

## **The Ifo Viewpoints 2005**

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### **Reward Childrearing in the Pension System!\***

In relation to its population Germany has fewer children than any other developed country. While economic stagnation and the pension crisis are among the consequences of this development, the pension system itself may be among its causes. The pension system itself may have contributed to the demographic crisis from which it now suffers.

Pension insurance is insurance against childlessness. Even those who are unable to have children need not hunger when old because they will be fed by the children of other people. This insurance coverage is a great advantage for all participants. Its problem, however, is that it weakens the economic incentives for having children in family planning by almost completely socialising the children's contributions to the preceding generation.

Before the introduction of pension insurance under Bismarck, it was also common in Germany to have children to maintain one's standard of living in old age. Today, hardly any young couple makes the connection between the desire for children and safeguarding their own retirement. Complete coverage against childlessness has led to a full comprehensive insurance mentality.

If Germans now have fewer children than former generations, thereby forming less human capital, they must instead accumulate more real capital as a substitute for the decline in pension contributions. This is the logical consequence that has led to Germany's partial pension funding scheme and to pension cuts in the pay-as-you-go system. But the funded pension components have not been completely thought through.

They do not reduce the false incentives in family planning and they lead to unacceptable burdens for families with children. Families finance the generation of their parents with their pension contributions. By rearing children they also finance future pensions. And now with the funded pension scheme they are meant to finance their own pensions once over. Two burdens are normal in the generational context. A third burden is one too many.

Instead of making a whole generation collectively responsible, the necessary pension cuts and a compensating funded scheme should be focused on the childless. Those who

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cannot or will not have children can be expected to invest the money that others spend on childrearing in the capital market to finance a supplementary pension.

The plan could work this way: The statutory pension scheme is retained but will not be blown up again and again with new tax money. Contribution rates and relative federal subsidies are frozen. Then the level of pension payments relative to wages will fall by half in 30 years since every employed person will have to finance twice as many old people. Even with the increase of the retirement age and a rise in the female employment rate it will fall from a present 48 percent to 32 percent, the current social welfare level. This will be totally insufficient, which means that additional pension pillars are needed.

One pillar is the child pension for parents. Whoever has raised children receives a pay-as-you-go pension that will raise the overall pension, together with the declining old pension scheme, back to 48 percent. This pension will be paid for by all employed persons, including the self-employed and civil servants. The other pillar consists of an expanded funded system with savings of eight percent of pay-roll earnings, which will also raise total pension payments to 48 percent. Saving becomes an obligation.

Everyone who enters the working world must contribute until they have children. When the first child is born, a third of the accumulated capital is paid out and the obligation is lifted for a third of the mandatory savings, since human capital with the corresponding pension claim is now available as a substitute for real capital. The same procedure is applied for every additional child up to three children.

Young couples now know what they need to do. To safeguard their retirement they must either save or have children. Faced with this situation, many will decide to act on their latent wish to have children. This safeguards their pensions because either real or human capital is available for their financing. This is the only way to master the pension crisis.

## The Envy Tax\*

Udo Steiner, the German Constitutional Court judge, once said that the Germans suffer from “equalitis”. That is a polite circumscription of the envy complex from which the German people suffer. Socialism was invented by Germans and in its core is an ideology of envy, the attempt to make enviousness acceptable and create a socially received organisation form for it. The envy ideology that was formulated by Karl Marx and Friedrich Engels spread from Germany to the entire world and for half a century became the reason of state for 28 percent of humanity. One fifth of the Germans participated in this experiment, like it or not.

National Socialism also exploited the envy complex for its goals. The reference to socialism in its name is no accident. Hitler knew how to do justice to the needs of the working class and the petty bourgeois. The persecution of the Jews was also to a substantial extent motivated by the enviousness of the proletariat of the wealthy middle class. The Jews were economically successful and held far more of the well paid jobs in society than corresponded to their share in the population. They were the natural victims of the envy complex.

Unfortunately, the envy complex is still alive, albeit in different guises. Although not even the PDS (the German socialist party) is arguing for a socialist planned economy today, envy under the cover of demands for social justice penetrates the public debate. It clouds the look at the economic necessities in times of globalisation and paralyses parliament and the administration in their search for adequate policy reactions.

Hardly a politician dares to explain to the people in clear words how a market economy works. Nobody tells them that inequality is the prerequisite for economic prosperity and that in a market economy income is not generated according to the principle of equity but according to the principle of scarcity. And the people are left in the dark about the fact that more equality can only be had at the cost of a shrinking pie available for distribution. Neo-liberal insights are truly frowned upon.

In Germany, wealth is suspect, especially such wealth that is based on one’s own labour. Old aristocracy and inherited wealth are still halfway accepted. So is the wealth of soccer players, tennis aces and media stars. But, god forbid, if someone is newly rich

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and has accumulated his wealth by his own involvement, risk taking, industry or luck. Then things become suspicious. Someone who improves his position on the social ladder is immediately presumed to be dishonest. He is under suspicion because he is making the relative position of others worse.

Germans' preferences are only in part directed at their own well-being. Almost more important is how they are faring relative to their neighbours. Presumably, many people would consider themselves happier even if some of the wealth were taken from the rich and were then simply destroyed.

Americans are quite different in this respect. They admire wealth. Envy is not accepted but is ostracised politically. Since everybody can at least in his imagination move from dishwasher to millionaire, he does not envy the millionaire's wealth but instead strives to become one himself. The consequences for economic growth and general prosperity are obvious.

In Germany, nobody wants to rise from dishwasher to millionaire; instead the problem is to be solved by a millionaire's tax. Shortly after the abolition of bank secrecy and the introduction of the transparency law for management salaries, several political parties took up the cause of a millionaire's tax. They justify it by the alleged redistribution from the poor to the rich caused by the tax reform.

This testifies to a strange conceptual confusion, but it reflects broad-based ideas of vested rights. Of course, the reduction of the top tax rate has been more advantageous to the rich than the poor. Since the lowest 40 percent of income recipients pay almost no (3 percent) income tax and the highest ten percent are responsible for about half (53 percent) of the income tax revenue, there is just no other way.

A millionaire's tax that has an income ceiling of one million deutschmarks or 500,000 euros, would cover 36,000 tax payers with total income of 49 billion euros. In the past, these tax payers paid about 20 billion euros in income taxes. This "leaves" another 29 billion euros, corresponding to a good third of annual net government borrowing.

Why doesn't one make *tabula rasa* and take away the millionaires' total income? Then, for one or two years one would perhaps have these 29 billion euros in additional tax revenue and would then have to close up shop. Because then at the latest, the millionaires would have left together with their incomes. Germany's economy would have collapsed as would have the other tax revenues. All Germans would be equally poor and the envy preferences would be finally satisfied.

### **Investment is the Core Issue\***

Germany was the slowest growing country in the EU during the past ten years, from 1995 to 2005, and even western Germany by itself ranked lowest on the growth scale. At the same time, unemployment has reached a dimension which is hardly manageable, as shown by the continuing violation of the Maastricht criteria.

Most jobs are being lost in construction and manufacturing. The losses in manufacturing are especially bad, as industry is the backbone of the German economy, or the “red hot core” as Gabor Steingart so aptly called it. The core is cooling off a bit in many Western industrialised countries, but it is cooling faster in Germany than elsewhere. Nowhere else has manufacturing employment declined so much in percentage terms since the fall of communism as in Germany.

Germany’s lowest rank position has little to do with unification, as western Germany by itself takes the second lowest position of all developed countries regarding the development in manufacturing employment. Despite the inclusion of about 2 million employees in east German manufacturing, total German manufacturing employment in 2004 was close to one million people below the level of west Germany alone before unification. Germany’s manufacturing employment is dropping in free fall.

Job losses were especially marked in the early 1990s, then eased somewhat until 2000 and accelerated again thereafter. From 1995 to 2004, manufacturing employment in terms of full-time equivalents (FTE) declined by 1.09 million without being replaced in the rest of the economy. Total German FTE employment fell by 1.26 million during that period.

Labour market and economic growth are stagnating because of a lack of investment. The German net investment ratio, i.e. the share of total net investment in net domestic product, amounts to only 3 percent. That is by far the lowest ratio of all OECD countries. Nowhere else have investors abandoned their country with similar resoluteness.

At the same time, households are saving because they fear for their jobs. Banks are swimming in money that nobody wants. The excess of saving over investment, measured by the country’s current account surplus, is flowing abroad. At about 4 percent of gross domestic product, the current account surplus has reached a record level. Growth forces are moving elsewhere.

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Most of the money is flowing abroad as financial capital. Where to is not well-defined, given the interconnections of the international financial system. However, the geographical distribution of direct investment has just been revealed by a new survey among 7500 firms by the German Chamber of Industry and Commerce (DIHT). Today's direct investment is centred primarily on the new EU member countries. At 43 percent, these countries lead the target countries of German firms' investing in 2005, even ahead of China, at 27 percent. China is then followed by the other EU countries, by the rest of eastern Europe and by North America.

The movement abroad is accelerating. 42 percent of companies active abroad are investing more abroad this year than last year, and only 12 percent are reducing their direct investment abroad. At 30 percentage points, the planning balance is the biggest since the surveys started in 1999.

The bigger the firms the easier comes the decision to invest abroad. Thus 69 percent of all firms with more than 1000 employees are planning new foreign investment in 2005. But the smaller firms are also going along. Among the class of firms with 200 to 1000 employees at least every other one is investing abroad this year.

Among the motives for foreign investment, marketing and service are on top, at 40 percent of the responses. But among the production decisions, the motive of cost savings (34 percent) ranks ahead of the motive of opening up new markets (26 percent)

Cost savings help the firms to remain internationally competitive. Thanks to the east European hinterland, to which more and more of the input chains are relocated in order to evade high German wages, German business can meet the challenge of Korea, China and other competitors. Contrary to popular beliefs, this does not usually create German jobs. Only 13 percent of the firms that create jobs abroad are planning to add to their German employment. The large majority, at 60 percent, is keeping domestic employment constant despite their expansion abroad, and 27 percent want to reduce domestic employment while creating new jobs abroad. Of the firms that invest abroad for reasons of cost only 10 percent want to create new jobs at home. 37 percent are planning layoffs in Germany. The popular thesis that foreign investment creates jobs at home is refuted by the DIHT, and it may be correct.

Whoever wins the election, this is the issue that must be dealt with. Ways must be found to make investors again interested in Germany and to restore the confidence that is necessary for them to keep their assets at home. If this path is not followed, nothing else will be achieved.

### **The Five Shocks: Why Germany is Lagging Behind\***

During the last ten years, Germany has been the slowest growing country of the European Union, and Europe has been the slowest growing continent in the world. From 1995 to 2005 Germany will only have grown by 14.6 percent, while the old EU on average will have grown by 24.0 percent, the U.S. will have grown by 39.9 percent and the world will have grown by 45.6 percent. Why has Germany performed so badly?

One theory, which has been endorsed by the head of Germany's SPD, Franz Müntefering, is that Germany is already where the others yet want to arrive. The slow German growth, he maintained, is just a sign of natural convergence. But this theory is not convincing, as Germany has recently been overtaken in terms of per capita income by quite a number of countries in Europe, including Ireland, the UK, the Netherlands and France, for example, and is still growing more slowly than these.

Another theory is that over the past fifteen years there have been various external challenges or shocks that have hit the country simultaneously. Rigid as it was, with an extensive welfare system and an overregulated labour market, the country was unable to react to these shocks and ran into trouble. This has a touch of Toynbee's theory according to which history's empires collapsed because they were unable to react to external challenges.

The first shock was intensified globalisation which brought a lot of new low-wage competition. Although globalisation is a gradual process, it gained momentum when China decided to participate in the market game. China is ten times Japan, and Japan was not easy either. German precision instruments and optical industry, for example, lost its competitive advantage when that country entered the game.

The second shock was EU integration including its northern and southern enlargements. The dismantling of the EU's internal borders has enlarged each country's market size and has brought about the scale economies that the Cecchini report had predicted. However, this has helped the small countries more than the big ones, and it has

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provided more competition for Germany, which is Europe's biggest economy. Think of Nokia, the mobile phone maker. Due to the economies of scale which the common market made possible, that company was able to fully exploit its inventions, while Siemens, the German mobile phone maker, recently decided to give up that market.

The third shock was the euro. The euro has induced a rapid convergence of long-term interest rates in Euroland, which in some countries had been 5 to 7 percentage points above the German level. Freed from exchange-rate risks, international investors no longer demanded a risk premium from the countries outside the deutschmark zone and were willing to provide their funds to all of them under the same favourable conditions that previously had been reserved for Germany. This is good for Europe, since it helps improve the allocation of capital and stimulate growth by transporting German savings to the remote and previously disadvantaged regions of the euro-zone, but it is of doubtful benefit to German workers, who also would have liked to have worked with this capital.

The fourth shock was eastern EU enlargement. This has brought extraordinary opportunities for trade and investment in the east, but it has also brought massive low-wage competition. On average, the wage costs of the ten accession countries that joined the EU in 2004 are only 14% of west German wage costs. The low-wage competition has led to substantial outsourcing and offshoring activities that have kept German firms competitive by reducing their demand for domestic labour. However, as neither the unions nor the welfare state accepted falling wages, unemployment and slow growth resulted.

The fifth shock was German unification, which has turned out to be a failure in economic terms. GDP per person of working age was 61 percent of the west German level in 1996, but now it is only 59 percent. The low growth of the eastern part of the country has pulled down the German average and, what is more, the enormous demand for public funds in the east has increased the public debt, which has made the country violate the criteria of EU's Stability and Growth Pact. The unsound financial situation in turn has contributed to making investors hesitant to sink their money in this country with obvious implications for economic growth.

All five shocks or challenges are historical developments that are good for the world as a whole, but they have created problems for Germany. In order for the country to meet the challenges and to continue to grow, it would have to make its labour markets flexible. Only if wages adjust downwards to accommodate the new international environment of the country, could German workers become competitive again so that the country could return to a better employment level, exploiting its human capital up to the capacity constraint. The new government, that the Germans elect in September, will

face the difficult task of confronting Germans with reality and to push through the necessary reforms of the labour market. It will have to decide whether Germany will make the effort to meet the Toynbee challenge it is facing.

### **Some Facts on VAT\***

CDU and CSU want to raise the value-added tax (VAT) by 2 percentage points and cut the employer contribution to unemployment insurance by 2 percentage points. This means a net revenue surplus and thus an additional tax burden, because the tax base of VAT is markedly higher than the part of wages that is subject to social security contributions. Estimates of the annual additional tax burden range from 1 to 3 billion euros.

The government needs the money to help consolidate the budget. The contribution to this is small, however, considering that genuine consolidation without further debt increases would require about 75 billion euro, the size of the 2005 budget deficit. Just reducing the deficit to the 3 percent limit would cost 9 billion euros.

The rationale for the change in financing is the attempt to reduce that part of the labour costs that is relevant for international location decisions and to shift decisions on investment locations in favour of Germany again. This rationale is correct in principle, as VAT is levied according to the so-called destination principle and is thus not relevant for decisions on production locations. Output is taxed with VAT of the country of destination and not with VAT of the country of origin. Unfortunately, however, the effect is minimal. At about 27 euros per hour, western Germany's average labour costs of industry workers lead those of major neighbouring countries like Sweden (23 euros), France (20 euros), Austria (21 euros) and Great Britain (19 euros). The planned reduction of the contributions to unemployment insurance will cut German labour costs by only about 20 cents, and do so only if, in the next bargaining round, the unions abstain from using the distributive margin to their own advantage and raise wages.

There is practically no reduction in domestic labour costs, i.e. if supplier country and destination country are identical. Here VAT has a similar effect as a wage tax and hardly differs from social security contributions. Consider an average-income west German worker, whose spouse earns one third extra and who has two children, say a journeyman painter. The painter is working already when another client appears for whom a paint job is done. For this the paint-shop owner writes a bill that includes the cost of paint, paint brushes and transportation as well as an amount of 1000 euros for the pure labour costs including all taxes but excluding any profits. Of these 1000 euros, at present 643 euros go to the government and only 357 euros go to the employee, i.e.

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only about one third. Included in the 643 euros, received by the government are 138 euros VAT and 46 euros contribution to unemployment insurance. The planned reduction of this contribution by 2 percentage points corresponds to a reduction of fiscal charges of about 15 euros, and the planned increase in VAT corresponds to an increase in fiscal charges of also 15 euros. The marginal tax burden remains at 64 percent.

With such a marginal tax burden, Germany ranks at the top of the world, surpassed only by France, with as much as 70 percent. High-tax countries like Sweden, the Netherlands or Denmark only levy a marginal tax rate of 61 percent, 59 percent, and 55 percent, respectively, on an average-income worker with identical marital status, and the neo-liberal Great Britain takes only 49 percent.

Any hope is misplaced, therefore, that the planned change in financing will contribute to a reduction of moonlighting, that Germans will again exchange some leisure for work or that the low domestic demand for construction, restaurant services or other services, which is caused by high labour costs, might rise noticeably.

VAT is essentially a hidden wage tax and can therefore only contribute to a very limited extent to the solution of the German core problem of extremely high taxes and fiscal charges on wages. True measures to reduce German labour costs must start at the collective bargaining law and at the wage competition of the welfare state that fixes the wages for simple work, but that is another topic.

Aside from all of this, it is still correct that VAT has a broader tax base than a pure wage tax and can thus be used as an instrument of redistribution in favour of employees subject to social security contributions. That is because it is also levied on all other income recipients like civil servants, recipients of statutory pensions and of other government transfers.

Above all, VAT is an implicit tax on the stock of assets existing at the time of its introduction, because it becomes effective at the time the assets are utilised for consumption whenever that takes place. The real value of total assets declines in line with the increase in the tax rate, whenever these assets are used to feed consumption in Germany. And it is unimportant in principle whether the tax is passed on or not, as this question only determines how the owners of real assets and those of financial assets, whose nominal value is guaranteed, share the burden.

### **Pathological Export Boom and the Bazaar Effect\***

Germany is specialising in the downstream stages of industrial production and relocating the labour intensive upstream stages to other countries. Germany, which today is already home to two thirds of the biggest industry fairs of the world, is continuing to evolve in the direction of a bazaar economy.

The value added share in German exports per unit of output is declining rapidly. While, on average, 38 percent of German exports consist of imports, such imports already account for 55 cents of each additional euro of real exports. This does not mean that export induced value added as such is falling. It only means that export volume and value added have decoupled. German export volume rises by 1.36 percent for each one percent of additional value added in exports.

Germans specialise more and more in bazaar activities and earn good money doing so. At the same time, the bazaars channel more and more merchandise per unit of value added through the country. No wonder that Germany has become second world exporting champion after the United States.

Many believe that specialisation in bazaar activities should result in a reduction of value added in exports. But this is not so. Rather, it is in the very nature of international specialisation that value added in exports rises more than proportionally, and specialisation in bazaar activities is no exception. The Cologne Institute for Business Research (IW) also errs when it equates specialisation in bazaar activities to a decline (!) in value added in exports.

The real question concerns the assessment of this specialisation and the associated boom in export-induced value added. The answer cannot simply be given by pointing to this boom as such. This cannot be for the simple reason that each and every specialisation is accompanied by a reduction in value added in other sectors that are battered by import competition. There is such a thing as excessive specialisation.

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In order to make an assessment, one has to look at the labour market, as it is this market that must bear the burden of factor movements among sectors. Unfortunately, there is no reason to be optimistic. From 1995 to 2004 a total of 1.26 million (full-time equivalent) jobs were lost in manufacturing and trade. At the same time, no new jobs were created in the rest of the economy. Employment even declined there, with the result that on balance all sectors suffered a loss of 1.29 million (full-time equivalent) jobs.

The coincidence of unemployment and export boom can be explained by the high and rigid wages which Germany still suffers. They destroy the labour-intensive upstream product stages too fast and also impair other labour intensive sectors like textiles, simple services, tourism or construction.

A lot of labour and a lot of capital are released by the labour intensive sectors. The released factors of production push into the capital intensive export sectors that are better able to cope with the high wages. These sectors therefore grow especially fast. But because of their high capital intensity, they can only fully employ the capital. Part of the unemployed are not absorbed there but move into the welfare state. Economic growth slows while exports boom. The country is suffering from a pathological export boom. And to be clear: It suffers from a pathological boom in export-induced value added and not just export quantities.

Since returns to capital are kept low by high wages, very little investment occurs. The excess of savings over investment flows abroad as capital export. It is astounding that many interpret the export boom and the surplus in the German current account, which measures this capital export, as an indicator of the strength of Germany as an investment location.

### **Why Minimum Wages Hurt Germany\***

Low-wage countries from all over the world are vying for German investment capital, and now east European low-wage workers are moving into the country, directly competing with German workers. The German government wants to protect the country by introducing minimum wages. By expanding the EU directive on the foreign posting of workers from the construction sector to all branches of industry, it wants to force foreigners who provide services in Germany to work at German union wages. The government claims it merely wants to prevent wage dumping, but in fact it is hurting the country and driving it further along the wrong road that has been travelled for decades with an excessive wage policy.

The central argument against minimum wages is simple but little known. If the Poles are willing to work cheaply for the Germans, German customers benefit. Tradesmen activities, services in restaurants and many other goods and services become cheaper. The real income of Germans rises, and many jobs that would have been left undone can be done now. The economy grows. Of course, the domestic workers who directly compete with the Poles suffer a disadvantage because their wages come under pressure. But this is no disadvantage in the aggregate, as it is offset cent for cent by the identical advantage that accrues to the customers and employers of the domestic workers. Minimum wages would help the tradesmen, but they would block the advantages that Germany as a whole would enjoy from the cheap Polish workers.

Furthermore, the posted worker law is being circumvented anyway, because it is all but impossible to control the hourly wages of the assigned workers. Union wages are paid formally, but people work longer than stated. In the final analysis, minimum wages would reduce the supply of Poles in Germany a little and would allow them to sell their labour better, at the expense of their German employers and customers in Germany, than would otherwise have been possible. The Poles are being helped in a similar way as if they were permitted to form a big wage cartel at the expense of Germany.

If foreigners are forced to work at union wages in Germany, German firms are driven abroad even faster. Germany has the second lowest investment share in GNP among all OECD countries, and its capital exports amounted to almost 4% of GDP in 2004. Domestic investment shrank by 0.9 percent, although it should have grown by 8 percent

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in view of the booming world economy. This alarming development would only be accelerated. The increase in unemployment would continue and would risk running out of control.

If union wages were declared generally binding by the government, as is being considered, east Germany, in particular, would suffer extremely. Union wages often no longer play a role there, and this is the very reason for the few green shoots. Submitting wages on a broad base to collective bargaining again by declaring union wages as generally binding would mean that entire regions in the east would deindustrialise.

Measures to increase wage rigidity remove an ever bigger share of employable Germans from the labour market and shift them to the welfare state. Germany has travelled this road for over 30 years because the growing welfare benefits have functioned like minimum wages. It cannot continue like this, as its economy is falling back, and the state already has no funds left. Politics cannot undo the laws of economics, as much as it may decry them. The SPD party leader Müntefering's moral indignation about the laws of economics could just as well be directed at the physical laws of gravitation. Each is equally unrealistic.

There is only one way: Accept the wage competition of the east Europeans, yield to the wage pressure and compensate the low earners by permanent personal wage subsidies. Activating social assistance, as proposed by the Ifo Institute and also recommended by President Köhler, points the way. Starting with Hartz IV, one would have to redesign unemployment pay II, Germany's new second-tier unemployment benefit system, in such a way that it becomes in fact a wage subsidy. The income-benefit schedule must be designed so that one receives most of the money from the state if one works at least half-time in the private sector and not if one does not work at all. To offset the fiscal burdens, the government would, however, have to lower the benchmark pay rate a bit, which for social reasons can be done only if at least one-euro jobs with the government are available. For one-euro jobs one should receive the one euro and unemployment pay II at today's level if one is willing to work in the private sector as a loan worker. Only by paying wage subsidies can the state help the low earners become competitive with the Poles without asking them to accept Polish incomes. There is no alternative to such a policy.

Politicians call the wage competition of the east Europeans dumping. That is a confusion of terms. Dumping is lowering prices below one's own costs, not below the competitors' costs. Only if the Poles were working more cheaply in Germany than in Poland would this be dumping according to the economist's definition. Wage competition is the market economy's elixir of life. Will the Germans ever understand the rules of the market economy? How far does the country want to move downhill until it realises that there will soon be no going back?

### **The Arguments of the Reform Opponents\***

The opponents of the German reforms are on the defensive, but they are putting up a strong fight, calling the protagonists of reform prophets of doom. Here a glossary of their arguments along with refutations.

*We are fine. The contention that Germany's economy is in trouble is a pure invention.*

Germany has mass unemployment and is the country with the slowest growth in Central and Western Europe since 1995. We are laggards.

*Slow growth is the unavoidable result of German unification.*

If the new states in eastern Germany were converging with the west, German growth would be faster not slower. Even western Germany alone has grown more slowly than any other country in Central and Western Europe, and eastern Germany has grown even more slowly.

*Whoever travels to other European countries, to the fastest growing economies like Ireland or Finland, sees with his or her bare eyes that these economies are not as well developed as the German economy.*

What the traveller sees is the capital stock in the form of real estate that was built out of the GDP of previous decades. Today's statistics show what the Germany of tomorrow will be like.

*Don't the record profits of firms such as Siemens, E.ON or BASF prove that the German economy is competitive?*

The problem is: Companies are competitive, but not workers. Businesses manage to survive by shifting production to low wage countries (bazaar effect). There the profits are made that cover the domestic losses. Companies that do not go abroad have problems. With 30,000 businesses going bankrupt every year in western Germany, a new record has been set.

*Don't the data of the Federal Statistical Office show that Germany is not a bazaar economy and that there is still sufficient value added in Germany?*

According to these data additional exports worth one euro immediately induce 55 cents worth of imports. Still, value added in export rises as in any country that

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specialises. But it falls too fast in other sectors. The net effect is measured by the growth rate of GDP, and that is, as mentioned above, the lowest anywhere.

*Is Germany not the export champion of the world?*

No, in 2004 we were the vice-champion, 9 percent behind the United States. We are only world champions if service exports are left out. Nevertheless Germany's export is strong. The strength was greatly boosted by the strong euro by which even German exports to the euro zone are enlarged when converted into dollars. In addition exports are inflated by the bazaar effect. A one percent increase in value added of exports increases the export volume by 1.36 percent.

*But we have a record trade surplus. Is that not proof of our competitiveness?*

This surplus, by definition, is a measure of Germany's capital exports. The savings that are not converted into investments in Germany flow abroad as loans, and foreigners then buy German products. It would be better if the savings flowed to domestic investors that would buy buildings or machines in Germany, because this would create new jobs here.

*Working longer has no benefits. Including overtime we already work 42.5 hours a week.*

The average collectively bargained working week is 38 hours. What is needed is longer working hours for the same monthly wage. Paid overtime does not help businesses save costs.

*If longer hours are worked, more people will be dismissed. We must distribute the few jobs we have more justly and work shorter hours*

The shortening of working times in Germany has demonstrably contributed to an increase in mass unemployment (J. Hunt, Quarterly Journal of Economics). There is no fixed amount of work. If people work longer per day, the capital stock also works longer (buildings and machines). There is an immediate boost to growth, and as a second step businesses will employ more people because there are people outside the factory gates that will only produce as much as they earn after working hours are lengthened.

*Instead of working longer we need technological progress to improve our competitiveness and to safeguard German jobs. Therefore the state must support innovations.*

For the economy the extension of working hours is the same as technological progress that enlarges the productivity of labour and capital. All effects on the operation

of the economy are the same. No one is arguing against promoting basic research. But extending working hours has a faster effect.

*Who will buy the additional products if people who work longer do not earn any extra money?*

The businesses will then indeed earn more money. The increase in enterprise profits and the boost in corporate spending power is identical, to the last cent, with the value of increased production. The entrepreneurs will not hoard the money, but they will spend it to purchase capital goods or they will loan the money to others who will spend it on buying such goods.

*In the new states there are many unemployed people although the wages are still much lower than in the west. Doesn't that prove that the lack of demand is the key factor?*

Unemployment depends on wages and productivity. In eastern Germany wages increased much faster than productivity. Demand exceeds regional production by nearly one half because of the gigantic public transfers and thanks to an inflow of capital. Never has there been such a large area with such a large excess demand.

*Is not productivity in the east already as high as in the west?*

No, GDP per employee stood at 72 percent in 2004. This does not even include the zero productivity of the unemployed. Productivity in terms of GDP per person of working age is below 60 percent of the level in western Germany. Monthly wages are already nearly 80 percent.

*The economic pessimists are themselves responsible for the loss of jobs because of the bad mood that they create.*

If the patient is to agree to an operation, he must be told the truth even if it worsens his mood. Opium is only called for if the illness is hopeless.

### **Will the Sinners Punish Themselves?\***

When Germany pushed for the Stability and Growth Pact as a prerequisite for giving up the deutschmark, it did not anticipate that it would be the first country to violate this pact. While the pact says that a government cannot borrow more than 3 percent of its GDP, Germany's public deficit was 3.7 percent and more in the years 2002 to 2004.

There have been more sinners, though. France also violated the criterion in these three years, Portugal did so in the year 2001 and the Netherlands in 2003. Greece even cheated by manipulating its statistics. While the reported deficits were below the limit, the country had to admit that the true deficit was on average 4.3 percent in the period 2000-2004 and never below 3.7 percent.

Other countries have been more successful due to lucky circumstances. Italy, for example, not only benefited from the creative accounting skills of its government but also from the fact the euro brought about interest convergence in Europe. The long-term interest rates for Italian government bonds declined from about 12 percent to about 4 percent in the ten years from 1994/95 to 2004/05. Given that the Italian debt/GDP ratio is currently about 106 percent; this in itself reduced the public debt ratio by more than 8 percentage points. All else being equal, Italy would have had a public deficit of 11 percent of GDP in 2004 rather than the reported 3.0 percent had the interest rate not declined, not counting that today's debt/GDP ratio would have been much higher. It was not the Italian government but the euro itself which helped Italy satisfy the Stability and Growth Pact. But now Italy seems to have run into trouble again and also wants to weaken the pact.

The idea of the pact was to impose firm borrowing constraints on European governments so as to forbid them making gifts at the expense of future generations and limit the risk that Europe one day would go the Italian way: borrow without limits and print more money to erase the real debt via inflation. While constraints are a good idea, it is understandable that the EU governments do not like them. Sinners do not like rules.

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The reform proposals that are currently being debated are adventurous to say the least, because they all seem to center around the question of which government expenses should be exempt from the calculation of the deficit. The list of exemptions includes a country's net payments to the EU, education expenses, investment in general or exceptional expenses. The pact would become meaningless under such circumstances

Future generations already bear an excessive pension burden in all European countries. In Germany, for example, the Council of Economic Advisors calculated the implicit pension debt to be more than 270 percent of GDP. If the open public debt of 67 percent of GDP is added, an overall debt-to-GDP ratio of about 340 percent results. Other European countries are in a similar situation. This is a problem in particular since Europeans are having fewer children than people from other continents. The future generations that are to pay the bill are simply not there.

Europe is moreover the continent with the slowest rate of growth in the world. Average EU growth in 2004, when the world economy had the strongest growth for more than a quarter of a century, was only 2.2 percent while inflation was 1.9 percent. This is about 4 percent in nominal terms, and more will hardly be possible in the longer run. With such low growth, the 3 percent criterion is no longer compatible with the 60 percent debt/GDP limit that the Maastricht Treaty had postulated for the euro countries. Countries that borrow 3 percent and grow at a rate of 4 percent will converge towards a debt/GDP ratio of 3/4 or 75 percent. A country like Germany which only has a growth trend of 1 percent in real terms and may continue to have only 1 percent inflation in the medium term would converge to a debt/GDP ratio of 150 percent.

All of this shows that the Stability and Growth Pact should be made tougher rather than weaker. The easiest way to keep the debt/GDP ratio under control would be to have a staggered deficit criterion that reduces the allowed public deficit to less than 3 percent for countries whose debt/GDP ratio exceeds 60 percent and increases the allowed public deficit to more than 3 percent for countries whose ratio falls short of this level. This would automatically take account of the growth differences and it would give a country the incentive to run surpluses in good times so as to increase the scope of manoeuvre in bad times. But there is little hope that this will come about since it is the sinners themselves who would determine the conditions under which they are punished.

## **How to Combat German Unemployment?\***

This year official unemployment in Germany will amount to more than 4.5 million. Adding those in early retirement and in various training measures, the number rises to 6 million. And including the hidden reserves of people who are willing to work but have given up trying to find a job, we have more than 7, perhaps 8 million.

Unemployment originates when the economy is slack or when labour has become too expensive in relation to full employment productivity. The first factor is insignificant since the unemployment has occurred while the world economy has been booming faster than in the last quarter century, and German exports are booming too. Exports create more demand than even the most daring government stimulus programmes could ever achieve. Only the second factor provides a suitable explanation for unemployment.

Since the demise of communism, an additional third of the world population is competing for internationally mobile capital and is offering cheap labour and fantastic returns. The combination of wages and productivity, under which the German workers were employed before the fall of the Iron Curtain, no longer applies today. In order to regain their competitiveness, German workers must become more productive or cheaper. Otherwise only the German firms stay competitive. German firms stay competitive regardless of the competitiveness of their workers because they are very well positioned in Eastern Europe and Asia and produce an increasingly larger value-added share of the goods manufactured in Germany in low-wage countries (bazaar effect).

Politicians proclaim that innovations will make labour more productive and will induce more investments at constant wages, thus creating more jobs. But innovations do not come out of the blue. The only measure that is immediately available and has the same effect as a productivity-boosting innovation is the extension of working hours at the same pay. For the laws of economics it makes no difference whether productivity increases because an engineer comes up with a wonderful invention that enhances the productivity of labour and machines or whether the individual worker, and with him the capital in the machines and buildings he uses, works longer every day. Both have fundamentally the same effect and create jobs.

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\* Published as "Mehr Arbeit durch Billigjobs," *Neue Ruhr Zeitung/Neue Rhein Zeitung*, February 11, 2005, p. NMA2.

But this will not suffice. Since unemployment is concentrated among low-skilled workers (here Germany is the “champion” among OECD countries), measures must be taken to increase the wage differentials in a socially acceptable manner. The welfare-to-work model developed by the Ifo Institute was designed with this in mind. Basically, it calls for a further modification of the second phase of unemployment compensation, which suffers from an extremely high benefit-withdrawal rate. In other words the current Hartz IV programme must be supplemented by a “Hartz V”. Firstly, this new programme would allow beneficiaries to earn up to €400 without penalties (Hartz IV only allows €50). Secondly, the first €200 of earnings would be supplemented by 20%. Thirdly, the withdrawal of benefits beyond €400 of earnings would be limited such that in combination with taxes no one would lose more than 70 cents for each additional euro earned. (Under Hartz IV 80 to 90 cents is lost.) Fourthly, if the beneficiary does not work, unemployment compensation would be reduced by about a third in order to reduce the financial burden of the state. Fifthly, all beneficiaries capable of working would be offered municipal jobs where they could have an income that would match the current level of social aid (or, equivalently, unemployment compensation II according to the new Hartz IV law). Sixthly, the municipalities would contract out the workers in their charge to the highest bidders.

This is a feasible and affordable way to create jobs for everyone. On the one hand, the wage claims of those affected will fall for jobs in the private sector without their incomes having to fall. At lower wages there will be more jobs because it will be worthwhile for businesses or private households to offer these jobs. On the other hand, for those who cannot be directly placed there will be loan employment, because for everyone there will at least be a fee that is higher than zero for which demand for labour would arise.

The proposal is also a programme that would integrate those now working on the black market into legitimate service-providing firms. Those who use workers in the shadow economy would turn to proper businesses because no workers can be found in the black market (beneficiaries must work eight hours a day). And these businesses can service their customers thanks to the cheap loan-workers they receive from the municipalities.