The Ifo Viewpoints 2003

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Bazaar Economy[*]

Even if the economy is now recovering, the deep structural change in the German industrial landscape observable since the mid-1990s will continue at an alarming scale. Outsourcing and offshoring remain the options for offsetting Germany's competitive disadvantages. German big industry has been engaged in Asia for some time, to benefit from low labour costs and to supply the international markets from Asia. Now German mid-sized businesses are establishing ties with Eastern Europe. These firms did not dare to venture into Asia but are now willing to risk involvement in Eastern Europe because the start-up costs are very much lower there. Eastern Europe also offers very low wages, but lies at Germany's doorstep and is part of our cultural area. In addition, the former Communist countries have overcome their transformation crises, have established stable legal systems, and a majority will join the EU in a few months.

The list of firms migrating to the East is long and reads like a Who's Who of the Mittelstand, the mid-sized companies that are the backbone of German industry. Sixty percent of enterprises with fewer than 5.000 employees surveyed by the Cologne Institute for Economic Research (IW) have already established locations outside the EU. These firms have not completely pulled up their stakes in Germany since they still plan to supply their worldwide customers from Germany. But they are increasingly shifting larger parts of their intermediate product chain to Eastern Europe. Either they have invested there themselves or they buy their inputs from other firms that have production sites there.

The low wages of the Eastern Europeans are too tempting to resist, especially since many competitors in Asia and other parts of the world pay lower wages. The hourly wages of industrial workers in the accession countries range from a third (Slovenia) to one tenth (Estonia) of west German wages. The largest country in the group, Poland, has hourly wages that are approximately a quarter of east German and a fifth of west German labour costs. These wage differentials will not change quickly. Even if we assume an annual convergence rate of two percent, which is double the rate observed in Western Europe in past decades, Polish hourly industrial wages would only amount to a third of west German wages in 2010 and less than half in 2020. No wonder that German enterprises are taking advantage of shifting production sites abroad to reduce costs.

[*] Published as "4,5 Millionen Verlierer," *Die Zeit*, December 22, 2003, p. 28.

According to a Bundesbank study, they had created no less than 2.4 million jobs abroad by 2000.

Businesses that do not play that game risk extinction. The number of German bankruptcies continues to set new records. In Germany today, there are three times as many bankruptcies as ten years ago and five times as many as twenty-five years ago. Because of these bankruptcies, the big German banks now face a major crisis that will be very difficult to overcome.

The industrial statistics clearly show how enormous the incentive is to avoid Germany's competitive disadvantages by outsourcing. Although German industrial production increased by fifteen percent between 1995 and 2003, real value added of German industry increased by only 5 percent in the same period. In the past both of these figures ran more or less parallel to each other. Two thirds of the increase of German industrial production since the mid-1990s presumably stem from outsourcing to low-wage countries and only one third is due to an increase of domestic value added.

This throws a bad light on the competitiveness and export strength of the German economy, because we must obviously distinguish between the competitiveness of German industry and the competitiveness of German workers. German enterprises will remain competitive on international markets thanks to their Eastern European hinterland, but German workers have already lost their competitiveness. Industrial employment decreased by ten percent in the same period without new jobs having been created to offset these losses. A total of four and a half million Germans were unemployed in 2003. Four and a half million Germans are no longer competitive.

Competitiveness can no longer be measured in terms of German exports. Because of outsourcing to Eastern Europe German industry can still shine on the international markets with its products and can point with pride to its export statistics. An Audi whose engine is produced in Hungary is counted at its full value in the German export statistics. However, "Made in Germany" is increasingly becoming a false label. Only the final assembly takes place in Germany. The value-added components are coming more and more from Eastern Europe.

Germany is becoming a bazaar economy that sells the world economical, high-quality products that were not produced in the country.

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The German Disease and the Agenda 2010*

The German coalition government has been given a second chance, but the slim majority will probably not suffice to implement the long-overdue economic reforms that economists have insisted on. To shoulder the tremendous tasks a grand coalition would have been better, but the power interests of the parties have prevailed. Now we can only hope that the present coalition has learnt from the past four years and will finally tackle Germany's long-term economic problems. Merely waiting for the economic upswing will not suffice to stimulate the labour markets and the growth forces of the country. Germany is enmeshed in a fundamental economic crisis that has less to do with the business cycle than with the structural incrustations of the social system and the labour markets as well as neglect of the educational system.

Social reform that replaces wage compensation payments with wage supplements is urgent because wage compensation payments create reservation wages that are too high for many employees and prevent the creation of jobs. Unemployment assistance and social welfare benefits should be combined and reduced drastically. The money saved should be used to pay wage subsidies in the low-wage sector. State-guaranteed loan employment in the low-wage sector – and only here – must be made available to prevent poverty from arising. The motto of the new welfare state should be "help people help themselves". Very little can be achieved with programmes such as €500 jobs or the Mainz Model, or even with better job placement by the Federal Labour Office as foreseen by the recent Hartz proposal. Better concepts have already been presented by the Ifo Institute and by the Scientific Advisory Council of the Federal Ministry of Economics.

In addition, labour law and collective bargaining must be reformed. Industry-wide wage agreements should not have a cartel status. If the majority of a company's employees accepts wage cuts to save jobs, no union should be allowed to intervene. Universally binding declarations, rules to honour wage agreements, and the favourability principle are now cartel-like political instruments. They are not compatible with a functioning labour market. Dismissal protection must be loosened for newly

* Published as "Verschlimmerung der deutschen Krankheit," *Financial Times Deutschland*, no. 202, October 20, 2003, p. 26.

hired employees so that they can be employed in the first place. At least the option of labour contracts with limited dismissal protection should be admitted.

The state must no longer be the implicit accomplice of the job-holders' cartel by concealing unemployment and easing labour market pressure with early or semi retirement schemes and Job-Aqtiv laws. Government subsidies that encourage able workers to retire at sixty or even before – a policy initiated under Helmut Kohl – betrays a naive understanding of the effectiveness of labour markets, a unscrupulousness attempt to falsify unemployment statistics, and a kow-towing to the union cartels. Such policies are extremely costly and are poison for the labour market. In a country with an ageing population, the retirement age must be raised instead of lowered.

The educational system must be fundamentally reformed, leaving the true asset of German education, the vocational dual training system, intact. All-day schools should be introduced and the thirteenth year of obligatory education eliminated, the sciences should be emphasised, and the teaching profession should be made more attractive. Teachers should have the social status they had a hundred years ago when Germany was an educational model. The best talents in the country should become teachers and not those who wouldn't stand a chance in private enterprise. Salaries for new teachers should be raised to encourage the most talented to apply. Germany spends 30 percent of GDP on social programmes but only 4 percent on education. More competition should be introduced in the universities so they can become centres of top research. The lukewarm solutions proposed by the German Conference of Educational Ministers have prevented this from happening.

Educational reform will cost money, and simultaneously the burden on labour must be lowered. In Germany, the marginal tax burden on the value added generated by an average employee is the highest in the world at 66 percent and is one of the main reasons for unemployment and the growth of the shadow economy. The lowering of the tax burden on labour and the promotion of education will create tremendous budgetary problems. Government borrowing is not an option because of the Maastricht criteria, and privatisation revenues are also limited under the current capital market situation. There is no alternative to broad cuts in government spending.

Implementing these cuts will be the real task of the new government. A swathe must be cut through the jungle of subsidies. Reducing subsidies by half would bring budget relief of between €50–75 billion and would lower the government share in GDP by 2.5 percentage points. In addition the government must stop the spiralling increase of health insurance and pension costs. Health insurance can certainly be privatised, and a new pension formula that slows down the rate of pension increases would bring considerable budget relief. Without cutting back the social budget, which accounts for 30 percent of GDP, Germany is ill-prepared for the future. But does reform have a chance with the coalition's slim majority?

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Hands Off the Mileage Allowance!*

In its search for additional tax revenue the German government is considering reducing the mileage or distance tax allowance for employees from 40 cents (36 cents for short distances) to only 15 cents. As a result about 3 billion euro would flow into the treasury. This measure is labelled and justified as a subsidy reduction.

A confusion of terms exists here since true subsidy reductions lead to a decrease in public expenses and not to an increase in its revenues as would come from a reduction of the mileage allowance. But that is secondary. Not semantics but economic logic is called for, and this by no means justifies a reduction or elimination of the mileage allowance.

It is true that lowering the allowance will reduce the distances commuters cover because many will no longer be prepared to take jobs far from their homes. This fact is clear but the interpretation is not. Some say that less traffic is better, others say that mobility is good. Who is right?

In a market economy the criterion for correct human behaviour, as a rule, is a situation without government influence, i.e. without an income tax. An income tax is neutral and distortion-free if its collection does not change the economic choices of the people.

Here's an example. Assume that someone is offered a job where he would earn 5,000 euro a year more but would also entail 4,000 euro more in commuting costs. He would accept the job if there were no taxes. And in fact he should accept it because his choice would bring a social surplus of 1,000 euro in comparison to retaining his old job.

An efficient system of taxation that does not alter his decision allows a deduction of the actual commuter costs. It defines the additional taxable earnings as 5,000 euro in salary minus 4,000 euro in commuter costs, or 1,000 euro. If, let us say, half of this 1,000 euro is taxed away, the advantage of changing jobs is reduced but still present. Thus a job change would still take place. A surplus for society in the form of 1,000 euro which arises from the change of jobs can be shared by the employee and the state.

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* Published as "Hände weg von der Entfernungs-Pauschale!," *Süddeutsche Zeitung*, no. 221, September 25, 2003, p. 20.

A system that does not allow a deduction of costs would change the employee's decision in comparison to the reference situation without taxes and is therefore inefficient. The net wage increase in such a system would be 2,500 euro. After deducting the gross commuting costs of 4,000 euro the employee would be losing 1,500 euro, although a social gain for the individual and the state of 1,000 euro would still have been possible. The employee would now be reluctant to change jobs and a possible gain of 1,000 euro for all participants would not be realised.

These considerations are not limited to commuter costs alone but touch on the basic economic principles of taxation. Whenever a tax allows more or less than the deduction of the actual costs, it leads to a detrimental distortion of choices. For precisely this reason we have income and profit taxes that allow for the deduction of income-related expenses. If the principle of tax deductions for actual income-related expenses is abandoned, sand is thrown into the gears of the economy. If certain expenses are declared non-deductible, they appear much larger in an individual's calculations than they really are, and this provokes economically incorrect decisions.

In order to justify the reduction of the mileage allowance it would be necessary to argue that this allowance is larger than the actual commuter expenses. However, at only 36 or 40 cents per kilometre, this is hardly possible. The estimations of the German Automobile Association (ADAC) on the mere monetary costs of driving lie in the range of 50 cents or more.

The non-deductibility of commuting costs acts like the imposition of a specific tax on such costs. A possible argument to justify such a tax is the cost of environmental pollution, congestion or road construction. But such costs provide weak arguments since the tax on mineral oil and the new German GPS road toll system are much more precise instruments for allocating these costs. Therefore: Hands off the mileage allowance!

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Working Longer*

Germany has a labour cost problem. The hourly wage costs of industrial workers have increased in the last twenty years by almost 40% in real terms. This is more than in most other countries and has weakened Germany's competitiveness. The hourly wages of German industrial workers are the highest in the world, and they exceed the wages of competitors in East Asia and in Eastern Europe several times over. This is a growing problem for the German economy. It explains the record number of current bankruptcies and the numerous relocations of medium-sized businesses abroad, which are often the last chance for survival.

Wages can be higher than elsewhere to the extent that German producers are better than others. To restore competitiveness, it is not necessary for wages to fall back to the Polish level. But it would be good if the gap to a country such as the Netherlands, which has built up over the last twenty years, could be closed again. Dutch wages have increased by only 23 percent, and Holland has achieved a high level of employment despite the lull in the world economy. German labour costs would have to fall by around 12 percent per hour to match this..

That could almost be reached if employer contributions to pension insurance, unemployment insurance and to nursing care insurance were charged to employees, or if employees paid for the employer contributions to pension and health insurance. Alternatively it would suffice if wage increases were held to one percentage point below productivity increases for 11 years. However, these alternatives will hardly find the acceptance of employees and their unions.

The only other reasonable choice is extending working hours. An 11% lengthening of working hours would give enterprises the cost savings that would offset the disadvantages built up over twenty years vis-à-vis the Netherlands. Eleven percent longer working hours means an increase of the working week by around four hours. Most employees would then work 42 instead of 38 hours a week. This is not the end of the world. It would restore working hours to the level they had twenty years ago.

In an international comparison, this would also not put Germany in an extreme position. Today Germany has the third lowest annual working hours of OECD

* Published as "Wieder 42 Stunden arbeiten," *Frankfurter Allgemeine Zeitung*, no. 168, July 23, 2003, p. 11.

countries. If Germans worked 11% more, this would place them in the middle range at 1,628 annual working hours, still less than countries like Great Britain, Finland, Ireland or Spain. They would be at about the Italian level, which is still compatible with a dolce vita. Isn't it worth trying?

46

Borrowing or Taxes?*

Europe is experiencing economic stagnation but not a recession. Governments should not use this lull as a pretext for their usual practice of new borrowing to make up for budget shortfalls. The Stability and Growth Pact provides for explicit measures for recessions and sets out clear conditions. As long as GDP does not shrink faster than 0.75 percent, the countries of the Eurozone must not exceed the 3 percent deficit limit. Pacta sunt servanda.

A number of countries are still clearly below the 3% deficit limit. These countries can and should step up spending and create scope for Keynesian demand policies, but not the other countries, and particularly not Germany. We should be embarrassed that we originally forced the other countries to accept the Stability and Growth Pact and last year ourselves violated the Pact with new borrowing of 3.6 percent, which could increase to 4 percent this year. That is a grave breach of confidence in the credibility and stability of our country and damages Germany's image as an investment location. All efforts must now be aimed at consolidating public finances.

To be sure, the tax reform should be implemented according to plan, but this should not involve more borrowing. How this will be possible this year is a total mystery. The government has still not defined the cuts it will make to lower borrowing to below 3 percent. We can be glad if the time schedule of the tax reform remains unchanged with the next stage being implemented in January 2004 and, more important, the following stage in January 2005.

Bringing forward the once postponed tax reform would mean a zigzag course that would only make things worse. The government's motive would be to win greater approval of an unsound budget policy, but they would be suspected of making accomplices of German taxpayers. This would be too obvious to be taken seriously.

For this reason it is unnecessary to speculate how a debt-financed early implementation of the tax reform would affect the economy. Presumably consumption would increase, but the investments of unincorporated firms would tend to shift abroad via financial markets because of the implicit devaluation of depreciation allowances. These are very complex mechanisms that cannot be explained in three sentences.

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* Published in a shortened version as "Steuerreform – Konsum ankurbeln," *Handelsblatt*, June 17, 2003, p. 2.

We need the tax reform as scheduled without an increase in borrowing. Work must be made worthwhile again and investments must be based on market consideration rather than with a view to possible tax savings. These are all long-term, structural aspects that have nothing to do with the business cycle. It would be a considerable accomplishment if the government managed to implement the projected reform on schedule and to fulfil the criteria of the Stability and Growth Pact. To achieve this, immediate and comprehensive measures are necessary to limit the costs of the welfare state and decrease subsidies. This is what the discussion should focus on. Only if the government manages to say which costs will be cut will it make a credible contribution to reducing the tax burden in Germany. Anything else is political play-acting.

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New Inflation Targets for the ECB*

Parturiunt montes, nascetur ridiculus mus. This month's long-awaited revision of the European Central Bank's inflation target was a disappointment. Although the ECB paid lip service to greater tolerance of inflation, nothing has really changed. The ceiling for eurozone inflation will remain at 2 percent. The Bank only wants to move closer to this ceiling. This is bad news for eurozone countries since they need a dose of inflation to get moving again.

Controlling the average inflation rate alone makes no sense as long as the span in national eurozone inflation rates, which averaged 2.7 percent over the first four years of the euro, remains as large as it is. This divergence has systemic causes that are likely to persist for the foreseeable future. Although the member countries already have very similar prices for traded goods, great differences prevail in prices for non-traded goods such as services, rents, building materials and catering. This is because of different wage levels, which in turn reflect differences in development. In the course of the economic convergence that will take place over the next two decades, wages as well as prices for non-traded goods and services will converge in all eurozone countries.

This adjustment in relative prices is a natural and desirable process that the ECB's monetary policy should tolerate, especially as it is advanced by the euro. The euro led to a convergence of interest rates in Europe and has lowered the real cost of capital in soft-currency countries that previously had to pay high risk premiums with their interest rates. For this reason the euro is stimulating investment in these countries, supporting real growth, boosting wages and increasing the rate at which prices are converging.

If the ECB tries to curb this transitional inflation with a restrictive monetary policy based on an ambitious inflation target, it will adversely affect the more developed countries, which will be forced towards too low a rate of inflation. Since nominal wages and prices in the core eurozone economies tend to be resistant to change, some inflation is always advisable because it facilitates real wage and price cuts in weak sectors. If inflation is too low, real wages and prices in these sectors will remain too high, triggering bankruptcies and job losses. The German and French economies are the main

* Published as "Die Euro-Bank sollte mehr Inflation akzeptieren," *Financial Times Deutschland*, no. 94, May 16/17, 2003, p. 19; see also "A shot of inflation would be good for Europe," F*inancial Times*, May 21, 2003, p. 15, and "2,5 Prozent sind besser," *Süddeutsche Zeitung*, no 100, May 2, 2003, p. 20.

victims, because they have high wages and high prices for non-traded goods. Moreover, both countries have lost the interest-rate advantage they enjoyed when they had their own currencies. Aggravating this is the possibility that the euro may have been introduced too early, before the D-mark and the French franc were able fully to realign after the 1992 currency crisis.

The real wage restraint necessary for restoring competitiveness in Germany and France could be more easily accomplished if the ECB had a higher inflation ceiling. This would enable Germany and France to become more competitive by just waiting for inflation in other countries, whose price levels are currently too low. With separate currencies, they could induce the same effect with an open devaluation. Unless monetary policy is loosened, such a level of competitiveness could take a decade to attain.

It is sometimes argued that the ECB should not consider country-specific inflation rates because the US Federal Reserve looks only at the US average. That argument is not convincing. First, unlike the dollar, the euro is young. Currently, Europe is undergoing a real convergence process with huge differences in inflation rates; this problem has long since been overcome in the US. Second, unlike Europe, the US has no extended social welfare net that prevents nominal wages from falling. European states offer unemployment benefits that depend on previous wages and welfare payments that are defined in nominal terms. These high replacement incomes keep a floor under nominal wages. Even if unions are willing to accept or unable to prevent real wage cuts, real wages cannot fall unless there is inflation. Yes, political reforms that cut unemployment and welfare benefits are also a possibility, but such reforms are very tricky.

For this reason the ECB should set an inflation ceiling of 2.5 percent until eurozone convergence is concluded, at the same time ensuring that no country falls to very low inflation levels, say below 1.5 percent. It should pay particular attention to the inflation floor, because deflation or low inflation in single countries would pose great dangers to the stability of the European economy.

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Putting a Stop to Autobahn Communism*

The opposition of the EU Commissioner Loyola de Palacio to plans of the German government to introduce road tolls for commercial vehicles this summer is hard to understand. The Commissioner argues that tolls may only be levied to cover the construction and maintenance costs of highways. Since the highways have already been financed and amortised, only a minimum toll could be charged for maintenance costs. It is also not correct to compensate domestic truck companies by granting them vehicle tax reductions, de Palacio maintains. However, a rational economic policy based on the criterion of economic efficiency presents completely different arguments.

On the German Autobahn communism still prevails. The limited space belongs to all motorists, and this is not rationed by means of a price mechanism but by the willingness to wait out the traffic jams. The selection of traffic participants according to their traffic-jam tolerance is similar to the selection of customers once in the queues before Eastern European shops according to how long their legs could hold them up. This leads to a false allocation of scarce resources and is immensely expensive. The time spent in traffic jams or in queues could surely be used more productively. The German automobile lobby, ADAC, estimates that 4.7 billion hours are lost annually in German traffic jams. Assuming that about 80% of this time affects the working age population and with the value added of the average employee lying in the neighbourhood of €28 Euro, the economic damage is about €105 billion. Added to this is an extra €12 billion in additional fuel consumption as well as the smaller amount of depreciation for the vehicles stuck in the traffic jams. This places the annual costs of traffic jams in Germany at approximately €120 billion or 5.7 percent of GDP.

This is where the economics of road tolls sets in. They serve to auction off the scarce road space and to allocate it to rivalling economic uses without allowing traffic jams to arise. Traffic jams rob motorists of time they could use more productively. Tolls take their money and transfer claims on goods and services to the state. Motorists lose in both cases, but in the second case the state wins, and also indirectly taxpayers from lower taxes or those who gain from higher government expenditures.

Well-designed road tolls, staggered according to times of day and congested routes, lead to a considerably better selection of means of transport than can be expected from

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the self-regulation of traffic via traffic jams. Transports that supply the highest economic benefit will prevail over other transports of lesser importance. Many transports will be shifted to times of day with less traffic volume and some transports will not take place at all since it will prove more economical to intensify local supply chains instead of directing transports back and forth throughout Europe. This will improve the efficiency of the European economy in the same way as the transition from a communist command economy to a market economy did.

From an economic perspective, the financing of old or new highways is only marginally important, and the road damages from commercial vehicles or the environmental damages from air pollution are not the real issues. The greatest damage caused by a truck on the highway is from the hindrance of other motorists, the so-called congestion externality, and this damage must be paid for by those who caused it. If one haulage firm decides to also use the Autobahn, thousands of cars and other trucks driving behind arrive a bit later at their destinations. Even if only seconds are wasted, the sum can be considerable. If the 2,000 vehicles travelling behind a truck between Munich and Inglostadt between 6.00 am to 10.00 pm reach their destination, on average, only a second later, the occupants of these vehicles lose 48 minutes, according to calculations by the Ifo Institute, which is an economic damage of €22. This is the toll that should be charged in this example to internalise the genuine damages caused by the truck and which would lead to more efficient traffic control. The toll the German government wants for a similar stretch is only €12, and the European Commission thinks this is too high.

German transport policy has always focused on ploughing more roads through the cities and landscape to relieve congestion, but this has been done to excess. To understand the economic rationality of this policy, imagine how an economic system would function where a Mercedes would be free and produced at government expense so long until the queues in front of the Stuttgart factory gate are gone. Such a policy is nonsense. Even if the expansion of the German road network is not yet completed and even if many chronic bottlenecks must still be eliminated, road tolls offer a reasonable alternative for overcoming the chaos on German roads.

Many countries have long experience with road tolls. The turnpikes in France, Italy and the USA are well known. Cities like Singapore, Bergen and Oslo also have toll systems, and recently one has been introduced in London. In most cases, traffic regulation, not revenue, was the main motive.

The road fees for commercial vehicles planned by the German government is a rough instrument that does not satisfy economic demands. It does not make sense to charge a toll when the streets are empty and motorists do not hinder each other, and at rush hour the tolls should probably be much higher than is planned today. Gradation according to actual traffic volume is urgently needed as well as an extension to the regional highways. But that all will come. This is only the beginning. The electronic toll system based on GPS being introduced in Germany is flexible enough to handle these problems.

The EU itself used congestion externalities to justify road tolls in its 1998 White Book “Fair Prices for the Use of Infrastructure", and its June 1999 Directive on the charging of heavy goods vehicles for the use of certain infrastructure permits the levying of road usage fees to reduce traffic jams. It is more than surprising that the Commission suddenly shifts into reverse gear when Germany merely follows its recommendations.

43

Twenty Mezzogiorni*

Europe will soon have a new constitution. But if the draft presented by Valery Giscard d'Estaing is anything to go by, it will be imbued with old ideology. The document ignores the free-market economy. There is not a word about the protection of property, and no commitment to free enterprise and the division of labour. Instead, it contains dubious secondary objectives like "sustainability" or "balanced economic growth", as if a constitution could ensure that such concepts become reality.

Far too little thought has been given to legal and economic ramifications of these grand constitutional proclamations. Take the proposed creation of European citizenship together with the prohibition of discrimination on the basis of national citizenship. Both were implicit in earlier treaties and are central to the European idea: Europeans have joined together and should not discriminate against each other. But the new draft would give these principles the status of constitutional law. If applied to other "rights" enumerated in the document, such as social cohesion and social protection, they could create social harmonisation by the backdoor. That would have grave consequences for the European economy.

Under the current principle of inclusion, an EU citizen who moves from one EU country to another to work is immediately and fully integrated into the social system of the host country. The EU migrant pays taxes and social insurance contributions and together with his family receives access to all the state benefits available to domestic employees. A migrant worker with a below-average income profits from the income redistribution of the welfare state just as a national does. By the calculations of the Ifo Institute, the net benefit that Germany has been granting amounts to €2,300 a year in the first 10 years. By restricting these equal benefits to working migrants the cost is limited. Those who migrate for reasons other than employment receive no welfare benefits apart from emergency health care. However, the current draft constitution could mean that the inclusion principle would apply to all migrants from EU countries, including those who do not come for the purpose of working. This is not explicitly stated. But the draft includes no restrictions on the rights, so the courts would probably interpret the concept of social inclusion even more generously than they do already.

* Published as "Zwanzig Mezzogiorn," *Financial Times Deutschland*, no. 31/07, February 13, 2003, p. 11.

Current problems with the principle of inclusion will only be amplified. If having work is no longer required before immigrating to a welfare state, the flood-gates will be opened. Masses of poverty refugees would flow from eastern European countries to seek their fortune. To prevent this chaos, EU migrants should have to wait for full welfare benefits, such as rent subsidies and public housing, while enjoying access to public services and other benefits they pay for via taxes and social insurance contributions. If differential treatment of this sort is not allowed, governments will be forced to compete to trim welfare benefits so that they are no more attractive as destinations than their neighbours. Traditional welfare states would not survive.

Harmonisation of social standards could prevent a downward spiral. But economic conditions are far too varied for this to work. In all eastern European countries, wages are less than one third of German social welfare assistance, and even in some Spanish, Portuguese and Greek regions, wages are less than half of German social welfare assistance. Harmonising welfare at a level still acceptable to western Europe would lead to the deindustrialisation of whole regions in the south and east.

The economic pain would then have to be eased by large fiscal transfers between governments. Theoretically, this is possible. Indeed, the draft constitution provides for such social cohesion. But the results could be disastrous. Look at Germany and Italy. The German government contributed to the eastern Länder's lack of competitiveness by offering western welfare payments which were pushing wages above productivity. Similarly, the Italian social system has prevented wages in southern Italy from falling to a competitive level. Consequently, both eastern Germany and the Italian Mezzogiorno suffer from mass unemployment. Productivity is stuck at only 60 percent of the other regions. And they are dependent on vast financial transfers.

It would be unwise to impose the Italian-German model onto Portugal, Spain, Greece, eastern Poland, Slovakia, Romania or Bulgaria, but this is precisely what a European social union would do. There would not be two but twenty Mezzogiornos in Europe if the non-discrimination planned in the draft constitution is applied without restrictions to social benefits for all EU citizens.

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Pensions and Children*

The pension crisis, which as we all know will lead to pension cuts, is basically attributable to the declining birth rate in Germany. Ten Germans now only have, on average, six children in the course of their lives. Also in terms of birth rates, Germany takes the bottom rank internationally. There are diverse reasons for the decline in the birth rate but one of the most important is the pension system itself.

Pension insurance is insurance against childlessness and the resulting old-age poverty. Even if people do not have children of their own, they will not become destitute when they are old because the children of other people will provide for them. Mutual insurance protection is a great advantage for all participants. The problem is that this insurance weakens the economic reasons for having children since it almost fully socialises the contributions of the children to the generation that preceded them. Before the introduction of the statutory pension scheme under Bismarck, it was common in Germany to have children to safeguard one's standard of living in old age. This motive is lacking today. Old age provision no longer depends on having your own children. It suffices if other people have children who later pay the pension contributions. Pension insurance has suppressed one of the most important motives for having children from people's consciousness.

It is no coincidence that Germany, where statutory pension insurance was devised, is now a country with one of the lowest birth rates. Since 1889 generations of Germans have experienced that old age is manageable without one's own children, and thus new life styles have developed from generation to generation that are adapted to the new institutional circumstances. Life as a single has become increasingly more attractive, and today DINKs are en vogue: double income, no kids. Two incomes without children is always better than one income and several children. It makes life much more pleasant.

But every generation becomes old at some point, and the elderly can only survive if they have taken precautions when they were young. Either they have added to society's human capital by having raised children, or they must save and thereby accumulate real

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* Published as "Rente nach Kinderzahl," *Frankfurter Allgemeine Zeitung*, no. 11, January 14, .2003, p. 12; compare also "Wer keinen Nachwuchs hat, muss zahlen," *Financial Times Deutschland*, no. 252, December 27, 2002, p. 30.

capital, directly or indirectly, so they can live from consuming this capital. A generation that adds neither human nor real capital must go hungry in old age.

Since Germans form less human capital today than former generations did, they must accumulate real capital as a substitute in order to replace the declining pension due to lack of progeny. This is the idea that led to the new German pension scheme and to pension cuts in the pay-as-you-go system. But the new scheme has not been completely thought through. It treats the symptoms of the German disease but not its causes. It does not reduce the negative incentives for family planning and leads to nearly intolerable burdens for those who by having raised children have already made the full contribution to the financing of pay-as-you-go system.

Instead of placing collective responsibility on a whole generation, the necessary pension cuts and the compensating new savings plan should be concentrated on the childless. Whoever has not raised children can be expected to take a pension cut of one half. The already built-up entitlements must not be infringed on, however. The reform should only affect today's young people. They have time enough to save up for a sufficient pension with the new scheme if they choose not to have, or cannot have, children.

The adjustment of pay-as-you-go pension benefits to the number of children is justified because it follows the causation principle and the ability principle. Those who have no children and in this respect have not done enough to safeguard their own pensions in the pay-as-you-go system must bear the consequences and accumulate savings instead. And the childless are in a position to save because they do not incur any costs for child rearing. They are relatively liquid and can invest the money not spent on children in the capital markets to supplement their reduced pension benefits.

Some may argue that by paying their pension contributions, young, childless citizens have already provided for their own pensions, and for this reason it is unfair to force them to join the new scheme as a second savings plan. This argument fails to see that historically the normal duty of every generation was to provide two services: In the working years one's parents and children had to be fed. Today, the first of these two services is provided in the form of pension contributions which fully go to today's pensioners. But many now fail to provide the second service because they choose not to have children. Thus it is justified to require a second service from these people in the form of the new savings plan. In this way they safeguard their pensions whose full financing can no longer be borne by the few future contributors. To require people that raise several children to participate in the new plan would be imposing a triple burden on them. As contributors they now provide for the elderly, as parents they finance the pensions of all future pensioners via the costs of child rearing, and as savers they would also have to finance their own pensions.

The adjustment of the pay-as-you-go pension system to the number of children is not only just, it will also lead to a change in family planning. If the childless must put 8% of their gross income in a compensating savings plan, having children could take on greater importance in life planning. Under these circumstances an undecided young couple may just decide to have children.

Experience shows that family planning reacts strongly to economic incentives. When the GDR introduced economic incentives for boosting birth rates in the 1970s, the number of new-born children clearly increased. And in 1957 when Saarland shifted from the generous French system of family support to the more miserly west German system, birth rates clearly declined. The so-called social security hypothesis, which holds that the pension system influences the decision to have children, has been confirmed by empirical studies, for Germany, too.

This is not an argument for a state population policy that would interfere with the free decisions of its people and dictate the choice for children. Quite the contrary. Today the state intervenes massively in family planning by way of the pension system when it socialises the pension contributions of the children and thus suppresses the natural provision motive behind having children. To introduce a pension system based on the number of children is to reduce the degree of socialisation and to reduce the influence of the state in family planning. It doesn’t mean giving the state more influence.

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Another Unification and More Illusions*

The Eastern enlargement of the European Union is the second reunification that western Germany has experienced within a short period of time. As with the first unification, it is part of the logic of history. The second is also fortunate for Europe because it overcomes the humiliation that many Europeans had to endure under Communist regimes, and it creates a long-term security zone and economic prosperity for the old Continent.

The difference between political wishful thinking and economic reality will certainly also be just as great as for the first unification. It is not politically correct to address the obvious economic difficulties. Again, politicians are driven forward by the force of their own rhetoric. Overwhelmed by the historical importance of the event, the warnings of economists go unheeded.

The truth is that Germany at least is not at all fit for European unification. Germany is in the midst of the worst post-war crisis. Economic growth has been feeble for decades, and the country is being overtaken by one European country after the other in per-capita income. The banks and the state itself are facing a financial crisis of major proportions. More and more employers are withdrawing from the encrusted labour markets. The number of insolvencies is increasing month after month and setting new records. Unemployment, even in western Germany, has been increasing on a linear trend that has been unchanged for thirty years. German unification has not yet been digested. A self-supporting upswing in eastern Germany is still not in sight even after a dozen years of waiting, and every third euro spent there still comes from the west.

Eastern enlargement will expand the EU by some 80 million people, many of whom will enter into wage competition with the west. At wage costs, which in virtually all countries, except for Slovenia, are less than 17% of western German labour costs, they will put the west German economy on great pressure and further reduce its already weakened competitiveness. Low-wage products from Eastern Europe will replace German products, and German enterprises, which are already waiting for the starting shot, will shift their investments to the east. In addition, massive migration flows will be induced by the great wage differentials in combination with German welfare benefits,

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which even with politically enforced quotas will hardly be brought under control, and even if so, only at price of an even more rapid outflow of investment capital. The fundamental problems of the German economy will become all the more obvious after Eastern enlargement.

The change would be smoother if Germany's labour markets were flexible and if the local wage structures could react to the changed competitive situation. An economy with flexible labour markets would gain from Eastern enlargement because it would always remain competitive and be able to supply the itinerant workers with new jobs. The new possibilities for the markets for capital, goods and human labour would bring welfare gains for both the new and the present members of the European Union.

Unfortunately, this condition is nowhere close to being fulfilled. Industry-wide collective bargaining precludes the necessary downward wage adjustment, and the welfare state with its wage replacement benefits that define quasi minimum wages also prevents wage structures from flexibly adapting to the new circumstances. This means that jobs will be lacking, and unemployment will increase all the more rapidly.

A foretaste of what is to come is the recent rise in unemployment in Bavaria, which has been striking although Bavarian unemployment is still among the lowest in Germany. At a total of 300,000 unemployed persons, about 100,000 persons immigrated to Bavaria in 2001, of which the lion's share came from Thuringia and Saxony, settling in Bavarian provinces close to the border. In the quickly turning labour-market carousel, the migrants took over jobs before the Bavarian unemployed were able to move there. In statistical terms the migration was a migration into unemployment.

Germany has two possibilities in light of these circumstances. The first, more probable one, is that it again ignores the warnings of the economists and waits for the problems to arrive. Then it will continue to fall behind, and we can only hope that the increasing unemployment will not bring about political instability that could threaten the state itself.

The other option is that it heeds the proposals of the specialists and acts while there is still time. The consensus among economic experts has never been so great as today. The Scientific Advisory Board of the Ministry of Economics, the German Council of Economic Advisors and the Ifo Institute have presented identical propositions for the creation of an activating welfare state to absorb the expected pressure on the labour markets and to initiate a positive development. On the table are also proposals for employee participation in their companies, the effective curtailment of social-welfare tourism, the restructuring of the tax system and a deregulation of the economy. Politicians need only implement them.