

Online Magazin IAB-Forum

Investment tax incentives can boost employment

9. December 2025 | Adrian Lerche



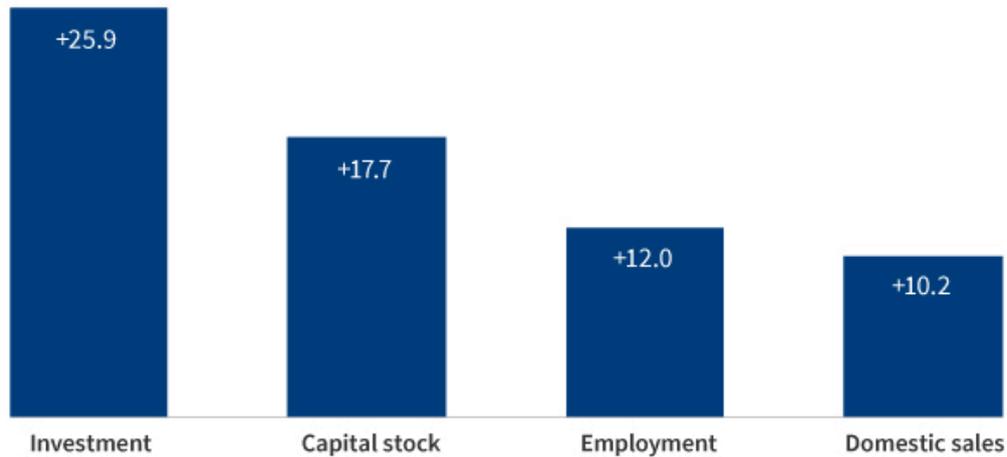
When firms face lower investment costs, it not only encourages them to purchase new machinery and equipment but also helps secure and create jobs. An analysis of the German investment tax credit programme shows that this policy provided an important boost to the economy in the former East Germany after reunification.

Do tax incentives that reduce the cost of new machinery and equipment create economic growth?
And how do such incentives affect employment?

An evaluation of the German investment tax credit programme (Investitionszulagengesetz), introduced in 1991 after reunification, offers useful insights. A 1999 policy change granted smaller firms in the East German manufacturing sector a greater increase in tax incentives than larger firms: On average, small firms received a 15.6 percent reduction on their investment cost while large firms received only an 8.0 percent reduction.

What are the effects of investment tax incentives on firms' production decisions? An impact analysis of the German investment tax credit programme (Investitionszulagengesetz)

Average changes from the pre- to post-reform period¹⁾ for smaller firms²⁾ (which benefitted more from the programme), relative to those for larger firms, in percent



¹⁾ The post-reform period 1999-2004 is compared with the pre-reform period 1995-1998.

²⁾ Firms with up to 250 employees in the manufacturing sector in the former East Germany.

Note: The sample includes East German manufacturing firms (excluding those in Berlin) that were active throughout the sample period 1995 to 2004 and employed between 40 and 1,500 workers in 1998. Changes of small and large firms explained by their federal state and their industry affiliation have been factored out.

Source: AFID Panel of industrial establishments and Survey of cost structure (AFID-Panel Industriebetriebe und Kostenstrukturerhebung) of the German Federal Statistical Office, own calculations. Graphic: IAB

Following this change, smaller firms improved economically relative to larger ones. The figure shows that their investments rose by nearly 26 percent more than for larger firms, and their capital stock grew by almost 18 percent more.

These investment effects also translated into more jobs: smaller firms expanded their workforce by 12 percent relative to larger firms. Thus, the common concern that such incentives might encourage firms to replace workers with machines did not materialise. A likely reason is that the positive production effect on firms' sales (see figure) created additional demand for workers, thereby counteracting any labour-reducing effects of new machinery.

In addition to these direct effects of reduced investment costs, the analysis reveals positive spillovers: through local production linkages, connected firms also expanded their production, thereby multiplying the local employment effect. At the same time, the analysis does not find any significant relocation of production from western to eastern German firms during this period.

Conclusion

Overall, the findings suggest that investment tax incentives gave a meaningful boost to the economy in the former East Germany – at least in the medium term. In light of today’s concerns about the weak economy in Germany, such incentives could again serve as a useful policy tool to stimulate growth and job creation.

References

Lerche, Adrian (2025): [Direct and Indirect Effects of Investment Tax Incentives](#). American Economic Review, Vol. 115, No. 8, pp. 2781–2818.

picture: Arthon/stock.adobe.com

DOI: [10.48720/IAB.FOO.20251209.01](https://doi.org/10.48720/IAB.FOO.20251209.01)

Cite article

Lerche, Adrian (2025): Investment tax incentives can boost employment, In: IAB-Forum 9th of December 2025, <https://iab-forum.de/en/investment-tax-incentives-can-boost-employment/>, Retrieved: 22nd of May 2026

Zitationshinweis

Adrian Lerche (2025): Investment tax incentives can boost employment , In: Online Magazin IAB-Forum 9. December 2025, <https://iab-forum.de/en/investment-tax-incentives-can-boost-employment/>, Abrufdatum: 22. May 2026

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