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Wage Differentiation and Share Ownership to Counter the Domestic Threat of Globalization

by Hans-Werner Sinn

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Hans-Werner Sinn

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1. Introduction

The rate of unemployment in Germany has never been as high as it is today and there is no sign that the situation will improve in any fundamental way. Unemployment is a structural, long-run problem which is associated with the globalization of markets and the dramatically changed competitive situation. This paper discusses a way to alleviate this problem.[1] Although the paper focuses on Germany, it is, to a large extent, also applicable to other countries of Western Europe.

The paper has four following sections. The first explains the exceptional historical situation Germany is currently facing. The second section is concerned with the opportunities that this situation offers for Germany. Germany will actually be able to achieve unexpected prosperity if it responds intelligently to the new challenges. The third section sets out some widespread errors and misunderstandings in the discussions about the unemployment problem. The main focus of the paper is in the fourth section. There, an attempt is made to outline an intelligent wage policy which will put Germany in a position to cope successfully with the future challenges. "Savings wage instead of cash wage" is the concept that is at the center of this paper's policy recommendation. It will be argued that a wage spread, combined with converting wage claims to equity shares, provides a way for Germany to succeed in emerging from its present dead end.

Remark: The author gratefully acknowledges careful research assistance by Juli Irving-Lessmann and Ulrich Scholten.

1 An earlier version of this paper was presented at a celebration at the occasion of the 30th anniversary of the German Federal Labor Office (Bundesanstalt für Arbeit) and was published in the information bulletin of that office in German; see Sinn (1997).

2. A Historic Challenge

What is this challenge exactly? I see it in a long phase of increasing competition which has rarely been equaled in the whole of Germany's history. Three overlapping developments that are all part of the globalization process have together resulted in a major adjustment shock for the German economy. These developments are the intensification of global competition, the integration of Europe, and the fall of the Iron Curtain.

Consider first the intensification of global competition. It is characterized by the breathtaking advancements in communications technology and the worldwide reduction in trade barriers agreed to in the GATT negotiations. Stimulated by Japan's example, the fastest growing economic region in the world has been built up in Southeast Asia around such centers as Singapore, Hong Kong, and Seoul. Of course Germany has been experiencing the low-wage competition from this region for quite some time but this pressure will increase still more in future, in particular when the current crisis is resolved and the region begins a new competitive attack based on their devaluated currencies. For quite some time the new competition has not been limited to only industrial products, it has already spread to the markets for industrial services. Western printing firms are already using the services of Chinese compositors and the services of Indian engineers are also much sought after by Western firms because their qualifications are high and their wages are low. Distance is no longer an obstacle to trade when computers can be used to provide services and the proportion of services that come into this category will certainly increase in future.

The second of the developments associated with the intensification of competition is the continuing integration of Europe. The main aim of the EU is to realize the four basic freedoms. Capital, labor, goods, and services should be able to cross the internal EU borders freely and without hindrance. Today, this aim has largely been met. The introduction of the euro will provide an extra push, thus overcoming the last obstacle to the smooth transfer of capital.

The third and most important development began with the fall of the Iron Curtain and the introduction of the market system into the former Eastern Bloc. At this very moment of history, suddenly and unexpectedly a completely new kind of competition appeared right at our own front door. This competition will certainly make things very difficult for many currently protected industry branches. Wages, which are from one-tenth to one-fortieth of the German level will enable Eastern European suppliers to flood the German markets with goods which the more distant low-cost producers in the Far East are unable to supply because of high transport costs. Furniture, building materials, and raw materials for the chemical industry are examples of products for which competition will be sharply increased.

The threat to German competitiveness reached a truly new dimension when the Berlin Wall came down. New tigers are lurking in the backyard. Around 80 million people from the Baltic countries, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, and Croatia make up the first group seeking admittance. Europe is at the start of a phase of particularly aggressive low-wage competition and massive westwards migration which will reach historic dimensions. Think of the second group of competitors, further to the east. This group will consist of another 240 million people if a line is drawn at the Urals. It is hard to imagine what will happen when this mass of people also take part in the wage competition. German labor markets will be unable to hold their own against such power. One way or another, whether through low-wage competition or through immigration, in the next decades there will be a reduction in the wage differential between East and West and this will also be at the expense of the German wages.

This development will not necessarily be to the disadvantage of Germany as a whole because it will offer phenomenal investment opportunities whose benefits will far outweigh the wage losses. However, there is no way of getting around the fact that the relative scarcities of capital and labor have changed enormously to the detriment of labor and that there will have to be a substantial reduction in real wages, compared to what could have been expected if the Wall had stayed in place.

The change in the relative scarcity of capital and labor not only drives the trade unions into a corner, it also cuts the ground from under the social consensus on which the Federal Republic of Germany has been based. So far, the main feature of economic development in Germany has been the fact that the real wages of employee households always grew in step with the real national product. Wage earners benefited from the huge amount of capital accumulation because the factor of production they supplied was always in demand and they were able to get higher and higher scarcity rents because this factor could not be increased very much. Wage and salary earners could forgo capital income because their wage claims were equivalent to a claim on capital income. This will be different in future. The fair market wage rate will to a very large extent be decoupled from the national product and will not participate in the general growth process.

Germany has already been through a similar development phase once before. From about 1820 to 1870, real wages tended to be constant because the supply effects of massive movement away from the land and extremely high birth rates completely offset the demand effects of the turbulent capital accumulation that occurred then. The result was growing social unrest which bordered on revolution and was kept in check by Bismarck's double strategy of introducing the welfare state and laws aimed at containing socialism. Marx clearly based his economic theory on his observation of this growth process with constant real wages.

3. The Opportunities for Germany

It would be wrong to believe that the intensification of world trade will only bring very great dangers for Germany. The opportunities are also very great!

First of all, continuous improvement and intensification of the international division of labor, from which Germany has benefited so much in the past, are among the opportunities that will be offered. In the future, too, Germany, which is rich in real and human capital, will be able to specialize in high-tech products, large industrial projects, industrial plants, complex products of the mechanical engineering industry, innovative materials produced by the chemical industry, and other capital-intensive producer goods. Globally, the demand for such goods will continue to grow uninterruptedly. Further, there are considerable opportunities which result simply from the increasing size of markets associated with the fall of the Iron Curtain and the expansion of the European Union. Larger markets allow bigger production series and thus lead to a considerable reduction in the costs of the firms. The European Commission's Cecchini Report forecast a welfare increase of around 5 percent of the European national product simply as a result of an expansion of the market within the old EC. One can expect an even greater welfare increase if the eastern enlargement of trading areas is taken into account.

Germany's geographical position will have particularly favorable effects. Germany is situated at the heart of Europe and its traditional economic and cultural contacts give it the opportunity to take on a key role in building up the Eastern European economy and to become the turntable for East–West trade. The German investment goods industry will be able to make a living from the immense re-equipment and construction investments needed in Eastern Europe. Here the contacts in the former GDR times could prove to be very useful. In what other Western European country are there already millions of people who can speak Russian and the other languages of the former Eastern Bloc?

In addition to the trade advantages, there are excellent investment opportunities in the East with the kind of high capital returns that can no longer be obtained in the West. German savings capital is flowing to the East in the form of direct investment, joint ventures, and loan contracts and this is providing savers with high, long-term capital income. Germany is by far the largest direct investor in the East. Is there anything wrong with Germany following the American example and becoming a country in which more and more people obtain a large part of their income in the form of dividends, interest, and rents? Such a development would certainly not be contrary to the interests of the Eastern Europeans because both sides would benefit from the capital investment. For those countries which have only just shaken off the yoke of communism, one can only wish that Western capital will take up the investment opportunities close at hand.

4. Wrong Counterstrategies

The opportunities opened up by the intensification of the international competition are very great but so too are the risks of reacting wrongly to the cheap-wage onslaught. The Germans are great in a crisis and their history has shown time and again that they are capable of making special efforts in an emergency. But they have not always made wise decisions. It will be necessary for them to find a sensible, intelligent strategy if they are to hold their own in the competitive process.

There are such strategies but they are not obvious ones. Before they are considered let us first look at the strategies which are wrong, problematic, or at least not satisfactory.

It would certainly not be sensible to close the borders to the East again and to replace the physical barriers with economic ones. Limiting trade by imposing quotas and tariffs in an attempt to protect German industries would be particularly foolish. The European Union in fact initially did exactly that when it issued a list of the "sensitive products and branches" with the aim of protecting them from competition with import quotas. Quite apart from the fact that these strategies could prevent the gains made possible by the improvement in the international division of labor being achieved, they could be politically extremely dangerous. They could nip the young Eastern market economies in the bud and could give extra votes to the nationalistic opposition parties, and this could have immense consequences for the stability of Europe.

Fortunately, on the political side, these dangers have been recognized and another course is now being taken. In time, before the final ratification of the Maastricht Treaty, the EC decided on a definite time plan for some Eastern European countries to become members.

One strategy that is very popular with the public is moving into high-technology areas, where Germany currently lags behind Japan and the United States. This policy makes sense when it is concerned with the development of economical production processes or new products. But here neither the wage bargaining parties nor the state can contribute anything much. It is the job of the private firms to look for new approaches and, if they are worth taking, the firms will certainly find them. It is not the job of the state to make these decisions, although, of course, a deregulation might help stimulate such a development.

Although the further development of the high-technology sector is useful, there are at least three reasons which prevent us from thinking that this can solve the wages problem.

Forcing research cannot result in the widespread expansion of employment in the foreseeable future. The relevant sectors which could make use of the inventions are too small. Germany must develop its service sector and it must also continue to keep operating in the fields of industry which use middle-level technologies, such as automobiles, basic chemicals, iron and metal products, textiles, and the like. It would be fatal to neglect these industries in the hope of developing computer technology, communications technology, gene technology, or space travel.

2. Developments in the high-technology area also need low wages. It is obvious enough that the technological onslaught of Korea and Japan did not happen on the basis of high wages. It is true that wages in Japan are high today, but this is the result of the technological developments and not their cause.
3. It would be an illusion to believe that the educational level of the German employees is so high that they do not have to worry at all about low-wage competition. This view of things completely fails to recognize that the educational standards are high in other parts of the world too, and that low-wage competition also occurs in product areas where a high level of education is required. It is precisely in technical education that Far East countries are well ahead of Germany, and there are no illiterates in Eastern Europe. It is true that German labor productivity is much higher than that of most of its competitors and that, for this reason, German wages will not have to fall to the level of wages there for it to be competitive. But it is wrong to maintain that competitiveness can be attained without any adjustment of wages at all.

The relationship between wages and labor productivity has frequently been misinterpreted. The quotient of the two quantities measures the unit wage cost, and this cost is not higher in Germany than in other countries. Time and again, it is argued that this is a clear indication that wages are not too high in Germany and that, therefore, the causes for unemployment ought to be sought elsewhere. The argumentation in this form is pretty misleading, because the unit wage cost comparison is only meaningful when employment levels are the same. When the employment level varies, it makes little sense, because this variation in itself will change the productivity level.

An extreme example may explain this. Suppose there are two types of jobs: 90 percent are highly productive and 10 percent are less productive. In the initial situation the wages of all the jobs are just a bit below the critical level at which the less productive jobs become unprofitable. The wage is then raised a little so that it is now just a bit above this critical level. The result is that the 10 percent of less productive jobs are closed, average productivity jumps up, and the unit wage costs fall.

A naive interpretation would have it that, because the unit wage costs have become relatively low in international terms, the wages problem has been solved. In reality, in this example the cause of the 10 percent unemployment was the wage rise.

Whether wages are too high or too low can only be seen from unemployment, not from the unit wage costs. Unemployment means that there is an oversupply on the labor market and this oversupply means that the wages are too high. It is as simple as that. All the mental acrobatics which aim at proving that other economic problems are the cause of the unemployment only disguise this simple fact.

This does not mean that full employment equilibrium cannot be disturbed by other factors such as stronger competitive pressure or labor-saving technological progress. Nevertheless, regardless of the role these factors might play, the wage should always be at the appropriate equilibrium level. Therefore, if there is unemployment, wages must fall until full employment is again reached.[2] An economy which puts the goal of supporting real wages above the full employment level is cutting off its nose to spite its own face because the loss of production associated with unemployment can never be made up.

5. The Right Strategy

Almost all economists agree that, contrary to the present trend, the recovery of the German economy must involve making wage sacrifices because wishful thinking is not enough to overcome the laws of the market economy. The question only is how this wage sacrifice can be carried out without encountering the foreseeable social problems. Can we take it that a large part of the German population would be willing to give up their claims on the national product for

2 Naturally this assumes that the impediments to wage flexibility inherent in the social system are also removed. The present form of social aid must be done away with, since it is a job-killing device implying a too high minimum wage. This does not mean that the welfare state must be dismantled. If social aid is given for working instead of for not working, the desired distributional goals can be reached without interfering with the necessary wage flexibility.

the benefit of the receivers of capital income just because their "scarcity position" has changed? Must the social consensus, which has so far been the support of this country, now be sacrificed to cold economic laws?

It need not. There is a way of keeping the existing claims on the national product and still being able to fight the low-wage competition. Essentially, this way consists of transforming some of the claims the employed have on the national product, or at least what they believe they must defend, into the ownership of capital.[3]

In concrete terms this means that the parties in the wage bargaining process (unions and employers' associations) agree to a long-term wage moratorium and that, in exchange, the employed are given participation rights in the firms equal to the cash value of the wage payments saved. Public companies can issue preference shares and publicly quoted companies can assign proprietary interest. Unincorporated firms can give the employees interest-bearing claims entitlements. Participation rights are granted to all those employed at the time the agreement is signed. Those who get jobs after this are only paid the agreed-upon lower wages.

Contracts of the kind I have in mind are not at all unusual. Recently, particularly in the United States, similar agreements between firms and employees have frequently been made. The exchange of wages for equity shares made by the United Airlines not long ago was an especially spectacular example. 55,000 employees were involved in an exchange of long-term wage reductions for shares worth over $4 billion. Since then, United Airlines has increased its employment by 20 percent and its shares have gone from one high point to another.

Naturally, it is not easy to work out how high the savings in wages brought about by the wage moratorium would actually be. Unions and employers will certainly have very different ideas about what the wage development would have been in the absence of such an agreement. But this lack of clarity is not, in principle, an obstacle. The parties to the agreement must negotiate the equivalent participation rights and set them down in the wage agreement just as they already do with wages. The best thing would be a wage agreement lasting several years. With United Airlines it was 5 years. What is certain is that the negotiated package would bring with it very large welfare benefits from which the employed, the firms, and the unemployed would all be able to profit.

The employees could successfully defend their income despite the low-wage competition, and they would buy a considerable gain in job security for a small loss in income security. Because wages are low and fired employees would be

Similar suggestions were made by Albrecht Schmidt, the spokesman for the Vereinsbank, in an interview with the *Süddeutsche Zeitung* on May 23, 1996. See also Sinn (1993).

able to keep their capital ownership, the firms would have little cause to fire people when times are bad.

The owners of the firms can enjoy higher returns. It is, of course, true that, although the firms would gain liquidity and risk advantages from the transformation of wages into participation rights, they would not be able to increase their profits from the employment of their existing workers. However the wage reduction makes the expansion of the firm worthwhile, and this is something which would otherwise not have been undertaken. More people will be employed and profits will rise with the increase in employment. This is the deciding point that should appease the employers and the unions. Both sides will benefit.

Finally, the unemployed, locals or foreign immigrants, who now find employment win every time. They, the outsiders, can be integrated into the production process because their integration will not be associated with a loss of income for those already employed.

It is important for the effectiveness of the strategy that the outsiders are not put on a par with the insiders. New employees should get the same wages as existing employees but they must not be granted any participation rights. This is what I mean by the wage spread. It is precisely this wage spread that makes an expansion of employment profitable for the firms and acceptable to the existing employees.

Let us use some diagrams to show why the suggestion is advantageous for all parties. In Figure 1 the demand curve for labor in a particular branch is shown. Imagine that all practicable and technically realizable jobs are distributed in terms of their "productivity wage," that is, the maximum wage rate they can bear. Some jobs will be very productive, and thus carry high-productivity wages, others will be characterized by lower-productivity wages. Start at the left with the most productive jobs and then proceed to the right to the successively less productive jobs.

As the figure shows, with a given level of wages, all the jobs whose productivity wage is higher than the actual wage rate will be realized. The other jobs are lost. They have been eliminated because it is not profitable to fill them, regardless of whether they were once realized or never have been.

The sum of wages, which is the product of the wage rate and the number employed, can be seen in the figure in the shape of a rectangle. Total profit, which is the difference between the productivity wages and the actual wage rate takes the shape of a triangle above this rectangle.

A reduction in wages is now made as shown in Figure 2. This wage reduction has two effects. With the given employment there is an increase in profits exactly equal to the fall in wages. If this increase in profits is transferred to the insider employees in the form of shares in the firm, the operation is distributionneutral for the old owners and the insiders. Total profits certainly increase at the expense of total wages, but everyone is as rich as before.

Now the second effect comes into play. The fall in wages and the limitation of compensation through participation rights to the insiders make it worthwhile for the firms to create new jobs. With United Airlines this was 20 percent of the initial jobs. By this means the outsiders are integrated and receive wage incomes that they otherwise would not have had. Above all, however, there is an increase in profits of the amount shown by triangle A, in which both the new and the old owners participate. The old owners and the insiders are obviously better off than they would have been if the deal had not taken place, and the unemployment has been eliminated.

Figure 1: Wage Levels, Employment, and Income Distribution

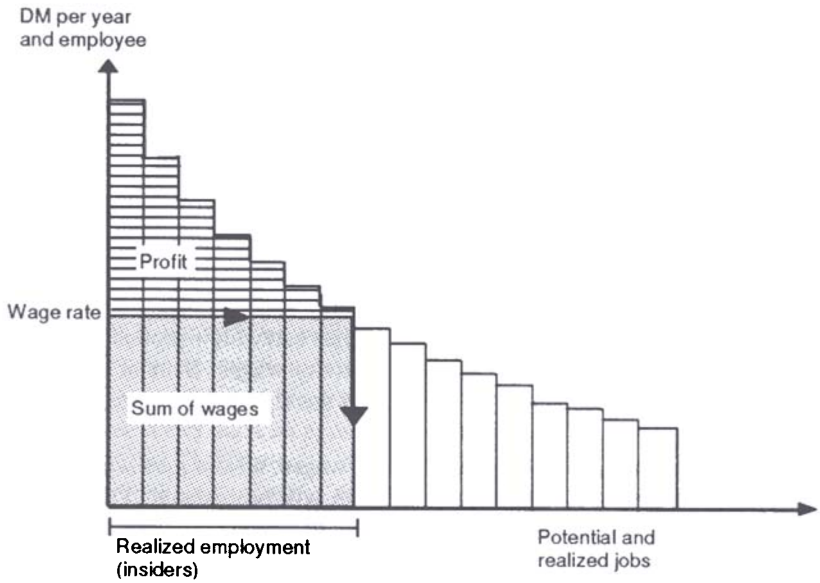
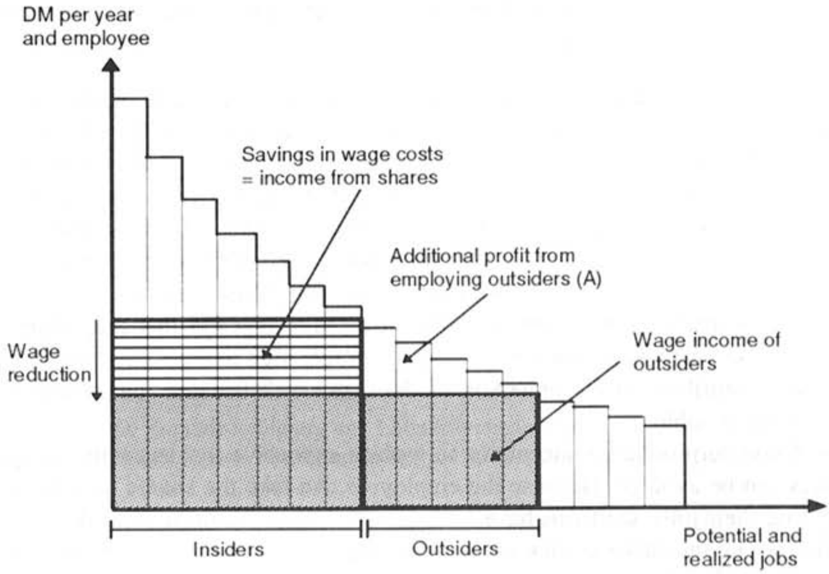


Figure 2: The Participation Model



The decisive condition for the success of the deal is the nonparticipation of the outsiders, that is, the actual wage differentiation in favor of the insiders. The recognition of the insiders' position of power distinguishes the model suggested here from other participation models which have been discussed on previous occasions. The investment wage models that were discussed in Germany in the 1960s always allowed for equal treatment of insiders and outsiders and for this reason were unable to provide any obvious incentives to take on new employees. An increase in employment would always have meant an increase in profit participation and that was why it could not occur. The profit participation plan of the American economist Weizman (1984) was also unable to promise any positive employment effect because it made no distinction between insiders and outsiders. In the Weizman plan the share of profits distributed to the employees is independent of the number of employees. This gives the firms an incentive to take on more workers. However, the existing employees try to oppose such new employment because it would dilute the value of their own participation rights and, if they believe that their attempt to oppose it will fail, right from the start they would refuse to accept a loss of wages equal to the value of the participation rights.

In principle, preservation of the insider rights could also be achieved through direct wage differentiation. It should be noted with interest that the agreements in the German chemical industry are tending to move more and more in this direction. However, direct wage differentiation has three disadvantages compared to assigning participation rights:

First, there is the danger that such a policy will not be credible, as the firm would always have to fear that new employees would sooner or later want to have the high insider wage, too. Assigning participation rights is a more credible way of keeping special rights for the insiders. Participation rights are clearly outlined property claims that are neither economically nor legally distinguished by any special closeness to wages. The fact that these rights were once established through forgoing wages gives the newcomers no claim to them.

Second, the participation rights give the firms advantages in that they represent liable assets which of course receive, on average, high interest payments but which also contribute to the reduction of the firm's risk because these interest payments are flexible.

Third, counterproductive incentives to replace expensive insiders with cheap outsiders can be avoided. Because the employees can take the shares with them if they lose their jobs, the firms have no incentive to fire the insiders, and these, in turn, have no incentive to stick to their existing jobs. They lose nothing if they are employed elsewhere at outsider wages.

The strategy suggested could also prove to be a safety anchor for the former East German states, where wages are a particularly long way from market equilibrium values. If wages were lowered there, the firms would experience an increase in profits which could be transformed into participation rights for those still employed. The lower wages would encourage industry to move there, increase employment, and speed up the upswing.

In the 1960s the trade unions had already asked themselves whether they should expand their wage bargaining policy to include participation rights but decided instead for codetermination.[4] Malicious gossip has it that the unions were not interested in participation models because they feared that the workers would turn into small capitalists and would turn away from the goals of the trade union movement. Such arguments, if they were ever made at all, now belong in the trash can of history. Today the concern is with income security for the majority of the German population. And it is also with social stability and security.

It is to be hoped that the unions and the employers' associations will become conscious of the size of the problem and revise their policies. The trade unions

For this, see Krelle et al. (1968'

still have sufficient negotiating power to fight for substantial capital ownership. But this power is disappearing with every bankruptcy and with every shift of production to other countries. In ten years the opportunity to trade forgoing wages for participation rights will be lost. There are excellent alternative industrial locations in the countries on Germany's eastern borders and these will give the firms so much negotiating power that they will be unwilling to pay another penny for a wage moratorium. The negotiations about capital ownership must be carried out now; otherwise, it will be too late. Life punishes latecomers.

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