

The Ifo Viewpoints 2006

- Scandinavia's Accounting Trick
- Shrinking Champion
- Increased Prices for Spoiled Meat?
- Germany: World Champion in Tourism
- Germany: A Land of Immigration?
- A Suit from a Cabinetmaker?
- Subject versus Object
- PISA and the German Three-class Society
- A New Welfare State
- Six Principles of the Combi-Wage

Scandinavia's Accounting Trick*

While most of the world's developed countries face increasing difficulties in coping with the forces of globalisation and competition from low-wage countries, the Scandinavian countries – Denmark, Finland, Norway, and Sweden – seem to have managed these challenges quite well so far. With an average yearly GDP growth of 2.8 percent from 1995 to 2005, the Nordics outshone the non-Scandinavian countries of the EU-15, which averaged just 2.2 percent. In 2005, the Scandinavians' average GDP per capita was 39 percent above that of the other EU-15 countries, while their average unemployment rate stood at 6.7 percent, compared to 8 percent elsewhere in the old EU. What is the secret behind Scandinavia's success?

One explanation of Scandinavia's strong performance is Sweden's courageous product market liberalisation, a less generous wage replacement system in Denmark, the Nokia miracle in Finland and, last but not least, the massive devaluations of 1992, which resulted in comparatively low wages for Finns and Swedes. However, while these factors have an undeniable explanatory power, the low unemployment and the high per capita GDP levels also have a much more straightforward explanation: the high share of government employment in the labour force. When private jobs are no longer competitive, government jobs seem the easy solution to keep people employed.

Indeed, it is surprising how large the share of government employment in Scandinavia is. In Sweden, it amounts to 33.5 percent of dependent employment, and to 32.9 percent in Denmark. On average, the share of state employment in total dependent employment across Scandinavia is 32.7 percent, compared to only 18.5 percent in the non-Scandinavian countries of the EU-15. In Germany, Europe's largest economy, the government's share in dependent employment is only 12.2 percent.

The high share of government employment naturally contributes to the region's low unemployment rate. But that's not all: it also explains to a large degree the high per capita GDP figures. The simple reason for this is that the value-added created by these government jobs is part of GDP, even if it could never have been produced in the market economy and given that it encompasses activities of private households that would

* Revised version. Earlier published as "Skandinavischer Schwindel," *Die Welt*, no. 261, November 8, 2006; also published in *Il Sole – 24 Ore* (Italy), *L'Echo* (Belgium), *Aripaev* (Estonia), *Vilaggazdasag* (Hungary), *The Australian Financial Review* (Australia), *The Straits Times* (Singapore), *Taipei Times* (Taiwan), *The Nation* (Thailand), *L'Avenir* (Congo), *Les Echos* (Mali).

otherwise not have been considered in the national accounts. According to the rules of national income accounting, in the absence of market prices, the contribution of the government sector to GDP is measured by the wage incomes paid out by the government, regardless of how productive or useful the government jobs are, and regardless of the question of whether such activities would have been undertaken at all by private businesses had the government not stepped in. Thus, the performance difference relative to Germany, say, could be caricatured as follows: while Germans collect part of the private value-added as taxes, which they then spend on unemployment benefits, Scandinavians give their unemployed a desk and count the unemployment benefits as value-added of the government sector and, therefore, a contribution to GDP. Furthermore, they encourage women to look after each other's children, thereby putting them in a position to enter child rearing as a contribution to GDP.

Apart from the accounting trick implicit in Scandinavia's success, the high share of government in employment may also make a real contribution to solving one of the most fundamental problems western economies now face. Prompted by capital flows to low-wage countries, specialisation, outsourcing, and even immigration, the equilibrium price of unskilled labour has fallen throughout the western countries. Yet, for obvious social reasons, these countries hesitate to let actual wages fall accordingly.

If they want to defend the incomes of the unskilled (or the less motivated), they have four options. The best is to educate the unskilled better, but this is a cumbersome and time-consuming process that offers no short-term solution. Thus, only the three following options remain in the short and medium term to cope with the awkward distributional trends brought about by globalisation.

The first of these three options is to defend the wages of the low-skilled by way of minimum-wage laws or by paying social replacement incomes, which imply minimum wage demands against the private economy. This is the strategy that most EU countries, Germany in particular, have chosen. It results in mass unemployment that is inefficient in itself and financially unsustainable. The second option is to pay wage subsidies instead of wage-replacement incomes, thus allowing for the wage dispersion necessary for full employment without letting the incomes of the unskilled fall. This is the strategy chosen by the United States with its earned-income tax credit and which, in a similar form, Edmund Phelps, this year's Nobel laureate in economics, has long advocated. The third option is the Scandinavian way described above, in which the government demand for labour keeps minimum wages high.

While many economists judge Germany's strategy the worst and America's the best, the Scandinavian strategy can be considered a second-best. Indeed, it is better to let

people clean public parks, nurse children, and take care of the old in government facilities than have them, as in Germany, do nothing. Even though GDP is artificially inflated, some useful activities are carried out.

Nevertheless, it might be better to let the market decide what kinds of products and services the low-skilled and less-motivated part of the workforce should and could reasonably turn out, which speaks for the American way of subsidising wages. The Scandinavian way is more than a mere accounting trick, but it is also less than a truly recommendable strategy for coping with the challenges of globalisation.

Shrinking Champion*

The German population is shrinking faster than others and no one is taking notice. The rate of shrinkage of the population resident in Germany amounted to 0.18 percent per annum in the period 2000–2005, which was the highest value of all Western countries. If account is taken of migration, the decline turns into small growth of 0.09 percent p.a., but this is also the lowest figure of all Western countries.

The cause is not a high death-rate, but an extremely low birth-rate. At only 8.5 newly born babies per 1000 inhabitants and year, Germany is at the bottom of the OECD birth statistics. There is no other Western people with fewer births relative to its size than Germany.

The Germans are not aware of this because they misinterpret the birth statistics. They are blinded by the so-called fertility rates. Indeed, in 2004, a woman averaged only 1.37 children, 0.71 fewer than the 2.08 that are necessary to maintain the population. In Italy and Spain, however, the average was even lower, at 1.33 and 1.32, respectively, and Japan only averages 1.29 children.

The fertility rate does not measure the number of children born every year, but only the number of children each woman has. In Germany, the population not only shrinks so fast because its women are not prolific enough but also because there are only few women of childbearing age. After all, in this country, the fertility rate started to decline in the early 1970s and thus earlier than elsewhere. The Italian rate fell about seven years later and the Spanish rate another four years later. German baby-boomers, who were born in the mid-1960s, are above forty already, and the group of thirty-year-olds, that was born in the mid-1970s, will soon be only half as big. The combination of a very low share of women of childbearing age and a very low birth-rate per woman is unique in the world. It explains the German population shrinkage.

Of course, this picture is only a snapshot, similar to an economy's growth rate that also shows only the current pace of the year under consideration. In several years, other populations may shrink faster than Germany's. Italy and Spain belong to the group of those countries that will assume Germany's inglorious record. At present, however, Germans do shrink faster than the others.

* Published as "Einmalige Party," *WirtschaftsWoche*, no. 35, August 28, 2006, p. 138.

We can only guess why the decline started here first. There are many possible explanations. One obvious explanation is that the wide-spread use of birth-control pills occurred here earlier than elsewhere. After all, it was Germany's Schering AG that invented these pills. Another explanation is the "1968 revolution" that meant a renunciation of the traditional values of society with respect to the role of women and family. Although this revolution also took place in France, the French are doing a lot for families with young children diminishing the size of this effect.

A third explanation is historical: Demoralised by the lost wars, Germans lost faith in themselves and their future. Granted, this third explanation is not really complimentary. Given, however, that the defeated Spaniards, Italians, and Japanese also belong to the group with the lowest birth-rates, a certain effect may be suspected.

A fourth explanation is pension insurance. This insurance socialises the fruits of the investment in one's own children because it distributes the contributions that these children, as grown-ups, make available for the provision of old people, to all old people, i.e. also to the parents of other children and to the childless. As Germany invented the pension insurance and introduced it much earlier than elsewhere, it is no wonder that people here have learned earlier than elsewhere that one fares better if other people's children provide for one's old age than to raise children oneself.

The road into childlessness is temporarily quite pleasant for a people. Women's capability is used for the production of market incomes, and the standard of living rises by a multiple. With two incomes and no children per-capita income is five times as high as with one income and three children. Investment in the future of society, which means educating children, is replaced by current consumption. To this is added the satisfaction of those women who feel liberated from the yoke of motherhood and understand the change into paid work as self-realisation. Let the big party begin.

Of course, a people can afford this kind of party only once. Afterwards the bill must be paid, and a hangover is certain. Pension crisis, old-age poverty, and economic stagnation are the inevitable consequences. The new German model of society has many proponents, but is not sustainable. The evolution and selection of societal models is in full swing worldwide. But it is evident even today that the German model will die with the Germans. National sensitivities and ideological predispositions cannot alter the fact.

Increased Prices for Spoiled Meat?*

Politicians must do something about the recent spoiled meat scandal in Germany. Too many detections have been made for them not to take action. But what has happened? While the federal states are prosecuting the offenders, the ministries of agriculture and economics in Berlin plan to introduce legislation that would forbid the resale of meat below cost. This, the proponents argue, would dry up the market for spoiled meat.

An economist is dumfounded by this proposal, which at heart is an attempt to reduce the supply of spoiled meat in shops by means of increasing the price for this meat. This experiment will fail. Since the price of spoiled meat will approach the price of good meat, the incentive to supply good meat will be weakened.

Up to now providers of good meat, who have made special efforts to maintain the quality of their products by accelerating transportation and by constructing an uninterrupted chain of refrigeration, have assumed that they would be able to demand a much higher price for their precautions, that their efforts would be rewarded. In future, part of this reward will be eliminated. Since revenues without this effort will be nearly as high as with the effort, the incentive to take extra precautions will be missing. More spoiled meat will come to market.

Consumers will also not be in a good position to protect themselves if the price gap between good and spoiled meat decreases. Prices have an information function in the market. People who are prepared to pay a high price can usually assume that they are getting better quality. This information function is impaired if price differences of spoiled meat and of good meat become blurred. Quality-conscious consumers will in future have trouble distinguishing good meat from spoiled meat. They are at the mercy of the scoundrels even more than before.

The prohibition of selling at below cost will also prevent many reasonable transactions that we encounter in everyday life. At the end of the day at a farmers' market, the vendors sell their remaining goods to the last customers below cost to avoid the costs of the return transport of the goods or the costs of their disposal. The baker who sells the rest of his bread before closing time acts similarly. This also offers lower-income groups the chance to buy inexpensive provisions without any loss in quality.

* Published as "Lobby-Verdacht," *WirtschaftsWoche*, no. 39, September 25, 2006, p. 198.

Increased Prices for Spoiled Meat?

When a car dealer sells last year's models below cost in order to clear stocks, this is just as legitimate as when sales are offered for computers or cameras to make room for new models. Currently, prices of computers fall by almost 25 percent a year. With market uncertainty, remaining stocks inevitably result when a vendor orders sufficient goods to avoid supply difficulties. The sale of such remaining stocks below cost is unavoidable due to the rapid decline of market prices.

What a strange concept of markets it is to contemplate a prohibition of sales below cost, as the two ministries now intend? Or is the idea not strange at all? Is it not perhaps a clever reason for price increases that the vendors' lobbyists are trying to achieve for their own benefit with assistance from the state? Interestingly enough, the contract between the coalition parties includes the intention of forbidding sales below cost. Did the spoiled-meat scandal come at just the right time in order to convince the public that this intention is justified?

Good arguments can be made for the lobby suspicion. It is understandable and common occurrence that vendors hope to ward off competition via limits on low prices. The insurance industry succeeded for decades in getting the federal supervision authorities to set minimum levels for premiums allegedly to protect consumers. Regulations on admitting workers from other countries are meant to protect the local trades from foreign competition; minimum wages are aimed at protecting unskilled workers from cheaper competition. We know that. It is always a matter of reducing competition and putting consumers at a disadvantage. The state itself joins the cartel when it helps vendors obtain higher prices than would otherwise be the case under free competition, to the detriment of consumers. Unfortunately, in this case the pie is not only redistributed but it also becomes smaller. The money equivalent utility loss for the consumers is higher than the increase in profit for the providers since overall economic output is restricted.

Ludwig Erhard realised the damage that the Nazi policies of universal price controls had on the economy. He knew that the ideas of Hitler's economics minister, Hjalmar Schacht, were not compatible with a functioning market economy, and for this reason he lifted the Nazi price controls in Germany earlier than even the Allies intended. This was the foundation of the German economic miracle. Perhaps the strategists in the two ministries should reconsider whether they wish to put this policy in jeopardy and turn back the wheel of history.

Germany: World Champion in Tourism*

Germany failed to become the world champion in football, and many now realise that Germany's claim to be the world champion exporter is a canard. The country tops the export league only in merchandise exports. In the overall export sweepstakes, where services are also taken into account, Germany slips down a notch – even if the exports of SAP and the foreign sales of German consulting engineers are included.

But in tourism, Germany is truly the world champion. The tourist services that Germans purchased abroad amounted to \$73.2 billion in 2005, topping that of the United States (\$69.2 billion), although the US has a population three and a half times larger than Germany's. From the Bahamas to Bahrain, from Phuket to Panama, from the North Cape to the Cape of Good Hope, German holiday-makers travel the globe.

Despite miserable growth rates and mass unemployment, Germans are enjoying themselves. No other developed nation on this earth has so few children in relation to its size; no population is shrinking faster than the German one. And still no nation spends so much money on foreign travel as the Germans. The Germans no longer invest in their future; they are too busy enjoying the present. German luxury liners ceaselessly plough the seas, Lufthansa flies from one record year to the next and the German language is spreading to the last remaining paradises on earth.

What could possibly lie behind this tourism boom?

One possible reason is that Germans still enjoy relatively high incomes, despite current economic problems. This argument falters, however, if one considers that Germany lies only in the mid-income range of European countries. Not only the English and French have overtaken Germany in per-capita income but also the Irish, the Austrians and the Dutch.

A second reason could be the long holidays. With about 6 weeks of holiday entitlement, Germany ranks in the top group, still behind Sweden, the Netherlands and Denmark but above the Western European average and more generous than countries like France and Britain that have only 5 weeks of holiday.

Income distribution is a third reason. Even though average incomes do not stand out in an international comparison, the income of those who have ample time for holidays

* Published as "Sylt oder Mallorca," *WirtschaftsWoche*, no. 31, July 31, 2006, p. 138.

does. German pensioners are better off than pensioners in almost any other country. The eastern German pensions are even ten percent higher than those in western Germany. Also the unemployed, who have lots of free time on their hands, are not short of money in Germany. And students, with five months of vacation a year, can, as a rule, rely on generous transfer income. Fully 41% of the adult population in Germany are recipients of government transfers. Thus, there is ample time and money for holidays abroad. The broad swathe of hotels along Europe's southern edge, from Tenerife to Rhodes, would not have its present shape without money from the German social insurance systems.

But why do Germans take their holidays abroad instead of vacationing at home? Indeed, those who are just barely able to afford a holiday from their transfer income are particularly keen on a vacation abroad.

This could be because of the weather, which is usually better elsewhere. But German summers are also becoming more attractive thanks to global warming. This summer has certainly been warm enough.

A more important reason is the wage structure in Germany. Tourists buy services, and the price of these services depends directly on wages and taxes. Germany has a very flat wage scale in an international comparison, with extremely high labour costs for simple services. This has destroyed some of the domestic demand for these services.

Labour costs themselves are the result of government transfers. On the one hand, these transfers result in taxes and social contributions that make labour more expensive. On the other hand, they create a wage competition that drives up the market wages for simple services. The transfers are defined, as a rule, as wage replacements, i.e. they only flow to their full extent if people are idle and they are withdrawn progressively if people work. They act as a minimum wage in wage bargaining, and compress the wage scale, pushing it up from below.

State transfer payments have increased the purchasing power of the masses, but at the same time they have made simple work more expensive and have thus diverted demand for tourist services to other countries. This is the simple reason why Germany is the world champion in tourism.

The increase in wages for simple work is also the reason why the customers of German holiday areas have changed. While mass tourism has turned away from Germany, higher income groups continue to use the high-quality services of German hoteliers. Formerly only rich people could afford a vacation on Mallorca. Poorer people went, if at all, to the North Sea or to the Alps. Today the opposite is true. The rich nowadays dine in Norderney or Garmisch, while the masses must fly to Mallorca.

Germany: A Land of Immigration?*

Exactly how many immigrants live in Germany? Until recently there was no clear answer to this question. It was only known that the foreign population amounted to 8.9 percent, and this was normal for Europe. Many were surprised at this low percentage, because it does not correspond to the picture they see on the streets.

Now that the Federal Statistical Office has published the results of its new micro census we know more. Now the talk is suddenly of 18.5 percent immigrants. The surprise could not have been greater: almost every fifth inhabitant in Germany is now an immigrant.

The contradiction between the two numbers is only apparent, since foreigners and immigrants are not the same. Immigrants can be naturalised, ceasing then to be foreigners, and they can also be Russian or Romanian Germans, who are counted in any case as German citizens. The 8.9 percent refers only to those immigrants who do not have German citizenship. In contrast, the 18.5 percent encompass all immigrants, counting the Russian and Romanian Germans as well as the children of these immigrants including those born in Germany. The Federal Statistical Office thus speaks of the “population with a migration background”. Foreigners who live here as tourists and are not registered are not yet included in this number.

A somewhat different definition of immigrants refers to that part of the population that was born abroad. Children born in Germany are not counted here, nor is citizenship taken into account. According to this definition, the share of immigrants in 2005 stood at 12.6 percent. This is quite a high figure. It is lower, to be sure, than the corresponding share in the classical immigration countries such as Canada, New Zealand and Australia, which lies between 18 and 22 percent. Nevertheless, this proportion is higher than in countries such as the Netherlands, Austria or Sweden, which have shares of between 10 and 12 percent. Even the United States had a smaller percentage of foreign-born population than Germany in 2000, at 11.1 percent. Germany is indeed a country of immigration.

Mass immigration has been going on for several decades and will not abate in the coming ones, especially in light of the imminent EU membership of Romania and

* Published as “Viele Tore,” *WirtschaftsWoche*, no. 27, July 3, 2006, p. 198.

Bulgaria as well as the granting of the free movement of labour for the other Eastern European EU countries as of May 2011. If Turkey is admitted to the EU, immigration will speed up even more.

To what extent immigration enriches German culture or puts extreme pressure on society has been the subject of much discussion. In terms of the economic benefits, the judgments are also mixed. On the one hand, the country needs immigrants in order to keep the economy running. Even if we include the newborn children of today's immigrants, which account for a third of all births in Germany, the number of inhabitants in Germany is currently falling more rapidly than the population of any other developed country in the world. Only continued immigration can stabilise the country. Without immigrants, the German economy would be lacking far more than the many goals scored by the naturalized Polish immigrants, the soccer players Miroslav Klose and Lukas Podolski during the recent World Cup championship.

On the other hand, Germany does not need the indirect immigration into the welfare state that has been going on for three decades. It makes no sense to let millions of foreign workers into the country when the less qualified nationals are induced by a generous replacement wage system to clear the stage to make room for those new immigrants. The rigid, low-wage limits fixed by social assistance and unemployment assistance (Unemployment Benefit II) – because no one is prepared to work for less than the state pays them for being idle – have led to a nonsensical migration pattern. Immigrants, who are not entitled to such benefits, take the jobs, while the nationals let themselves be pushed, not altogether involuntarily, into the easy chairs that the welfare state has prepared for them.

Up to now this economic foolishness has been financed by new public borrowing and taxes that are primarily paid for by the high-income groups. The lower 40 percent of income recipients in Germany pay no income tax at all while the upper 10 percent shoulder fully half of the total. No wonder that the lower strata of society have no real objection to immigration. Many even welcome the arrival of others who occupy an even lower rung than they do. They profit from cheap döner kebab sandwiches and are happy to have their rubbish picked up by the immigrants. But it is no wonder that the taxpayers are fleeing. Today, Germans invest 50 percent more abroad than at home, and young talent is also leaving the country.

Germany can no longer afford this course, since the redistribution at the expense of the tax-payers has its limits even if the grand coalition thinks it can continue to expand these limits by financing an increasingly larger part of the welfare budget from taxes. However, the capital-flight reactions will prevent a continuation of this course even if

the democratic forces insist on an intensification. Instead of redistributing even more income, Germany must at last reassess its social model and make it fit for mass immigration.

A Suit from a Cabinetmaker?*

A criticism of the combi-wage proposals of the CDU/CSU

The CDU/CSU have presented their combi-wage proposals. Fearing that the combi-wage will be too expensive, they want to limit the wage subsidies to subgroups of the labour market. Their fears are justified. Under no circumstances is it possible to channel all dismissed employees back into the labour market with permanent subsidies. That would be exorbitantly expensive.

But it is also not possible to limit subsidies in the way that the general secretaries of the CDU/CSU intend by restricting them to the so-called long-term unemployed and to new, young entrants to the labour market. If these groups are subsidised at 40 percent, as in the proposal, little more than a displacement effect will be achieved. No new jobs will be created due to the so-called marginal principle, one of the elementary laws of economics.

According to the marginal principle, market price and transaction volume on markets where competition prevails are always determined by the providers with the highest costs who are just barely able to stay in the market: The expensive providers determine the prices, and the cheaper providers make the profits! Imagine a market for cars with initially only equally expensive domestic traders. The price of cars is so high that these traders just manage to get by. Now a limited contingent of cheap re-imports is thrown onto the market. Since the price of cars sold by domestic traders cannot fall, the overall turnover volume can also not increase. The re-imports will completely replace the cars sold by domestic traders.

It is very similar on the labour market. Currently there are only expensive providers of labour. At their labour costs, there is not a sufficient number of jobs. Now the CDU/CSU wants to infiltrate the labour market with previously unemployed persons at lower labour costs by reimbursing the firms for part of the labour costs. The result will be that the subsidised workers will be fully employed because they are cheaper than the others. Since the other workers cannot work for less, however, the overall volume of labour also cannot change. After the allotment of subsidised employees is exhausted, it will only be the normal workers whose labour costs will play a role in decisions to create new jobs. As a result, we can expect a virtually complete displacement effect. The plan will be very expensive and the labour market effect will be zero.

* Published as "Ein Anzug vom Schreiner?," *WirtschaftsWoche*, no. 23, June 3, 2006, p. 178.

We would have a repeat of what the 400 euro jobs have already attempted. Since the recipients of replacement wages did not profit from the exemption from payroll taxes because the advantage was cancelled out by the deductions from their welfare payments, they have not been able to offer their labour more cheaply than before. For this reason these jobs were taken on by pupils, students, assisting spouses and pensioners, who were not faced with a deduction of welfare payments and whose wage demands were correspondingly lower. They replaced normal employees one to one, but, since they only represented a sub-group on the labour market that as such could not conquer the market as a whole, no effects on overall employment resulted.

Any attempt to increase employment by subsidising sub-groups of a market while the demands of normal employees remain unchanged, are doomed to failure. Either all providers on a market are subsidised or none at all. Partial solutions make no sense. Only if everyone is subsidised can one guarantee that the marginal providers of labour become cheaper and the transaction volume increases.

This does not mean that combi-wages are only possible at immense costs. One can keep the costs low by limiting the subsidies to a sub-group of the labour market itself rather than to parts of the labour force within a particular labour market. In concrete terms, one can subsidise especially the low-wage earners, who as a rule are the low skilled, and in this way populate only particular, demarcated labour markets.

This is precisely the concept of Activating Social Assistance, which grants personal wage subsidies to everyone in the lower income groups, also to those with jobs, thus comprehensively lowering wage demands and ensuring social equilibrium. The Ifo proposal of Activating Social Assistance, which could easily be implemented via a slight modification of the second phase of unemployment assistance (Unemployment Benefit II), would save the state 8 million euros annually in the short term, provide jobs for 3.2 million people in the medium term and raise the standard of living of low-wage earners clearly above the Hartz IV level. But one could also choose the proposal of the German Council of Economic Experts or that of the Scientific Advisory Council attached to the Federal Ministry of Economics, both of which are similar to the Ifo plan.

Economists are constantly amazed at how politicians seek to re-invent the wheel and introduce flaws into their legislation because they only think in legalistic and political terms and neglect even the simplest laws of economics. This is precisely the case with the combi-wage. Why does the CDU/CSU not trust the advice of the specialists who have dealt with this problem for some time and have arrived at a unanimous proposal. You don't take shoes to the baker to be repaired or have a suit tailored by a cabinetmaker.

Subject versus Object*
O the design of wage subsidies

Germany will surely get wage subsidies, the so-called “combi-wage programme”. Politicians have recognised that Germany’s mass unemployment of the unskilled can only be ended if public support is granted for participating in the labour market rather than for staying away. The only question is whether the combi-wage is to be introduced as object or subject support, i.e. whether the firm or its employees are to be subsidised. Public discussion of the combi-wage is beset by confusion because no clear distinction is made between these alternatives.

This confusion becomes evident when the argument is made that the introduction of wage subsidies would induce employers and employees to conspire and agree lower wages in order to receive higher subsidies. Statutory minimum wages, it is maintained, are needed to guard against this.

To a certain extent, the argument is understandable when subject support is meant. The lower the wage, the bigger the subsidy that the government must pay the employee if he is to be guaranteed a given income. It is incomprehensible, however, in the case of object support, because in that case it is just the reverse: the higher the wage, the higher the subsidy that the government must grant the employer if a given level of labour costs is not to be exceeded. According to this logic, one would have to demand a statutory maximum wage to prevent the state from being exploited.

The idea of a conspiracy between the employer and his employees is wrong, however. Firstly, the government will neither fully compensate wage reductions nor wage increases but set subsidy rates that always imply only partial compensation. Secondly, Germany has a labour market in which companies compete with one another.

To be sure, in the case of subject support, there will be a reduction in wage demands to the extent of the support, and that is exactly why more jobs will be created. But even with very generous subsidies, the wage cannot fall to zero. The market equilibrium may be reached at a wage that is estimated at one third below today’s low-wage level. Even with more generous subsidies, lower wages are not possible as employers would bid up wages when competing for scarce employees. Statutory minimum wages at today’s low-

* Published as “Subjekt versus Objekt,” *WirtschaftsWoche*, no. 15, April 10, 2006, p. 186.

wage level are not only unnecessary, they are harmful. They would prevent the creation of new jobs.

In the case of object support, labour costs fall in the extent of the support. With limited subsidies, gross and net wages are unchanged because they are constrained above the market-clearing level by the available public replacement incomes. If the subsidy is sufficiently generous, market equilibrium will be reached here, too, and only then can the employers' competition for scarce labour lead to higher wages.

Regardless of subject or object support, the resulting market wage is independent of where the money goes. Both types of support will yield the same labour costs, the same net wages and the same employment effects if the government expends the same support volume and subsidises the same economic activity.

However, the same activities are not being supported. In contrast to subject support, object support cannot take account of the individual characteristics of the employees. In particular, it is hardly possible to consider other incomes like interest, rents and government benefits, and if so, only at prohibitive administrative cost and at the expense of privacy. As a consequence, there would be many losses due to the scattershot approach to support. An uncontrolled subsidy machinery would be set in motion whose costs could hardly be contained. The negative experiences made with German public housing construction show what may be expected.

Those in favour of object support argue that subject support would create a revolving-door effect because employers would be induced to replace expensive already working employees with cheaper new employees. This would cause the greater fiscal burdens. The revolving-door effect would be prevented in the case of object support if this support were limited to an increase in employment compared to a historical base year. This argumentation is wrong.

For one, subject support can be financed despite the full revolving-door effect if German "Unemployment Benefit II" (ALGII) is redesigned according to the Ifo Institute's Activating Social Assistance programme. The free earnings bracket where own income does not imply subsidy cuts would have to be raised from €100 to €500 and ALGII at inactivity would have to be cut by one third. And if need be, community loan jobs would have to be created at wages equal to the level of today's ALGII. This would create more than three million jobs, reduce government outlays by €5 billion, and raise poor people's standard of living markedly above the level of ALGII.

Furthermore, the revolving-door effect would also come about with object support and would, in addition, have dramatic effects on firms. New firms, founded after the

Subject versus Object

base year, would enjoy the full support, whereas old firms that have reached maturity would get nothing. Therefore, old firms would be driven into bankruptcy and give way to new firms. In view of the foreseeable mass protests of the established firms, I pity the political party that promoted such an approach.

PISA and the German Three-class Society*

It is now official: The UN Special Rapporteur on the Right to Education, Vernor Muñoz Villalobos, has sharply criticized the tri-partite German educational system and has made it partly responsible for the poor performance, in terms of equal opportunity, in the PISA tests. The country of poets and thinkers has again been pilloried because of its poor educational system.

Muñoz is right. The tripartite educational system, rare in most parts of the world, no longer fits the times. It reflects the three-class society of the nineteenth century. Formerly, the nomenclature was the folk school, the middle school and the upper school, an implicit admission that the schools were for the upper class, the middle class and the common folk. Today the politically correct terms are lower secondary school, intermediate school and upper secondary school (Gymnasium), but the new names hardly disguise the fact that the German educational system cements the existing inequality in society.

Germany separates its pupils into the three school forms already at the age of ten, while virtually all other countries keep them together until they are out of puberty, at the age of 14 or 15, and only then separate them, and mostly such that some pupils leave the common school earlier than the others. The early selection maximises the influence of parents and minimises the importance of the children's actual talent. A child of academic parents has a seven-times greater chance at an upper secondary education than a child of a skilled labourer. Children of a foreign background are particularly disadvantaged. While 40 percent of German pupils go on to upper secondary school, only 18 percent of foreign pupils make it. Every second foreign pupil (49 percent) attends a lower secondary or special school. Among the German pupils only one in five (21 percent) does.

The German system admittedly has more than just disadvantages. The early separation of pupils gives special support to the talented ones. The German upper-secondary school diploma (Abitur) is still considered an excellent degree. The French baccalauréat or the Anglo-Saxon high school diploma, which more than half of all pupils achieve, are comparatively inferior.

* Published as "Alte Ideologien," *WirtschaftsWoche*, no. 11, March 13, 2006, p. 250.

Nevertheless, the advantage of a better promotion of gifted pupils does not offset the obvious disadvantage that the talent reserves of working-class children are not exhausted. One finds many children at German upper secondary schools that do not belong there, and among the children of craftsmen and workers there are many that could have achieved a higher education if they had been supported early enough.

As the Ifo Institute's Ludger Woessmann has determined, in an extensive econometric study based on the OECD PISA data, there is no empirical evidence that the early separation of pupils has a positive influence on the average PISA test results. In fact, there is even some evidence that the early separation tends to reduce average pupil performance. In any case the early separation leads to a massive increase in the performance differences of the tested pupils. Germany, alongside Belgium, has the widest spread in pupil performance of all OECD countries, which has received the strong criticism of the OECD. If these greater differences could be seen as the price for higher average pupil quality, the German system could still perhaps be justified. But since this system increases the differences without improving average performance it should be committed to the dustbin of history.

Germany must again debate the benefits of the comprehensive school. In principle the comprehensive school that some states had introduced in the 1970s on an experimental basis was not a bad idea. The problem was that the idea was burdened with the ballast of an antiauthoritarian educational philosophy and was not successful as a result. It is now time to forget the old ideologies of the left and right and to adjust the German educational system to international standards.

The way Germany has tried to achieve equality and justice is misguided. Since Germany abuses equal opportunity with its educational system, it needs an excessive welfare state to produce the desirable measure of equality at least after the fact. The underprivileged claim, by way of democratic redistribution, what was refused them in their education. This is expensive and has counterproductive incentive effects. High German unemployment and anaemic economic growth have their main cause precisely here. How much better it would be to reduce the inequality from the very beginning, when educating pupils. Then the state could save a portion of the high redistribution costs that crush private initiative and motivation. And if everyone is aware that their children have a fair chance for advancement, they will be more reconciled to a liberal society and its economic benefits. Workers with hopes that their children can become millionaires will no longer demand an envy tax on millionaires, as Germany has just introduced.

A New Welfare State*

A market economy is efficient, but it is not just. Because wages are determined by the law of scarcity, some people cannot earn enough money to live a decent life.

In Western Europe, the welfare state helps these people. It guarantees a socio-cultural subsistence minimum by paying replacement incomes in the form of social aid, unemployment benefits, or early retirement benefits. If the market does not provide you with a sufficient labour income, the state will provide an income without work for you.

But, as humane as this policy is meant to be, it is largely responsible for the mass unemployment from which Europe now suffers. The reason is simple. Replacement incomes are wages for doing nothing. They establish “reservation wages” or minimum wage demands against the private economy that employers are increasingly unwilling or unable to satisfy.

Employers are not altruists. They employ a domestic worker only if there is a surplus of his contribution over his cost and if this surplus is not smaller than the respective surplus that a rival worker in another country or a robot could generate. And workers are not stupid. They accept a job only if they earn more than the public replacement income. Thus, workers who are not productive enough to justify a wage above the replacement income are bound to become unemployed.

While this is an old problem in Western Europe, it has been dramatically exacerbated by the fall of the Iron Curtain, which, together with China’s opening, has suddenly brought 28 percent of mankind into the western market system. The integration of the Asian Tigers in the 1970’s and 1980’s was difficult enough. The addition of the ex-communist countries will remain the world’s biggest challenge in the first half of this century.

* Published as “Arbeit für alle,” *Die Welt*, March 1, 2006, p. 9; printed also in *Die Presse* (Austria), *L’Echo* (Belgium), *Kapital* (Bulgaria), *Financial Mirror* (Cyprus), *Ekonom* (Czech Republic), *Aripaev* (Estonia), *Taloussanomati* (Finland), *Vilaggazdasag* (Hungary), *Diena* (Latvia), *Diario Economico* (Portugal), *Dilema Veche* (Romania), *Danas* (Serbia), *Sme* (Slovakia), *L’Agefi* (Switzerland), *Diario Las Americas* (USA), *Jordan Times* (Jordan), *Al Raya* (Qatar), *Al Eqtisadiyah* (Saudi Arabia), *South China Morning Post* (Hong Kong), *The Japan Times* (Japan), *The Korea Herald* (South Korea), *Daily Times* (Pakistan), *The Straits Times* und *Lianhe Zaobao* (Singapore), *Taipei Times* (Taiwan), *Les Echos* (Mali), *Business World* (Philippines), *AKI-Press* (Kyrgyzstan), *Optovik* (Uzbekistan), *El Siglo XXI* (Guatemala), *Ultima Hora* (Paraguay).

While the integration of these economies may yield gains from trade for most countries involved, it creates huge problems in the West, stemming from more intense downward pressure on the wages of the unskilled than ever before. Financial capital and direct investment will flow from West to East, the Western economies will be forced to specialise in highly skilled, capital-intensive production that creates fewer jobs, and unskilled immigrants will move to the West.

All of these forces will increase the excess supply of unskilled labour in the West, thereby reducing the equilibrium wage rate. True, the movement towards a new equilibrium will last decades. Most readers of this article will be dead before it is reached. But the process will be enduring and persistent.

If Western labour markets were flexible and gave way to the increasing pressure, employment could be maintained with falling wages for unskilled workers. But, given that the welfare state makes wages “sticky,” an increasing level of mass unemployment is the most likely consequence of globalization.

Politicians in the West react to the downward pressure on wages by making them even more rigid. Germany, for example, plans to impose a legal minimum, as other countries have done in the past. But such measures will merely worsen the situation: specialisation in activities in which unskilled workers are not needed intensifies, even more capital will leave the country, and even more people will be attracted from abroad, driving more nationals into the welfare system. Mass unemployment in the West will be higher, not lower.

Europe’s welfare system, based on replacement incomes and minimum wages, will not survive globalization. It may take another decade or two for politicians to understand this, but in the end they will. There is no way to turn back the tide of history.

The real question, then, is whether the European welfare state must die altogether.

A new welfare system that could both preserve Europe’s social values despite the forces of factor price equalization and avoid mass unemployment would have to be based on wage supplements rather than replacement incomes. Everyone would have to work, at whatever wage he finds employment, and the government would then pay a supplemental income to ensure a socially acceptable standard of living.

When governments pay people while they work, rather than only if they do not work, as is the case today, welfare benefits imply no minimum wage demands. Income from labour freely adjusts to forge an equilibrium between supply and demand. At lower wages, more jobs are created, because employers find it profitable to realise a larger fraction of the blueprints on their tables and the ideas in their heads. And poverty will

be avoided because unskilled workers will have two incomes: one earned by themselves and one provided by the government.

Such a system is expensive, but so is the current system, which pays millions of people 100 percent of their incomes while they are not working. In the new system, the state pays even more people, but the payments per head are much smaller as they represent a supplementary rather than a full income.

It is a matter of algebra and econometrics to determine which system is cheaper. According to reasonable estimates for Germany by the Ifo Institute, a welfare system based on wage supplements will, indeed, be cheaper. In any case, substituting replacement incomes by wage supplements will not only lead to more employment and higher GDP, but ensure that fewer people are deprived of the dignity that only a responsible working life can offer.

Six Principles of the Combi-Wage*

The plans for introducing wage subsidies, called “combi-wages” in Germany, are entering a final stage. After all three coalition parties have explicitly come out in favour of subsidised wages, the goal is clear. But caution is in order. Mistakes must be avoided and the plan must have a cogent economic design. Hence this review of the problem and its solution.

Given the qualifications of the workforce, the technological knowledge, the capital stock and the international wage competition there is a quasi natural spread of domestic wage rates, which would ensure full employment in all segments of the labour market. This wage spread would come about automatically in competitive labour markets, and it would be efficient because the available human labour would be exploited fully and the national product maximized correspondingly. However, the inequality would be immense. Many people would not be able to make a living from the resulting earnings.

This is the reason why the welfare state ensures a subsistence level by means of wage replacement payments, in particular in the form of social welfare and, in Germany, the new Unemployment Benefit II. These wage replacements compress the accordion of wage distribution from below, thus producing unemployment. Wages at the lowest level of qualifications must be at a certain distance above the wage replacement income, and all the rest of the wage distribution builds on this level. By means of a chain of substitution, low to medium wages are shifted above the market clearing level. The unemployment caused by the wage increase is greatest among the lesser qualified and decreases gradually into the area of the more highly qualified. Wages of university graduates are so far above the level of social welfare that the accordion effect is lacking here. No wonder that Germany with its high wage replacement level is the OECD champion in unemployment for the lesser qualified, whereas joblessness among the more highly qualified is average in an international comparison.

The shift from wage replacement payments to wage supplements or combi-wages allows the return to the natural wage spread because wage subsidies do not represent minimum wage claims. The outsourcing of simple labour is slowed down, fewer people are replaced by robots, fewer factors of production are shifted from the labour-intensive domestic sectors to the capital-intensive export sectors, and above all people can afford

* Published as “Sechs Grundsätze,” *WirtschaftsWoche*, no. 3, January 12, 2006, p. 128.

to acquire the services that others offer. At the same time, poverty is avoided because low wage earners receive a state supplement to their wages. For these effects to occur, six basic principles must be followed.

First: The state must grant its wage subsidies permanently. Only in this way can the larger wage spread be made socially acceptable, which is the precondition for a permanently higher level of employment.

Secondly: The combi-wage must not be linked to statutory minimum wage constraints since it has its effect precisely because it eliminates the minimum wage constraint implicit in the replacement wage system. Wages for simple jobs will nevertheless not experience a free-fall since at some point there are more vacancies than unemployed and employers compete for workers by offering higher wages. According to estimates by the Ifo Institute, wages for simple labour will fall by approximately a third if an additional 2.3 million lesser qualified are to find employment.

Third: It is impossible to create more jobs without lowering labour costs, and it is impossible to lower labour costs only for newly employed persons because otherwise there would be revolving door effects. Cheaper outsiders would replace more expensive insiders. For this reason combi-wage models that seek the reintegration of the unemployed with temporary monetary benefits make no sense. And for this reason combi-wages must also be paid to insiders with jobs when their wages fall.

Fourth: In order to identify the needy insiders, combi-wages must be oriented around personal income and family circumstances. The wage subsidy must therefore be designed as a negative income tax. Mere wage subsidies to enterprises would lead to inequity, inefficiency and increased fiscal burdens. Utter chaos would be the result.

Fifth: A combi-wage that would be available to all previously unemployed persons is out of the question. This was the self-proclaimed core of the Hartz reforms. These reforms sought to reduce the labour costs of all previously unemployed persons, without time limits, down to 50% of negotiated wages. The idea was absurd. Its implementation would have cost gigantic sums. Only subsidies at the lower end of the wage scale are feasible.

Sixth: For such combi-wages to be financed, wage replacements must be correspondingly reduced. Today the state spends about €100 billion per annum for unemployed persons, including early retirees. A part of this money must be employed for combi-wages. Giving low-wage earners subsidies to their wages can be cheaper than continuing to finance the unemployed a hundred percent. According to calculations of the Ifo Institute, a combi-wage in the form of activating social welfare would cost approximately €5 billion less than the Hartz IV reforms. The state should spend its

Six Principles of the Combi-Wage

money for joining the labour force instead of for staying away, and it will not need to expend any more money for this than it already does.