she has been extremely cautious and loyal to President Biden. With a brief election campaign, she might not have to clarify her positions, but it is clear that she no longer opposes fracking or insists on Medicare for all, moving toward the political center.

THE US ECONOMY IS MORE DOMINANT THAN EVER

Since the global financial crisis erupted in 2008, the US economy has taken off on a higher trajectory than the EU economy. It has grown steadily by about 2 percent a year while the EU economy has grown by 1 percent a year. Strangely, this is hardly mentioned in the US public debate, which is all about China. This leaves the impression that Americans are suffering badly. President Biden's idea to launch the concept of "Bidenomics" as a great success was factually accurate, but it backfired politically. The main public concern has been high inflation that peaked at 9.1 percent in June 2022 but has now fallen below 3 percent.

For the last couple of years, the US economy has recorded the lowest unemployment since the 1960s, plummeting to 3.5 percent. At present, the unemployment rate has risen to 4.3 percent and is increasing, but that is tiny by historical and international standards.

In 2008, the US and EU GDP were of approximately the same size, USD 15 trillion versus USD 16 trillion, respectively, but in 2023 the US GDP had grown to USD 27 trillion, while the EU GDP was only USD 18 trillion, or USD 20.6 trillion if we add the United Kingdom. During these 15 years the US economy had expanded by 82 percent in current dollars but the EU GDP only by 26 percent, that is, the EU growth was only one-third of the US growth. Much of this was exchange rate changes, but the point is that Europeans prefer to invest in the US. Most shocking is the market values of the biggest companies in the world. Of the 20 most valuable companies in the world, 15 are American and only two European.

Given that the US economic situation is so different from the European, the US economic thinking is correspondingly different. The main US global economic concern is China. Both the Democrats and the Republicans are primarily focused on high-tech, most of all semiconductors, and the preferred tool is prohibitions of exports of top technology to China. This drives the US in the direction of protectionism and industrial policy.

JOINT PROTECTIONISM IN FOREIGN TRADE

From a European perspective, it is extraordinary how small US exports are. In 2022, US exports of both goods and services were only 12 percent of GDP. Therefore, Americans care much less about foreign trade than Europeans, and they are inclined to be much more protectionist.

US trade policy is driven by three concerns that are all protectionist. The first is the large and steady US trade and current account deficit, but it is largely financed by massive capital inflows, to which little attention is being paid. The second issue is the decline of manufacturing in the United States, which is similar to what has happened in other Western countries. US manufacturing produces more than ever, but it is so efficient that it requires few workers. The third

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issue is China. There is a general sense that China was admitted into the World Trade Organization too easily in 2001 and that it has stolen jobs from the US. Added concerns are Chinese state subsidies in high-tech, notably chips and the solar industry, and restrictions on or maltreatment of US investment in China. Both parties are focusing on the male white working class in the three swing states Michigan, Wisconsin, and Pennsylvania, who traditionally work in the car and steel industry.

Trump was the most protectionist president since the 1930s, and he is intent on doubling down on protectionism. His official proposal is to impose a 10 percent import tariff on all imports and 60 percent on Chinese imports. In his leisurely way, he has talked about increasing the tariff to 20 percent, and privately he has even discussed replacing federal taxation with import tariffs. In practice, that is impossible. Total US imports correspond to all US federal tax revenues, so this would imply an average import tariff of 100 percent, which would sharply reduce US imports.

Biden has traditionally been highly protectionist, focusing on the concerns of the Midwest working class. Many Europeans were disappointed that Biden did not eliminate the steel and aluminum tariffs that Trump introduced for purported national security reasons, but Biden avoids even talking about it. The three big Biden investment laws – the Chips Act, the Infrastructure Act, and the Inflation Reduction Act – all contain important requirements for "made in America." This hits both Chinese solar exporters and European wind turbine producers. Nor has Biden done anything to reinforce the World Trade Organization and appoint judges to its appellate body, so it can no longer provide dispute settlements. Biden tends to say as little as possible about trade policy toward Europe, while offering no relief, and he competes with Trump when it comes to protectionism against China.

Given that China is the top global producer of electric vehicles and solar energy, the Biden protectionism against China appears to contradict his green energy ambitions. He has raised import tariffs on Chinese electrical vehicles from 25 percent to 100 percent in 2025 and he has boosted the tariff on semiconductors and solar cells from China from 25 percent to 50 percent in 2025. These tariffs are surprisingly uncontroversial. Trump argues that Biden is following his lead but does not go far enough, while Biden offers full support to the protectionist automotive and steel trade unions, unlike Trump.

Chips have become the new global competition, and there are only two competitors – the United States and China. Europe and other parts of the world do not even participate, with limited exceptions such as Dutch ASML and British ARM. The common US view, well captured in Chris Miller's excellent book, *The Chip War*, is that China has stolen US intellectual property and must not be allowed to do so any longer. The US is restricting the chips and chips technology that can be exported to China as well as the chips that can be imported to the United States. This is actually a consensus policy of the two parties.

Harris has distanced herself in substance from Biden on trade policy by attacking Trump's protectionism. She has repeatedly called Trump's increased import tariffs a "national sales tax," correctly clarifying that such tariffs would mainly be paid by the poor and the middle class and that they would increase inflation. It remains to be seen if this traditional economic argument will catch on. While she supports the trade unions like Biden, she is not equally closely tied to them. The United States is likely to remain protectionist regardless of president.

SHARP DIFFERENCE OVER IMMIGRATION

Immigration is a top issue and in substance it is quite confusing. The United States requires large-scale immigration for continued growth. The expansive high-tech industries suffer badly from labor shortages, calling for more immigration of qualified software engineers from India and China, but work visas are scarce and hard to come by. Vancouver, Canada, has become a major high-tech hub for US companies, populated with Indian citizens who have not received work permits in the United States.

Trump has declared that he wants to deport all illegal immigrants, who allegedly amount to 11 million. Considering that they account for a large share of the unqualified labor in farming, factories, construction, and household work, this would amount to a major disruption of the US economy. This policy is being driven by Trump's long-time close aide Stephen Miller, who is likely to carry out major deportations of immigrants, if Trump wins the election, which would cause major damage to the US economy. Trump's billionaire donors do not seem to pay much attention to this part of his policies, although the high-tech companies are highly dependent on highly qualified Indian and Chinese engineers.

The Democrats are happy to accept more immigration, but they dare not go far because of Trump's vicious opposition. They want substantial, well-regulated legal immigration, while limiting illegal immigration, but offering a possibility for illegal immigrants to legalize their residence in the US.

IN THE LONG RUN, THE US FEDERAL FINANCES ARE UNSUSTAINABLE

Economists and outside observers are worried about the US public finances. In 2023, the US budget deficit was almost 9 percent of GDP and the gross public debt amounted to no less than 122 percent of GDP. Americans tend to discuss net public debt, that is, deducting the social security trust funds, leaving the public debt at a still high 100 percent of GDP.

What is most surprising from a European perspective is that few seem concerned about the vast public debt and the large budget deficit, which seems likely to stay around 7 percent of GDP for the foreseeable future. Everything has gone so well for so long, so why would it not continue? One explanation is that at the end of June 2023, foreign investment in US securities amounted to no less than USD 27 trillion, according to the US Treasury, which corresponds to the US GDP. This explains why the exchange rate of the US dollars has stayed so high and the high market value of US companies: the whole world invests in the United States. But for how long will they continue doing so, if the US public debt continues to grow? As the late Rüdiger Dornbusch taught us, financial crises usually occur later than expected but then move faster than anybody had anticipated. The US's financial role in the global economy is very peculiar, making it difficult to know what will happen and when.

The difference between Trump's and Harris's fiscal policies are great. Trump's fiscal policy is pretty clear. As president, he legislated a major tax cut for corporations and the wealthy in 2017. He now wants to proceed, cutting the corporate profit tax from 21 percent to 20 percent and making the tax cut for the wealthy permanent. Otherwise, it would elapse in 2025. Trump has also promised to abolish taxes on tips, which are quite important in the US economy. Trump has not specified any expenditure cuts, and the US federal government does little but social benefits (social security, Medicare, and Medicaid), defense, and interest payments, neither of which Trump wants to or can reduce, while many Republican politicians call for trimming social benefits. In addition, Trump toys with the unrealistic idea of replacing all federal taxes with sky-high import tariffs. A new Trump presidency will lead to the conservation of the large budget deficits and ever greater public debt.

The Democrats opposed the Trump tax cuts of 2017 and they would be happy to let the tax cut for the very wealthy – for people earning more than USD 400,000 a year – lapse, while increasing the corporate profit tax from 21 percent to 28 percent. Harris has followed Trump's lead and also promised to abolish taxes on tips – which is particularly important in the swing state Nevada, with Las Vegas and a large hospitality industry. The Democratic tax proposals would strengthen the federal revenues substantially. On the other hand, Harris has proposed substantial new social expenditures, essentially child tax credits and subsidies for people buying their first home. As currently stated, these new expenditures would be less than the increased taxes, which means that the Democrats would be more fiscally responsible than the Republicans.

The presidents who increased the public debt the most in recent memory were Republican: Ronald Reagan, George W. Bush, and Donald Trump – but an important reason was their strong standing in Congress. The best means of blocking federal spending is a Congress that opposes the president.

OVERTLY, GREAT DIFFERENCES OVER ENERGY POLICY, BUT THE REAL DIFFERENCES APPEAR SMALL

The public positions on energy policy vary greatly between Republicans and Democrats, but the reality far less so. Green energy is highly contentious. Republican-led states, such as Texas and Florida, have adopted legislation against all kinds of green policies, but paradoxically Texas, the still dominant producer of fossil fuels, is the US leader in both solar and wind energy. It is far more difficult to receive permissions to build wind farms in the North-Eastern Democratic states.

Trump has taken a strong stand in favor of coal, which has given him big majorities in coal states, such as West Virginia and Kentucky, but coal is being outcompeted by natural gas, which is much more environmentally friendly. In 2019, Harris opposed fracking, but Biden was not because then he would hardly have been able to win in Pennsylvania, the possibly most important swing state, and Harris has followed his lead.

Trump's energy slogan is "Drill, baby, drill!" but he has failed to notice that Biden has actually pursued that policy. At present, the US produces 13.4 million barrels of oil a day. No country in history has produced that much oil. Yet, Biden does not want to boast about it, because that would arouse the many environmentalists in the Democratic party. Therefore, he keeps quiet about it. It remains to be seen how Harris will handle energy policy. So far, she has been very cautious not to tread on this sensitive ground. Under Biden, the US has greatly expanded its exports of LNG and domestic gas prices are now lower than ever. In effect, Biden has preempted Trump's policy, which neither of them recognize. Biden has oddly restricted new US export projects for LNG. This restriction is likely to be eased with broad public support.

All the Biden investment laws – the Infrastructure Act, the Inflationary Reduction Act, and the Chips Act – contain plenty of "buy American" restrictions, which raise the price of green energy. The same is true of the high new tariffs on green energy from China, which both Trump and Biden have supported. Since Harris seems more interested in green energy than in protectionism, she might turn this around, but so far she has not spelt that out.

SHOULD ANYTHING BE DONE TO THE MAGNIFICENT SEVEN?

The global economy is dominated by the "Magnificent Seven," the seven biggest US high-tech companies – Apple, Microsoft, Nvidia, Amazon, Meta, Alphabet, and Tesla. Each of the three first has a market capitalization that exceeds the value of the whole German stock exchange. US private investment in artificial intelligence is enormous – 50 times higher than in the European Union. The two most valuable European companies are typically research and development companies, but they are too few. The Danish pharmaceutical company Novo Nordisk is currently no. 13 and the Dutch chipmaker ASML no. 20.

The US multi-billionaire owners are becoming increasingly controversial both to Democrats and Republicans for many reasons. Traditionally, the billionaires on the coasts – Wall Street, Silicon Valley, and Hollywood – tended to lean towards the Democrats, while the billionaires in energy and manufacturing were usually Republicans. Now the thousand or so billionaires are swinging to the right. The most obvious reason is that they don't want to pay taxes, nor do their companies. A related reason is that they oppose regulation, which is true of most big companies. Specifically, the Democrats are critical of cryptocurrencies that Trump now embraces.

Yet, the economic and political dominance of the biggest companies is becoming oppressive in the US and many Republicans and Democrats oppose their dominance, which often extends to monopoly. Biden has driven antitrust surprisingly far, but this is really a bipartisan issue that is likely to become more important over time as the dominance of the biggest companies proceeds in all walks of life.

POLICY CONCLUSION

From a European perspective, it is difficult to understand the limited American appreciation of the continued success of the US economy. This misperception of the US's economic strength has bred great protectionism in both the American parties, but Trump's protectionism is truly extreme. Presumably, Harris will be less protectionist than Biden has been. The US protectionism is mainly directed against Chinese technology, but Europe is a collateral victim rather than a partner. The two biggest differences between Trump and Harris are over immigration and taxation. Trump favors mass deportation of immigrants, while the Democrats want orderly immigration. On taxation, Trump supports the billionaires calling for minimal taxes on them and their corporation, while Harris wants higher taxes for corporations and the wealthy. The Democrats talk a lot about the need for green energy, which actually develops.

Kimberly A. Clausing

US Presidential Election 2024: Consequences for Fiscal Policy

The policy ideals of the Biden-Harris Administration[1] and those of former President Trump are starkly contrasting in almost every respect, but perhaps one of the largest differences concerns tax policy. Their tax policy ideals differ in four key respects. First, the Trump Administration enacted deficit-financed tax cuts, and the Trump campaign has proposed doubling down on that approach, whereas the Biden-Harris Administration added less to national debt and shows more commitment to fiscal responsibility. Second, the Trump Administration consistently enacted tax policies that make the tax system less progressive, giving disproportionate tax cuts to those at the top of the income distribution (Tax Policy Center 2017). Candidate Trump has proposed new policies that would move in the same direction, whereas the Biden-Harris Administration has consistently proposed (and in some cases, enacted) tax policies that would make the tax system more progressive (US Treasury 2022; US Treasury 2024).

Third, the Trump campaign has suggested that tariffs will be an important part of their tax policy portfolio (Bloomberg 2024), whereas the Biden-Harris Administration has emphasized that tariffs have important distortionary and regressive impacts when used as a general source of federal tax revenue (White House CEA Blog 2024). Fourth, the Trump Administration tax policy priorities would have large negative spillover effects on the rest of the world, whereas a possible Harris Administration would avoid such collateral damage, working more productively with partners abroad on global collective action problems.

KEY MESSAGES

- **The Trump Administration enacted deficit-financed tax cuts, and the Trump campaign has proposed doubling down on that approach. The Biden-Harris Administration added less to national debt and shows more commitment to fiscal responsibility**
- **The Trump Administration consistently enacted tax policies that make the tax system less progressive, giving disproportionate tax cuts to those at the top of the income distribution; candidate Trump has proposed multiple new policies that would move in the same regressive direction. The Biden-Harris Administration has consistently proposed (and in some cases, enacted) tax policies that would make the tax system more progressive**
- **A potential Harris Administration is more likely to prioritize strengthening corporate taxation, addressing climate change, and fully funding the IRS. In contrast, a possible second Trump Administration is more likely to lower corporate taxes, reduce IRS funding, and back away from climate change commitments**
- **The Trump campaign has emphasized that large tariffs will be an important part of their tax policy portfolio; this would harm the US economy, reduce job creation, and redistribute tax burdens toward those lower in the income distribution. Such massive tariffs would also damage international relations and risk waves of retaliation. In contrast, the Biden-Harris Administration has emphasized that tariffs have distortionary and regressive impacts**
- **Trump Administration tax policy priorities would have large negative spillover effects on the rest of the world. Harris Administration tax policy priorities would avoid such collateral damage, more productively engaging with partners abroad on global collective action problems**

THE FISCAL MOMENT IN 2025

The fiscal moment in 2025 is far more challenging than those faced by US politicians in recent memory. Both deficits and debt are at high and rising levels. CBO's latest projections (from June 2024) show deficits averaging 6.3 percent of GDP for the coming decade, with debt-to-GDP ratios climbing from 99 percent in 2024 to 122 percent in 2034. Further, in an environment of higher interest rates, net interest expenditures on servicing the debt (currently about 3 percent of GDP and rising) are now approximately the same size as total defense spending, far higher than in recent years, putting more pressure on the budget.

Neither Trump nor Biden have excelled at fiscal rectitude, although Covid spending left a large mark on both of their spending trajectories. Still, the Biden-Harris Administration added less to the national debt than did the Trump Administration, either including or excluding Covid-related spending. President Trump approved USD 8.4 trillion in new (net, ten-year budget window) debt during his term, USD 4.8 trillion of which was not Covid related. The analogous fig-

[1] At the time of this writing, President Biden had recently stepped down as the Democratic party nominee for the 2024 race; Vice-President Harris became the presumptive Democratic nominee. As a presidential candidate, Harris's statements on tax policy have been aligned with the tax policy priorities of the Biden-Harris Administration. In this piece, I assume that continuity persists.

ures for President Biden are USD 4.3 trillion of new debt, USD 2.2 trillion of which was not Covid related (Committee for a Responsible Federal Budget 2024a).

An additional fiscal challenge stems from the looming expiration of part of the Tax Cuts and Jobs Act. During the Trump Administration, the largest legislative achievement was Public Law 115-97, colloquially known as the Tax Cuts and Jobs Act (TCJA), which dramatically (and permanently) cut corporate tax rates, while temporarily enacting large cuts in personal income, pass-through business, and estate taxes. Most of these temporary tax cuts expire at the end of 2025. A full extension of these tax cuts, as well as clawing back automatic business-tax raisers that were enacted as part of the TCJA, would have a ten-year budget cost of approximately USD 5 trillion, or closer to USD 6 trillion if additional interest costs were included, assuming that the tax cuts are not offset by other tax increases or spending cuts (Committee for a Responsible Federal Budget 2024b).

So far, the Trump campaign has expressed unbridled enthusiasm for fulling extending the TCJA; in part, this plays into a deliberate strategy at TCJA's enactment, whereby the unpopular parts of the legislation (the corporate tax cuts) were made permanent, while the most popular parts (the individual tax cuts) were temporary. Given the rising cost of extending the TCJA, this commitment to full extension is likely to entail large deficits, since other offsets are unlikely to "finance" these tax cuts. Further, both the temporary and the permanent tax cuts delivered skewed benefits, disproportionately boosting after-tax income for those at the top of the distribution, and enacting only modest cuts for those in the middle of the distribution or further down. Extending these tax cuts would thus continue a regressive pattern of tax cuts. Some provisions are particularly regressive, including the estate tax cuts, which benefit only the top two-tenths of 1 percent of the population. The pass-through business tax cuts are also starkly regressive, with about 55 percent of benefits going to the top 1 percent of households, and only 3 percent going to the bottom half of the income distribution. Finally, the Trump campaign's enthusiasm for tax cuts is not limited to merely extending the TCJA; there have also been campaign musings about a 15 or 20 percent corporate tax rate, or even completely replacing the income tax with tariffs, discussed below.

In contrast, the Biden-Harris Administration has expressed support for only a partial extension of the TCJA, and they have rejected extending any tax cuts that benefit those at the top of the distribution. While the Biden-Harris Administration plans for financing a partial TCJA extension have not been spelled out, they have issued multiple "Greenbooks" (e.g., US Treasury 2022; US Treasury 2024) in which they spell out potential tax policy increases that would be more than sufficient to pay for a more limited extension (or other fiscal priorities). These menus of tax policy changes all emphasize reforms that would increase the progressivity of the tax system, by increasing corporate taxes and taxes on higher-income individuals, while providing more generous child tax credits, earned-income tax credits, and premium tax credits (to help the after-tax incomes of those lower in the income distribution). Biden-Harris Administration Greenbooks have not proposed substantial new tax cuts beyond a menu of tax credits supporting lower-income Americans (and those with children), alongside tax credits that would support housing and clean energy development.

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TAX POLICY PRIORITIES FOR THE FUTURE

Beyond questions about how to extend the TCJA, the election will also have important tax policy consequences across multiple dimensions. Three key distinctions are illustrative: the approach to corporate and international tax policy, the approach to climate policy, and the approach to funding the IRS.

A second Trump Administration would make corporate tax rate cuts far more likely, despite their lack of popularity, and Trump has suggested on multiple occasions that he'd like to go as low as 15 percent. Republicans have expressed skepticism and hostility about the international tax agreement, including reforms that would implement a country-by-country minimum tax on multinational income. However, countries throughout the world have implemented the agreement, and almost all US multinational companies are within the scope of the agreement. Absent US adoption, US multinational companies may end up paying "undertaxed profits rule" levies to foreign governments. US multinational companies may also face digital sales taxes abroad, absent progress on implementing other parts of the international tax agreement. A second Trump Administration can be expected to react to these developments with intransigence, threatening trade wars in response.

In contrast, the Biden-Harris Administration has made international collaboration a centerpiece of their international economic diplomacy, helping to negotiate the international tax agreement (overviewed in Clausing 2023) that is reducing the twin pressures of tax competition and international profit shifting (see Hugger et al. 2024). A key objective of a Harris Administration would be to build on that progress and use this moment as an opportunity to better level the tax playing field between US and foreign operations. Because the international agreement is being implemented throughout the world, it will be easier to raise revenue from the corporate tax without fearing undue competitiveness pressures on US multinational companies (Clausing 2024a).

A second key contrast is climate policy, much of which is done through the tax code. Republicans, and Candidate Trump, have made no secret of their desire to repeal the clean energy tax cuts that were enacted under the Inflation Reduction Act, whereas a Democratic administration can be expected to continue to pursue climate change mitigation policies through both tax and regulatory measures. In recent work (Bistline et al. 2024), we model the consequences of different 2025 climate policy trajectories for US emissions, fiscal balances, and household costs, showing that these policy choices will have stark consequences for the path of US emissions reduction efforts as well as fiscal outcomes.

A third example of tax policy contrasts is the approach to tax enforcement and the IRS. The Biden-Harris Administration has prioritized a well-funded IRS, and increased IRS funding was a key component of the Inflation Reduction Act. Unlike most spending, IRS funding generates net tax revenue, perhaps more than official estimates suggest (Mazur and Sarin 2023). It also improves the experience of typical taxpayers, who benefit from a well-staffed IRS that can answer queries, quicker handling of returns, more accurate auditing procedures, and greater government fiscal capacity. The United States has a large tax gap (Krause et al. 2023); collecting more of the tax that is due has the potential to benefit ordinary taxpayers by reducing tax burdens and better meeting the nation's fiscal needs. In contrast, both Republicans in Congress and Project 2025 (a group hoping to steer the agenda of a second Trump Administration) have indicated a strong desire to curtail expansions in IRS funding (Gleckman 2024). One might expect Trump to go the same way, given the stance of his first administration and his current troubles with the IRS (Associated Press 2024).

TARIFFS AS FISCAL POLICY

Perhaps the largest distinction between Trump's fiscal policy plans and those of the Democrats concerns Trump's desire to rely much more heavily on tariffs to fund the government. Candidate Trump has suggested a 10 percent across-the-board tariff on all US imports, as well as an additional 50 percent tariff on Chinese goods. At times, he has suggested even higher tariffs, or to simply replace the income tax with tariffs. The idea of replacing the income tax with tariffs is, simply put, infeasible (Clausing and Obstfeld 2024).

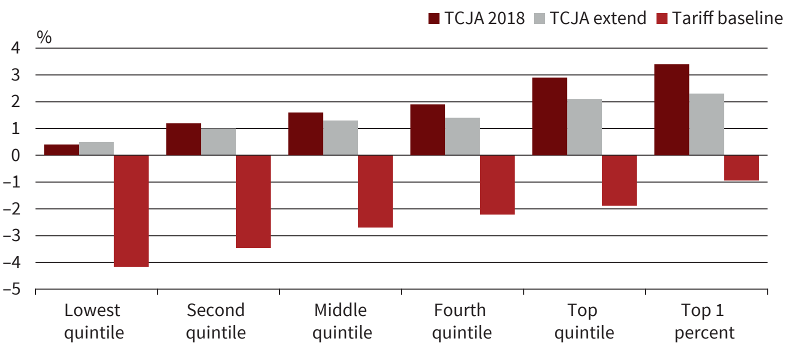
As fiscal policy, the revenue potential of tariffs is limited; there is no way that tariffs could supplant the income tax. The tariff tax base (about USD 3 trillion in goods imports) is much smaller than the income tax base (more than USD 20 trillion in income). Tariff rates would have to be very high to raise even a decent fraction of what the income tax raises, and as tariff rates rose, the tax base would shrink, as consumers would buy fewer imports due to their higher prices. Even if the tariff policy were pushed to its maximum, it could replace only part of the income tax. Such a policy would come at a very high cost in terms of harm to economic efficiency, after-tax income inequality, macroeconomic stability, and international relations.

Further, as we note in Clausing and Lovely (2024), tariffs burden US households, and they are an inefficient and regressive consumption tax. A wealth of evidence from the Trump tariff increases indicates that the tariff burden fell entirely on US buyers of imports, not foreigners, as Trump has so often claimed (Fajgelbaum et al. 2020a and 2020b; Fajgelbaum and Khandelwal 2022; Amiti et al. 2019 and 2020; Cavallo et al. 2021; Flaaen et al. 2020; Houde and Wang 2023). When consumers pay higher prices for imported goods, that also raises prices for domestic goods, since domestic goods compete with imports. Even ignoring that channel, and considering just higher import costs, Clausing and Lovely (2024) calculate that US consumers would face (together) a USD 500 billion tax increase each year from Trump's new tariff proposals, which would lower after-tax incomes across the board.

Tariffs are also a particularly regressive and distortionary consumption tax (Russ et al. 2017; Fajgelbaum and Khandelwal 2016; Gailes et al. 2018; Acosta and Cox 2024). Tariffs are regressive, especially in the short run, since lower-income households save less of their income than higher-income households. Thus, the tariff increases would harm those at the bottom the most. According to Clausing and Lovely (2024), the bottom quintile would lose 4 percent of after-tax income from Trump campaign tariff proposals, whereas the top quintile loses closer to 2 percent of their after-tax income. Figure 1 shows both the distribution effects of Trump's tariffs proposals (in the pink columns) as well as the TCJA (and extensions thereof; red and gray columns) in one diagram. If the TCJA is extended alongside the proposed tariff increases, the bottom four-fifths of the population would lose net income.

Figure 1

Changes in After-tax Income, by Quintile (and the Top 1 Percent)



Note: Tax Policy Center (2017 and 2022) provides the TCJA distribution data; the baseline TCJA distribution is for 2018 and TCJA extension is for 2026. Tariff calculations are based on methodology described in Clausing and Lovely (2024).

While some argue that these regressive effects on the consumer side of the market would be offset by gains to lower-income households in their roles as workers, the evidence does not support that view. The evidence from the first round of Trump tariffs consistently finds harm to many US workers from the imposition of tariffs (Autor et al. 2024; Flaaen and Pierce 2024; Russ and Cox 2018 and 2020). This is due to a multitude of factors, including the harm caused by the inevitable retaliation of trading partners as well as the hit to domestic competitiveness associated with costlier imported intermediate goods.

While tariffs have elements that are similar to a consumption tax, tariffs are far more distortionary, since they shift economic resources away from activities where the United States has a comparative advantage and toward goods that the United States is less suited to making. (Since there is limited room to expand production in a full-employment economy, production of goods that were formerly imported displaces production of exports and nontraded goods.)

Our trading partners will no doubt retaliate, as happened with the prior rounds of Trump tariffs. It will also harm goodwill among nations, goodwill that is desperately needed to address so many important global collective action problems, including climate change, public health, and security.

President Biden has chosen to keep Trump's China tariffs in place. Some of this stems from tensions with China, which make it difficult to reverse course. Still, even these tariffs have large costs, although they are much smaller than the Trump campaign's proposed new tariffs. (They affect a tax base about one-tenth the size.)

The Biden-Harris Administration has also announced new tariffs on imports from China, affecting a select group of products that comprise 4 percent of US imports from China. These measures were attributed in part to concerns regarding unfair trade practices in China. The value of the trade targeted by these actions is less than 1/150th of the trade that the new Trump tariff proposals would target. Further, the Biden-Harris Administration has indicated opposition to the across-the-board tariffs proposed by the Trump campaign, and a recent White House post described why tariffs are not a good general revenue source (White House 2024).

POLICY CONCLUSIONS

As I've described in recent testimony (Clausing 2024b), the US faces enormous fiscal challenges at present. Democrats and Republicans need to work together to reduce deficits and debt. There are places where spending can be reduced, but spending reductions alone can't handle this fiscal moment, and Congress should work to build a tax system that is more fit for purpose.

Candidate Trump and the Biden-Harris Administration are very far apart on fiscal matters. The Trump campaign has suggested budget-busting extensions of Tax Cuts and Jobs Act provisions, alongside new tax cuts; proposed revenue increases (including tariffs) and unspecified spending cuts would be insufficient to avoid large increases in the deficit. In contrast, the Biden-Harris Administration has suggested many possible tax increases (in annual Treasury Greenbooks) that could help build a stronger tax system to meet US fiscal needs, without placing significant burdens on most Americans.

The election will also have important consequences for both the distributional effects of the current tax system and key tax policy priorities. Candidate Trump has suggested a fiscal switch that involves lower income taxes and higher tariffs, both of which would make the US tax system less progressive, whereas Biden-Harris proposals have emphasized tax policies that would increase tax system progressivity.

Finally, in 2025, there is an opportunity to both raise US revenues and work with other nations in addressing important global collective action problems, including both international tax competition (discussed in Clausing 2023) and the challenge of climate change (discussed in Bistline et al. 2024). In these domains, and in that of trade policy, a second Trump Administration is far more likely to antagonize international partners than to work collaboratively toward progress. International economic cooperation would be far more productive under a Harris Administration.

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William McBride and *Erica York*

US Presidential Election 2024: A Comparison of Fiscal Policies Proposed by Leading Candidates for US President

KEY MESSAGES

- **The 2024 US presidential election will determine who will work with Congress to address three major fiscal issues: the expiration of key tax reforms from the 2017 Tax Cuts and Jobs Act (TCJA), the ongoing trade war with China, and the trajectory of the federal debt**
- **Vice President Kamala Harris supports increasing taxes on high earners and corporations while substantially increasing redistribution through the tax code. Her proposals, including raising the corporate tax rate to 28 percent, would shrink the economy by an estimated 1.6 percent and fall short of raising the revenue necessary to cover increased spending**
- **Former President Donald Trump seeks to make the 2017 tax cuts permanent, reduce the corporate tax rate further, and implement higher tariffs. While his tax policies could boost growth, his aggressive tariff strategy would harm the economy and fall short of paying for the tax cuts**
- **Rather than addressing the projected debt burden, which is unprecedented and unsustainable, both candidates' plans are likely to worsen the US debt trajectory and create a drag on economic growth**

The outcome of the 2024 US presidential election will have repercussions for all areas of US policy but perhaps especially fiscal and trade policy. One major issue to be decided is the direction of the US tax code, as most of the 2017 tax reforms sunset after 2025. In addition, intersecting fiscal policy and trade and international relations, the next president will decide the direction of the trade war with China as well as ongoing transatlantic spats and the proliferation of protectionist industrial policies. Overarching all of this is an increasingly unsustainable and dangerous federal debt trajectory, and a debt ceiling negotiation scheduled to occur early in 2025. Each area gives the next president a significant opportunity for reform and the potential for a major course change in US policy.

We first lay out the policy environment the next president will inherit before moving to a discussion of the two leading candidates' proposals and the estimated effects they would have on the US economy, federal budget, and policy direction.

POLICY LANDSCAPE

In 2017, then-President Trump signed into law a major rewrite of the US tax code. The law, the Tax Cuts and Jobs Act (TCJA), permanently reduced the corporate income tax rate from 35 percent to 21 percent, transformed the international rules from a worldwide system to a hybrid territorial system, and temporarily restructured and reduced individual and estate taxes.

Most of the changes expire after 2025, and several business provisions related to investment costs, including deductions for research and development (R&D) expenses and investments in machinery and equipment, expire over the same period. The scheduled changes set the next US president up to influence major tax legislation.

We estimate continuing all the individual, estate, and business tax changes that are otherwise set to expire would reduce federal tax revenue by USD 4.2 trillion from 2025 through 2034, worsening a currently projected deficit of USD 22 trillion over the period and a debt-to-GDP ratio that will exceed its all-time high within the next three years.

The economic and political impacts of letting the TCJA expire add further challenges. Our estimates indicate that allowing the indi-

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vidual tax cuts to expire would increase tax burdens for more than 62 percent of US taxpayers and lead to a reduction in GDP as people adjust to higher marginal tax rates on work, saving, and investment.

In his first term, Trump also instigated a trade war by imposing new tariffs (taxes) on imports of washing machines and solar panels (Section 201), steel and aluminum (Section 232), and billions of dollars' worth of consumer, intermediate, and capital goods from China (Section 301) throughout 2018 and 2019. Based on pre-trade war levels of trade, the new tariffs applied USD 80 billion of taxes a year on USD 380 billion of imports. Foreign retaliation currently applies to billions' worth of US exports, amounting to approximately USD 13.2 billion in tariff revenues for foreign governments.

The Biden administration has made minimal adjustments to the tariffs, maintaining all the Section 301 tariffs on China, imposing higher tariffs on certain Chinese goods, and expanding the scope of the Section 232 steel and aluminum tariffs to cover certain imports from Mexico. Biden and Harris have also overseen the implementation of several protectionist industrial policies in the Inflation Reduction Act (IRA) and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act; these policies have inspired other countries to adopt protectionist policies of their own.

The next occupant of the White House will have to address the expiring tax changes under the TCJA, while dealing with massive debt levels and simmering trade tensions.

HARRIS'S TAX PROPOSALS

The Biden administration's fiscal year 2025 budget outlines a tax policy vision of additional taxes on high earners and US businesses offset by more tax credits for a variety of taxpayers and activities. VP Harris's campaign has confirmed she will support all the tax policies included in the FY 2025 budget with some revisions (to capital gains taxes, as noted), including these major changes:

- Raise the US corporate income tax rate from 21 percent to 28 percent
- Increase the corporate alternative minimum tax introduced in the Inflation Reduction Act from 15 percent to 21 percent
- Increase the global intangible low-taxed income (GILTI) tax rate from 10.5 percent to 21 percent, calculate the tax on a jurisdiction-by-jurisdiction basis, and revise related rules
- Repeal the base erosion and anti-abuse tax (BEAT) and replace it with an undertaxed profits rule (UTPR) consistent with the OECD/G20 global minimum tax model rules
- Increase the top individual income tax rate to 39.6 percent on income above USD 400,000 for single filers and USD 450,000 for joint filers
- Expand the base of the net investment income tax (NIIT) to include nonpassive business income and increase the rates for the NIIT and the additional Medicare tax to reach 5 percent on income above USD 400,000
- Tax long-term capital gains and qualified dividends at 28 percent (as opposed to 39.6 percent as in the budget) for taxable income above USD 1 million and tax unrealized capital gains at death above a USD 5 million exemption
- Create a 25 percent "billionaire minimum tax" to tax unrealized capital gains of high-net-worth taxpayers on an annual basis

The budget proposes working with Congress to address the upcoming expirations of the TCJA, outlining three policy goals: opposing tax increases on people earning less than USD 400,000, opposing tax cuts or larger deductions for people earning more than USD 400,000, and paying for the partial tax cut extension with additional tax increases on high-income taxpayers and corporations.

Harris has proposed further expanding several Biden administration initiatives. While the budget would temporarily boost the child tax credit, she would permanently expand it and raise it further to USD 6,000 for newborns. To address housing affordability, she would increase the budget's proposed first-time homebuyer's tax credit to USD 25,000 and attempt to cap rents by threatening disallowance of certain depreciation deductions. Harris would expand the use of price controls across several sectors, most notably by accelerating the speed of Medicare negotiations for prescription drug prices (part of the IRA, also enforced through tax measures) and banning certain price increases for food and groceries.

Lastly, Harris supports ending taxes on tips for service and hospitality workers, an idea originally pitched by Trump on the campaign trail.

TRUMP'S TAX PROPOSALS

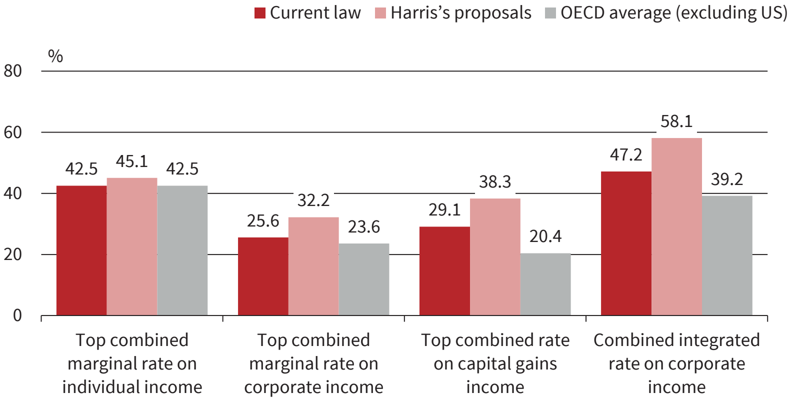
Former President Trump has not released a fully detailed tax plan as part of his current bid for reelection, but he has floated several tax and tariff policy ideas.

On taxes, he has made it clear he seeks to extend the expiring TCJA changes and further reduce the corporate income tax rate. Additionally, he's proposed exempting tip income and Social Security benefits from individual income taxes, expanding education savings accounts, and rolling back the IRA's green energy tax credits.

He would also significantly expand barriers to trade on several fronts, suggesting "reciprocal tariffs," imposing a 10 percent or higher universal baseline tariff on all imports, revoking permanent normal trade relations (PNTR) with China, and raising current tariffs on China to at least 60 percent.

Figure 1

Top Tax Rates under VP Harris's Proposals Would Reduce US Competitiveness



Note: Estimates include average state top marginal income tax rates and average top local income tax rates, calculated as an average of local rates imposed in the two highest population jurisdictions.
Source: State and local tax statutes; OECD Statistics 2022–2023; Bloomberg Tax; PwC Worldwide Tax Summaries; authors calculations.

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While he has discussed the idea of fully replacing the individual income tax with higher tariffs, such a combination of policies is mathematically impossible at current income tax revenue levels. The most likely direction of tax policy under Trump would be permanence for the 2017 tax cuts, further income tax reductions, and significant import tax hikes.

POLICY CONCLUSIONS

Comparing Top Tax Rates and Tax Types

Under Harris's proposals, top tax rates in the United States would rise far above international norms (Figure 1).

The current top combined corporate tax rate – including the average of state rates – is 25.6 percent. Harris would increase it to 32.2 percent, the second-highest corporate tax rate in the OECD (behind Colombia's 35 percent).

The current top combined personal tax rate is 42.5 percent, consisting of the top federal rate (37 percent) and the average of state and local rates. This is about equal to the OECD average. Under Harris, the top combined rate would rise to 45.1 percent before accounting for the proposed 5 percent additional Medicare tax, half of which falls on the employer. Including the employee-side portion would raise the top rate to 47.6 percent.

Table 1

Economic and Revenue Effects of the Major Tax and Tariff Proposals of Each Candidate

	Harris's FY 2025 budget tax proposals	Trump's major tariff and tax proposals
GDP	–1.6%	–0.1%
GNP	–1.3%	–0.4%
Capital stock	–2.7%	0.1%
Pre-tax wages	–1.1%	0.4%
Full-time equivalent employment	–666,000	–121,000

Source: Tax Foundation General Equilibrium Model, June 2024.

The current top combined capital gains tax rate is 29.1 percent, consisting of the 20 percent capital gains tax rate, the 3.8 percent net investment income tax (NIIT), and the average of state and local income tax rates on capital gains. By taxing high earners' capital gains at 28 percent and raising the NIIT to 5 percent, Harris's proposals would raise the top tax rate on capital gains to 38.3 percent – the second-highest in the OECD (behind Denmark's 42 percent).

The combined integrated rate on corporate income reflects the two layers of tax corporate income faces: first at the entity level through corporate taxes and again at the shareholder level through capital gains and dividends taxes. Currently, the top combined integrated tax rate on corporate income distributed as capital gains is 47.2 percent. Under Harris's proposals, it would rise to 58.1 percent – the highest in the OECD.

By placing a higher burden on work, saving, and investment, the Harris tax plan would weaken key drivers of US economic growth.

While Trump would maintain or potentially improve the competitive position of the US when it comes to income tax rates, he would move in a harmful direction when it comes to tariffs. Though consumption taxes are typically thought of as less distortionary than income taxes, tariffs are highly distortionary because they are narrowly targeted and invite foreign retaliation. Moreover, they could reduce US output through a few channels.

Tariffs may be passed on to producers and consumers in the form of higher prices. Raising the cost of parts and materials would raise the price of goods using imported inputs and reduce private sector output. Similarly, higher consumer prices due to tariffs would reduce the after-tax value of both labor and capital income.

Alternatively, the US dollar may appreciate in response to tariffs, offsetting some or all of the potential price increase for US consumers. The more valuable dollar, however, would make it more difficult for exporters to sell their goods on the global market, resulting in lower revenues for exporters.

Both channels would lower the returns to labor and capital, reducing incentives for work and investment, resulting in a smaller economy and lower incomes. Foreign retaliation against US-imposed tariffs compounds the drop in output and incomes without raising any additional revenue for the US Treasury.

Comparing the Macroeconomic Effects

Using the Tax Foundation's General Equilibrium Model, we have estimated the economic and revenue effects of the major tax and tariff proposals of each candidate (Table 1).

For Trump's policies, we modeled making the TCJA individual, estate, and business tax provisions permanent and further reducing the corporate income tax rate to 20 percent. Additionally, we modeled a tariff increase to lift the average rate of the Section 301 tariffs on China to 60 percent and a separate 10 percent universal tariff on all US imports. We also modeled in-kind retaliation from foreign trading partners on US exports.

The tax provisions would be pro-growth, boosting long-run GDP by 1.2 percent, the capital stock by 1.1 percent, wages by 0.4 percent, and employment by 926,000 full-time equivalent jobs.

However, the tariffs would create a significant drag on the economy. Our model passes tariffs back to the factors of production, such that tariffs reduce the amount of revenue businesses have to compensate their workers and shareholders, resulting in a reduction in real incomes. We estimate US-imposed tariffs would reduce long-run GDP by 0.8 percent, the capital stock by 0.6 percent, and jobs by 685,000.

Further, the potential of retaliation also threatens US economic strength. While retaliatory tariffs are not direct taxes on US exporters, they raise the after-tax price of US goods in foreign jurisdictions, making them less competitively priced in foreign markets. As such, retaliatory tariffs also result in lower US output. We estimate in-kind retaliation from foreign trading partners would reduce US GDP by an additional 0.4 percent. In total, we estimate these proposals from Trump would reduce GDP by 0.1 percent, raise wages by 0.4 percent, and eliminate 113,000 jobs.

If Trump pursued further tax cuts, such as the proposal to exempt Social Security benefits from income taxes, we estimate it would be somewhat pro-growth (increasing long-run GDP by 0.1 percent).

For Harris's policies, we modeled the major tax proposals described in the FY 2025 budget, excluding the novel minimum tax on unrealized capital gains, an undertaxed profits rule (UTPR), and unspecified R&D incentives. Because the budget does not specify or account for TCJA extension, we excluded that from our analysis. We also exclude her recently proposed top tax rate on capital gains and dividends (which differs from the budget).

We estimate the tax changes in the budget would reduce long-run GDP by 1.6 percent, the capital stock by 2.7 percent, wages by 1.1 percent, and employment by about 666,000 jobs. The budget would decrease American incomes (as measured by gross national product, or GNP) by 1.3 percent in the long run, reflecting offsetting effects of increased taxes and reduced spending, as debt reduction reduces interest payments to foreign owners of the national debt.

Raising the corporate income tax rate to 28 percent is the largest driver of the negative effects, reducing long-run GDP by 0.6 percent, the capital stock by 1.1 percent, wages by 0.5 percent, and jobs by 128,000.

Our economic estimates likely understate the effects of the budget since they exclude two novel and highly uncertain yet large tax increases on high earners and multinational corporations.

Harris's additional proposals that go beyond those mentioned in the budget, including a larger child tax credit, increased subsidies for housing, an exemption for tip income, and partial TCJA extension, would reduce revenue substantially and have an uncertain but likely small positive effect on economic output.

Comparing the Revenue Effects and Fiscal Impact

Both candidates are still rolling out new policy ideas, making it impossible to produce a precise calculation for how they will impact the budget deficit. As it stands, both candidates' policy proposals would worsen the debt trajectory.

On a gross basis, we estimate the proposals specified in the FY 2025 budget would increase taxes by about USD 4.2 trillion over a decade. After accounting for tax credits, spending changes, and the economic effects of the tax increases, the net effect would be to reduce deficits by USD 1.4 trillion over a decade.

However, Harris's additional ideas would more than offset this deficit reduction. For instance, continuing the TCJA for people making under USD 400,000 would cost about USD 2.5 trillion over a decade, further CTC expansions would cost about USD 1 trillion, and housing subsidies and the tip exemption would add more than USD 200 billion. In total, her policies would add more than USD 2.3 trillion to deficits over a decade.

The fiscal picture under Trump's proposals is similarly bleak. The combination of permanence for the 2017 tax cuts, a 20 percent corporate tax rate, universal tariffs of 10 percent, and 60 percent tariffs on Chinese imports would add USD 1.6 trillion to the deficit over the next decade. Tacking on the exemptions for tips and Social Security swells the deficit impact to USD 3 trillion or higher. If Trump pursues rolling back all the IRA credits, a difficult lift in Congress, it could reduce the net deficit impact of his policies to USD 2 trillion.

CONCLUSION

In short, while the specifics are lacking, neither candidate has offered an entirely sound set of fiscal policy reforms. Both would riddle the tax code with carveouts and raise taxes in ways that would add at least USD 2 trillion to deficits over the next decade without improving economic growth.

Markus Jaeger

Foreign Economic and Macro Policies after the US Presidential Election

KEY MESSAGES

- **Foreign trade and macroeconomic policies under a Harris administration would largely provide for continuity with the Biden administration, while policies under another Trump administration would have the potential to be highly disruptive**
- **Regardless of who becomes the next president, US national-security-focused trade and investment policies will continue to be tightened in the context of US-Chinese strategic competition**
- **Trump trade policies could prove hugely destabilizing to international trade, severely strain US-EU trade relations, and lead to a full-blown trade war with China**
- **Fiscal policy will remain loose under both a Harris and a Trump administration, but the latter would also seek to pressure the Federal Reserve to pursue loose monetary and weak dollar policies**
- **The EU should ready its new geoeconomic instruments to deter US discriminatory measures, while signaling openness to negotiations about how best to defuse transatlantic economic conflict**

The US presidential elections on November 5 could lead to dramatic change in US economic policies. National-security-driven trade and investment restrictions targeting China will continue to be tightened, regardless of who is elected president. But policies under a Trump administration could prove highly disruptive to international trade and the global economy. A number of other radical proposals, including the taxation of capital inflows and the abolition of income taxes in favor of import tariffs, would face significant domestic political obstacles. By comparison, a Democratic administration under Kamala Harris would provide for relative continuity, but trade policy would continue to drift towards moderately greater protectionism.

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PRESIDENTIAL POWERS AND ECONOMIC POLICY

The US Constitution grants Congress the power to regulate international trade. But Congress has delegated important trade- and investment-related authority to the president. The president can invoke various trade, national security and emergency acts to take wide-ranging trade- and investment-related measures.

The US executive has wide-ranging powers to impose import restrictions on cross-border trade and investment flows, whether in the case of substantial threat to US industry, other countries engaging in discriminatory trade policies or violating existing trade agreements, or on the grounds of national security. By invoking substantial threats to national security, foreign policy, or the economy, the president can take all kinds of discriminatory trade- and investment-related measures, not just import-related ones. Whether across-the-board, indiscriminatory tariffs on imports, introduced under presidential emergency powers, would hold up if challenged in domestic courts or by Congress, and for how long, would remain to be seen.

In terms of macroeconomic policy, the Federal Reserve is responsible for monetary policy, while the Treasury, legally speaking, is in charge of international economic policy, including policies related to the dollar. In practice, however, the dollar exchange rate is determined by the markets. Fiscal policy is the prerogative of Congress and presidential influence is highly dependent on whether the president's party holds majorities in Congress.

To what extent a second Trump administration would ride roughshod over laws, rules, and precedent is impossible to say. The analysis that follows assumes that institutional (laws) and political (Congress) constraints will continue to matter and act as constraints on radical policy change.

A HARRIS ADMINISTRATION WOULD PROVIDE FOR RELATIVE CONTINUITY

Trade policy under Biden (2021–2025) was far less disruptive than under Trump (2017–2021). Biden was keen to neutralize long-standing transatlantic trade disputes, including the Trump-era steel and aluminum tariffs, the long-running Airbus-Boeing subsidy dispute, and disagreement over digital taxes, without solving them permanently.

Meanwhile, a revival of industrial policy, which comprised discriminatory subsidies, caused transatlantic trade friction. In addition to withdrawing its support for free cross-border data flows, the Biden administration did nothing to revitalize the World

Trade Organization (WTO) and it refrained from negotiating any new free trade agreements. The gradual drift towards greater trade protectionism would likely continue under a Harris administration. Trade policy would certainly not take a more liberal turn, given the limited domestic political and electoral incentives to do so. For all practical purposes, Congress would need to grant the president trade promotion authority. But regardless of which party wins the congressional elections, this is highly unlikely to happen.

With respect to trade policy vis-a-vis China, the Biden administration maintained the Trump tariffs and it imposed further, though more targeted, tariffs on less than USD 20 billion worth of Chinese steel and aluminum, electric vehicles, batteries, and semiconductor imports. In comparison, the Trump administration tariffs affected USD 380 billion worth of Chinese imports. Like his predecessor, Biden also tightened national-security-focused export control and inward investment restrictions targeting China and he introduced outbound investment controls, aimed at limiting China's access to US technology in the context of its "small yard, high fences" policy and US-Chinese strategic competition. These policies would continue under a Harris administration.

Under Biden, Congress passed a massive fiscal stimulus package (America Rescue Plan, 2021) worth almost USD 2 trillion to counter Covid-19. The administration also passed major investment programs, such as the Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act that helped support investment spending and economic growth. The major fiscal stimulus and continued large fiscal deficits, combined with post-pandemic supply side constraints, led to multi-decade high inflation and forced the Federal Reserve into significant monetary tightening. The combination of an expansionary fiscal and tight monetary policy translated into a strong dollar.

A Harris administration promises broad continuity in terms of macro policy. Harris has pledged to increase the corporate income tax from 21 percent to 28 percent and to provide financial support to homebuyers and families in the form of tax credits. More than a minor fiscal retrenchment would be unlikely, if any tightening is implemented at all, and fiscal deficits would remain high. Crucially, to what extent Democrats would be able to implement their agenda would depend on the outcome of the congressional elections, where the Democrats are likely to lose the Senate and may fail to recapture the House.

TRUMP 2.0 COULD PROVE HIGHLY DISRUPTIVE

As far as trade and investment restrictions related to national security and technology are concerned, the Trump and Harris administrations would be unlikely to differ much. A Trump administration may show less concern about getting allies on board (e.g., export control policy). However, this difference would be more a difference in tone rather than substance, as the Biden administration nudged Dutch and Japanese companies to align with US export control policies targeting China, even if it did so somewhat politely and behind closed doors.

Table 1

Presidential Powers and Trade Policy

Legislation	President can:
Trade Expansion Act (1962) – Section 232	Impose tariffs based on a recommendation by the Department of Commerce if imports threaten or impair national security
Trade Act (1974) – Section 122	Impose quotas and tariffs for up to 150 days against countries that have large balance-of-payments surpluses with the US
Trade Act (1974) – Section 201	Impose temporary duties or other trade measures if the US International Trade Commission determines that imports cause threat or serious injury to US industry
Trade Act (1974) – Section 301	Impose trade sanctions if US rights under trade agreements are violated or if a country takes unreasonable, discriminatory action restricting US commerce
International Economic Emergency Powers Act (1977)	Block transactions and freeze or confiscate assets in case of threat to national security, foreign policy, or economy (among other things)
Foreign Investment Risk Review Modernization Act (2018)	Block foreign investment in US companies on national security grounds
Export Control Reform Act (2018)	Control exports, re-exports, and the transfer of items and restrict activities of US persons

Source: Author's compilation.

Harris and Trump policies are unlikely to differ much in terms of further restricting Chinese access to advanced, especially "emerging and foundational" technologies by leveraging, if necessary, the dependence of third countries on US technology (e.g., foreign direct product rule). US-Chinese strategic competition would largely shape the direction of both Harris and Trump geoeconomic policies, as it did under previous administrations.

RISK OF A HYPER-PROTECTIONIST TRADE POLICY

A Trump administration would risk being far more disruptive with regard to international trade. During his presidency, Trump imposed across-the-board tariffs on steel and aluminum, among other imports, and extensive tariffs on imports from China. His administration also used tariffs or the threat of tariffs to force allies to renegotiate trade agreements (NAFTA, KORUS) and it forced the EU to agree to start negotiations for a transatlantic trade agreement.

Trump has floated radical trade policy plans, including a 10 percent surcharge on all US imports. (This proposal is reminiscent of President Nixon's 1971 decision to force other countries to renegotiate their exchange rates following the closing of the gold window.) Trump also threatened to impose tariffs of 60 percent on all imports from China and wants to prohibit certain types of imports from China altogether (e.g., certain healthcare products).

If implemented, such restrictions would risk a major destabilization of the international trade regime. Restrictions might lead to tit-for-tat retaliation, and potentially trigger a full-blown trade war. It might also force countries to raise their tariffs on the world's largest exporter, China, as 60 percent US tariffs would lead Chinese exports to be diverted to third countries. In addition, transatlantic trade relations would come under renewed strain over long-standing trade disputes that were put on ice by the Biden administration (e. g., Airbus-Boeing, digital taxes, steel and aluminum tariffs and quotes) and over new disputes that are likely to arise over other issues (e. g., EU Carbon Border Adjustment Mechanism).

It is difficult to predict with much confidence what a second Trump administration would do, as it is unclear what the actual goal of US trade policy would be. Are tariffs meant to reduce US trade deficits, shelter selected sectors from foreign competition, force other countries to make asymmetrical trade concessions, reduce trade-related national security risks, or simply create political theater that appeals to the electoral base?

These objectives are of course not mutually exclusive. But understanding what the ultimate objective is would help predict how US trade policy might evolve after initial protectionist measures are imposed. Regardless, the immediate effect of implementing major tariffs would be an escalation of international trade conflict, lead to trade diversion, and weigh on economic growth and investor confidence. It would also prove inflationary and lead to relatively higher US and international interest rates, or at least keep them elevated for longer with negative implications for global growth, especially in capital-importing emerging and debt-challenged developing economies.

TAX ON CAPITAL INFLOWS IS UNLIKELY TO BE REALIZED

Among other radical proposals floating around the Trump orbit is a tax on foreign purchases of US assets. The rationale seems to be that such a tax would reduce foreign capital inflows, weaken the dollar, and hence reduce the trade deficit. This logic is questionable, not least because the US trade deficit is largely a function of the economy's savings-investment imbalance. It is far from straightforward how much of an impact a weaker currency in what is effectively a very closed US economy would have on savings and investment and hence the trade and current account deficit, not least because other macroeconomic parameters would also be affected by a capital inflows tax. All other things equal, such a tax should make domestic investment more expensive. Whether it would actually lead to a narrowing of the savings-investment gap and an improvement in the current account balance would depend on how other economic parameters will change in response to such a measure. In the past, a weaker dollar has not necessarily led to a falling trade deficit, in part due to offsetting, loose domestic financial conditions. If the tax does lead to a decline in US investment, US economic growth will be negatively impacted. In addition to proving highly disruptive to the global economy. It might also weaken the dominant international role of the dollar. A proposal like this is unlikely to get approved by Congress, once US financial institutions and companies start mobilizing against it.

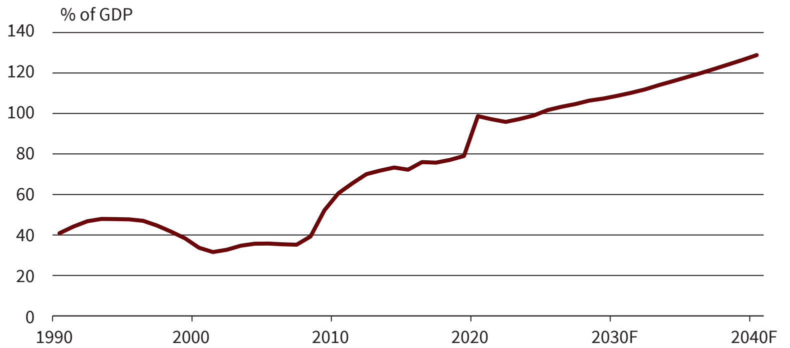
Under Biden, the US cooperated closely and largely smoothly with the EU on Russian sanctions policies. By comparison, the president's ability to ratchet up sanctions is very considerable, as it may seek to pressure Ukraine to negotiate an end to the war, while threatening to escalate support for Ukraine if Russia fails to come to the negotiating table. Although the bulk of Russia-related sanctions has been implemented via executive orders, which means that the president can simply revoke them, Congress has also passed sanctions legislation that makes it more difficult and even impossible for the president to abolish specific sanctions without congressional action. By contrast, the ability to ratchet up sanctions is considerable due to the International Emergency Economic Powers Act and the National Emergencies Act. With respect to US sanctions policy vis-à-vis Russia, a Trump victory would increase uncertainty.

A LOOSE FISCAL POLICY AND LARGE DEFICITS

The US has been running large deficits in recent years. Annual deficits are projected to average more than 6 percent of GDP for the 2024–2028 period. The International Monetary Fund (IMF) has called on the US to "urgently" address its large budget deficits. The Congressional Budget Office (CBO) projects federal debt to reach 122 percent of GDP in 2034, up from 97 percent of GDP last year.

Against this backdrop, Trump has promised to make permanent the tax reductions contained in the 2017 Tax Cuts and Jobs Act when the legislation expires in 2025. The CBO puts the additional costs of extending the 2017 tax cuts at USD 4–5 trillion over

Figure 1
Large Fiscal Deficits Will Lead to Further Increase of Federal Government Debt



Note: F = Forecast.
Source: Congressional Budget Office.
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the next decade, or around 10 percent of 2034 GDP. To what extent Trump will be able to make the tax cuts permanent will depend on whether Republicans end up controlling Congress. If they do not, Trump would be forced into negotiations with Democrats. Democrats would demand higher spending in exchange for agreeing to make some tax cuts permanent. Either way, the effect would be a larger budget deficit.

A significant deficit reduction is unlikely, regardless of the election outcome. Democrats dislike cutting expenditure and Republicans dislike increasing taxes. And even if the Republicans control Congress under a Republican president, it would remain to be seen how keen they would be to slash spending once they are in office. Discretionary non-defense spending accounts for only 3–4 percent of GDP and it will be difficult to reduce it substantially, while a reform of mandatory spending, mainly social security, will not find support in either party. US fiscal policies will remain relatively loose and the debt-to-GDP ratio will continue to increase.

One of the wonkier macro proposals floated by Trump concerns replacing federal income taxes with additional revenue raised from tariffs. Individual and corporate income taxes raised about USD 2.6 trillion in revenue last year, compared to the roughly USD 3 trillion raised on US imports of goods. To be deficit-neutral, such a measure would need to levy tariffs worth significantly more than 90 percent on imports, as higher tariffs would lead to a sharp fall in imports. The consequences for the US economy and the international trade regime would be severe. Like the equally wonky capital inflow tax proposal, this proposal is highly unlikely to get approved by Congress, even if the Republicans were to hold majorities in both houses.

RISKS TO INDEPENDENCE OF THE FEDERAL RESERVE

Radical ideas have also been floated in the Trump orbit regarding monetary and exchange-rate policy. Trump has raised the idea of reducing the Fed's independence presumably to allow for an easier monetary policy and a weaker dollar, possibly to offset likely dollar appreciation following the imposition of higher tariffs. This would lead to higher inflation and increased financial uncertainty.

However, a Trump administration would find it difficult to gain control of the Fed's interest rate policy. Legally and politically, it would be difficult to curtail the Fed's independence. While the president may be able to replace Jerome Powell as the chair of the Board of Governors, it would be next to impossible to remove him (and others) as members of the Board and hence as voting members of the Federal Open Market Committee (FOMC), which sets the Fed funds rate before their respective terms end. Moreover, the FOMC takes decisions by majority, and besides the seven members of the Board of Governors and the New York Fed president, it consists of the eleven regional Reserve Bank presidents (four of which are FOMC voting members at any one time). The regional Reserve Bank presidents are not appointed by the president, though subject to approval by the Board of Governors. So, Trump would need to purge all or at least most of the members of the Board of Governors and replace them with loyalists. But, as happened during the first Trump administration, the Senate would balk at confirming highly economically unorthodox Fed appointees that would weaken the Fed's commitment to monetary stability. Finally, only two Board members will see their terms expire before the end of 2028, further limiting the degree to which Trump would be able to stack the FOMC with loyalists and doves during the next presidential term. For the Fed to lose its independence, Congress would need to pass legislation, which is highly unlikely, not least because even if Republicans were supportive of such reform, they would need to overcome a Democratic filibuster in the Senate.

Verbal attacks on the Federal Reserve to pursue an expansionary monetary policy and a weaker currency are likely but would not fundamentally put at risk the Fed's independence and commitment to price stability. A possible legal wild card might be whether the Trump administration could exploit the fact that legally speaking, the Treasury is in charge of international economic policy, including policies related to the dollar. But without the Treasury also gaining control of interest rates, its ability to set exchange-rate targets would be practically irrelevant.

POLICY CONCLUSION: EU SHOULD PREPARE FOR POST-ELECTION UNCERTAINTY

The election of Kamala Harris would lead to relative continuity of economic policy. The US would continue to become more protectionist and impose further trade and financial restrictions targeting China. Fiscal deficits would remain high, but the Fed would be left to get on with its job of maintaining low inflation.

Fiscal policy will remain loose under both Harris and Trump, though the latter's tax-cutting plans would translate into an even looser policy, not least because the Republicans, assuming they end up in control of Congress, will not be keen to substantially reduce federal spending, their rhetoric when a Democrat occupies the White House notwithstanding. Democrats, should they unexpectedly end up controlling Congress, would be amenable to raising taxes on corporations and high-income earners, but would also increase spending. Budget deficits will remain high in virtually all scenarios. All other things being equal, inflation and interest rates would be higher under Trump due to a looser fiscal policy and higher tariffs as well as lower immigration – and perhaps even "net negative" immigration, should Trump be able to make good on promises not to just curtail immigration but also to deport illegal immigrants.

The trade policy envisioned by Trump would be very disruptive to international trade. In addition to direct, potentially tit-for-tat retaliation in response to 10 percent US import surcharges, a 60 percent across-the-board tariff on American imports from China would lead Chinese exports to be diverted to third countries, which would then have little choice but to impose tariffs on Chinese goods. China would not take this lying down and would feel compelled to retaliate, which would likely lead to at least US counter-retaliation. The risk of a broader trade war would then become a distinct possibility.

Given the uncertainty about what the Trump administration actually wants to achieve with its trade policy, it is difficult to predict how trade conflict would play out after an initial round of tit-for-tat retaliation. Increasing US protectionism would prove hugely disruptive and would add to the increasing trade and investment restrictions and geoeconomic fragmentation that have characterized the global economy in the past few years against the backdrop of intensifying geopolitical competition.

The EU should prepare for a worst-case scenario by readying its geoeconomic toolbox, including its anti-coercion instrument. It should also engage with likely appointees, senior advisors, and members of Congress on either side of the aisle to signal the EU's ability and willingness to deter and, if necessary, retaliate against discriminatory US policies and spell out the potential economic costs of a broader transatlantic trade conflict. But it should also attempt to understand what the ultimate goal of US trade policy is – especially under a Trump administration – so as to evaluate where there may be room for compromise. In the meantime, the EU should urgently accelerate efforts to enhance its economic security through export diversification, the reduction of import-related vulnerabilities, the promotion of the international role of the euro and, last but not least, efforts to increase euro area macroeconomic stability to be able to deal with policy-induced increasing international economic and financial instability and uncertainty. Enhancing economic security is highly desirable, regardless of who wins the US elections.

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Andreas Baur, Lisandra Flach and *Dorothee Hillrichs*

German-US Trade Relations before the Election: Implications of a Trump Comeback

KEY MESSAGES

- **The US is Germany's largest trading partner, accounting for 11 percent of German exports and 7 percent of imports in 2023. Services comprise nearly 50 percent of German imports from the US and 30 percent of exports to the US, underscoring their significance in bilateral trade**
- **Germany maintains a large trade surplus with the United States, equivalent to approximately 2.1 percent of Germany's GDP in 2023. One major driver of the surplus is a substantial increase in German goods exports to the US in recent years while German goods imports from the US have stagnated**
- **In terms of value-added, around 7 percent of Germany's manufacturing value-added is exported to the US, compared to only 0.8 percent of US value-added exported to Germany, highlighting the importance of US market access for the German economy**
- **A simulation exercise shows significant decreases in German exports to the US and China in response to potential new tariffs that Presidential candidate Donald Trump announced in his campaign. However, trade diversion in form of increasing trade between Germany and other countries partially offsets the negative direct effect of US tariffs, resulting in a 2 percent overall decrease in German exports**
- **Germany and the EU should prioritize deepening its single market, especially in services, to remain an attractive US trade partner. Simultaneously, the EU should pursue new trade agreements to mitigate risks from potential US protectionist measures**

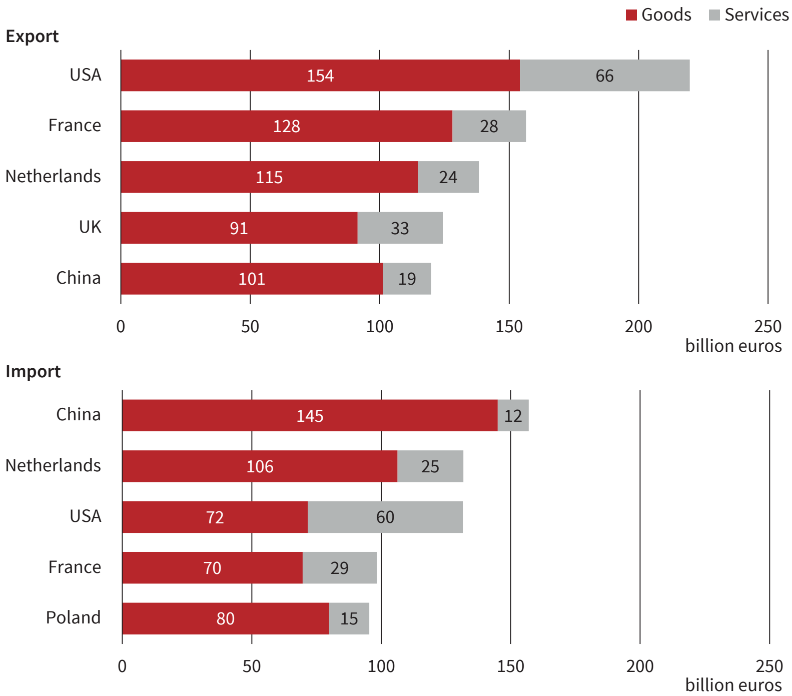
For months now, the world has been looking eagerly toward the US, where a presidential election is due this November. Former President Donald Trump is once again running for the White House on behalf of the Republican Party. He announced his trade policy agenda early on in his election campaign speeches: following the example of his first term in office, Trump intends to impose a 20 percent tariff on all US imports, while imports from China would be subject to a blanket 60 percent tariff across the board. Tariffs of this magnitude would not only trigger numerous chain reactions in the US economy but could also significantly disrupt the global economy. Import tariffs of this magnitude would make all foreign products more expensive for US consumers and companies (Clausing and Lovely 2024). A decline in US demand for foreign products is therefore to be expected. Given that the US is a very important market for German exports, what would be the effects of the Trump's new tariff proposals for the German economy?

In this article, we begin by examining Germany's current economic ties with the US. The US is one of Germany's most important trading partners, both in goods and services. Overall, Germany has a significant trade surplus with the US, which is primarily attributable to large increases in goods exports in recent years. Against this background, we conduct a counterfactual analysis using an economic model to assess how German exports would change if the US actually imposed import duties of 60 percent on Chinese imports and 20 percent on all other imports. The model simulation accounts for global interdependencies arising from global value chains. This means that not only is the direct effect of an increase in the price of German products for US consumers taken into account, but also indirect effects that would affect Germany via other economies like China or Canada. Our findings indicate that while German exports to its two largest trading partners, the US and China, would drop significantly, German exports as a whole would only fall by around 2 percent. This suggests Germany can partially compensate for the reduced demand from the US through increasing exports to other countries.

THE US IS GERMANY'S LARGEST TRADING PARTNER

The United States has traditionally played a central role as a trading partner for Germany. With a volume of more than EUR 220 billion, the US was once again the largest purchaser of German goods and services exports in 2023 (see Figure 1). This accounts for 11 percent of total German exports. Imports from the US amounted to around EUR 132 billion in the previous year, making the United States one of Germany's most important suppliers as well (share of total imports: 7 percent, third largest supplier). With a total volume of around EUR 351 billion, the US was by far Germany's largest trading partner last year, clearly ahead

Figure 1
German International Trade by Partner Countries in 2023



Source: Bundesbank; authors' calculations. © ifo Institute

of China (EUR 277 billion) and the Netherlands (EUR 270 billion).[1]

Two features of trade relations with the US stand out from a German perspective. First, services play a crucial role in bilateral trade relations between Germany and the United States. They account for nearly 50 percent of German imports from the US and approximately 30 percent of German exports to the US, significantly exceeding the German average share for services trade in total trade (imports: 26 percent, exports: 20 percent). Given this prominence, it is essential to consider both goods and services trade when analyzing German-US trade relations. In addition, the persistent German trade surplus with the United States is particularly noteworthy, amounting to around EUR 88 billion or approximately 2.1 percent of German gross domestic product (GDP) in 2023. This represents Germany's largest bilateral trade surplus globally. In comparison, even Germany's trade deficit with China, its largest bilateral deficit, stood much lower at around EUR 34 billion or 0.9 percent of German GDP in the same year. From an economic standpoint, bilateral trade surpluses or deficits are not inherently positive or negative. However, Germany's substantial trade surplus with the US could become problematic, as Donald Trump and his inner circle view US trade deficits as indicators of unfair trade practices, and an explicit goal of Trump's trade policy is to achieve a balanced trade balance (Lighthizer 2023). Germany ranks fourth among countries with which the US has its largest trade deficits, behind China, Mexico, and Vietnam. Consequently, should Trump return to the White House, Germany could become a primary target of an increasingly protectionist US trade policy.

GERMAN GOODS EXPORTS TO THE US HAVE RISEN SIGNIFICANTLY IN RECENT YEARS

In particular, German goods exports have been an important driver of the German trade surplus with the US in recent years (Figure 2). After a brief slump during the Great Recession in 2008/2009, German goods exports to the US grew significantly not only in relation to German GDP, but also in comparison to German goods imports from the US. As a consequence, German exports of goods to the US were already more than double the value of German imports from the US in 2023 and contributed more than 90 percent to Germany's trade surplus with the US. German services exports to the US have also risen continuously in relation to German GDP in recent years. However, services imports from the US have followed a similar growth trend, implying that the bilateral trade balance in services is close to be balanced.

CARS, MACHINERY AND PHARMACEUTICALS DOMINATE GERMAN-US EXPORTS

German goods exports to the United States are dominated by three product groups: cars, machinery, and pharmaceuticals (see Figure 3). Taken together, these

[1] However, even the US does not come close to the importance of the European single market for the German economy: if one considers German trade with all EU member states as a whole, this was more than five times as large as German-US trade, with a volume of more than EUR 1.9 trillion

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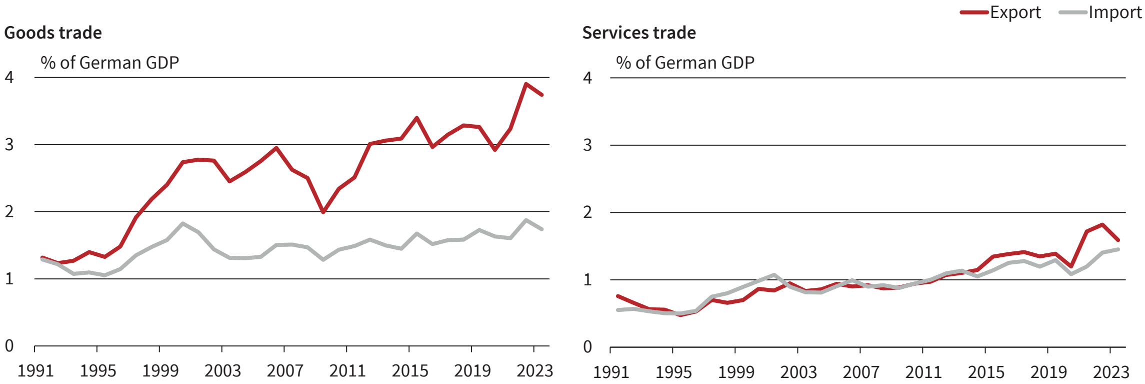
Figure 2
German Trade with the US



Source: Eurostat; authors' calculations. © ifo Institute

product groups account for almost 60 percent of German goods exports to the US. It is striking that in particular for pharmaceutical products from Germany the US market plays a disproportionately large role: more than 20 percent of all German pharmaceutical exports are sold to the US. In contrast, the corresponding share for cars or machinery is significantly lower at 10 percent. On the import side, pharmaceutical products are also the largest group of goods Germany imports from the United States. Moreover, imports in the aerospace sector (which are classified as other vehicles) as well as oil and natural gas imports play an important role.

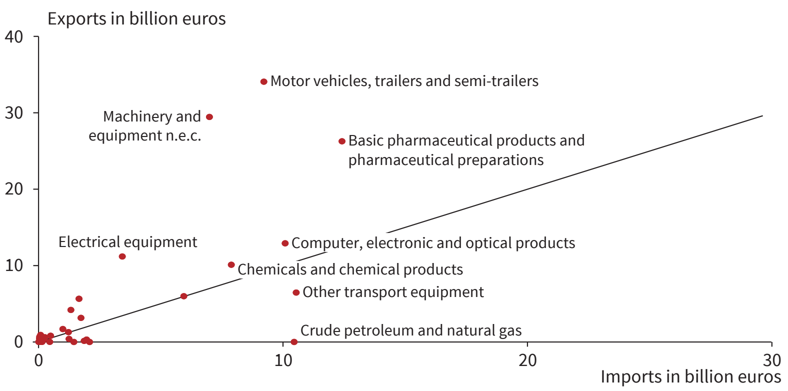
TRANSATLANTIC RELATIONS SHOW ASYMMETRY IN MUTUAL ECONOMIC IMPORTANCE

In the age of global value chains, conventional trade statistics can only provide an incomplete picture of the US market's economic importance to the German economy, as they fail to account for indirect trade links. For example, more than 50 percent of German exports are intermediate products that are further processed in third countries and potentially re-exported to the US. Similarly, German exports do not only consist of German value-added, but also incorporate foreign intermediate inputs. To capture these indirect interdependencies, measuring trade flows on a value-added basis is crucial – a method also used in GDP calculations. Based on data for 2022, Figure 4 shows that Germany directly or indirectly exports around 7 percent of its entire manufacturing value-added to the United States. In contrast, German demand plays a comparatively limited role for the US, accounting for 0.8 percent of value-added in US manufacturing. These asymmetries narrow slightly when considering the EU as a whole, but significant differences persist: over 8 percent of value-added in EU manufacturing is exported directly or indirectly to the United States, while only about 3.3 percent of value-added in US manufacturing depends on EU demand. Overall, transatlantic trade relations exhibit therefore a significant imbalance: access to the US market is far more important for Germany and Europe than access to German or European markets is for the United States. This asymmetry in mutual economic importance could provide leverage to the incoming US administration in trade policy negotiations with its European partners.

THE IMPACT OF US TARIFFS ON GERMAN EXPORTS

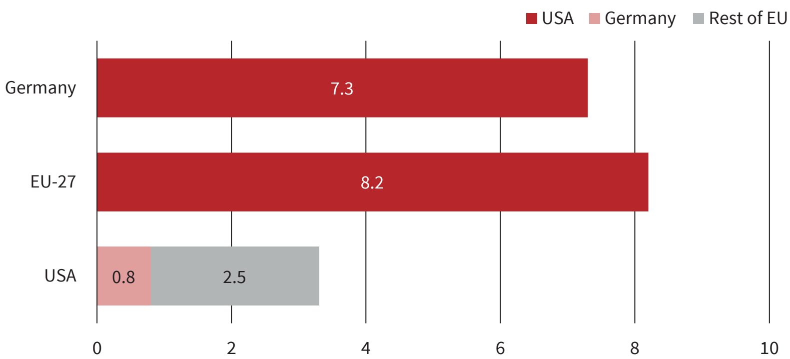
The previous descriptive analysis illustrates the role of the US economy as Germany's largest trading partner.

Figure 3
German Trade with the US by Product Group in 2023



Source: Federal Statistical Office of Germany; authors' calculations. © ifo Institute

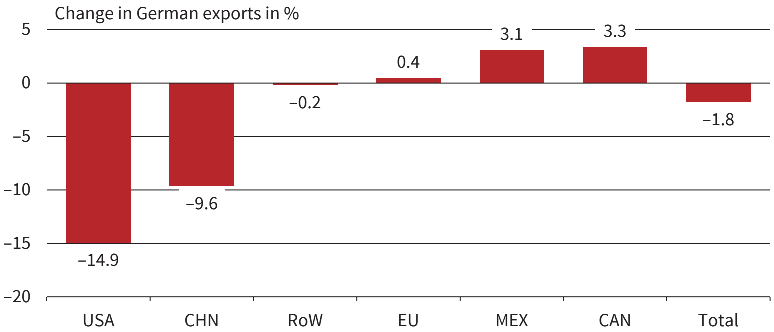
Figure 4
Value-added Exports by Destination
in % of value-added in manufacturing (2022)



Source: Eurostat FIGARO; authors' calculations. © ifo Institute

Figure 5

Export Effects of Tariff Increase



Note: The figure shows the effect of the announced tariffs on German exports. Destinations abbreviated with ISO Codes. RoW = Rest of the World.

Source: Authors' calculations using GTAP data.

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In view of this importance, it is crucial to be able to assess the impact of Republican presidential candidate Trump's tariff proposals on the German economy in advance. To quantify these effects, we make use of the ifo Trade Model to examine and simulate the impact that the tariff increases announced by Trump in his campaign speeches could have on German trade.

The ifo Trade Model is a static general equilibrium model that is able to identify the long-term level effects of such tariff increases. This provides insights into the potential response of trade flows, trade volumes, sectoral value-added as well as real gross domestic product and gross household income effects.[2] The results outlined below focus on the effects on German foreign trade. The analysis with a general equilibrium model includes not only direct exports to the US, but also trade along the value chain as well as possible trade diversion effects to other target markets in response to higher US tariffs. In this way, it offers a comprehensive picture of a new global economic equilibrium.

Figure 5 shows the trade effects for Germany if the US imposes tariffs of 60 percent on goods from China and 20 percent on goods from all other countries, including Germany. German exports to both the US and China decrease significantly. The sharp decline in exports to the US reflects the direct negative demand effect of rising import prices. The sharp decline in exports to China can be explained in part by the interdependencies within production networks: China is facing a sharp rise in US tariffs, which is significantly curbing US demand for Chinese products. This in turn has a negative impact on Chinese demand for intermediate products from all over the world. While some German exports are being diverted to Canada and Mexico, exports to other EU member states and the rest of the world are hardly changing on average. Overall, German total exports fall by close to 2 percent, which shows that at least some of the direct export losses on the US market can be offset by rising exports to other countries.

The overall effect on German exports calculated in the simulation conceals major sectoral differences within the German economy. In particular, German exports in manufacturing would decline significantly as a result of Donald Trump's tariff proposals. The German automotive industry (−4.9 percent) and pharmaceutical industry (−4.7 percent) would see the largest declines in exports, driven in particular by the direct decline in exports to the US (automotive: −32 percent; pharmaceutical: −35 percent). On the other hand, the German service sector could even slightly increase its total exports, as German service exports would partly replace US services in third markets and in the US itself, since US services become more expensive as a result of protectionist trade policies.

POLICY IMPLICATIONS

The United States remains a crucial partner for Germany and Europe, both politically and economically. Strengthening and future-proofing transatlantic trade relations is therefore vital for Europe's interests. Regardless of the outcome of the upcoming US. presidential election, European policymakers should focus on making these relations resilient for the future.

A key prerequisite for enhancing the EU's attractiveness as a trading partner is a flourishing European single market. The more comprehensive and integrated the EU single market becomes, the more appealing the EU is to the United States as a trading partner, and the greater the EU's influence in geoeconomic competition. For this reason, further deepening the single market is crucial for the future of transatlantic economic relations. Due to the comparative advantage of the US in the services sector, prioritizing a far-reaching liberalization of services trade in the single market is essential (for the growth potential of cross-border services in the single market, see Dorn et al. 2024).

Even though the chances of success currently seem slim, a transatlantic trade agreement could significantly strengthen trade relations with the United States, while also providing new impetus for growth on both sides of the Atlantic. The upcoming change in government in the US could present a good opportunity for the EU to renew its efforts towards an agreement on eliminating tariffs for industrial goods with the US. Corresponding negotiations were initiated in 2018 by then US President Trump and EU Commission President Juncker. Given that the EU's average tariff level is higher than that of the US, the EU could present an attractive offer for a transatlantic 'level playing field' in import tariffs.

Nevertheless, Germany and the EU should also prepare for the risk of reduced US market access due

[2] The quantification can be carried out at a disaggregated level and allows to derive trade and output effects for 65 sectors. The ifo Trade Model covers more than 120 countries and 65 economic sectors. It covers more than 90 percent of global value-added. All data required for the simulation (e. g., international value-added linkages) come from the global input-output database GTAP 10. As the model accurately represents global value chains and country-specific parameters at the sectoral level (e. g., sectoral productivity), the adjustments caused by a tariff increase can be appropriately approximated. The technical details of this model are described in several studies by the ifo Institute (see e. g., Aichele et al. 2016; Baur et al. 2024).

to protectionist trade barriers. As demonstrated in our simulation study, alternative export and import markets can at least partially mitigate the negative economic impact of a protectionist US trade policy. To this end, concluding new EU trade agreements, such as with the South American Mercosur states, offers a crucial opportunity to diversify European companies' market access and reduce vulnerability to potential US protectionist measures.

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Mark N. Katz

What Difference Will It Make? Impact of a Harris or Trump Presidency on American Foreign Policy

KEY MESSAGES

- **If she is elected president, Kamala Harris is likely to continue President Joseph Biden's foreign policy, though her tone on the Middle East may differ somewhat from his**
- **Just as Biden continued much of former President Donald Trump's foreign policy, a re-elected Trump is likely to continue much of Biden's**
- **While Biden and Harris have been strong supporters of NATO, Trump has been more critical of it. Still, many see Trump's criticisms of NATO as being designed to push its European members to spend more on defense, not to pull the US out of the alliance**
- **Trump has provided ample reason to doubt that he would be as supportive of Ukraine as Biden has been and Harris is likely to be. Still, Trump does not want to see Ukraine collapse on his watch. And Trump's relations with Vladimir Putin might deteriorate sharply if the Russian president does not accept Trump's conflict resolution efforts**
- **European policymakers should increase their countries' defense expenditures in order to encourage the US to maintain its commitment to NATO. But European policymakers should also intensify planning for an independent European defense in case the American commitment falters**
- **European policymakers should do more to point out to their American counterparts that the Western competition with China is not just taking place in Asia, but worldwide – including in Europe**

DIFFERING TONES BUT SIMILAR POLICIES

If Vice President Kamala Harris is elected as president of the United States in November 2024, the substance and tone of American foreign policy can be expected to remain much the same as it has been during President Joseph Biden's term. But if former President Donald Trump is elected, the tone of American foreign policy will undoubtedly change back to the belligerent "America First" theme he adopted during his first term. Europeans, then, understandably fear that Trump's disdain for NATO has not diminished. Ukrainians also have reason to fear that Trump will not be nearly as supportive of Kyiv as Biden has been or as Harris is likely to be.

It has been noted by several observers, though, that American foreign policy during both the Trump and Biden administrations has been broadly similar (Wong 2022). Could it be, then, that if Trump is elected again, he will continue many of the same policies that Biden pursued – especially where these were continuations of his own policies? Harvard University Professor Stephen M. Walt (2024) argued just this in a January 2024 *FP* article entitled, "Another Trump Presidency Won't Much Change US Foreign Policy."

It is noteworthy that Trump and Biden – as well as Harris – have indeed had similar approaches on several foreign policy issues.

Trump and Biden have seen China not just as a security threat but also an economic one. Biden maintained the trade sanctions that Trump imposed on China. Harris, by contrast, has criticized Trump's sanctions on China as having negative effects on US consumers. It is not clear, though, whether she would move to lift any of them. She has, however, consistently described China as a security threat. She expressed support for "Taiwan's self-defense, consistent with our longstanding policy," as Biden has done (McCartney 2024). By contrast, Trump has raised doubts about whether the US would defend Taiwan against a Chinese attack (Tang 2024).

Late in Trump's first term, Washington helped arrange for normalization agreements (popularly known as the "Abraham accords") between Israel on the one hand and four Arab states – the United Arab Emirates (UAE), Bahrain, Morocco, and Sudan – on the other. Biden not only supported this process but tried to extend it to Saudi Arabia (Singh 2024). Both Harris and Trump are likely to continue to support the Abraham accord process.

Trump pulled the US out of the 2015 Iranian nuclear accord, known as the Joint Comprehensive Plan of Action (JCPOA), in 2018. Despite Biden's hopes of reviving it, the growing tensions between Iran and the US on several issues (including Iranian support for Hamas and Hezbollah against Israel and support for Russia against Ukraine) prevented this. Trump's view of the JCPOA is likely to be as negative as it was during his first term. While Harris supports reviving it, it is doubtful that she can be any more successful at doing so than Biden (Von Hein 2024).

Harris has been more critical of Israeli military policy in Gaza than Biden, but some observers believe that she has stated publicly what Biden has expressed privately (Daniels et al. 2024). Yet while she has criticized Israeli Prime Minister Netanyahu's policy toward Gaza and voiced sympathy for the plight of the Palestinians there, Harris has also expressed "unwavering commitment" to Israel and described Hamas as a "brutal terrorist organization" (Dovere 2024).

Trump, by contrast, has publicly been more supportive of Israeli efforts in Gaza, urging the Israelis to "finish what they started" and "get it over with fast." But Trump has also said, "I'm not sure that I'm loving the way they're doing it," and "let's get back to peace and stop killing people." One of the Israeli journalists conducting this interview with him claimed that both Trump and Biden were "turning their rhetorical backs on Israel" (Sullivan 2024). It seems highly likely that the Gaza conflict will continue past the January 20, 2025, inauguration date for the next president even if a broader conflict between Israel and Iran is avoided. Harris might be more critical of Netanyahu than Trump, but both Trump and Harris can be expected to continue supporting Israel while also urging an end to the conflict.

Trump adopted a harsh policy aimed at stemming illegal immigration across the US-Mexico border. While Biden criticized Trump for this, US border policy under Biden ended up having many similarities to Trump's (Kight 2023). Whether Harris or Trump wins the November 2024 presidential election, both will continue these efforts though their rhetoric about this issue will differ markedly.

Two areas many see Harris and Trump differing over are American support for NATO and American support for Ukraine. Harris has supported Biden's policy of strong support for NATO and can be expected to continue this if she is elected. Trump, by contrast, has been highly critical of NATO both during his first term and subsequently, and is thus likely to remain so during a second term.

Trump's criticisms, though, have mainly been about how several NATO governments are not spending enough on defense and seem directed more at getting them to "pay their fair share." This, however, is something that post-World War II presidents before Trump and Biden have also called for. They, of course, did not threaten to withdraw the US from NATO or encourage Russia to "do whatever the hell they want" to NATO members that do not spend enough on defense like Trump has done (Ibesa and Kim 2024). But since the end of Trump's first term at the beginning of 2021, the number of NATO states spending at least 2 percent of their gross domestic product (GDP) on defense has risen from six to 23 in 2024 (Falkenek 2024). Trump's threat of not being willing to defend states that do not spend enough, then, now appears to apply to fewer countries. Although former Trump National Security Adviser John Bolton (among others) have warned that Trump's threats to pull the US out of NATO should be taken seriously (Bolton 2024), Trump may actually intend them as a bargaining tactic. If either Trump or Harris wins the election, both can be expected to push other NATO members to increase their defense expenditures, though in very different tones of voice.

Regarding Ukraine, Harris can be expected to continue Biden's policy of providing Kyiv with strong support, Congress permitting. Whether Trump would do so, however, is unclear – especially given his past animosity toward Ukrainian President Zelensky and his oft expressed admiration for Russian President Putin. Trump has even claimed that he can settle the Russian-Ukrainian conflict "in a day" (WSJ Video 2023).

But if Trump wins a second term, how would he react if – as seems highly likely – he cannot resolve the conflict "in a day," or at all? Will he really end US aid to Ukraine and risk the humiliation of the Kyiv government collapsing on his watch like the Kabul government did on Biden's? This does not seem like something Trump would relish. Indeed, at one campaign appearance in February 2024, Trump claimed that he would do more to protect Ukraine than then candidate Biden (Gold 2024). Trump might also react quite negatively if Putin did not accept his conflict resolution efforts. Trump might be more assertive than Harris about stating that the war needs to end with a ceasefire in place or some other compromise that Kyiv does not want to make (Arnsdorf et al. 2024). Harris, though, might also be more willing to push for an end to the conflict on terms such as these, even if she is reluctant to say so publicly during the election campaign. Interestingly, there are those who see not just Harris, but also Trump as being more supportive of Ukraine than Biden has been (Kaminski 2024). Trump's positive description of his July 2024 phone conversation with Ukrainian President Volodymyr Zelensky also suggests that Trump's previous animosity toward him may have dissipated (Holmes 2024).

As he was during his first term, Trump may be willing to make deals with authoritarian adversaries in the hope of replicating a "Nixon in China" moment. But if the experience of his first term is any guide, Trump may be no more successful at this in a second term. Both Trump and Harris, though, can be expected to cooperate with America's authoritarian allies such as Saudi Arabia and the United Arab Emirates (UAE), albeit with differing levels of enthusiasm.

Policy toward climate change is also something that Biden and Trump have disagreed upon. Harris has backed Biden's support for policies to mitigate this problem while Trump largely opposes them

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(Wolf 2024). Neither Harris nor Trump, though, may be able to do much about it. Harris may not be able to get climate change policies passed by Congress if (as seems likely) either of its two houses is controlled by Republicans. Nor will Trump be able to do much to stop Democratic-controlled state governments as well as corporations, foundations, and investors concerned with environmental, social, and governance (ESG) issues from adopting their own climate change policies. For both Harris and Trump, climate change issues are likely to be a lower priority than security and trade issues.

THE VICE-PRESIDENTIAL FACTOR

According to *POLITICO*, Harris's choice as vice president, Governor Tim Walz of Minnesota, diverges "little from his running mate's messaging" on foreign policy issues (O'Brien and Bazail-Eimil 2024). He has been supportive of Israel but called for humanitarian assistance to the Palestinians in Gaza, critical of Russia and supportive of Ukraine, skeptical of free trade agreements when he was a member of Congress but supportive of expanded trade as governor of Minnesota (Berman and Roy 2024). Republicans have criticized Walz for being "soft" on China, but he has been a consistent critic of Beijing's human rights shortcomings (Rogin 2024). As vice president, he is likely to support Harris's foreign policy and certainly not challenge it.

On the other hand, Trump's choice for vice-presidential running mate – Senator J. D. Vance of Ohio – has some very pronounced views on foreign policy. Vance has opposed US military support for Ukraine because he does not think it can win its war with Russia, sees Asia as a more important priority for the US than Europe, strongly supports Israel, and is a climate change skeptic. Unlike Trump, whose foreign policy views seem transactional and subject to change depending on circumstances, Vance's views appear to be more deeply held and ideologically rooted (Lindsay 2024).

This is important because given Trump's current age of 78, there is a strong possibility that he may not be able to serve out the full four years of the presidential term lasting from January 2025 to January 2029. Vance, though, may only be able to put his imprint on American foreign policy if Trump passes away and Vance inherits the Oval Office from him. If instead he is ailing but alive, Trump himself can be expected to try to project an image of just being "temporarily indisposed" and rely not on Vance but trusted Trump family members and White House staff to act on his behalf. These might well engage in their own freelancing efforts which they claim Trump supports, but these are likely to be more pragmatic and transactional than ideological.

But whether it is Harris, Trump, or (in the event of the president's death) either of their vice presidents who end up overseeing American foreign policy for all or part of the next four years, reacting to events might be the main driver of their foreign policies and not the foreign policy agenda that they advocate before taking office.

POLICY CONCLUSIONS

European policymakers, of course, cannot be complacent about the extent to which American support for NATO and Ukraine will continue if Trump or even Harris is elected president in November 2024. It would be prudent, then, for European governments to continue to increase their defense spending and support for Ukraine not only because these are sensible policies but also to encourage the US to continue doing so. European governments have no interest in giving Trump or similarly minded politicians in Washington an excuse for not defending a Europe that they claim is not interested in defending itself.

Hopefully, the US commitment to defending Europe will continue. But if they fear the possibility that it will not, then European governments should intensify consultations and preparations regarding independent European defense efforts. While a good thing to do in and of itself, this would also be useful for showing Washington that Europe is indeed serious about its own defense. There is, of course, a risk that if Europe convinces the US that it is willing and able to defend itself, then there are those in Washington who will conclude that the US no longer needs to be as involved in defending Europe and can turn US attention more toward the Chinese threat in Asia.

To forestall this possibility, European leaders should launch a campaign to persuade American officials, legislators, media, and public opinion that just as the West's Cold War competition with the Soviet Union took place throughout the globe, its competition with China is also worldwide – including in Europe. Indeed, Chinese support for Russia in its war against Ukraine has made China a threat to Europe. European policymakers should work with American ones on countering and hopefully reducing Chinese support for Russia, which threatens both Europe and America.

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Valentino Larcinese

On the Growing Dangers of Money in American Democracy

KEY MESSAGES

- **Democratic politics requires balancing a trade-off between equality and liberty. The current US campaign finance system, shaped largely by a series of Supreme Court decisions, has prioritized liberty, particularly through a questionable interpretation of money as speech**
- **As a result of these rulings, money from individuals, corporations, and unions can flow to candidates without regulation, restriction, or, in some cases, transparency (through "dark money")**
- **Although it is challenging to establish direct causal effects, growing evidence suggests that money does influence politicians. Moreover, through issue advertising, financial contributions shape the political agenda and influence the salience of certain issues in public debate**
- **This dynamic has significant implications for the policies produced by the American political system. Wealthy donors tend to be substantially more conservative on economic issues than the general population**
- **Campaign finance reform is one of the most pressing challenges facing the future of US democracy and requires urgent attention**

As US citizens prepare to elect a new president this November, the flow of money to finance candidates' campaigns intensifies. In the 24 hours following his conviction for falsifying business records in early June, the Donald Trump campaign received more than USD 50 million. In the month following President Biden's withdrawal from the race, as it became clear that the Democratic Party's grandees were firmly backing his vice president, Kamala Harris received an astounding half-billion dollars. As money poured into the coffers, some prominent Democratic donors had the audacity to publicly advocate for what they expected if the Democrats won the presidency. Just two days after Biden's withdrawal message on Twitter, Expedia's Chairman Barry Diller and LinkedIn founder Reid Hoffman called for a change at the helm of the Federal Trade Commission, where Lina Khan has drawn the ire of large corporate groups.

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The role of money in US politics has increased at an impressive rate in recent years. As shown in Figure 1, candidates in the 2020 electoral cycle raised almost USD 15 billion, of which USD 4 billion was donated for the presidential election. These numbers set US politics apart from all other democracies, where money still plays an important role, but contributions and spending are more tightly regulated, and electoral campaigns are often publicly funded. Why is there so much money in American politics? And how much of a difference does it make for American citizens and the policies they receive?

CAMPAIGN FINANCE AND THE TRADE-OFF BETWEEN LIBERTY AND EQUALITY

Democratic politics requires a delicate balance between equality and liberty. On one hand, democracy is based on equal representation of all citizens, a process in which, ideally, each individual holds the same weight. At the same time, free speech is essential for public deliberation and the scrutiny of different candidates and proposals. Unfortunately, these two principles can conflict with each other, particularly when inequality of resources, a normal feature of a capitalist market economy, leads to some individuals or groups having a disproportionately louder voice, drowning out the voices of less resourceful citizens.

Landmark regulations passed in the 1970s recognized this trade-off and attempted to limit the influence of a few wealthy donors on democratic processes. The Federal Election Campaign Act of 1971 (FECA) and its 1974 amendments established disclosure requirements and set limits on the amount of money that could be donated to candidates, political parties, and Political Action Committees (PACs).

Since then, however, various Supreme Court decisions, starting with the landmark 1976 Buckley vs. Valeo case, have clearly prioritized liberty over equality. In Buckley vs. Valeo, the Supreme Court distinguished between contributions and expenditures. It accepted limits on contributions as necessary to prevent corruption but rejected spending limits, arguing they would restrict free speech and violate the First Amendment. According to this interpretation, "money is speech."

The American system also makes a crucial distinction between coordinated spending, which is subject to limits as it is akin to campaign contributions, and independent spending, which is uncoordinated with candidates and not subject to limitations.

Within this framework, all attempts to rein in big money have been frustrated, either by the creativity of political actors and lobbyists or by Supreme Court rulings. The most significant of these efforts was the Bipartisan Campaign Reform Act of 2002 (BCRA), sponsored by Senators Russ Feingold and John McCain. The BCRA responded to the proliferation of soft-money contributions, which were unregulated and not subject to FECA limits since they were not used to promote specific candidates or in coordination with campaigns.

However, the BCRA has since been rendered ineffective by various Supreme Court rulings. Most notably, the 2010 Citizens United vs. FEC and SpeechNow.org vs. FEC rulings struck down restrictions on independent political expenditures by corporations and unions, arguing such limits violated the First Amendment. Independent expenditure-only committees, commonly known as Super PACs, could now raise and spend money from individuals, corporations, and unions without limitations – not just for issue advocacy but also for electioneering communications, as long as they maintained the fiction of non-coordination with candidates. The floodgates were opened, and money could now flow freely without restrictions. Additionally, donors could remain anonymous by using conduits, such as 501(c) organizations, turning soft money into dark money.

THE RISE OF SUPER PACS AND THE FICTION OF INDEPENDENCE

Unlike traditional PACs, Super PACs can raise and spend unlimited sums of money to advocate for or against political candidates. The critical distinction is that while PACs contribute directly to campaigns, Super PACs are prohibited from coordinating directly with candidates or their campaigns.

The post-Citizens-United era has seen an explosion in the number and influence of Super PACs, fundamentally altering the dynamics of American electoral politics. In recent election cycles, Super PACs raised and spent billions of dollars, dwarfing the amounts raised by traditional PACs and candidates' campaigns. As of August 15 this year, Super PACs and other groups with no limit on what they can raise and spend (outside spending) have already spent USD 1.1 billion, double the amount spent during the same period in the 2019–2020 electoral cycle when independent expenditures hit an all-time record (Cloutier 2024).

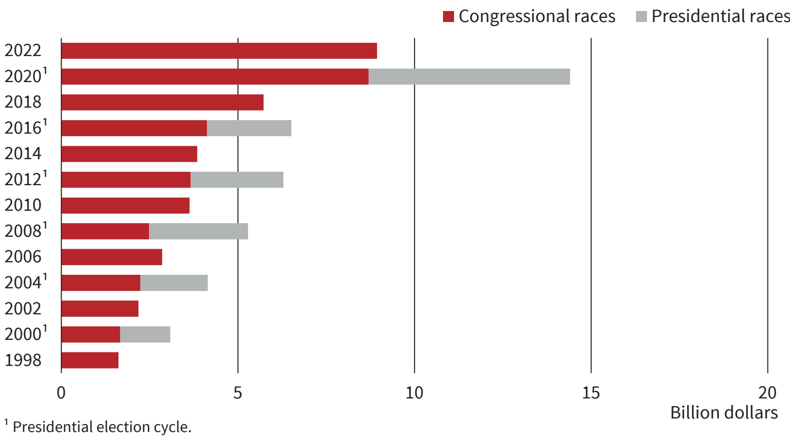
Hence, the current US campaign finance system fully prioritizes a possibly flawed idea of free speech over equal representation. Several points are important to note. First, the Supreme Court has played a key role in creating the current situation. Key rulings like Citizens United were passed by a 5–4 majority on purely ideological lines. The conservative dominance in the Supreme Court since the Bush Jr. presidency has been instrumental in shaping the current interpretation of this trade-off.

Second, the legal rationale for allowing Super PACs to operate without contribution limits – that they operate independently of candidates – is purely fictional. The distinction between coordinated and uncoordinated spending is nebulous both in principle and in practice, since electioneering can happen tacitly, without formal contacts between the agents involved. Moreover, the revolving door between parties, corporations, and Super PACs ensures that those conducting "independent" campaigns are well-acquainted and have no difficulty coordinating in practice.

Third, even when Super PACs do not coordinate with candidates, their influence is not any less problematic. By setting the agenda of public debate, Super PACs can increase the salience of certain issues solely based on their importance to donors. This likely induces office-seeking politicians to follow the policy agenda advocated by wealthy donors, even without explicit coordination. Additionally, by raising the prominence of certain issues, Super PACs can benefit particular candidates without issuing direct endorsements. According to the "issue-ownership" hypothesis (Petrocik 1996), and to plenty of evidence from surveys, voters tend to perceive Republican candidates

Figure 1

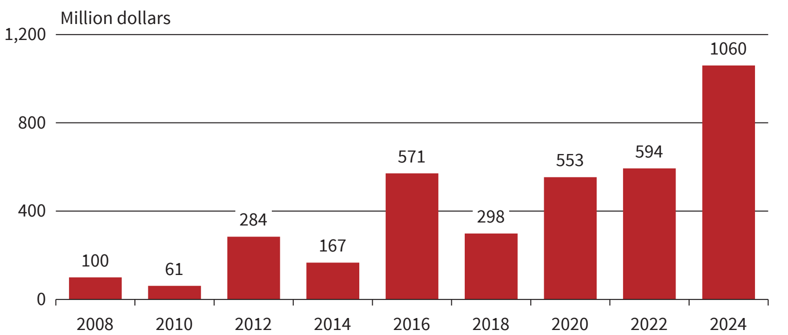
Total Cost of Elections (1998–2022)



[1] Presidential election cycle.
Source: OpenSecrets.com.
© ifo Institute

Figure 2

Outside Spending Is Outpacing Prior Election Cycles



Note: OpenSecrects analysis of federal campaign finance reports through Aug. 15, 2024, compared to spending through the same date in prior two-year election cycles.
Source: Cloutier (2024).
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as more credible on certain issues (like law and order, or immigration) and Democrats as more credible on others (like environment or healthcare). By amplifying the salience of certain issues, wealthy donors can boost specific candidates, even without explicit endorsements.

THE "DONORATE" VS. THE ELECTORATE

This surge in Super PAC activity has fueled concerns about the outsized influence of wealthy individuals and special interest groups in elections. It is indeed hard to portray donations of USD 125 million (Timothy Mellon to Donald Trump's MAGA Super PAC) in one electoral cycle as mere free speech.

This is particularly troubling because the policy preferences of donors – especially large donors – are very different from those of most citizens. Rich Americans are especially more conservative on economic issues, particularly on matters related to labor market regulation, taxation, social spending, and redistribution (Page et al. 2013; Broockman and Malhotra 2020; Broockman et al. 2019; Cohn et al. 2023). In fact, on the economy, the wealthiest Americans have been found to be consistently more conservative than even the top 10 percent (Page et al. 2013 and 2018). Similarly, a survey of big donors shows that Republican contributors are significantly more conservative on economic issues than Republican voters, with this difference increasing for top 1 percent donors (Broockman and Malhotra 2020). In summary, campaign contribution patterns may induce legislators to give more weight to the political preferences of rich voters, which tend to be substantially more conservative than average on economic and fiscal matters.

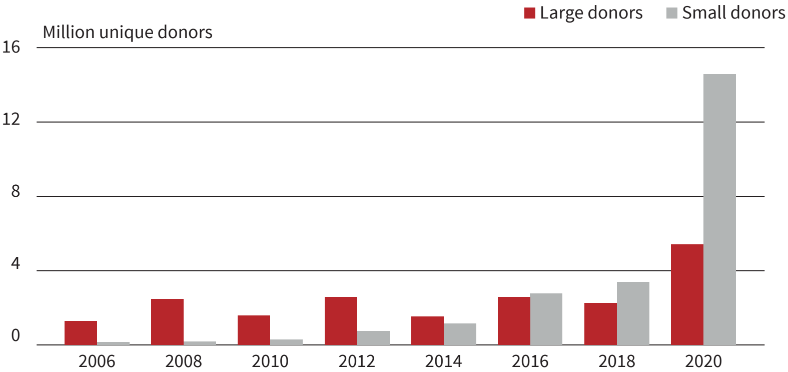
More generally, compared with the electorate, even just considering people who actually exercise their right to vote, the "donorate" heavily overrepresents white, male, wealthier, and older citizens (Hill and Huber 2017). In both parties, the differences between donors and non-donors are substantially more relevant than the differences between voters and non-voters. Hill and Huber (2017) also find that donors of both parties are ideologically more extreme than voters, including primary voters who tend to be more extreme than the rest of the electorate. Hence, the recent surge of money in politics could also be partially responsible for the increasing polarization of American politics.

On the other hand, the increase in small campaign contributions that has also been witnessed in recent years can, in fact, make the "donorate" more representative of the electorate. Small contributions are mostly expressive forms of support for a candidate, akin to volunteering time or participating in rallies.[1] Barack Obama's 2008 campaign claimed success in mobilizing new small donors, particularly using the new opportunities offered by the internet. Kamala Harris raised a record half-billion dollars during the first month of her campaign, of which about 40 percent (or USD 200 million) came from donations of less than USD 200. Approximately one-third of Donald Trump's donations in this electoral cycle come from small donors (less than USD 200), much of it contributed immediately after his conviction.

The available data shows indeed that the number of small donors has increased substantially in recent years, from about 50,000 in the 2006 electoral cycle to nearly 14.5 million in 2020 (see Figure 3, reproduced from Bouton et al. 2024). Small donors tend to have lower incomes and are more likely to be female and from ethnic minorities compared to large donors (Bouton et al. 2024).

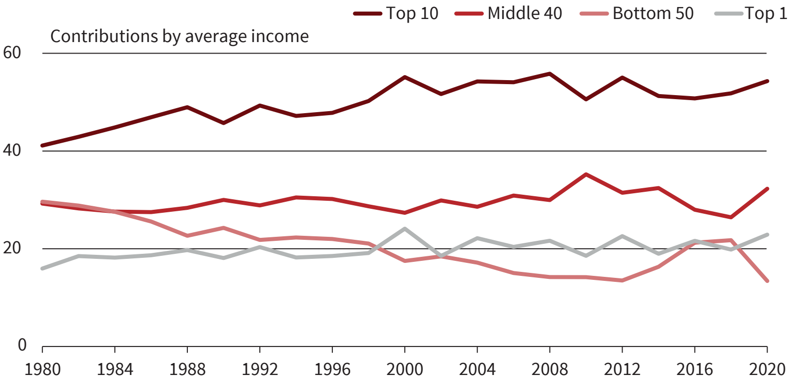
While the number of donors has increased, the concentration of contributions has also intensified (Bonica et al. 2013). In 2018, 0.01 percent of the voting-age population accounted for nearly half of total contributions (Cagé 2024). In Larcinese and Parmigiani (2023), we show that wealthier areas (census tracts) are increasingly accounting for a larger share of donations. In 1980, census tracts below the median income accounted for about 30 percent of total contributions; by 2020, their share had shrunk to around 15 percent, well below the share of total contributions donated

Figure 3
Total Number of Small and Large Unique Contributors by Election Cycle (2006–2020)



Source: Bouton et al. (2024). © ifo Institute

Figure 4
The Raising Concentration of Campaign Donations at the Census Tract Level



Source: Larcinese and Parmigiani (2024). © ifo Institute

[1] Evidence also suggests that candidates relying disproportionately on small donors tend to be more effective legislators (Prat et al. 2010).

by the top 1 percent (Figure 4). We point out that this trend may well be a consequence of increasing income inequality. If rising inequality leads to greater political influence for the wealthy, which in turn results in policies that further exacerbate inequality (such as tax cuts for high-income individuals), we may be witnessing a spiral where both economic and political power become increasingly concentrated in fewer hands, an oligarchic spiral.

DOES MONEY MATTER?

The American judicary has always taken a very narrow view to justify restrictions on the flow of money into politics: that such limits are necessary to prevent corruption. In this view, only an explicit, proven quid pro quo is considered problematic. Unsurprisingly, this quid pro quo has been notoriously difficult to prove in court. The same difficulty applies to academic research attempting to demonstrate the influence of money on legislative activity and public policy. Finding the "smoking gun" is challenging; consequently, most evidence is correlational, and finding causal effects of campaign contributions on policymaking has proven difficult.

Nevertheless, several recent studies have shown that contributions do function as leverage in political decisions. Using a large dataset covering the period from 1988 to 2014, Fouirnaies and Hall (2018) demonstrate that shifts in procedural power, such as committee membership, lead to significant reallocations of campaign finance money. In their study of the sugar industry, Grier et al. (2022) show that the voting behavior of members of Congress is influenced by changing patterns of contributions.

Gilens et al. (2021) took advantage of the fact that the Citizens United ruling had different impacts in different US states, as some states had previously banned independent corporate expenditures and were thus forced to re-allow them. These "treated" states saw an increase in corporate-friendly policies compared with other states. At the same time, no effect was found on policies that had little or no impact on corporate welfare.

Other studies find that members of Congress respond more to the political preferences of wealthy donors than to the preferences of their electorate (Canes-Wrone and Gibson 2019; Canes-Wrone and Miller 2022). This is consistent with evidence showing that implemented policies tend to align well with the preferences of the top 10 percent of the income distribution but are virtually uncorrelated with the preferences of the remaining 90 percent (Gilens 2012). Of course, other explanations for this correlation are possible; for example, representatives may simply share the same preferences as the top 10 percent because they come from similar social backgrounds. However, this explanation would not be less problematic as it would call into question the role of money in political careers and in the persistence of political elites.

POLICY CONCLUSION: WHAT CAN BE DONE?

Campaign finance in the US is a complex and pressing issue, but you will rarely find it as a topic of debate for presidential candidates. Long gone are the days when presidential candidate John McCain made campaign finance reform a key part of his agenda. This is not surprising given how much presidential campaigns now depend on big donors.

However, this does not mean reforms are not being attempted at the federal level or experimented with in local politics. One of the most notable federal efforts was the introduction of the For the People Act (H.R.1) in 2021, which aimed to overhaul the campaign finance system by promoting transparency, reducing the influence of dark money (political spending by 501(c) organizations that do not disclose their donors), and strengthening enforcement mechanisms. The bill passed the House of Representatives twice but faced significant and effective opposition in the Senate.

At the state level, some jurisdictions have experimented with public financing models, implemented in various ways. One interesting example is the Seattle City Council, where residents receive four publicly funded vouchers worth USD 25 each and can distribute them to candidates who, in turn, agree to specific spending limits.

Another approach to public funding is matching small-dollar donations to encourage broader participation in the political process and reduce candidates' reliance on large donors. New York City's public matching funds program, for instance, provides candidates with public funds that match small contributions (up to a 9-to-1 ratio), significantly amplifying the impact of grassroots fundraising.

However, while these solutions can be effective at the local level, they are unlikely to make a significant impact in federal politics. It is worth noting that a system of public funding for presidential elections was once provided by FECA, and every serious contender for the presidency used these funds until the early 2000s. Public funding consisted of matching funds for small donations (less than USD 250) in the primaries and a fixed amount for presidential nominees in the general election. However, public funding came with spending limits. The surge in private money led candidates to abandon public funds so they could raise and spend without restrictions. Al Gore in 2000 was the last candidate to use matching funds for the primaries, and Obama in 2008 was the first to refuse public funds for the general election, correctly anticipating that he could raise and spend much more with private contributions.

Thus, it seems unlikely that the creative solutions for fairer elections being tested at the local level will have any broader impact on federal politics. The overarching challenge remains the Supreme Court's interpretation of the First Amendment and the fiction of separation between coordinated and independent spending. Any meaningful reform at the federal level would likely require either a constitutional amendment or a significant shift in the Court's jurisprudence, both of which are highly unlikely in the current political climate.

The remaining hope is that, as the cost of campaigns continues to rise, and as new technologies enable ever more sophisticated fundraising and spending strategies, the pressure to revisit the campaign finance system will grow. Whether the United States can strike a balance between the legitimate need for free speech and political debate, and greater political equality among its citizens, remains one of the most pressing questions for the future of its democracy.

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Pádraig Carmody and *Paul S. Ciccantell*

The 2024 Presidential Election in the US: Potential Impacts on Global Politics and Economics

KEY MESSAGES

- **The world is in a period of profound political and economic disruption**
- **The outcome of the US presidential election has the potential to accelerate this or contribute to the construction of a reformed and more legitimate international order**
- **How competition between the US and China is managed will be key to global stability and prosperity**
- **Africa, Europe, and other world regions need to prepare for shocks wrought by a potential Trump victory**
- **The stakes are very high for both the US and the world**

THE GLOBAL CONTEXT

The world is in a period of profound turbulence and economic and political restructuring. According to estimates from the United Nations, a quarter of humanity lives in conflict-affected areas, the most since World War II (WW II) (UN Security Council 2023). Many of the institutions of multilateralism are often gridlocked, such as the United Nations Security Council or the World Trade Organization (BDI 2022). Clearly the so-called Pax Americana, where American power projection and institution-building reduced global conflict, is now largely a thing of the past, except perhaps in Western Europe and littoral East Asia (Lind 2023). However, even in "zones of peace" such as Western Europe, there are "grey zone" operations ongoing, where major powers and their proxies attack each other through cyber and other means as part of a "new" or "Second Cold War" (Schindler et al. 2023). Such disruption presents China with a period of "strategic opportunity" (Deng 2022) as it engages in a "war of maneuver," as compared to the US's "war of position" (Carmody 2024a). The long-term consequences for the global economy and geopolitics of this rivalry are likely to be profound.

As billions of people around the world go to the polls, 2024 has been dubbed the "year of elections." Probably the most consequential of these will be in the US, as whether or not Donald Trump is (re)elected will have potentially substantial implications for the emerging international (dis)order.

Trump is deeply skeptical of international institutions, and pulled the US out of several of them, such as the World Health Organization (WHO), when he was president previously. He has consistently expressed skepticism of the North Atlantic Treaty Organization (NATO) since the 1980s, when he took out a full-page newspaper ad to critique it, as he sought to open up the Soviet Union's market to his hotel chain (Abramson 2018). Trump is an admirer of "strong men" and practitioner of transactional *realpolitik*, although some reports suggest that when he met with North Korean dictator Kim Jong-un, he was more concerned about the performative optics than the substance of the talks (Schepers 2019). What would his (re)election mean for the current international order, economy, and ongoing conflicts?

In contrast to Trump, a Harris administration would be likely to maintain Biden's policies focused on rebuilding and depending on international alliances. Harris's recent nomination by the Democratic Party and her choice of Minnesota Governor Tim Walz have clearly reinvigorated Democrats in the US, many of whom were anticipating a Trump victory after Biden's disastrous June debate performance. The old age/generational critique has become widely accepted in the US, and Harris turned this to Democratic advantage now with Trump as the "oldest major party nominee for president ever." Her ascendance has raised hopes among, at least some, disillusioned young people that maybe something can change.

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ENHANCED DISORDER?

While there are multiple conflicts now raging around the world, with tragic human and other consequences, from a global geopolitical perspective probably the most consequential of these is the war in Ukraine. For some "realists" such as John Mearsheimer (2014), this conflict is primarily the West's fault, as it sought to encroach on Russia's "sphere of influence." This position has recently received support from other public intellectuals such as Jeffrey Sachs (2024) of Columbia University. According to other analysts such as Jonathon Dimbelby (cited in Paul 2024), Ukraine will never be able to defeat Russia militarily given the size and capacity for endurance/suffering of the latter, and consequently there will have to be a negotiated settlement to the conflict, which will include recognition of the latter's sovereignty over some of the territory it has seized.

Trump says he would resolve the Ukraine conflict in a matter of hours. While this is undoubtedly hyperbolic, there are indications that he would push that country to settle with Russia, under threat of withdrawal of American military aid and support (Arnsdorf et al. 2024). According to Trump's last National Security Advisor, Robert O'Brien (2024), all wars end around a table, and enhanced sanctions on Russian energy exports are needed to bring that country to negotiations. Would such an outcome lead to greater peace or might it inflame further war through rewarding aggression? While the contours of any such agreement might determine whether or not Vladimir Putin's Russia would be "satiated" in Ukraine or Europe, although previous military interventions in Georgia and elsewhere would suggest not, the bigger question perhaps from a global geopolitical perspective would be how such a settlement might be received in, or viewed from, China. A Harris administration would likely seek to maintain US support for Ukraine, but, as has been seen since Republicans took control of the House of Representatives in 2022, divided government in the US and the pro-Putin segment of the Republican Party will make this support difficult to maintain.

According to the United States Central Intelligence Agency, Chinese President Xi Jinping has told his military that he wants them to be ready to conquer Taiwan in three (now two) years (Yen 2023). The Russian invasion of Ukraine prompted the then US Speaker of the House, Nancy Pelosi, to visit Taiwan, and President Biden to do away with any strategic ambiguity by repeatedly saying that the US would defend it militarily in the event of a Chinese invasion. The Russian invasion of Ukraine also coincided with the US reinvigorating its alliance structure and catalyzing new arrangements between security partners in a "lattice" rather than "hub and spoke" structure (United States 2022), reflecting a new flexible geometry in adaptation to the shifting balance of power under multipolarization.

One of the foundational tenets of realism is that states can never know for certain what the intentions of the adversaries are. Recently, President Xi has said the US is trying to trick China into invading Taiwan and that it wouldn't take the bait, although some analysts have said this is to try to drive a wedge between the US and Europe (Spirlet 2024). How would a Trump presidency in the US respond to the eventuality of an invasion?

One of the signal features of the previous Trump presidency was his hawkish stance on China. According to one of his advisors, the road to "making American great again" runs through Beijing (Pillsbury 2017). Trump is also famously unpredictable, or erratic, partly as a strategy to keep opponents/interlocuters guessing and off-balance as part of the "art of the deal" (Trump and Schwartz 1988). Previously, Trump has said "Taiwan took our business away" and that they should have been "tariffed," and was equivocal about whether or not the US would defend the island if there were a Chinese invasion (Taiwan News Plus 2023). As has already been noted, he is also exceptionally transactional, and would he implicitly be willing to "trade Taiwan" in exchange for economic concessions from China, for example? Such an approach would be in keeping with an "America first" foreign policy but would have strategic risks, such as the disruption of global supply chains in the semiconductor industry, given Taiwan's centrality to that trade. There are other risks as well: trade concessions from China could be reversed, whereas a military takeover of Taiwan could likely not be, and a "successful" invasion might also make Trump appear weak. Harris's likely maintenance of Biden's unambiguous support for Taiwan, with significant but far from unanimous bipartisan support in Congress, would likely lead the US into direct conflict with China in the wake of an invasion of the island.

One of the paradoxes of the current political situation in the United States is that while the country is very politically divided, there is a largely bipartisan consensus on how to deal with China, with Biden having retained and expanded many Trump policies, such as extensive tariffs on Chinese imports. China policy may therefore be largely continued as is, irrespective of who wins the election. However, technology policy, which has implications for competition with China, may differ between the potential administrations substantially.

From a long-term perspective, the decline of US hegemony that began in the 1970s (see e. g., Arrighi 1994 and 2007; Bunker and Ciccantell 2005 and 2007) has had a wide range of consequences that are shaping this election and its likely consequences. One of the most salient is the increasing numbers of conflicts that are displacing large numbers of civilians and, in combination with the climate crisis, creating waves of migrants seeking survival and work in the Global North. Vice President Harris's charge of trying to improve conditions in Central America via increased private and national government investments to keep people from migrating was one recognition of the fundamental political problem of migration to the US (Marczak 2024; White House March 2024). Marczak (2024) argues that Harris's strategy is to "approach: Listen to a broad array of stakeholders, act, follow up, and then adjust tactics as needed. This approach can take time to implement, but it also proves adaptive to unexpected challenges" is likely to characterize her efforts to address immigration and other difficult issues if she is elected. Similarly, efforts in Europe to subsidize state attempts to keep migrants from crossing the Mediterranean seek to reduce migrant flows.

Large flows of migrants ("migrant caravans crossing Mexico to the border" in the US) lead to increasing political instability and right-wing challenges for power in the US and EU, which accelerate the decline of US hegemony and increase global instability and migration. The rhetoric about immigration would be very different depending on the results of the presidential election, but the practical effects are likely to be similar. A rational US policy of evaluating asylum claims in line with international law, providing work permits for migrants, developing policies to promote effective assimilation, etc., will remain a progressive dream in the US for the foreseeable future because of the rhetorical power of the "border crisis," despite its disconnect from reality. A Harris administration, particularly with the likely Democratic majority in the House of Representatives but with a Republican Senate, would likely oversee the continuing slow decline via economic nationalism and political paralysis, while a Trump administration with control of both houses of Congress would likely drive more rapid decline and increasing global poverty, conflict, and migration.

On a related note regarding US hegemonic decline, there is a need to recognize the broad economic benefits to the US and the Global North of post-WW-II US hegemony and neoliberal globalization that promoted economic growth and lowered costs to consumers by incorporating cheap labor into the world economy. Trump's plans for raising tariffs and trade barriers, and starting trade wars with rivals and allies, is couched as economic nationalism and Biden has largely followed suit, but this rhetoric ignores the successes of neoliberalization from the perspective of many sectors of the Global North. The likely continued relative decline of the US regardless of who wins this election carries significant consequences for ongoing instability.

ENHANCED TECHNOLOGY WARS?

According to Luttwak (1990), geoeconomics represents a logic of conflict while using the language of commerce, and this has arguably been the main form of "great" power conflict in recent decades. According to some estimates, the Chinese are winning this competition. Dalio (2021, 430) argues "the technology war is much more serious than the trade/economic war because whoever wins the technology war will probably also win the military wars and all other wars." "A study by the Australian Strategic Policy Institute revealed that China leads the world in thirty-seven out of forty-four critical technologies, including … 5G internet" (Garlick 2023, 155). Chinese companies are now the largest grouping in the Fortune Global 500 index (Chandler 2022) and their geographic reach is also extensive, with 70 percent of broadband infrastructure in Africa built by Chinese firms, for example – giving them "latent structural power" (Arnold 2024). However, China lags behind in new or fundamental innovations or what Jin (2023) calls "zero to one" technology, while excelling in adaptation of, or incremental innovation in, existing ones.

While Trump's industrial policy was defensive/reactive, making heavy use of tariffs, for example, Biden's has been more proactive through the use of extensive funding of research and innovation in semiconductors, for example, which holds the potential to be more successful over the medium to longer-term in maintaining American competitive advantage in key sectors – an approach Harris would be likely to maintain.

POTENTIAL IMPACTS GLOBALLY

What would the implications of a Trump victory be for other world regions? While the Biden administration has been vigorously contesting "space" with China in Africa, holding a Summit for Democracy in Zambia, funding the Lobito transport corridor in Angola, and striking a deal to make electric vehicle batteries in Congo, for example (see Carmody and Hampwaye 2024), Trump would likely again dilute American engagement with the region, as he did previously (see Owusu et al. 2019). When he was president, Trump infamously referred to African states as "sh**hole countries" and as a space where his friends went to get rich. His wife, Melania Trump, wore a pith helmet – a symbol of colonial oppression – when she visited the continent (Carmody 2019). Trump would likely institute more regressive economic policies towards the continent, as he did last time when he was in office, when he withdrew trade privileges from Rwanda when it banned secondhand clothes imports, some of which were from the US, in an attempt to build up its own textile and clothing industry, for example. In Trump's worldview, Africa cannot do much for him, or by extension, America, and is consequently insignificant, except perhaps as a potential security "threat." Such neglect would be particularly shortsighted, even from a self-interested point of view, given Africa's growing population, economy, and importance in world affairs. Harris's potential policy approach, beyond continuing Biden's efforts to rebuild alliances, remains unclear, although her personal experiences as the child of immigrants from Jamaica and India may give her greater sensitivity toward international issues such as migration and poverty.

For other regions of the Global South beyond Africa, a Trump reelection would bring both threats and opportunities. Multipolarization is an embedded metatrend in the global political economy, and the (uneven) "Rise of the South" is likely to continue. However, the loss of "hegemonic stability" created by relative US decline may make some regions more prone to conflict, as has recently been evidenced in Myanmar, Sudan, and elsewhere. Australia's Lowy Institute already characterizes the conflict between the US and its allies and China in the Pacific islands as a new "Great Game" of rivalry for power and influence (Sora et al. 2024). Trump will, however, be less likely to be engaged in trying to find solutions than the Biden administration, as he views the world through the prism of his own interests (Hughes 2018); a latter-day "*l'état, c'est moi*" philosophy (Chait 2017). Some countries, however, might fare better economically. For example, Mexico's "friendshoring boom" would likely continue under Trump (Chovanec 2024), as even Chinese companies locate operations there to avoid tariffs, unless he identifies it as another "foe" as he referred to the European Union previously. Harris's roots in California and the importance of immigration there, as well as her efforts as vice president to reduce migrant flows at their sources in Central America, may lead to more rational and humane immigration policy and international relations with the region. However, recent Harris political advertising promises "securing the border" and "hiring thousands of border agents," reflect the power of the image of immigration as a threat to "safety" in the US and as a political tool.

For Europe, a Trump reelection would likely bring "strategic autonomy" closer. This might take the form of a soft (planned, voluntary) or hard (unplanned, rushed) geopolitical decoupling from the US. China has been attempting to drive a wedge between the US and Europe to promote such a decoupling, as partly evidenced by the choice of destinations when President Xi visited the continent in 2024: France, Serbia, and Hungary (Al Jazeera 2024). French President Macron had previously spoken of the need for Europe not to be a "vassal" of the US in relation to Taiwan when he visited China (Rankin 2023), Hungary is a persistent "disruptor" in the EU, and Serbia was the site of the 1999 NATO bombing of the Chinese embassy. Serbia also has a "four pillars" strategy, which relies on China for infrastructure, the US for security cooperation, Russia for energy, and the European Union for inward investment, among other things (Entina 2013). Harris, in contrast, will likely maintain Biden's emphasis on strengthening the NATO alliance, but her lack of foreign policy experience and clear policy statements make future policy actions less obvious.

POLICY CONCLUSIONS

Irrespective of who wins the US presidential election in November 2024, the world appears to be heading into a period of profound geopolitical competition (Ciccantell et al. 2023), if not conflict or conflagration, in addition to facing a variety of existential threats to humanity from climate change to the global biodiversity crisis. The (existential) imperative of cooperation is strong, while the shorter-term incentives around competition and conflict appear, for the moment, to be stronger (Braw 2024), given the competitive logic of the interstate system and global market economy and interactions between them. In many ways, the world is confronting a situation with critical parallels to the 1920s and 1930s: internal and interstate political and military conflicts, intense poverty, food shortages, autocratic states using violence to control citizens. This is compounded by the rapidly growing consequences of climate change disrupting agricultural systems, rural and urban communities, and daily life, which all combine to help create substantial flows of migrants, political instability, civil wars, and larger conflicts that force states and peoples to consider alternatives to the current political and economic order; particularly nationalist, populist, and fascist authoritarianism.

In such a context or configuration, it is important that the emerging international order be shaped more through cooperation, likely initially among like-minded states, and reformed so that it is more inclusive, representative, equal, and consequently legitimate. This implies a twin-track approach of bolstering existing international institutions while reforming them to make them more participatory and consequently less objectionable to many across the Global South in particular. To help accomplish this, there should be an end to Western double standards in relation to human rights violations, in Ukraine vs. Gaza for example, if these countries wish to (re)build their international legitimacy.

As its economy has slowed and unemployment has risen in China as the critical generative sectors (Bunker and Ciccantell 2005) of steel and property development that have driven China's ascent have stagnated (Bloomberg News 2024a and 2024b), the regime there has adopted a less confrontational approach to the US, although this is likely tactical rather than strategic. The stoking of nationalist sentiment, around Taiwan for example, remains a viable strategy to diffuse, deflect, or contain dissent domestically. China is still dependent on Western technology, investment, and markets, but an invasion of Taiwan would lead to a hard decoupling from the US and Europe, as has already largely happened to Russia. The US already has the ability to prohibit outward investment in strategic sectors to "countries of concern" through the "reverse CFIUS" (Committee on Foreign Investment in the United States). This has had the effect of routing new investment in semiconductors to Vietnam, for example, where they can still access Chinese components. That country has recently signed major infrastructure agreements with China (Ha 2023), leading some to suggest it has "thrown its lot in" with that country, although maritime territorial disputes and conflicts continue.

There is a high likelihood that, regardless of whether Trump or Harris wins, failed US foreign policies will continue. US Mideast policy failures since it took over Great Britain's role after the Suez Crisis in 1956 have contributed to destabilizing Iran, Iraq, Syria, Palestine, and much of North and sub-Saharan Africa. That has encouraged huge migrant flows into Europe that are unsettling politics in many countries, even if labor is needed for their economies. The long history of US intervention in Mexico and Central and South America, most recently in the form of the "War on Drugs," contributed to the economic and political inequalities and conflicts that are driving thousands to undertake the incredibly dangerous journey there (Dickerson 2024). The US's long history of largely ignoring Africa has furthered China's ascent and the displacement of large numbers of African migrants to Europe and, on a smaller scale, to the US via Latin America.

The US tradition of neglecting China was replaced with a fascination with firms entering its large domestic market, but its economic and strategic successes have left the US with a bipartisan consensus of the "threat" it presents and what is now for Biden/Harris and the "China hawks" in Congress an explicit guarantee to defend Taiwan, whose only geoeconomic significance is computer chip production. Xi's potential plan to invade Taiwan in the medium term is perhaps unlikely to be dissuaded by US efforts to reinvigorate alliances with Japan, Australia, and the Philippines. Trump's anti-NATO and pro-Putin rhetoric has created a significant "fifth column" in the US that will continue to undermine efforts to help Ukraine and US allies in Europe, furthering instability and conflict there. The US was never as successful as the UK as an imperial power, able to play competing groups off against one another, but in the context of the decline of US hegemony, the consequences of this long history of often bipartisan foreign policy failures is likely to increase instability and conflict, regardless of who wins the US presidential election.

A second Trump administration will try to dramatically weaken the US state apparatus and reduce taxes on businesses and the wealthy, and politicize the civil service and federal judiciary. The "originalist" so-called conservative judiciary movement is determined to move the US back to the world of 1790 in law and culture. Rejection of climate change efforts will leave the US in the medium term with unlivable coastal areas as sea levels rise, heat overwhelms urban areas and the southern and western US, and many agricultural industries disappear, all without any effective policy response. Trump's most fundamental electoral mistake, perhaps, was allowing the Heritage Foundation and dozens of his former government officials and advisors to publicly formalize the plans for his second administration as Project 2025: https://www.heritage.org/conservatism/commentary/project-2025.

In the seemingly unlikely outcome of a Democratic trifecta (presidency, House of Representatives, and Senate), potential progressive priorities of continued infrastructural modernization to catch up with China, creating a national health system, increasing reliance on international institutions and law, and creating a rational system of immigration could help the world move more peacefully toward a multipolar system as US hegemony continues to decline. Western countries could facilitate economic development and their soft power through incentivizing foreign investment and local firm development in Africa, for example, through public procurement (Carmody and Owusu 2007) or "negative tariffs" on manufactured imports from the continent (Sandefur and Subramanian 2024). This could serve both security and development objectives (Carmody 2024b). Such initiatives would be more impactful if developed through like-minded states.

The Biden administration is attempting to preserve American global leadership by diffusing and diversifying it through network extension and reconfiguration. A second Trump administration would likely continue previous policies of "pulling up the drawbridge," with long-term negative effects for both the US and potentially the rest of the world.

Global military expenditure is at an all-time high, with the security dilemma to the fore, as countries spend more in response to their neighbors spending more (Carmody 2024b). If democracy can survive, there is hope for greater international cooperation, where the international order is reformed to make it more representative, equal, and legitimate. If not, we are in new, dangerous, and uncharted waters with the Russian invasion of Ukraine perhaps being the opening shots of WW III (see Hung 2021). A Trump victory would also further accelerate the ostensibly slow-moving but visible "grey rhino" catastrophe of climate disruption. Consequently, the stakes are high, and the outcome(s) uncertain from the upcoming US presidential election. Academics, policymakers, and citizens urgently need to work toward creating a more equitable global order that reflects the concerns of younger generations about the increasingly dire consequences of climate change and the inhumanity witnessed in real time on TikTok, Instagram, and other social media platforms happening daily in Gaza, Sudan, and elsewhere.

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Thorsten Beck

European Banking after the 2023 Crisis

KEY MESSAGES

- **The 2023 banking turmoil had limited effects on banks in the euro area and the EU. Nevertheless, there are important lessons to be learned**
- **Business models matter. Specific banks in the US were hit, with a funding structure relying on sectorally concentrated large and related depositors**
- **Bank runs have become faster due to less sticky deposits in an internet-based banking model and social media**
- **Fragility is a feature, not a bug, of banking. There is no simple, one-size-fits-all solution to the prudential regulation of interest rate risk in the banking book**
- **Basel III allows for the implementation of several policy options without major reforms in order to emphasize supervisory intervention, such as the introduction of criteria for risk-based pricing of deposit insurance premiums**

The 2023 banking turmoil in the US and the failure of Credit Suisse were a stark reminder of the fragility of banking but also the importance of effective regulation and supervision. And while this turmoil did not affect banks in the euro area or the European Union, it would be wrong to be complacent. Even though European banks have indeed been shown to be resilient, and some of the credit for this goes to the Single Supervisory Mechanism (SSM), which has dramatically improved supervision over the past ten years, there are always lessons to be learned from bank fragility in other countries. This paper discusses some of these lessons and different policy options that have been raised to make banks safer beyond the already implemented regulatory reforms, most prominently Basel III.

BUSINESS MODELS MATTER

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The banking fragility of 2023 hit specific US banks, with business models relying on sectorally concentrated large and related depositors. While bank regulators and supervisors often focus on asset concentration, it has become clear that concentration in the funding structure can also be an important source of fragility. In addition, Silicon Valley Bank (SVB) and other failed banks had experienced rapid growth due to high deposit inflows from its client base during the pandemic (mostly tech companies). But rapid growth tends to be a good predictor of future fragility, and this also held for SVB, which invested primarily in government bonds, which in turn lost market value when interest rates increased dramatically starting in late 2021. While not reflected on its balance sheet (under the assumption of held-to-maturity), rapid deposit withdrawals forced SVB to sell these bonds at a loss, which ultimately triggered insolvency. Similarly, Credit Suisse had been suffering from risk management and governance problems for many years. The trigger in this case for rapid loss of access to funding markets was the forfeiture of confidence by a large equity investor.

This brings me to the broader point of banks' business models. The SSM has put an emphasis on banks' business models to gauge the sustainability of the banks it supervises beyond compliance with specific regulatory norms. This is a healthy approach, as lack of viability is a clear warning signal that goes beyond the compliance with (mostly static) regulatory norms.

The other important lesson to be learned is that of the application of Basel III. SVB was in the group of banks not subject to Basel III regulation after the threshold was increased in 2018, and therefore did not have to comply with Basel III liquidity ratios. Further, it was not subject to the more rigorous stress testing and supervision applied to large banks in the US. Nonetheless, supervisors had pointed out weaknesses in SVB's governance structure, including the absence of a chief risk officer, but the follow-up was insufficient as the bank's situation deteriorated.

BANK RUNS HAVE BECOME FASTER

One important lesson is that bank runs have become faster. The SVB failure highlights that sectoral concentration in funding and social networks can increase the speed of runs; in this specific case, the heavy concentration of depositors in the tech sector and the interconnectedness between them, relying on the same venture capital funder. In addition, fast retail payment systems (instant payments) and payment applications allow depositors to move funds away from a deposit account in a question of seconds and without limitations. More generally, the move from a branch-based towards an internet-only banking model has made deposits less sticky and more prone to withdrawal in times of crisis (Erel et al. 2023; Benmelech et al. 2023). Social media can also play a significant role, as shown by Cookson et al. (2023), who find that negative sentiment tweets about specific banks are associated with greater outflows of uninsured deposits in those banks in the first quarter of 2023.

INHERENT FRAGILITY

The 2023 fragility was also a reminder of the inherent fragility of banking. It is important to note that this fragility is a feature, not a bug, of banking, as liquidity and maturity transformation are at the core of banking. So, the challenge is not to eliminate the risk (which would amount to "throwing the baby out with the bathwater"), but rather to manage the corresponding risks. Drechsler et al. (2021) provide evidence that the deposit franchise provides a natural interest rate hedge: banks finance a part of their activities with deposits that pay interest rates that are lower and react significantly less than one-to-one with reference market rates, which constitutes a hedge against the impact of interest rate fluctuations on the rest of their balance sheet. However, this hedge is likely to break down in the worst possible moment, as the bank failures witnessed in the US in early 2023 clearly illustrate.

The optimal prudential treatment of interest rate risk might therefore interact with banks' funding structure. Suarez (2023) shows that the minimum equity buffers required for banks to remain solvent when interest rates unexpectedly spike decrease with the importance and stability of the deposit franchise. Thus, the more stable the deposit base of a bank and the less likely depositors are to withdraw, the lower the minimum capital required to ensure a bank's solvency even in an adverse interest rate scenario.

There is thus no simple, one-size-fits-all solution to the prudential regulation of interest rate risk in the banking book, with the preferred prudential measure as well as its detailed calibration depending on the value of the bank's deposit franchise, the stickiness of its deposits, the cost of increasing loss absorbing capacity, and the term premium earned on long-term assets. The treatment of interest rate risk under Pillar 2 is thus preferable to a one-size-fits-all approach under Pillar 1.

RESOLUTION AND RECOVERY

The banking fragility of 2023 has also reminded us that the way bank failures are managed rarely corresponds to what was planned and announced ex ante. While SVB was initially sent into liquidation and uninsured depositors were not reimbursed, a systemic risk exception was later applied to compensate uninsured depositors. And while there was a resolution plan in place for Credit Suisse, it was not followed; rather, Credit Suisse was forced into a shotgun merger with UBS, and with the support of the Swiss government, creating an even larger too-big-to-fail financial institution.

Given the absence of bank failures in the EU during the 2023 turmoil, the resolution framework (most prominently within the euro area) was not put to the test. But it is safe to say that if an institution the size of SVB, not to mention Credit Suisse, had turned out to be fragile and required intervention, it would most likely have failed the test. The options and conditions for resolving banks within the euro area are currently very restrictive, and the effective baseline assumption is that of precautionary recapitalization by national governments, as in several previous cases. While a recent reform package (CMDI) has proposed strengthening options for resolution in the EU, it is not clear whether the ultimate legislation will fulfill these ambitions.

In the absence of a strong and effective resolution framework, more emphasis on recovery options is needed, i.e., supervisory interventions before a bank is about to fail. This includes enhancing the capacity to recapitalize banks on an ongoing basis, i.e., before resolution or liquidation becomes necessary. Contingent Convertible (CoCo) bonds enable capital to be raised in times of stress when other options are impossible, either owing to unfavorable market conditions or because they are unattractive to shareholders (Pazarbasioglu et al. 2011).

In the EU, banks issue CoCo bonds as AT1 instruments, which, depending on their design, may absorb losses or be fully or partially converted into equity. However, conversion relies mostly on a book equity trigger, usually set by CoCo issuers at a very low level (most often at 7 percent of CET1 to risk-weighted assets, considering that the minimum regulatory level is 5.125 percent), which in practice means that conversion would be triggered when the bank is already insolvent.

Activating the conversion of CoCo bonds by a regulatory trigger upon a proper stress test assessment, by a higher trigger based on risk-weighted assets, or by a trigger determined by market prices, could increase the usefulness of CoCo bonds during episodes of banking stress (Calomiris and Herring 2013) and might work best in combination with measures to contain run incentives, such as contingent charges on uninsured outflows or enhanced liquidity backstops (Perotti and Martino 2024).

MORE RADICAL REFORM PROPOSALS

There are other more radical options, some of which have been discussed previously, meant to address the underlying fragility of banking (Beck et al. 2024). Most of these proposals seem not only impractical, at least in the short run, but would involve major changes to the current concept of banking.

Narrow banking proposals are usually brought to the fore after banking crises and vary from subjecting banks to a 100 percent reserve requirement to milder forms equivalent to imposing stricter versions of existing liquidity requirements. A related proposal is to require banks to have their uninsured deposit funding fully backed (after applying appropriate haircuts) by collateral prepositioned at a central bank discount facility, a proposal first formulated as the “Pawnbroker for All Seasons” by King (2016). However, this would imply that the collateral framework of central banks plays a central role in determining the provision of bank credit to the economy and might lead to conflicts with the price and financial stability objectives of central banks.

Another proposal aims at imposing temporary redemption charges upon uninsured deposit outflows, thus targeting incentives to withdraw at par and directly reducing run incentives (Perotti and Martino 2024). Critically, such charges may also shift expectations about further withdrawals by others, avoiding an escalation driven by fear of dilution rather than solvency concerns. Measures that discourage or slow down bank runs would buy time and reduce supervisory concerns about triggering unstoppable runs by activating timely recovery measures.

However, departing from the par value conversion of uninsured deposits would imply a fundamental change in the nature of bank deposits as a money-like instrument. In addition, very high charges may be needed to affect run incentives, and tightening convertibility conditions for uninsured deposits may simply not stop the outflows if the depositor is asked to choose between paying a fee and losing access to his entire deposit in the event of the failure of the bank.

A final proposal is to extend deposit insurance to all deposits, regardless of their size (Heider et al. 2023), in order to avoid bank runs.[1] However, extending deposit insurance to all deposits will further increase the volume of large deposit accounts on bank balance sheets (attracting funds now outside the banking system), thus removing any incentives for their holders to consider the stability and risk profile of their chosen banks. However, competition for such funding by riskier banks is also likely to destabilize more prudent banks and encourage them to increase their risk-taking. Finally, a significant extension of deposit coverage is likely to increase the opposition to creating a common deposit insurance scheme in the euro area, as it would raise the concerns about the socialization of losses due to excessive risk-taking.

LOOKING FORWARD, BEYOND THE CRISIS

While European banks have shown resilience in 2023, their price-to-book ratios are still below one, pointing to investor pessimism about the long-term profitability of European banks. The difference between European and US banks can be explained by different factors, including the more favorable macroeconomic growth prospects for the US.

[1] The argument by Heider et al. (2023) focuses on the disciplinary effect that TLAC/MREL have on banks’ risk-taking incentives. If market discipline via TLAC/MREL works, an increase in large deposits and more risk-taking would come with costs, like higher interest rates on MREL bonds.

One important element is the lack of a European single market in banking. The completion of the banking union with an effective resolution framework and a European deposit insurance system is a necessary but not sufficient condition for the creation of such a single market. We will only have arrived at a single market in banking when we no longer refer to French, German, or Italian banks (or champions), but to European banks. The main barrier to both the completing of the banking union and a truly European banking market is national politics. Unless national governments are willing to take a backseat when it comes to their banking systems, limited progress seems feasible.

Stronger capital markets are also an important ingredient of a more effective European banking system. A thriving single capital market can help banks by allowing them to raise funds more easily, securitize assets, and sell off non-performing assets, as well as enable an easier resolution and exit process for failing banks. Ultimately, a strong European banking system, where large banks are no longer tied to specific sovereigns, and a single capital market can not only provide the necessary efficiency and scale for financial service provision in Europe, but also reduce dependency on large US investment banks.

POLICY CONCLUSIONS

The 2023 banking turmoil had limited effects on banks in the euro area and the EU. Nevertheless, there are important lessons to be learned. Effective regulation and supervision is a moving target, adjusting to changing circumstances and banks’ business models. There are several incremental policy changes that can provide supervisors with the necessary data and tools to strengthen the resilience of the European banking system, even without major reforms.

A forthcoming report by the ESRB’s Advisory Scientific Committee discusses some of the policy options that have been put forward in the aftermath of the 2023 turmoil (Beck et al. 2024). These include:

- amending the supervisory reporting framework to provide clearer information on the structure of banks’ deposit funding (mostly by implementing regular weekly reporting for the largest banks and further granularity in the concentration of funding by business sector) and complementing accounting-based information with market-based information in the (confidential) supervisory assessment of banks.
- revising the assumptions on the run-off rates of uninsured deposits that underpin the computation of the liquidity coverage ratio (LCR); while the LCR is not designed to cover all tail events, including bank runs, the higher speed with which liquidity stress has unfolded recently calls for a review of these outflow assumptions.

– including criteria for risk-based pricing of deposit insurance premiums, related to depositor concentration or the share of uninsured deposits; deposit insurance premiums do not only have the function of accumulating reserves for depositor payouts in the case of failure or resolution, but also impact risk-taking incentives by aligning premiums with bank-specific risk.

These policy options could be implemented without major structural changes to the current regulatory and supervisory framework and within the margins of discretion of Basel III.

The question of a profitable banking system that can support economic and societal transition processes, however, can only be addressed through the creation of a single market for banking and the establishment of a capital market union, steps for which there seems to be limited political support at the moment.

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The Impact of Working from Home on the German Office Real Estate Market*

KEY MESSAGES

- **A quarter of the workforce regularly works from home, oftentimes blending office and remote work**
- **The office market is undergoing a stress test, with challenging conditions expected to persist**
- **The permanent shift toward working from home (WFH) is expected to decrease long-term office space demand by around 12 percent**
- **In industries with high WFH rates, new office leases show a flight to quality with higher rents**
- **An office building's ability to meet the growing "new work" demands is now a key leasing factor**

"Return to the office!" – This call from major companies like Amazon, Google, and Zoom has sparked widespread attention. In Germany, corporations such as SAP and VW are also placing renewed emphasis on in-person collaboration among employees. Since the pandemic, working from home (WFH) seems to have become deeply ingrained in the modern work culture. Indeed, survey data from the ifo Institute reveals that over the past two years, a quarter of all employees have regularly worked remotely. This tension between the stabilization and the rollback of WFH practices calls for careful examination and context.

As work models evolve, many desks in corporate offices remain empty, at least on certain weekdays. The trend toward WFH is driving plans to downsize office space, leading to price corrections, more subletting, and rising vacancy rates. Recently, The Economist (2024) even cautioned about the potential risk of a new financial crisis stemming from the impact of remote work on US commercial real estate. There are thus many indications that WFH could present a long-term headwind for the office market.

The surge of hybrid work models raises key questions about the future of corporate offices. Where is the working world headed regarding WFH, what size office spaces will be required in the future, and how does the purpose of the office change? The answers to these questions are of particular importance for the current discussions about WFH and the challenges on the real estate market.

In this study, we examine WFH trends and their impact on the office real estate market across Germany's top seven cities: Berlin, Hamburg, Munich, Cologne, Frankfurt am Main, Stuttgart, and Düsseldorf. For the first time, we integrate data from the ifo Institute's WFH surveys with the office market database of the real estate consultancy Colliers. This unique combination enables us not only to track the aggregate development of WFH and the office market, but also to capture the effects of WFH on office real estate at the industry level.

In the first part of our study, we assess the current state of the German office real estate market, which is facing an unprecedented stress test in a challenging economic environment. Rental market activity has plummeted to levels seen during the Covid crisis, coupled with rising vacancy rates, and there is little indication of a swift recovery on the horizon.

The second part of the study focuses on the impact of WFH. Amid the push and pull between establishing WFH and returning to the office, the trend is moving toward better coordination between in-person work and remote work. In most office-based industries, this shift leads to structured hybrid working models with designated in-office days but not a return to the pre-Covid norm of five-day in-office workweeks. Regular remote work has thus become a fundamental aspect of the new work environment.

As WFH becomes more prevalent, office occupancy rates are dropping, leading many companies to plan for reduced office space. Our conceptual forecasting model estimates an approximately 12 percent long-term demand reduction by 2030, equivalent to 11.5

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million m² of office space across the top seven cities, assuming office employment remains steady.

The WFH impact is already evident in the short term through increased subletting, which has now quadrupled to over 8 percent. The full effect will only be seen in the long term through a structural decline in demand for space. Importantly, industries with higher levels of WFH adoption show decreased office space needs but increasing rents. This rise in rents is driven by a preference for newer, centrally located offices, coupled with inflation and construction costs.

Hybrid work is transforming offices into hubs for collaboration and creativity. Based on structured expert interviews, we find that the "new work" capability of office buildings is increasingly becoming a critical factor in firms' leasing decisions. Our analyses do not indicate significant changes in location preferences, with central locations remaining in high demand.

SAMPLE, DATA AND METHODOLOGY

Our study analyzes the office real estate market in major German cities. In addition to the general market development, we pay particular attention to the effects of the rapidly changing economic and working world on the office market. The sample includes the seven largest office centers – Berlin, Hamburg, Munich, Cologne, Frankfurt am Main, Stuttgart, and Düsseldorf – between 2013 and 2023. In some cities, we also look at the wider metropolitan region with the immediate vicinity of the cities. In Munich, this includes the districts of Munich, Dachau, Ebersberg, Erding, Freising, Fürstenfeldbruck, and Starnberg. In Frankfurt am Main, we also include Eschborn and Offenbach; in the Stuttgart metropolitan region, the district of Esslingen in addition to Leinfelden-Echterdingen; and around Düsseldorf, the district of Mettmann and the Rhine district of Neuss.[1] For the empirical studies, we combine an extensive database on WFH and office properties in these cities.

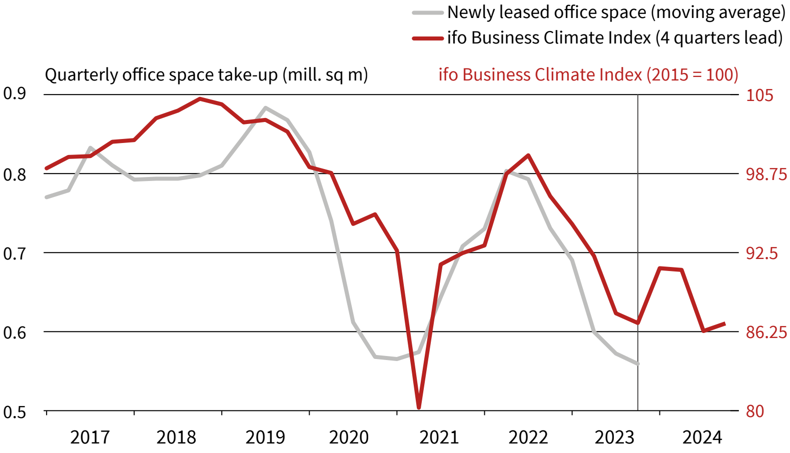
The first data set used is the office market database of the real estate consultancy Colliers, which records more than 35,000 leases of office space for the period under review. This transaction data provides a very comprehensive picture of market activity in the top seven cities, as the data includes not only the office leases supported by Colliers itself, but also all lease agreements known on the market.[2] The entries in the database provide detailed information about each rental deal, including size, rent, quality, location, and industry. Compared to the listing data used in other analyses, the two major advantages of

[1] The market areas covered deviate from the typical definition in Colliers market reports, because in some cities, they also include the wider metropolitan area with the surrounding counties.

[2] In the years 2013 to 2017, there were individual gaps in the market coverage of Hamburg and Cologne, while in the later years the market activity there was monitored just as comprehensively as in the other cities.

Figure 1

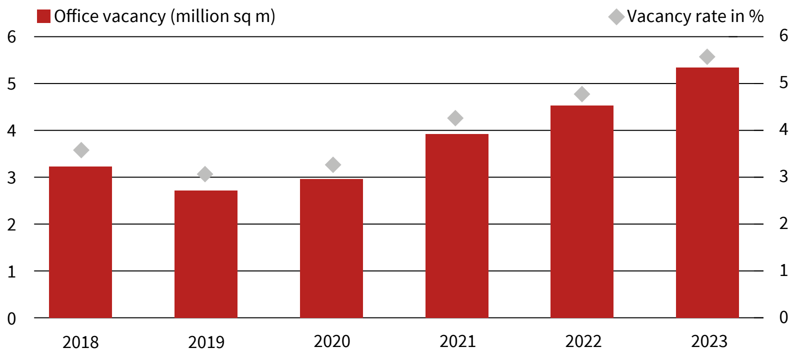
Development of Office Leasing Volume and ifo Business Climate Index



Source: Colliers; authors' calculations. © ifo Institute

Figure 2

Development of Office Vacancy and Vacancy Rates in Germany's Top 7 Cities (Annual Average)



Source: Colliers; authors' calculations. © ifo Institute

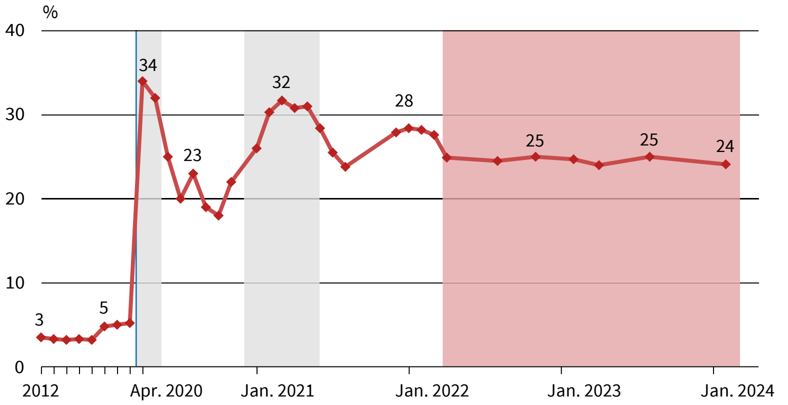
transactional data are that it captures actual lease data and provides information about the industry of tenant companies. For the empirical investigations, the raw data from Colliers is processed so that only observations with existing entries for rent and space are included in the analysis sample. In addition to transaction data, Colliers' office market database includes location-based data on office space inventory and vacancy.

Second, our study is based on extensive and representative survey data from the ifo Institute on the use of WFH in companies. As part of the survey waves, various special questions were asked in April, August, and October 2023 on the topic of WFH and office use.

Third, in addition to the quantitative analysis, a qualitative survey was conducted at the real estate consultancy firm Colliers. The aim of this qualitative survey was to understand the changing user requirements for office space based on selected reference objects. The results were collected in November 2023 through 44 in-house expert interviews in all seven cities. The consultants from the office leasing sector were interviewed in a structured manner about leases they had supported, if they took place between 2018

Figure 3

Work-from-home Rate of Employees in Germany 2012–2024



Note: The blue line marks the outbreak of the Covid-19 pandemic in March 2020, the shaded gray areas highlight lockdown periods, and the shaded pink area marks the post-pandemic period since April 2022.
Source: Eurostat (2012–2019); infas360 (2020–2021); ifo Business Surveys; calculations by the ifo Institute (2021–2024).

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and 2023, had a minimum size of 2,000 square meters of office space, and were in a modern office building.

DEVELOPMENT OF THE OFFICE REAL ESTATE MARKET

In the first section, this study offers a comprehensive overview of the current state of the German office real estate market, focusing on two key indicators: demand for space and vacancy rates.

The office property market in Germany's major cities has enjoyed years of steady growth. The gray line in Figure 1 shows the development of office leasing in the top seven cities from 2017 to 2023. In each of the years from 2017 to 2019, a quarterly take-up of more than 0.8 million m^2 was achieved.[3] This pre-pandemic period was characterized by robust economic development, low inflation rates, and low interest rates. The outbreak of the Covid pandemic in 2020 led to an abrupt slump in demand for space. After the pandemic-related decline, take-up of office space recovered in 2021 and 2022, but without returning to pre-crisis levels. Data from the year 2023 indicates a substantial market cooling. Leasing volumes in the top seven cities have fallen back to levels seen during the height of the Covid crisis in 2020. The reasons for this downturn are multifaceted, involving macroeconomic factors like the recession and rising interest rates, alongside regional issues such as structural shifts within cities. A key structural factor is the rapidly evolving work environment, which will be explored in detail in the second part of this analysis.

In the past, the development of the office property market was strongly correlated with the ifo Business Climate Index, as depicted by the red line in Figure 1. While historical trends are not always predictive of the future, the current index values provide a useful outlook. According to the ifo Business Climate Index, which is aggregated quarterly and adjusted with a one-year lag, a swift recovery in the office market seems unlikely.

The decreasing demand for office space is accompanied by rising vacancies in the top seven cities from 2018 to 2023. The analysis in Figure 2 reveals that vacancies increased from an annual average of around 2.7 million m^2 in 2019 to over 5.8 million m^2 in the last quarter of 2023. During this period, the vacancy rate doubled from an annual average of less than 3 percent in 2019 to around 6.1 percent in the last quarter of 2023. The largest increases in vacancy rates were observed in Berlin and Munich, although starting from a low level. Older office buildings are particularly affected by vacancies, indicating a market segmentation. While demand for high-quality, modern office spaces has driven prime rents higher, conventional office properties are experiencing higher vacancy rates as demand for them declines. This suggests that the broader market faces significant challenges, while the premium office market remains strong.

IMPACT OF HYBRID WORKING ON THE OFFICE MARKET

In the second part of our analysis, we explore the impact of the evolving work landscape on the office real estate market. The rise of WFH, a key aspect of the "new work" trend, has sparked debates about the future of office spaces. Enabled by digitalization and accelerated by the pandemic, this shift allows for more flexible work locations, alters office requirements, and likely reduces the demand for space. Our analysis breaks down these developments and their implications for the office market.

[3] The negative deviation of the take-up volume in our analysis compared to the Colliers market reports is a result of extensive data cleansing and our different market area layout.

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Work from Home or Return to the Office – Where Are We Headed?

Remote work in Germany has increased significantly and permanently since the pandemic. Figure 3 shows the development of the WFH rate in Germany from 2012 to the present, i. e., the proportion of employees who work at least partially from home.[4] The pandemic forced many organizations to experiment with WFH at short notice. While the WFH rate was only about 5 percent before Covid, up to 34 percent of employees worked from home during the pandemic lockdowns. Since April 2022, the WFH rate has remained constant at around 25 percent – a remarkable stabilization over a two-year period. WFH encompasses two different working models. The most common model, with 17 percent of employees, is hybrid working, which blends face-to-face and remote work. Only about 7 percent work exclusively from home (Federal Statistical Office 2023). Although most employees are still working entirely on-site, these figures show how established the new working models with the option to WFH have become. The ifo Business Survey (Aug. 2023) provides additional insights: Currently, 69 percent of companies offer WFH and have established agreements. Among large companies, which account for most occupied office space, the figure is as high as 87 percent. The WFH rules include company agreements (34 percent), divisional or team-level arrangements (15 percent), and individual agreements (29 percent). The remaining 31 percent of companies have no regulation or no WFH.

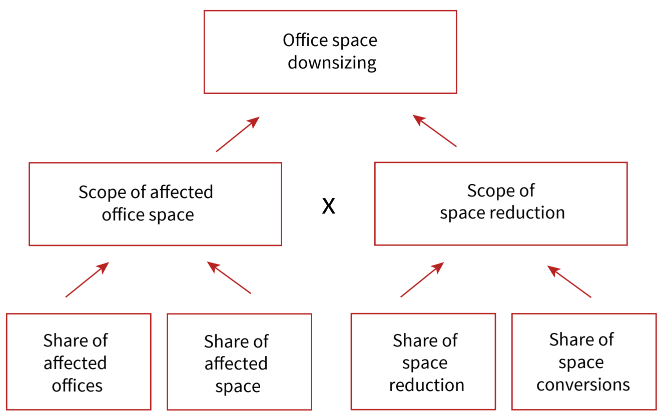
Whether or not one can work remotely varies based on job requirements, organizational needs, and personal preferences. WFH is most prevalent in computer-based office roles, and its likelihood increases with higher education, income, and urbanization (Alipour et al. 2023). This means that highly skilled office workers in service industries, such as IT, management consulting, finance, and public administration, are the primary drivers of WFH and its impact on the office market. Peak WFH rates in these industries reach up to 70 percent. Conversely, WFH is less common in manufacturing, hospitality, logistics, and construction (ifo Institute 2023; Federal Statistical Office 2023).

Employees favor WFH for its flexibility and reduced commuting, valuing it as much as an 8 percent pay raise, which boosts satisfaction and lowers turnover (Bloom et al. 2015 and 2024; Mas and Pallais 2017; Nagler et al. 2024). However, many employers worry that long-term WFH could hinder productivity and innovation. A survey of German CEOs found that 68 percent prefer a full return to the office, while only 5 percent of employees wish to return daily, and 35 percent want permanent WFH (KPMG 2023; PwC 2022).

Currently, there's a tension between WFH becoming established and the push to limit it. The ifo Business Survey (Aug. 2023) reveals that 84 percent of companies plan to maintain their WFH policies, while only 8 percent seek to limit them. The media coverage of companies recalling employees to the office doesn't signal a full return to pre-pandemic norms. For instance, Zoom now requires two days in-office for nearby employees, SAP three days, and Volkswagen four. These examples show that firms are refining hybrid work models, not eliminating WFH. The future of WFH is more about "how" than "if."

The trend is towards structured hybrid work, which blends set in-office days with WFH flexibility on the remaining days. Research supports this model as it balances company and employee needs (Bloom et al. 2022; Choudhury et al. 2024; Krause 2023). Creative collaboration and meetings occur during joint office days, while WFH days are reserved for focused work. In the structured hybrid work model, employees still enjoy flexibility and reduced commutes, while companies benefit from stable productivity and improved retention. The ifo Business Survey (Dec. 2023) shows Friday as the most popular WFH day (55 per-

Figure 4
Model of the Long-term WFH Effect on Demand for Office Space



Source: Authors' presentation. © ifo Institute

Figure 5
Forecast Scenarios of the Long-term WFH Effect on Demand for Office Space

	Scenario 1: Minor office downsizing	Scenario 2: Likely office downsizing	Scenario 3: Major office downsizing
Scope of affected office space	40 %	60 %	80 %
Scope of space reduction	10 %	20 %	30 %
Total office space downsizing	= 4 %	= 12 %	= 24 %

Source: Authors' calculations. © ifo Institute

[4] To determine the development of the home office rate in Germany, we combine data from Eurostat (2012–2019) as well as monthly surveys from infas360 (2020–2021), and the ifo Institute (2021–2023). A uniform time series from an administrative source with information on the development during the year up to the current margin is not available. The Federal Statistical Office (2023) calculates a higher home office rate of around 10 percent for the years before the pandemic, while the figures for 2021 and 2022 are congruent with the results of the ifo Business Survey at around 24 percent.

cent), followed by Monday (35 percent), with in-office attendance peaking mid-week, which is consistent with the adoption of structured hybrid work in many organizations.

Reduced Office Occupancy and Plans to Downsize

The increasing flexibility in the world of work is directly impacting the office market. In Germany, around a third of the 45 million employees work in offices, with this figure rising to over 40 percent in the top seven cities (Hammermann and Voigtländer 2020). The adoption of hybrid working models has significantly lowered office occupancy. According to the ifo Business Survey in April 2023, there are now three times more empty desks on-site due to WFH than before the pandemic. In sectors like IT, advertising, management consulting, and pharmaceuticals, this affects up to 40 percent of jobs. This indicates that German offices are now permanently less occupied post-pandemic.

Additionally, reduced occupancy is leading companies, particularly larger ones with hybrid models, to downsize their office spaces to cut costs. The ifo Business Survey (Aug. 2023) reveals that one in eleven companies, and one in four large companies, plan to reduce their office space. In some industries, such as automotive (38 percent), broadcasting (40 percent), IT (21 percent), and advertising (35 percent), these figures are even higher. Since these numbers don't fully account for ongoing and future adjustments, the overall impact on office space demand will likely be greater.

When examining the link between unoccupied desks and plans to downsize offices due to WFH, we find that industries with more underutilized on-site workspaces have a higher proportion of companies planning to reduce their office space. The order of magnitude seems plausible: with 20 percent of unoccupied on-site workplaces, about 15 percent of companies plan to downsize.

How Much Less Office Space Is Required Because of Hybrid Working?

Analyzing the impact of WFH on the office market requires a look at both short- and long-term factors. Initially, there was uncertainty about the future of office work after the pandemic, complicated by the long-term nature of office leases, which typically last about seven years. With around 15 percent of contracts renewed annually, the effect of work models will only materialize over time. Affected companies are expected to adjust their office space needs during lease renegotiations, with some opting for immediate changes through subleasing unused space.

To estimate the long-term effect of WFH, we present a conceptual forecasting model, acknowledging the inherent uncertainties. Our model assumes that most companies and public organizations will adopt structured hybrid work models while maintaining their current number of office employees. The reduction in office space will depend on the degree to which companies adopt hybrid models and the corresponding decrease in space requirements. The overall impact is calculated by multiplying the proportion of companies offering WFH by the percentage of office space they no longer need, accounting for both savings and potential repurposing of current office space.

Figures 4 and 5 illustrate our scenarios, providing a simplified yet valuable insight into how hybrid work could reshape office space demand over time. The forecast estimates that approximately 60 percent of total office space will be impacted by hybrid work models, with an average reduction of 20 percent in space usage. The 60 percent impact reflects the share of corporate office occupiers adopting hybrid work multiplied with the extent of their office spaces that are affected by this shift. We anticipate that 80 percent of occupied office space is affected, which are primarily large companies with a high prevalence of WFH. In their offices, about 75 percent of the space will be affected by hybrid work, considering that areas like receptions or restrooms won't change. The 20 percent average space reduction constitutes the net effect of savings and conversion. Savings of 20–30 percent can be achieved by introducing desk sharing, although the downsizing is limited by the peak office occupancy on coordinated attendance days. Simultaneously, up to 10 percent of office space might be repurposed into new common areas or meeting rooms, slightly offsetting the overall reduction. Beyond this most likely scenario, we also model a minimal reduction of 4 percent, assuming a 40 percent impact on office space and a 10 percent reduction. Conversely, a significant downsizing of 24 percent is possible if 80 percent of office space is affected and reduced by 30 percent.

Our model projects a long-term reduction in office space due to WFH ranging from 4 percent to 24 percent, with a likely average of around 12 percent. This translates to a reduction of approximately 11.5 million m² out of the 96 million m² of office space in the top seven cities. Compared to Pink and Wecke's (2023) estimate of a 2 percent to 15 percent reduction, our forecast is slightly on the higher end. The reduction will manifest both in the short term through increased subletting and in the long term through sustained lower demand. With only 15 percent of leases renewed annually, this implies an average annual decline of about 1.8 percent over seven years. This gradual decrease signals a "rolling" crisis for the rental market, while the investment market will likely adjust more swiftly to the anticipated lower demand. Overall, the office market is facing a significant stress test.

WFH Effect on Subletting, Demand for Space and Rents

The empirical analysis of office leasing data reveals that the share of subleases in the total rental volume, measured as a moving average over the last four quarters, has increased significantly. This share has almost quadrupled, from less than 2 percent before the pandemic to 8 percent today. It should be noted, however, that there was already a slight increase before Covid. This suggests that sublease space has different economic backgrounds, including but not solely the trend towards hybrid working. In addition, the latest increase has occurred at a time when the leasing volume declined. Still, the surge in subleasing since the pandemic can largely be attributed to the impact of WFH.

In our analysis, we combined ifo survey data on WFH with Colliers office rental data, allowing us to explore statistical relationships at the industry level between increased WFH, office space demand, and rents for the first time. While these correlations don't establish causality, they offer valuable insights. We examined changes across industries from 2019 to 2023, revealing key trends.

Figure 6 shows a significant negative correlation between the rise in WFH rates and the average demand for office space: industries with higher WFH adoption saw a greater decline in office space demand. This pattern remains consistent even when considering the increase in unoccupied local jobs or the total demand for office space instead of the average area.

Figure 7 depicts a positive correlation between WFH growth and rising average rents per square meter across industries. This suggests a potential "flight to quality," where companies are opting for smaller but higher-quality and more expensive office spaces. Alternatively, it may reflect companies reducing their overall space but willing to pay more per square meter, thereby still saving on total rental costs.

Changing Requirements for Offices

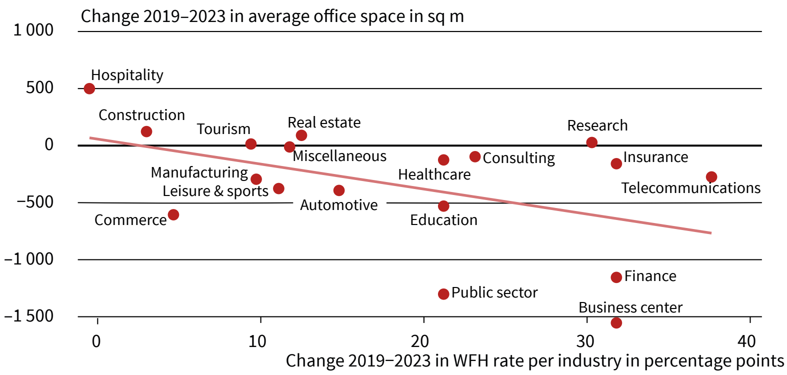
The transformation of work is reshaping the role of the office, shifting it from a purely functional workspace to a hub for personal interaction. This "new work" trend is evident in the move away from traditional individual offices toward more flexible group and open-plan spaces, with enhanced communication zones, dedicated meeting rooms, and breakout areas. While desk sharing reduces the number of desks, it is often accompanied by extending the areas designed for informal exchanges.

A qualitative analysis of rental criteria in Figure 8 highlights the growing significance of "new work" capabilities in office buildings, especially in the context of hybrid work models. The data show that the importance of office space supporting these new communication and work structures has surged from 6 percent to 33 percent, making it a critical factor in firms' decision-making about office spaces.

Flexible usage concepts and office layouts with expanded communication zones have gained importance since the Covid pandemic. However, more flexibility doesn't always lead to space savings: 16 percent of surveyed properties maintain a 100 percent occupancy rate despite offering WFH options. The preference for open-plan offices and shared workspaces now surpasses that for group or smaller offices, emphasizing the need for collaboration zones in hybrid work environments. At the same time, the importance of quiet zones has doubled, reflecting a growing demand for diverse spaces in modern offices.

Figure 6

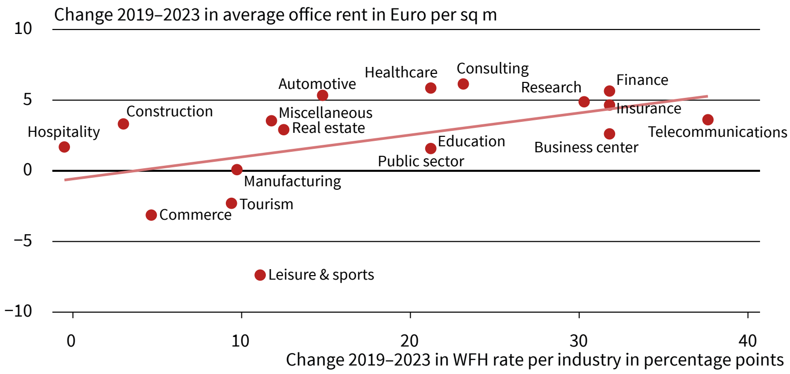
Development of Demand for Office Space and WFH in Sectors



Source: Colliers; calculations by the ifo Institute. © ifo Institute

Figure 7

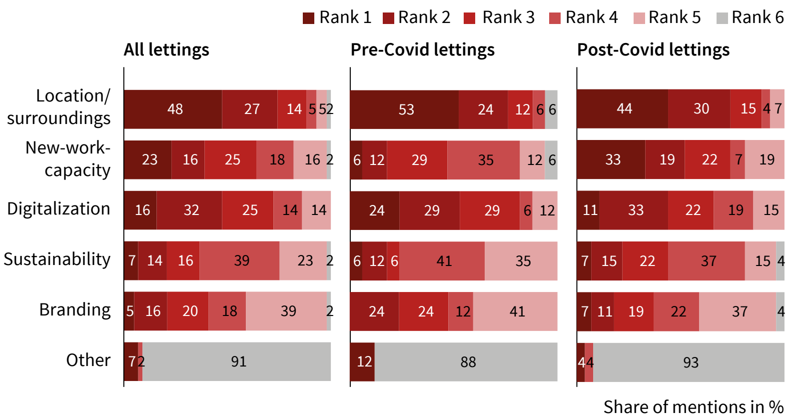
Development of Office Rents and WFH in Sectors



Source: Colliers; calculations by the ifo Institute. © ifo Institute

Figure 8

Change in the Leasing Criteria of Office Buildings



Note: Rank 1 = Criterion with the highest relevance for leasing decision. Rank 6 = Criterion with the lowest relevance fo leasing decision.
Source: Colliers; calculations by Colliers. © ifo Institute

How Are Location Preferences Changing?

Another possible impact of the new working models on the office market is changing location preferences. On the one hand, one could assume that the decline in office use is particularly burdensome in city centers, which have a high density of offices and suffer from lower retail sales due to working from home (Alipour et al. 2022). On the other hand, the importance of central locations for the reduced office days may have increased.

The analysis reveals that office rents since the pandemic have increased across city centers, convenient locations, and surrounding areas. Unlike residential real estate, there is no "donut" effect; instead, central locations remain in high demand despite higher rents. This suggests that centrally located offices might constitute an incentive for employees to work on-site. Anecdotal evidence from expert interviews further support this, showing a growing preference for central, well-located offices that cater to employee needs.

POLICY CONCLUSIONS

What implications does our study have for the future of WFH and the office real estate market?

First, the evolving dynamic between the stabilization and rollback of WFH shows a trend towards structured hybrid work models. These models feature coordinated in-office days blended with flexible days at home, contrasting with the pre-Covid standard of five days per week in the office. This work arrangement facilitates a balance between face-to-face collaboration and location-independent working.

Second, the function of the office transitions to a hub for interaction, maintaining its role as a central space for collaboration, creativity, and corporate culture. The increasing importance of "new work" capabilities in office buildings highlights growing demands on the office environment, significantly influencing leasing decisions.

Third, WFH has profoundly impacted the office market, presenting long-term challenges for both the rental and investment market. We anticipate a rise in vacancy rates and subletting as immediate responses, with re-leasing challenges and refinancing pressures manifesting over several years due to the lengthy terms of many leases. This "rolling" crisis suggests a need for office property owners and project developers to adapt to evolving market demands. The recent insolvencies of 48 office project developments in the top seven cities with a total area of almost one million m2 and an investment volume of over EUR 6 billion illustrate the scope of this stress test (Colliers 2024a).

Fourth, the decline in demand exacerbated by WFH is likely to widen the segmentation in the office market. Modern offices that accommodate new work styles are in demand, while older buildings face numerous challenges, including the adaptability to new work models and increasing ESG standards. About two-thirds of all office properties risk becoming obsolete or "stranded assets" without necessary modernizations (Colliers 2023). In comparison, the WFH effect seems small, but it exacerbates this problem.

Fifth, the financial stability of investors and banks with significant stakes in commercial real estate is at risk due to increased refinancing costs and demand declines from WFH. This risk is compounded in the US, where the commercial real estate market is acutely affected by WFH, raising concerns of a potential financial crisis (The Economist 2024). Although the losses may lead to individual forced sales and insolvencies, office properties account for only a small single-digit share of total real estate assets in Germany and the loan-to-value ratios in Germany are typically lower than in the US. Nevertheless, there is a high debt refinancing gap in the coming years, especially for office properties, which can be estimated at up to EUR 18 billion (Colliers 2024b).

Sixth, converting obsolete office space into residential units is a popular proposal to alleviate housing shortages. However, practical challenges make this solution complex and costly, with conversions often resulting in luxury rather than affordable housing. A study from the United States shows that only about 10 percent of office buildings could be converted considering technical, economic, and regulatory factors (Gupta et al. 2023). If a conversion takes place, the new residential spaces tend to be luxury apartments rather than affordable housing due to high construction costs.

Finally, despite the shift towards WFH, central urban locations continue to attract office tenants. The inherent advantages of city centers, such as agglomeration effects that are crucial for innovation and productivity, ensure their continued desirability and provide compelling reasons for employees to work in the office.

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