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Retirement of Hans-Werner Sinn

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RETIREMENT OF HANS-WERNER SINN

Editorial

This issue of the CESifo Forum features a selection of speeches and texts marking the retirement of Hans-Werner Sinn contributed by his academic and political contemporaries. Some of these articles have already been printed (in German) in the book: *"Hans-Werner Sinn und 25 Jahre deutsche Wirtschaftspolitik"*, edited by Gabriel Felbermayr, Meinhard Knoche und Ludger Woessmann, and published by the Hanser Verlag in Munich in 2016. Video recordings of the official ceremony held on 23 January 2016 in the Great Hall of the University of Munich can be viewed at
http://www.hanswernersinn.de/en/Event_22012016.

Chang Woon Nam and John Whalley
Editors

Retirement of Hans-Werner Sinn

From Leftist to Liberal: Hans-Werner Sinn and German Economic Policy

Ludger Woessmann*

Hans-Werner Sinn (HWS) has always flirted with the fact that he is at heart a leftist. He was in a socialist youth group and, like his father, in the SPD. He grew out of this phase while studying amidst the 1968 generation. But the derogatory epithet of 'Socialist of the Chair' – as the economists were called that paved the way for the Bismarckian social reforms – he later gladly applied to himself. Without doubt he is a 'missionary' economist who wants to improve the living conditions for everyone. But in his academic grappling as to how to achieve this goal, he soon realised that the freedom of competitive markets is an indispensable means to this end. And so most everyone now perceives him as a liberal.

The book *Jumpstart* marked his public coming out in 1991 – the same year in which his Munich Center for Economic Studies was founded. He assumed the presidency of the ailing Ifo Institute in 1999. What followed was an opening for international exchanges at the highest academic level by means of CESifo, and Ifo's clear focus on international scholarly standards, but also his involvement in any imaginably important economic debate. In 2003 in *Can Germany Be Saved?* HWS clearly realised that a book aimed at the general public was the way to propel arcane academic theory into the public debate, and which made him a household name. Since then he has written a whole series of bestsellers, more than any other economist.

By the time of the evaluation in 2005 at the latest, it was clear that his radical cure had effected a turnaround at Ifo. Both in terms of academic competition and in the economic policy debate, Ifo was ahead of its rivals. And in the words of two former chairmen of the German Council of Economic Advisors, Wolfgang Wiegard and Wolfgang Franz, "HWS was and certainly is the most innovative and influential economist of the last two or three decades in Germany".

But what was and is HWS's position in the economic policy debate? Despite what many of his opponents may think, HWS is not a blind market-fanatic. Actually quite the opposite: he has always been focused on identifying where markets fail and then analysing how governments can intervene to improve the results. If anything HWS is also a state fanatic. In his heart of hearts, he has always remained the classical public-sector economist who analyses the role of the state in the economy. When his colleagues accused him of putting his faith in a benevolent state, he still did not change course precisely because both the state and the market can fail. He is convinced that it is the task of the economist to bring the voice of reason into the public debate – despite policy-makers' immunity to good advice.

When from the mid-1990s he amicably debated with the President of the Kiel Institute for the World Economy, Horst Siebert (full disclosure: my doctoral supervisor) about the opportunities of globalisation, HWS stressed the dangers of systems competition: precisely because the state is there to intervene when markets fail, market failures can again creep in through the backdoor in systems competition among the states.

HWS's economic-policy pragmatism is also reflected in his methodological pragmatism. In the controversy over methodology in the German economics profession in the late 2000s, he refused to take sides. He could not agree to a return to the separation of theory and policy: "policy without theory is just as useless as theory without policy implications". But also a commingling of theory and econometric empiricism is not enough for him because modern economics all too often is lacking in institutional knowledge. For HWS, "economics is most responsible when there is an equilibrium of three elements – theory, institutions and

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econometrics – in order to be able to provide economic policy with sound recommendations”.

Those who know him realise that HWS is at his best when he encounters a headwind. He was initially decried for his remarks on the Target balances, but that only strengthened his resolve – and in the end, even the Bundesbank was willing to examine the problem. Once HWS has penetrated a subject and is sure of his position, nothing can make him change his course. He has been accused of stubbornness, of persevering with his own position despite better arguments. I do not think you can really level this charge against HWS, although we Westphalians are noted for our bullheadedness. But in order to prevail in the policy debate, you need to have stamina – and to be bull-headed.

Despite all stubbornness, HWS is a firm believer in academic freedom – and not only for himself. In my more than twelve years at the Ifo Institute, he never once told me what to do or not to do, what to say or not to say. As a true academic, he was never able to submit himself to a party line or ideology. For this reason he also cannot be pigeonholed in the simple one-dimensionality of the left and or the right. But when it comes to freedom or patronizing, there is no room for doubt: he is definitely a liberal.

A Request to Hans-Werner Sinn, Economist, Commentator and European

Wolfgang Schäuble*

Hans-Werner Sinn is an exceptional economist. He is at home in many different economic disciplines. He is a creative scholar who is not afraid to speak his mind. At the same time, he does not shy away from the hard work of empirical research. On top of all this, he has a considerable talent for communicating to a broad audience, where he never fails to spur on the debate. His work is accessible to non-specialists in a way usually only seen among academics in the United States and Britain. His acerbic comments and his mental acuity are not always comfortable for the government, but that is something we politicians have to accept.

Amid all the current discussions about Europe, urgent crises and the latest news about the economic difficulties in certain European countries, Hans-Werner Sinn never loses sight of the fundamental questions regarding the future of the European Union's institutions. He has a vision of a 'United States of Europe' and the establishment of a genuine federalised European state. I personally would prefer a systematic multi-level democracy: not an entity similar to a nation state where power exudes from the centre, but a specifically European mix of sovereignty at the national and Community levels, an inter-connected system of democracies that complement each other, with different scopes and competences – a system of double democracy, both national and European.

Irrespective of how the institutional future of Europe will look exactly, with his plea for further integration Hans-Werner Sinn is putting his finger into the Eurozone's actual wound: the current lack of a joint fiscal and economic policy, not to mention deeper political union. As we know, this is not a new problem. Right from the beginning of European unification, it was always the case that greater integration would have been preferable. But the general public in the member states were on the whole ill-disposed towards closer integration. In the 1990s, there was once again a major debate about whether we should first create a political union or a currency union. Countless books that have been written on the euro since then inform us that a currency union cannot work without a fiscal and economic union. We in the Eurozone are – by necessity – currently striving to shake up this conventional wisdom. But if we had tried to do things differently back then, in the 1990s, we still wouldn't have a common currency today. Instead, we would still be debating how a political union should look. For this reason, we took the same approach with the euro as we did when the European Defence Community collapsed in 1954 after it failed to be ratified by the French parliament: we began with what was possible and then moved forward step by step from there.

Regarding deeper European integration, which I want as much as Hans-Werner Sinn does, we should continue with the tried and tested European method of creating cores of cooperation within the European Union and letting smaller groups of member states that are particularly willing to cooperate take the lead. This was the proposal that Karl Lamers and I made in our 1994 paper on a 'core Europe'. A 'multi-speed' or 'variable geometry' Europe – always with the option of other member states joining if they wish – already exists in many policy areas: the Schengen Area and the work on the financial transaction tax are just two examples. The euro area in particular constitutes a kind of core Europe that repeatedly entices additional member states to join, as we saw most recently with the accession of Lithuania in 2015.

In contrast, the notion that we can achieve a United States of Europe through a 'quantum leap' – led by Germany, no less – seems to me to be an unrealistic, politically *naïve* idea considering the current situation, which will likely continue for the foreseeable future. It is also inconceivable when you consider the European reality that has developed over time, namely a

* Federal Minister of Finance.

European Union made up of 28 countries with equal rights. No, it is not a one-off quantum leap that will propel us into a future of deeper European integration, but the patient exploitation of the opportunities that present themselves – something that happens more quickly during times of crisis and more slowly during stable periods.

In any case, we need to know which direction we want to move in. European realism could also benefit from a *soupçon* of idealistic verve: in the unbelievably dynamic and interconnected world of the 21st century, we Europeans cannot afford to indulge our tendency towards navel-gazing much longer. We need to use our collective power to help solve the pressing global regulatory questions – whether these relate to the financial markets, the economy in general, or issues of security, migration and the environment. Hans-Werner Sinn occasionally sees things differently from the German government and provides different answers, but, as a committed European, he always shares the goal of ensuring that Europe continues to stay relevant and develops into a power that can help to shape our world. To conclude: we can allow Hans-Werner Sinn to step down from his position, albeit with regret – but we cannot allow him to stop participating in the political and economic debate!

Not against the Laws of Economics – Hans-Werner Sinn as a Public Intellectual

Jens Weidmann*

Introduction

Hans-Werner Sinn has been a professor of economics for more than 30 years and President of the Ifo Institute for more than 15 years: under his stewardship the Ifo Institute has developed into an internationally renowned research institution. But Sinn is more than an outstanding academic and an exceptional manager of science. He is also an influential public intellectual who has shaped every major political debate over the past few decades by injecting economic arguments into it.

Kurt Tucholsky once said that: "to have an effect on other people, you must first speak to them in their language". And Hans-Werner Sinn did exactly that. Like few other German economists, he was able to make economic arguments accessible to the public. More than a dozen books, hundreds of opinion pieces and numerous radio and television interviews are proof of this. They provide a great translation service from the often model-based arguments of the economic profession to a language that the public is able to understand. In doing so, he was sometimes polarising, often trenchant and always battlesome – but these are defining characteristics of a public intellectual. Public intellectuals argue their cases passionately. They have an attitude and not just an opinion. This is indispensable to ensure that their public statements encourage others to form their own opinions and to engage in a discourse.

For Hans-Werner Sinn, interacting with the public was never an end in itself. It is one of his firmly held convictions that no policy maker can permanently ignore what he calls the laws of economics. Because doing so would eventually turn out to be extremely costly. He is convinced that politicians are always tempted to ignore the laws of economics because taxpayers often discover the true price tag of a policy measure only years later. Hans-Werner Sinn therefore wanted to alert the public early about when policies were inconsistent with economic principles. "It is my duty to speak publicly about economic and fiscal policies and to initiate debates", as he put it in an interview. It is this motivation which gave rise to his enormous number of public interventions.

Even if I wanted to, I could not give you the full list of topics he has covered. I will highlight just three issues that have been milestones over the last 25 years of Germany's economic history. And they all bear some lessons for today's economic challenges in Europe. The first stop on our journey through German economic history will be Germany's economic unification.

Germany's economic union: incomplete convergence

When East German companies entered into the economic, monetary and social union with West Germany in 1990, their productivity lagged far behind that of their western competitors. In their book 'Jumpstart: The Economic Unification of Germany', Hans-Werner Sinn and his wife, Gerlinde, pointed out that, to avoid rising unemployment in the eastern part of Germany, wages there would have to remain below those in the western part until eastern German companies had increased their capital stock, and thus labour productivity, sufficiently. But at that time, policy makers were already confronted with a strong migration movement from eastern to western Germany. Huge differences in wages between the two parts of Germany would have further accelerated this movement. So, maintaining large discrepancies in wages

* President of the Deutsche Bundesbank. Speech made at the International Scientific Symposium and Official Ceremony to Mark Hans-Werner Sinn's Retirement and the 25th Anniversary of the Center for Economic Studies (CES) in Munich on 22 January 2016 (source: http://www.bundesbank.de/Redaktion/EN/Reden/2016/2016_01_22_weidmann.html).

was not the preferred option for most policy makers. They accepted that labour unions and employers' associations agreed to fully adjust wages to those in western Germany in as little as five years.

The book 'Jumpstart' correctly predicted that it would be "completely impossible that productivity of the East German economy could increase quickly enough to make these wages compatible with full employment or at least low unemployment". And indeed, in the first five years of economic unification, unemployment in eastern Germany rose from virtually zero to almost 17 percent. Unemployment in the western part increased only by 3 percentage points.

But to be fair, other factors may have also contributed to the increase in unemployment. One was the currency conversion. Some of you will remember the controversial debate about how to convert the East German Mark into the *Deutsche Mark*. In the end, wages in eastern Germany were converted one to one into the Deutsche Mark. The then President of the Bundesbank Karl-Otto Pöhl had warned – for the same reasons that Hans-Werner Sinn put forward – that this was to the disadvantage of companies in eastern Germany. However, he later acknowledged that there was hardly any alternative, as "political realities were stronger than economic logic". The high level of unemployment in eastern Germany was cushioned by transfers from the western part. While the exact amount of these transfers is difficult to calculate, Hans-Werner Sinn once estimated that transfers paid up to the present day amount to around 1.8 trillion euros – roughly the size of the German GDP in 1991, but this number certainly comprises more than just the transfers via the social security system.

A central tenet of 'Jumpstart' is that it would have been much cheaper to compensate employees for accepting lower wages than to compensate the unemployed for their job losses. 'Implement distributional objectives through transfers and not by altering factor prices' was the economic principle that Hans-Werner Sinn saw violated in the formation of the economic union between the two Germanys. And he feared that this would allow wages to remain above the market clearing level for too long. And also the distributional objectives were only partly achieved: not least because unemployment in eastern Germany is still higher than in the western part, per capita income in eastern Germany is still only 71 percent of that in western Germany.

It is this experience which explains at least partly why many German economists are sceptical about establishing a transfer union in Europe, as at the European level these problems are aggravated by the fact that the balance between control and liability would be thrown further out of kilter. Decisions would mainly be taken at the national level, while the consequences of those decisions would be spread across the entire euro area. Many proposals in terms of risk sharing and mutualising liabilities have been put forward over the last years, including Eurobonds or the establishment of a common deposit guarantee scheme, but little has been said about the necessary transfer of fiscal sovereignty. Without a transfer of national fiscal powers to the European level, such a set-up would undermine the incentives for sound and sustainable policy decisions in the member states. I will come back to this point later on.

Germany's welfare system and the forces of globalisation

Hans-Werner Sinn's impetus to explain to the public when policy makers try to defy basic principles of economics struck again in the early 2000s. In another round of public interventions, he warned that the German welfare state was ill-equipped to deal with the forces of globalisation. Germany's reform of the labour market is the second stop on our journey into the past. The key economic principle at stake was again the same: distributional objectives should not be aimed at by changing factor prices.

With regard to the entry of China and India into the global markets, Hans-Werner Sinn was convinced that this would put downward pressure on the wages of the less skilled workers in Germany: trade in goods and mobility of capital creates a common labour market, and on such a labour market there can no longer be substantial differences in wages. He was rightly concerned that Germany's approach of using wage substitutes to compensate the losers of globalisation would define an implicit minimum wage that would prevent wages from adjusting. This was another attempt to defy economic forces. And as a result, globalisation produces unemployment rather than gains from trade. So a way had to be found to compensate the losers of globalisation without preventing the market from adequately determining factor prices. Together with other economists, the German Council of Economic Experts and also the Bundesbank he therefore called for a change in the welfare state paradigm: to rely more on wage subsidies and less on wage substitutes.

This made Hans-Werner Sinn one of the trailblazers of the so-called Agenda 2010 reforms that were enacted between 2003 and 2005. A central element of the reforms was to shorten the period of eligibility for unemployment assistance and to tighten work availability requirements. In return, the government began topping up low wages. Germany's welfare system now paid, as Sinn put it, "more for taking part and less for staying away". And the recipe worked as predicted: unemployment began to trend downwards and employment began to rise. The full truth is, however, that this was also supported by a changing behaviour on the part of trade unions and employers' associations, resulting in more moderate wage policy and the strengthening of establishment-level agreements as trade unions reacted to the further increase in the already high level of unemployment. These changes allowed Germany to rise to the multiple challenges stemming from German unification, the competitive pressures from EU enlargement to the east, and globalisation.

By the way, even today and against the background of almost full capacity utilisation the wage settlements are still mindful of their employment effects. The Bundesbank's focus with regard to wages is purely analytical. The crucial question is here, whether their development is in line with our main objective: price stability. And in this regard we have in particular to check for second-round effects. According to our analysis such second-round effects can currently be denied for Germany. This perspective on wages is not a policy recommendation. Not only because we do respect the autonomy in wage bargaining but also because we agree with Hans-Werner Sinn that wage negotiations should not be overburdened by aiming other policy goals – for example by targeting the current account.

Recent economic policy decisions, however, such as the introduction of the minimum wage and the option to draw a full pension at 63 offered to long-term contribution payers can be seen as a roll-back of the Agenda 2010 reforms. And again, these decisions illustrate the key challenge related to policy advice I mentioned earlier: in the short run, where the economic situation and employment is relatively stable, the minimum wage, for example, might even have positive economic effects, as it leads to an increase in the income of the workforce. And consequently, the Bundesbank assumed in its macroeconomic forecasts for last year that the minimum wage would have a slight, stimulating growth effect. In the medium term, the consequences of the minimum wage are certainly less benign and will first of all depend on whether a politicisation of the work of the Low Pay Commission can be avoided.

Reforms for a more stable monetary union

The last stop on our time travel expedition is the euro-area crisis, which is also one of Hans-Werner Sinn's central points of focus in his academic and political work. In his book 'Der Euro' he writes: "the tension in Europe stems from a fundamental conflict between wish and reality – or what has been dubbed the primacy of policy over the laws of economics. For years, policy makers have been able to get their own way and pretend that fiscal constraints, laws of economics, and mathematics simply do not exist". In his description of the euro area's current state he is rather negative: "today the Eurozone is a shambles, staggering from one crisis to the next".

As Hans-Werner Sinn knows, I am not as pessimistic as he is with regard to the state of the euro area. This is not only because of the difference in age and the fact that as life advances, recollection takes the place of hope – to quote the German writer Wilhelm Raabe. After all, there has been some progress in the euro-area countries and institutions. But I agree with him that one important reason for the euro-area crisis was the limited success of capital markets in constraining public and private indebtedness in the euro-area member states, which found its expression in an exaggerated convergence of risk premiums for lending to governments and households in the euro area after the introduction of the euro.

This convergence could be partly explained by the elimination of the exchange rate risk because of the introduction of the euro. But the convergence in risk premiums went even further as investors mispriced the risks associated with the increase in public and private debt levels. While the rescue mechanisms that were put in place prevented the crisis in the euro area from escalating, they did so by a bailout of creditors to banks and sovereigns. The principle of creditor liability was further undermined.

This is another of the economic laws, violation of which Hans-Werner Sinn warned would turn out to be very costly. "Creditor liability is the core tenet underpinning the market economy", he wrote. "Investors only act with caution when making their investments if they reckon with being held liable in case their investment fails". Hans-Werner Sinn devoted at least three books to this issue, all of which contain impassioned calls to realign control and liability.

An important step in this direction with regard to investments in banks was made at the beginning of this year, when the Bank Recovery and Resolution Directive (BRRD) became effective. It helps to ensure that, in the future, the shareholders and creditors of a bank will be first in line to absorb any risks and losses. And in this context it is important to note that because of the new Basel III regulation, banks are now obliged to maintain higher capital buffers. This helps to increase bank shareholders' liability if the bank has to be restructured or even resolved. To ensure that the principle of liability – or as Walter Eucken put it: "those who reap the benefits must also bear the costs". – is also respected with regard to sovereign debt, the founding fathers of the euro had incorporated the no-bailout clause into the Maastricht Treaty. It was the 'linchpin of the construction of the euro', as Hans-Werner Sinn wrote in one of his books.

But with the institutions and rules in place before the crisis, simply letting a sovereign default happen proved to be risky for the financial stability in the euro area. Because government bonds were treated, wrongly, as risk-free in the capital regime for banks, they held a significant stock of government bonds – the sovereign-bank nexus is strong in the euro area. Hans-Werner Sinn suggested a number of measures that would bring more market back to the sovereign debt market. Here, I would like to mention only two that strike me as being particularly important – and which are similar to points that I also make frequently:

- The first is to do away with the regulatory privileges afforded to public debt.
- The second proposal is to limit assistance from the rescue mechanisms to what is absolutely necessary to assess whether the situation at hand is one of illiquidity or insolvency.

While Hans-Werner Sinn tries to achieve this by limiting the time for assistance up to two years the Bundesbank has suggested to introduce an automatic three-year maturity extension for all government bonds – which would be activated the moment a government applies for an ESM programme – designed not to let private bondholders off the hook until it is clear that the problem is one of illiquidity and not insolvency. Addressing both issues is crucial to enhance the functioning of the Maastricht framework, which is – as it has to be recalled from time to time – still the legal foundation of the monetary union.

Last but not least, Hans-Werner Sinn unquestionably deserves special acclaim for pointing the public's attention on the impact of central banks' crisis measures. He anchored his criticism in the discussion at one specific keyword: the balances of the 'Trans-European Automated Real-time Gross settlement Express Transfer system', known as TARGET for short. He even dared to write a book about that topic, which was previously known to only a handful of experts. I am sure that no one else than Hans-Werner Sinn could have taken such an unwieldy subject and propelled it to the top of the German bestseller list for business books.

I do not wish to rehash the whole Target debate here. The Bundesbank shares many of the observations made and conclusions reached by Hans-Werner Sinn. However, our opinions do differ in several points of analysis. For instance, we do not see the Target system as the problem *per se*, but rather as a system that reflects existing problems in the euro area. Above all, the underlying risks stem from the provision of liquidity and the liquidity provisioning framework, as well as in the subsequent cross-border distribution of liquidity. Similarly, in banking, it is the non-performing loan that is a potential risk, not the payment system through which the payments were routed. Consequently, our critical appraisal focuses on aspects of such liquidity provision where the boundary between monetary policy and fiscal policy is in danger of becoming blurred. For example, when emergency liquidity assistance is granted on a very large scale, the collateral framework is severely watered down, or when government bonds are purchased. This is doubtless in keeping with Hans-Werner Sinn's views. But our views probably differ in our assessment of the risks that the Target system presents for Germany, say.

Despite some differences of opinion it is without any doubt one of Hans-Werner Sinn's outstanding achievements that he has fostered intense broad public debate – even though the sometimes sharply propounded arguments did not always make life easier for us in the Eurosystem.

Conclusion

Dear Hans-Werner Sinn,
Arthur Schopenhauer once wrote: "there is no greater consolation in age than the feeling of having put the whole force of one's youth into works which still remain young". Well, I am not sure your age necessarily warrants the need for consolation. Looking at your latest publications, you seem to have maintained a lot of this force. And you have obviously saved some of your youth for a host of other achievements above and beyond those which I have discussed today.

But I hope that the short-time journey I have undertaken now through your public interventions over the past decades demonstrates at least one thing clearly: that your achievements will not age. They contain lessons that are still relevant today and will remain relevant tomorrow.

And there is no doubt that your publication list will become even longer. You already said in an interview that you were planning to write more books. I wish you the strength and energy for many more public interventions.

Hans-Werner Sinn and Germany's Natural Unemployment Level

Edmund Phelps*

Over my several stays in Germany I came to feel involved in the country. And I came to sense unease among some economists there, despite the impressive postwar reconstruction, over the direction that the country's political economy was taking. In a conversation around 1975, Herbert Giersch, then Head of the Kiel Institute, spoke about the costs of the corporatism emerging in the German economy and, in a conversation around 1990, Heinz König, the previous President of the ZEW Mannheim, expressed his worries about developments in corporate governance. Now responsibility to sound the warning has passed to the next generation – of which our honoree is right in the middle (and I at the senior end).

Hans-Werner Sinn, it is safe to say, has done more than any economist of his generation to raise the question of the future of Europe. On a personal note, I would add that I did not find this surprising. I first met him in 1983, I think, in Mannheim where he came to teach a course and I came to finish my introductory textbook. He struck me as both the smartest and most trenchant of the economists I had met in Germany. We met next in December 2002 at a conference of the Ifo Institute, where he was President and I was the keynote speaker. I well remember that night with him and his engaging wife Gerlinde Sinn touring the Christmas stalls in Munich's center and exchanging over dinner our thoughts about what is missing in Germany. So when I needed a partner to co-organize with me and my Center on Capitalism and Society a 2006 conference on what ails Europe, it was obvious that Professor Sinn and his Ifo Institute were the right partners.

* The 2006 Nobel Laureate in Economics, Director of the Center on Capitalism and Society at the Columbia University, and Dean of the New Huadu Business School, Zurich.

The event, held in Venice that summer, was perhaps the first large-scale meeting to confront a range of data indicating a decline of economic performance in continental Europe. And, to my knowledge, it was the first to propose that the problem was a 'dearth of dynamism', resulting in a rate of commercial innovation that pales in comparison with the rapid innovation in Continent's brilliant decades. The conference looked widely for causes of a loss of dynamism, not just at market forces such as aging, institutions such as corporate governance, and economic policies such as taxation and welfare programs. Economic culture was also studied: have the values that grew to spark the long epoch of innovation in 19th Germany and France century somehow been overcome by some other values inimical to innovation? Of course, there were not many firm conclusions reached by any of the authors, let alone a consensus among the authors. Yet this conference and the volume that came out of it, *Perspectives on the Performance of the Continental Economies*, constituted a watershed for several of the participants – Professor Sinn and I included.

In his contribution Sinn focuses on the interaction of two forces: the forces of globalization and the welfare state. His thesis is that full-time equivalent employment in German manufacturing declined by 1.21 million from 1995 to 2005. Where did they go? They "went to the welfare state, into state-financed unemployment". German readers know that this is a theme in his best seller, *Ist Deutschland noch zu retten?* yet he was shy about referring to that book at the conference or even the volume that followed. (I became aware of the book only when he sent me the book in its 2007 English edition, *Can Germany Be Saved?*)

Was he right? The truth is hard to determine. While the employment-to-population ratio for men age 15–64 fell from 79.26 percent in 1990–1994 to 76.24 percent in 2000–2004, it bounced back to 81.20 percent in 2005–2009 and even to 83.60 in 2010–2012. The truth might be that those cast out of their jobs were reeling for a while from the shock, though most continued to keep an eye out for a job, thus remaining in the labor force. But new employers gradually found round pegs for their round holes, with the result that employment recovered. The 'natural rate' lives! And the 2004 Schroeder reforms may have pushed the natural boosted employment to a level above the 1990–1994 level.

Yet the world is generally evolving. No one could have foreseen that the loss of competitiveness in southern Europe toward the end of the previous decade would give a further boost to German employment – in the short run at any rate. And no one can be sure that the long-run effect of Germany's new real exchange rate is not a rise of mark-ups, a resulting decline of domestic sales and thus ultimately a fall of employment. And no one can be sure that the Schroeder reforms will survive this new phase. So Sinn may have the last laugh.

I have learned from Sinn's thesis. We have to wonder whether the remarkable exodus of Americans from the labor force participation proves to be permanent, aided by government programs, or whether what is left of the dynamism of the American economy will be strong enough ultimately to take up all the people who left the labor force during the financial and fiscal crisis. We have to wonder whether the Greek economy will have the dynamism – meager though it is – to draw into new jobs the many people who lost their jobs during the crisis.

Science advances through the interplay of ideas from many minds.

Pension Reform: Hans-Werner's Research and Policy Impact

James Poterba*

Two of the hallmarks of Hans-Werner's long and distinguished research career are his uncanny ability to identify the most important unresolved issues in economic policy design and his remarkable capacity to offer novel and insightful analysis on these issues. Even on questions that have been studied by many others, Hans-Werner has found ways to provide new perspective and to suggest creative solutions, enriching both academic discourse and the public policy debate. These talents are well-illustrated by his analysis of public pension reform, a subject that attracted his attention in the late 1990s.

Hans-Werner began to study pensions at a time when there was a growing recognition that Germany's public pension system was on an unsustainable trajectory. The tax rates that were projected to apply to future workers seemed infeasible. What should be done? With characteristic clarity and insight, Hans-Werner observed that the key challenge was the result of demographic change. A decline in Germany's rate of population growth, which translated into forecasts of growing numbers of older and retired individuals relative to the number of active workers, was the basic source of long-term pressure on the pension system. Hans-Werner communicated this insight to policymakers, and at the same time, he found an innovative way to formulate the analysis of public pension systems for the research community. His widely-cited *International Tax and Public Finance* paper on 'Why a Funded Pension System Is Useful and Why It Is Not Useful', published in 2000, developed the concepts of explicit and implicit tax burdens for a public pension program. It showed that a transition from a pay-as-you-go to a funded pension system, without any change in the benefits promised to existing participants, would not alter the sum of these burdens – a key point that needed to be recognized in analyzing policy reforms.

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Hans-Werner did not limit himself to conceptual discussion of pension systems. Working with other researchers at CES, he developed a model of Germany's pension system that made it possible to analyze how various reforms, including complete or partial transition to a fully-funded system, would affect the system's sustainability and the tax burdens on various generations. Hans-Werner also drew attention to potential reforms that were not directly focused on public pensions, but that would have important consequences for the pension system. He suggested, for example, that tax and benefit policies be tilted to encourage higher fertility, perhaps by varying the rate of contribution to the pension system as a function of an individual's number of children. He also pointed to the potentially important role of immigration policy in addressing long-term pension funding challenges. By framing the challenge of pension reform in a broader economic context, Hans-Werner was able to bring novel policy options to the public policy dialogue.

The research that Hans-Werner carried out in the late 1990s played a key role in stimulating further analysis of public pension reform in Germany and many other nations. Its impact was not limited, however, to the research community. It also was an important input to the significant reforms of the German public pension system that were adopted in 2001, the so-called 'Riester reforms'. These changes, which shifted away from the pay-as-you-go model and introduced a fully-funded pension account as a component of old-age support, were in the spirit of the reform proposals that Hans-Werner had analyzed. These reforms were pioneering. Taken together, the German public pension reforms of 2001 and 2004 substantially strengthening the pension system's long-term sustainability.

Hans-Werner is one of the most versatile economists of his generation. He has repeatedly displayed comfort and ease in mastering new concepts and tools for the analysis of particularly pressing policy questions. When the problem of funding public pensions became a first-order topic of policy debate, he directed his research attention to understanding source of the problem, even though this had not been a topic of his prior research. He also proposed potential solutions. Once pension reforms had been enacted, Hans-Werner's research shifted to other, more immediate, issues. Few economists have offered insights and constructive policy advice on so many different topics, spanning taxation, climate and energy policy, pensions, immigration, monetary and credit policy, and labor market reform. Fewer still have been able to carry out path-breaking research while also performing policy analysis that has constructively advanced the policy process. Hans-Werner is a member of this extraordinary group.

On the Young Sinn, the Political Economist, the Entrepreneur and the Friend

Assaf Razin*

For many among us "life is a succession of tasks, rather than a cascade of inspiration, an experience that is more repetitive than revelatory, at least on a day-to-day basis. The thing is to perform the task well and find reward even in the mundane" (Roger Cohen). This definitely cannot be said for Hans-Werner Sinn! He does not find rewards in the mundane and repetitive tasks at all. Sinn has been a great source of inspiration to me over the last thirty years. What impressed me the most is how he almost single-handedly succeeded in breaking down bureaucratic rigidities in German academia.

The young Hans-Werner Sinn

In his doctorate dissertation at the University of Mannheim, Sinn dealt with economic decisions made under uncertainty. Spinning off from the axiomatic analysis of decision theory, he turned to the more policy-oriented analysis of risk decisions under limited liability, in parallel to the ground-breaking analysis of Stiglitz and Weiss at the time; he independently developed similar ideas. He subsequently applied work on limited liability to the theory of bank regulation. His later work focused on the stimulating effects of accelerated depreciation and the various components of capital income taxation on inter-temporal, international, and inter-sectoral allocation. This research is a gold standard in the field of public finance and squarely positioned Sinn as a major league policy-oriented researcher.

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Sinn also contributed to the scholarly debate over the German pension, arguing that the low returns on statutory pension insurance based on the pay-as-you-go method only has an apparent, but not a real efficiency disadvantage compared to a capital-market funded pension insurance.

Hans-Werner Sinn's positions on economic policy

In 2003 Sinn saw Germany's attractiveness as an investment location endangered by excessively high labour costs and called for structural reforms of the labour market. These reforms included escape clauses from collective wage agreements, the abolition of dismissal protection laws and longer working hours without wage compensation. He also criticised the negative effects of the German wage replacement system on employment. As an alternative, he developed the model of activating social welfare in 2002. His policy recommendations influenced the Agenda 2010 reforms.

Sinn has referred to the German economy as a 'bazaar economy' due to the rising share of input from abroad in German industrial production. He argues that Germany has inflated the value added component of its exports too strongly at the expense of its domestic sectors, and at the same time, placed too much emphasis on the final stages of production; leading to a pathological export boom.

The global 2008 crisis was rooted, according to Sinn, in the abuse of liability limitation by US investment banks. The lack of capital reserve requirements encouraged financial intermediaries to gamble. In addition, the lack of personal liability for homeowners similarly created an exaggerated willingness to take risks, and thus led to the housing bubble in the United States. As for German reforms, Sinn has called for considerably higher capital reserve requirements, the balancing of offshore business and a return to the accounting principle of lower cost embodied in the German Commercial Code (HGB).

Based on his scholarly work on the Green Paradox, Sinn criticised the Greens of pursuing environmental protection policies with unsuitable means, and of ignoring the economic laws of European emissions trading. In his book, *The Green Paradox*, he argues for including all of the world's countries in a post-Kyoto, joint emissions trading system.

Hans-Werner Sinn's first-rate academic entrepreneurship

I first met Hans-Werner Sinn at a conference in Kiel on capital income taxation. I immediately saw in him a rising academic star: passionate about debating economics and clever. He invited me to CES, which was a start-up institution back then. German academic institutions were isolated from the rest of the world at that time. Hans-Werner Sinn recognised that academic isolation breeds scientific stagnation, did not like what he saw and was determined to modernize German academia. Two and a half decades later, thanks to pioneering efforts by Sinn (and a few others), the German academic world is now unrecognisable. It features a US style graduate student curriculum, various economics department research seminars, publications in top journals by young faculty members, and great deal more.

Sinn took over the presidency of Ifo and completely transformed the institute. He did so through several initiatives: by recruiting first-rate policy-oriented economists, writing policy papers on major pan-European policy issues, and creating CESifo, which became a leading European scholarly center for debates on economic policy issues.

Hans-Werner Sinn – a friend

Hans-Werner and Gerlinde are a major reason why I always enjoy coming to Munich. Whenever I visit the city, they invite me to their charming home. There – often with other invited guests – I have often enjoyed frank discussions of policy topics in a relaxed, informal setting. The Sinns are wonderful hosts and I deeply cherish their friendship.

Hans-Werner Sinn, Cassandra and the Aristotle's Lesbian Rule

Harold James*

Hans-Werner Sinn has been by far the most influential German economist of the past twenty-five years, and it is a pleasure to pay tribute to his substantial positive effect on economic debates in Germany and on German politics. He has made a unique contribution in a number of areas – notably on the costs of German (re)unification in the 1990s, of the German economic and industrial structure, of the attempt to reduce carbon dioxide emissions, and most recently of the European monetary union. His approach is based on solid economic reasoning and consequently a rigorous application of logic. But often he appears as a highly coherent Cassandra, a prophet whose warnings are not taken seriously.

In part, this is because the Cassandra logic falls naturally to economists: their task consists in constructing a credible and simplified framework of analysis that allows an identification of a major problem. In Hans-Werner Sinn's case, that framework consists in a calculation of implicit liabilities, and often also in the analysis of the cumulative logic of transfers: a common outcome is thus an identification of a 'trap'. Germany was snared in a trap by the decisions that occurred, in particular in respect to wage determination, in the territories of the former GDR; or the announcement of CO_2 targets; or the payment settlement system TARGET2 within the Eurozone leads to a trap in which core countries are locked into continuous fiscal transfers if they do not want the value of their claims to be jeopardized.

Analysis of traps is inherently unpopular, politically and intellectually, because it seems to demand radical (and potentially costly) action to break the trap. Politicians like to muddle through, and they have a tendency to avoid tough decisions that will inevitably alienate some share of their electorate. In the academic sphere, political scientists tend to kick back against Cassandra presentations: if anything, they have a tendency to be Dr. Pangloss, and think that all is for the best in the best of all possible worlds, or to put in Hegelian terms, that the actual is real.

It is also the case that the historical track record of economists who have succeeded in persuading large numbers of their peers to sign large scale public declarations announcing the presumed lessons of their discipline have not had that much luck. Probably the most famous economists' declaration ever, the 1,028 US economists who had their opposition to the 1930 Smoot Hawley tariff entered into the congressional record, had no obvious policy impact. No serious economist would really deny the soundness of the general argument for freedom of trade. In retrospect, the consensus of economic historians is that the tariff should not be held responsible for the spread of the Great Depression. Other famous statements of collective economists' wisdom, like the 364 British economists who signed a letter to the London *Times* condemning Margaret Thatcher's deflation or austerity policy look much more questionable in hindsight, and indeed several of the signatories have admitted that a disinflationary regime shift was indeed what Britain then needed. The German appeals of 2012 of 160 and 172 economists against the European rescue measures may well appear similar – logically correctly presented, but irrelevant to the question of how in the threat of a financial collapse confidence could be returned to a situation that risked tipping into a disastrous equilibrium.

Fixing on a single large problem – that can be summed up in a big statement – is often a less powerful way of influencing political debate than debating and presenting wide ranges of options. Debate and discussion revolves around careful nuances between the multiplicity of approaches. Hans-Werner Sinn rightly thinks in terms of a secure framework of rules to contain moral hazard, and to enforce the principle of responsibility. In this regard, he takes up the core mes-

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sage of the German Ordo-liberal tradition, even though he is a pragmatic thinker. But there is an old problem, already identified by Aristotle. In the Nicomachean Ethics (5x), he set out the logic of looking for a malleable rule: he thought as an analogy of the lead (rather than iron) rule that sculptors on the island of Lesbos used: “when the law speaks universally, and a case arises on it which is not covered by the universal statement, then it is right, where the legislator fails us and has erred by over-simplicity, to correct the omission-to say what the legislator himself would have said had he been present, and would have put into his law if he had known”. It may well be that instead of creating a trap, the careful negotiation of sustainable flexibility – Aristotle’s Lesbian rule – can offer a way out of traps that are constituted by rules that have become too rigid.

Riester Pensions

Peter Diamond*

While Hans-Werner Sinn has written extensively on pensions, I focus on a single, valuable contribution: 'Why a Funded Pension System Is Needed and Why It Is Not Needed', *(International Tax and Public Finance* 7, 389-410, 2000). The abstract includes: "based on explicit present value calculations, the paper criticizes the view that the PAYGO system wastes economic resources. In present value terms, there is nothing to be gained from a transition to a funded system even though the latter offers a permanently higher rate of return. … Nevertheless a partial transition to a funded system may be a way to overcome the current demographic crisis …"

The paper explains that many time series of contributions can pay for a given future benefit stream by having a present discounted value (PDV) equal to the PDV of benefits. By collecting more contributions earlier (and so less later), a system acquires funding. As benefits to earlier cohorts were greater than could have been financed by their own contributions, later cohorts receive benefits below what could be financed by their contributions. Sinn concludes that a higher rate of return on assets than on contributions comes from a distributional choice, not an inefficiency in PAYG.

Sinn considers partial funding as part of responding to the unsustainability of a pension system. That is, he thinks it distributionally worthwhile to collect contributions above the level that will just maintain PAYG from large cohorts who are having fewer children (to educate) per capita than their parents. In his words: "in the presence of the demographic crisis, burden smoothing implies partial funding: where human capital is lacking, and to the extent that it is, real capital could be used to fill the gap".

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Sinn discusses risk when pension funding includes equities: "if the economy's price of risk taking is appropriately taken into account, the mere fact that stocks have a higher [expected] rate of return than bonds does not imply that an increase in investment [in stocks] would be a welfare improvement". Key is how well different designs for individual accounts can address the risks in individual portfolios. Two issues are the administrative costs of buying and holding stocks and the quality of the individual portfolios in terms of bearing risks.

I consider three methods of organizing defined contribution accounts. One is to let the private market provide the investment opportunities, subject to rules that apply to investment generally and some specific rules for this type of account. The German Riester pensions and the US IRA markets work in this way. Second is to allow only specialized firms subject to tight regulation, as pioneered by Chile and followed in several Latin American countries. And third is having a government provider offering limited portfolio choice.

Reliance on a wide variety of private providers is expensive and faces individuals with portfolio choices that many are ill-equipped to evaluate well. The importance of fees is often overlooked. Under plausible assumptions, over a 40-year working life, an annual administrative charge of 1 percent of a person's pension accumulation will reduce the total accumulation by nearly 20 percent. It is estimated that Riester pensions cost 12 percent of lifetime contributions on average, but with huge variation and a lack of transparency. The high cost of IRA management in the United States has been recognized, but not seriously addressed.

A second issue is the financial sophistication needed to optimize portfolio choices over a lifetime, a sophistication widely missing in the general public. Compounding this problem are conflicts of interest for financial advisers and inadequate information provision. The Chilean use of a highly restricted range of alternative portfolios and tightly regulated competition between providers has held costs down and provided reasonable portfolios. But, higher costs in other countries with a similar approach show the importance of successful implementation. The design does greatly reduce reliance on the financial sophistication of savers.

Historically, provident funds – a single fund run by the government – did poorly in less developed countries, showing the sensitivity of results to the quality of governance. Bolivia uses the Chilean approach but without worker choice of provider. This has resulted in low costs but dissatisfaction with the quality of services. The Swedish Premium Pension has centralized administration which lowers costs while allowing very wide choice of mutual funds. Importantly, there is a government-run default which has low costs and a well-designed lifecycle portfolio and attracts over 98 percent of new entrants. The pension system for US federal government employees (the Thrift Savings Plan, TSP) has limited choices for individuals, very low costs and limited reliance on worker financial sophistication. While TSP covers over 3 million workers, a system for an entire country would have higher costs, but is likely to be considerably cheaper than reliance on a broad market.

Paying attention to costs and quality of actual portfolios is central for designing a system well. Key is the quality of implementation, including repeated thoughtful modifications of rules in response to poor outcomes, as has been done in Chile. Government competition with private providers, as in Sweden and in prospect in Chile, also appears useful. Riester pensions could readily be made much better for workers.

Hans-Werner Sinn: A Tribute to His Contributions to Research in Economics and Public Policy

David E. Wildasin*

Among his many interests and contributions, Hans-Werner Sinn's work in the area of public finance is perhaps especially noteworthy. His research on the 'welfare state', in particular, is wide-ranging, intellectually deep, and highly policy-relevant.

Take, as a first illustration, his important papers on 'A Theory of the Welfare State' and 'Social Insurance, Incentives, and Risk Taking'. These papers explain how social insurance and tax systems, often seen primarily as redistribution mechanisms that have adverse effects on economic incentives, may also have important favorable incentive effects: although they may they *discourage* productive income-producing effort and investment, they may also *encourage* risk-taking activities, notably entrepreneurship, investment in human capital, and innovation. Because it is difficult or impossible for the private-sector to insure people against some of these risks, the welfare state may, in this important respect, promote socially-efficient risk-taking. The important message here is that the welfare state can help to invigorate a dynamic, fundamentally market-driven economy. However, as Hans-Werner observes, the implementation of such policies can be undermined if people who are asked to contribute financially to the working of social insurance programs – the lucky winners in life, among them – are able to escape this burden through migration.

This brings me to my second illustration. Hans-Werner has undertaken an extensive program of academic research and policy analysis dealing with demographic change and its fiscal implications. The critical importance of migration, fertility, and mortality for public finances should by now be virtually self-evident. Due to deep and prolonged reductions in fertility rates, native-born populations are aging rapidly in all of the richer countries of the world. Persistent wage and income differentials, and reduced barriers to economic integration give rise to a further persistent demographic trend, namely, increased gross and net migration flows, especially toward rich countries. Barring demographic catastrophes or dramatic changes in policy, these decades-long demographic trends will continue for at least several more decades, inevitably with profound effects on the highly redistributive and heavily age- and income-conditioned fiscal systems rich countries.

Hans-Werner Sinn is one of a comparative handful of economists to pay close attention to these developments two decades and more ago. He has led the way in explaining the far-reaching effects of population aging and economic integration. From his papers from the mid-1990s onward we see not only how perceptively he has anticipated evolving policy challenges, but how constructively he has advanced our understanding of policy options. His essays on the pension system of Germany, written more than a decade and a half ago, show how feasible reforms can distribute, as fairly as possible, the cost of maintaining pension solvency. One way to do so is by raising contributions immediately, by relatively modest amounts. Alternatively, mandatory private savings, subject to public monitoring and regulation, could also build a financial reserve with which to meet future pension obligations. The latter, however, is to be preferred, since, as he write, one must not overlook 'the covetousness' with which politicians would view such a reserve: "public money is a great temptation". A wise remark from a political economist who recognizes the inevitable role played by imperfect political processes in shaping economic policies. We might hope that politicians – and, even more so, the public – would take these insights to heart, sooner rather than later.

Alas, the window for policy changes does not remain open forever. As discussed in his more recent research, aging societies may become gerontocracies where the

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demands of an ever-older beneficiary population intensify the burdens on a shrinking population base of younger workers. Future fiscal crises would at least be mitigated, if only policymakers could make the necessary reforms – which, by now, are long overdue. But perhaps this is asking too much of today's increasingly gerontocratic democracies, a somewhat discouraging thought, however realistic it may be.

Researchers around the world have profited immensely from Hans-Werner Sinn's academic contributions to fundamental economic policy problems. But one must also not neglect his truly remarkable efforts on behalf of the entire profession, notably through the nurturing of CESifo, an institution that has stimulated productive research by economists worldwide and that has made the fruits of their efforts available to policymakers and the broader public.

I recall very well my first visit, one of many, to the newly-founded CES back in 1991, a visit that resulted in CES Working Paper No. 2 – in the exalted company of Richard Musgrave's No. 1, no less! (The working paper count is now well over 5000.) It also resulted in a research collaboration with Dietmar Wellisch, then of Tuebingen, on redistribution and immigration, published first in English, and then, in German, in *ifo Studien* – one example, of a multitude, of the cross-fertilization of ideas that the CESifo group has nourished. Hans-Werner Sinn is one of those exceedingly rare economists who has successfully navigated the broad and sometimes turbulent currents of institutional development, academic and policy research. It is a pleasure to express my admiration and gratitude to Hans-Werner Sinn in recognition of his remarkable career of professional accomplishment!

Hans-Werner Sinn: 'False Prophet' or Spiritus Rector of the Agenda 2010?

Wolfgang Wiegard*

Prologue

"The economy is stagnating, the bad news mounting up. Every month sees a record number of bankruptcies, many companies are stuck in a serious crisis, unemployment is assuming menacing proportions ... Germany is the sick man of Europe, it is bringing up the rear in terms of growth ..." Hans-Werner Sinn (HWS) wrote this description of the German economy in the preface to his legendary book, *Can Germany Be Saved?*, first published in October 2003. As medicine for the ailing German economy, HWS prescribed a '6 + 1' programme, consisting of three labour-market policy and two social-policy components as well as a tax reform proposal and in addition a reform agenda for the new federal states of eastern Germany.

A little more than a decade later, a stock-taking of the German economy looks completely different: for the past several years, Germany has become the growth and economic engine of Europe, its (harmonised) unemployment rate is the lowest in the EU, German companies are holding their own in international competition and public finances are now in surplus.

Was or is HWS doomsayer, a 'False Prophet' (Handelsblatt, 16–18 January 2015), a 'Prof. Propaganda' (SPIEGEL 29/2012)? On the contrary, his past analyses and reform proposals have contributed to an economic policy response to a desolate situation, and bold reforms have been implemented. This is especially true with regard to labour-market and social policy.

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Labour-market and social-policy reforms

Labour markets and social policies were at the heart of the HWS reform agenda for the ailing German economy from 2000 to 2005. Too high labour costs, rigid protection against dismissal, but above all false incentives in the income replacement system of the German welfare state were identified by HWS as the main reasons for the dramatically high and increasing unemployment in Germany at the beginning of the millennium. The recommended remedies were, firstly, a reduction in hourly wages, an extension of working hours (without compensation) as well as flexible opt-out clauses in collective labour agreements. Such clauses are now an integral part of almost all labour contracts. Secondly, in response to the high unemployment especially among low-skilled workers, the Ifo Institute submitted an innovative reform concept – its 'Activating Social Assistance' – already in 2002. Both the Academic Advisory Board of the Federal Ministry of Economics and the German Council of Economic Experts – two of the most important bodies of institutionalised economic expertise in Germany – adopted this proposal, with some modifications, and expanded it. The basic idea is as simple as it is convincing: low wages due to low productivity are to be increased by government wage subsidies, so that simultaneously more jobs can be offered in the low-skill segment and incentives can be provided to take up employment in this sector. In essence, these ideas were incorporated by policy-makers in the Agenda 2010 and the Hartz IV legislation, albeit not fully implemented.

Also at the interface of labour market and social policy in the run-up to EU eastern enlargement, HWS and his staff at Ifo drafted a proposal for a 'selectively delayed integration' of immigrants from EU countries into the social security systems of host countries. This was intended to address migratory incentives that are purely redistributive by nature by limiting the eligibility for certain tax-financed social benefits during a transitional period. It should be noted that the Academic Advisory Board at the Federal Ministry of Finance in its report 'Freedom of Movement and Social Security' (2000) presented quite similar considerations and reform options. The relevance of these proposals is seen today in the demands put forward in connection with the Brexit referendum by Prime Minister David Cameron of temporarily excluding immigrants from other EU countries from tax-financed social benefits.

Proposals to reform the pension system and for a radical tax reform completed the programme for a new start of the German economy. With the concept of a 'dual income tax', the ideas of HWS, the Ifo Institute and Council of Economic Experts regarding an investment and growth friendly tax system were, once again, almost identical.

Epilogue

With a total circulation of more than 110,000 copies, with a series of lectures televised by BR Alpha and an audio book version totalling 15½ hours, *Can Germany Be Saved?* is one of the most successful German business books ever. The impact on his academic colleagues, including those in government advisory councils or the Council of Economic Experts, was enormous. Insofar as the Hartz reforms and the Agenda 2010 adopted key ideas of HWS, the reform agenda at the time left indelible marks in economic policies. Most economists can only dream of successes like these.

A World Champion, a Provocateur and the Impact of Economic Policy

Gabriel Felbermayr*

Germany on 25 October 2004: the cover of the *Spiegel* magazine shows a rusty container and the headline *Germany: World Champion in Exports (of Jobs)*. The cover story explores what seems to be a paradox: how can Germany export more than any other country in the world on the one hand while suffering from record unemployment of 5 million and lagging behind in terms of economic growth on the other?

For Hans-Werner Sinn, this does not present any contradiction in terms – quite on the contrary. In his book *The Bazaar Economy. Germany: World Export Champion or Economic Slowcoach?* Sinn organises his attack on the complacent export fetishism of many of his contemporaries in two waves.

Firstly, high and growing exports are not necessarily linked to high levels of domestic prosperity and strong economic growth. An economy organised like a bazaar exports goods, whose main components it has previously imported without significant domestic value creation in the form of wages, profits or taxes. Such developments lead to booming exports and stagnating gross domestic product. In other words, what seemed like a paradox was not actually one.

Secondly, there is also no contradiction between being a world champion in exports and record unemployment. Hans-Werner Sinn shows that both are due to Germany's core problem: excessively high wages. Many German citizens in 2004 see this line of argument as provocative: if wages are too high, how can the German economy be so competitive that no other country exports more? The response originates in the standard model of international trade theory. The relatively capital-rich Germany exports capital-intensive goods – cars, machinery, chemicals – and imports labour-intensive goods. Wages above the market-clearing level create unemployment, lower employment and enable the country to appear more capital-rich than it is. It is obliged to increasingly specialise in capital-intensive export goods. This pathological overspecialization is accompanied by higher exports of cars, machinery and chemicals. And this is all due to – and not despite – higher wages.

Both points are closely related: the increasing capital-intensity of domestic production is only possible because the production of labour-intensive intermediate products is transferred to abroad and Germany increasingly becomes a bazaar economy. Both phenomena can be attributed to excessively high wages.

The term 'bazaar' has nettled Germans for years. Many companies with high-exports felt under attack because their high-tech products were semantically thrown into the same boat as trash and junk. In the Financial Times Deutschland (6 May 2005) Hans-Werner Sinn said: "at this point I would like to express my deepest regrets and would like to assure everyone that I also feel extremely sorry for German products. Please forgive me for my blasphemous choice of term".

As far as the facts are concerned, however, Hans-Werner Sinn proved an important empirical point. German exports as a share of domestic value creation has fallen from around 74 percent to 63 percent since 1995. It is clear that the higher the share of imported input goods, the less official export statistics are suitable as an indicator of economic strength. The OECD and WTO have recognised this and have been monitoring the phenomenon for the last two years with a self-constructed database. Moreover, current scientific research is focused on deepening our understanding of the value chain contents of international trade flows.

Since the publication of his book in 2005 Germany has changed significantly: the core problem of the pre-

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vious 'sick man of Europe' *(Economist)*, namely rigid and excessively high wages, was addressed by the Hartz reforms. That fact that this turnaround actually took place was partly thanks to Hans-Werner Sinn's gift for provocation, which made technical economic arguments the focus of a broad economic policy debate. By dismantling the fable of Germany as an export wonder, Hans-Werner Sinn destroyed the illusions held by politicians and voters and paved the way for painful reforms, which defused the threat of deindustrialization.

Today Germany no longer occupies pole position in terms of export statistics. It has, however, made some progress as far as growth statistics are concerned: since its period as export world champion in 2003–2008, Germany's annual growth has accelerated from less than 1.5 percent to over 2 percent (since 2010). Others are now lagging behind as far as growth is concerned.

Germany's business model is nevertheless far from perfect. Germany once again became a world champion for several years now: no other country in the world has a higher current account surplus. Once again, however, this is no cause for joyful celebration. On the contrary, the surpluses are not sign of strength, but the result of misguided policy just like the pathological export boom. The distortion of the interest rate level through various euro bail-out policy measures channel German savings abroad, where they are used to buy German goods on credit. The intrinsic value of several of these investments is dubious. It is once again time for resolute reform. This time, however, Germany's fate does not lie entirely in its own hands and the reform required applies to the entire Eurozone.

Hans-Werner Sinn's Thesis of the Pathological Export Boom

Wilhelm Kohler*

On 2 June 1999 the cover of the *Economist* referred to Germany as: 'the sick man of the euro.' From 1993 onwards Germany's real annual growth had been 0.8 percentage points lower than the other EU15 countries, while its unemployment rate was 1.1 percentage points above that of the other EU15 countries. By 2005 this differential had risen from 1.1 percent to 4.43 percent; while the growth gap had increased by over one percentage point.

All Germany seemed to have left was its traditional export strength. From 2000 to 2005 Germany's exports of goods and services grew by 7.4 percent on annual average, *versus* 5.1 percent in other EU-15 countries. This undiminished export strength, by contrast, seemed to contradict the idea that the surge in unemployment in Germany could have anything to do with slightly excessive wage levels. We faced a puzzle: Germany the 'sick man' and highly competitive in exports?

In this situation Hans-Werner Sinn came up with a provocative hypothesis: according to Sinn the export boom was not a sign of Germany's competitive strength, but could be explained as part of the 'sick man' pathology. The boom itself was to some degree 'pathological'; and not a sign of economic strength, but a symptom of its disease. Sinn presented his thesis of a 'pathological export boom' as a theoretical excursion in the context of an empirical finding: he had proven that out of 18 percent growth (1995–2003) the real production value of German manufacturing only accounted for a small share (2 percentage points) of the increase in domestic value creation, with the larger share represented by higher domestic and/or foreign input materials (7 and/or 9 percentage points). German firms were focusing on a steadily shrinking share of value creation related to industrial products. The same applied to exports. Opinions differ as to whether this trend was accurately described by Sinn's image of Germany as a 'bazaar economy'. There is, however, no doubt about the shift in the view of value shares in international trade that it triggered.

With this image of the 'bazaar economy' Hans-Werner Sinn wanted to counteract the slightly complacent use of statistics on the export boom to relativize the metaphor of the 'sick man', parallel to his theoretical argument supporting the pathological nature of the boom. There were two strands to his theoretical argument. The first was that citing booming exports as evidence against traditional explanations of very high unemployment was not theoretically tenable. In slightly simpler terms, the argument goes like this: real wages that are above the equilibrium level push up the prices of work-intensive goods on the one hand, while the production of all goods requires more capital on the other. In an age of globalization both effects not only apply to Germany, but also impact its trade partners. Moreover, if real wages are not fixed in those partner countries, then this more capital-intensive type of production is linked to a reallocation geared towards more labour-intensive goods; which means that employment remains high in these countries. This, however, gives rise to surplus demand for capital-intensive goods, and this is – to some degree residually – satisfied by the country with real-wage rigidity. If that country, as in Germany's case, exports capital-intensive goods, this leads to an export boom. That boom can be described as 'pathological', because it was originally related to excessively high real wages.

The second strand of Sinn's argument features a controversial economic policy message. In the case cited above an extremely strange exchange takes place between countries with different labour market situations. The country with wage rigidity 'exports' the implied changes in relative goods prices, and even the change in real wages, to countries that do not intrinsically exhibit any wage rigidity; and 'imports' the cor-

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related worldwide over-supply of labour in the form of unemployment. The price implications of wage rigidity are also internationalized, while the related quantitative volume effect – the *worldwide* over-supply of labour – is nationalised. The country with real wage rigidity effectively acts as a magnet for the whole world's unemployment.

Sinn's thesis of the 'pathological' export boom represents an elegant application of established theories on the potential solution to an empirical puzzle. The extent to which this argument can be used to empirically explain Germany's situation at that time remains open to debate. Germany's situation has since taken a turn for the better, but Sinn's point is of a more fundamental nature. It would be desirable for empirically-oriented trade economists to look at the empirical importance of those mechanisms underlying the idea of a pathological export boom. Exogenous real wage increases in large countries, and in trade partner countries without real wage rigidity, could be shown to cause real-wage increases, coupled with reallocation to capital-intensive sectors.

Potential Counter-Productivity of Second-Best Climate Policies

Rick van der Ploeg*

The Green Paradox and the potential counter-productivity of badly designed climate policies have been put forward by Hans-Werner Sinn in his German language book and in an academic article (Sinn 2008a and 2008b). In fact, the ideas go back to much earlier theoretical work that shows that an *ad valorem* tax on fossil fuel that increases over time leads to an acceleration of fossil fuel extraction (e.g. Sinn 1982; Long and Sinn 1985). Characteristically, he has also warned for the Green Paradox in no uncertain terms in the German policy debates. He must have been at least in part motivated by the very high subsidies for solar energy in German electricity generation. Given his excellent track record in both public finance and resource economics it is no surprise that the principle of second-best economics is at the root of the Green Paradox. Politicians hate to implement popular policies such as pricing carbon to fight global warming. Instead, they dither and procrastinate carbon pricing and try to make commitments for their successors instead. Politicians also prefer the stick to the carrot, so rather subsidise renewable energy production over and above what might be necessary to internalize learning-by-doing externalities instead of doing the honest thing and properly price carbon.

Second-best policies such as postponing carbon pricing and subsidising renewable energy have the unintended consequence of pushing down fossil prices, both in the future and *via* the logic of intertemporal arbitrage in the present. As a result, fossil fuel demand and carbon emissions increase in the present, thereby accelerating global warming. This had adverse welfare consequences in the short run. In the longer run, however, even such second-best policies lock up more fossil fuel in the crust of the earth and thus limit cumulative emissions and thus curb the eventual increase in global warming. These beneficial welfare effects dominate the adverse short run welfare effects if the price elasticity of fossil fuel demand is small, that of fossil fuel supply is large, and the ecological discount rate is small.

If this is not the case, second-best policies are really counterproductive in which case Sinn suggests to tax financial assets held by fossil fuel producers. Such a tax curbs the desire of fossil producers to accumulate financial wealth and has the opposite effects of a postponed carbon tax. The Green Paradox can be seen as an intertemporal version of spatial leakage, which is the notion that pricing carbon in one set of countries depresses fossil fuel prices and thus accelerates fossil fuel demand and global warming in the rest of the world. The Green Paradox effects of postponed carbon pricing induce leakage both in the present and the future.

The Green Paradox has spawned a huge rather technical literature among academics with unfortunately not enough serious applied work with convincing evidence on significant and substantial adverse effects of second-best climate policies in the real world. However, the gravitas of Sinn can be witnessed from the much wider perspective he offers in his book. In it he discusses at times rather provocatively that the efforts of many governments to promote say alternative energy, impose emission controls on cars, and enforce tough energy-efficiency standards for buildings has done nothing to stop the relentless rise in carbon emissions. Quite rightly Sinn emphasises that policies such as diverting agricultural land to produce biofuel make the poorest on our planet hungrier and worse off. His plea is therefore to not try to regulate the demand for fossil fuel but to directly curb the supply of fossil fuel by leaving more of the stuff in the ground and thereby curb cumulative emissions. This gets close to a Coasian approach where suppliers of fossil fuel are bribed not to extract it.

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His ambitious proposal is to organise all countries that are net importers of fossil fuel into a global cartel with a credible coordinated cap-and-trade system supported by taxing capital income of the oil and gas sheikhs at source. His passionate plea to tackle global warming at the root of the problem should gain more traction in policy circles and showcases his unique qualities as a policy-driven intellectual and scholar. Although vocal green policy activists in Germany and elsewhere have often taken umbrage with Sinn's unwelcome critiques of badly designed energy and climate policies, they would do well to take his analysis aboard in order to get efficient and effective ways to combat the warming of the planet. Our grandchildren and their offspring would not forgive us if we did not take urgent action for perhaps the most important challenge of our time.

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Hans-Werner Sinn, Climate Change and the Green Paradox

Nicholas Stern*

Hans-Werner Sinn has been a leader in the analysis of the principles of public economics and public policy for around four decades. And he has led public discussion. He is truly a public intellectual, in the best sense of the term: greatly admired by his fellow academics and a powerful and constructive influence on the public stage. I have had the privilege of interacting and collaborating with him on many occasions and issues, including *via* the editing of the *Journal of Public Economics,* the Munich Lectures which I gave in 2002 and, in recent years, around the economics of climate change.

His work on the economics of climate change, in particular 'The Green Paradox' , my subject here, reflects his great skills in theory and his wisdom and judgement about how the world works, or could work. As always he gave a refreshingly different focus from the rest of the literature, in this case by concentrating on the supply-side. In so doing he showed and stressed how apparently well-intentioned policies could go wrong. One example he stressed was the misguided use of some (not all) biofuels, such as those based on corn, which can be very inefficient and divert resources from food.

He argued, very sensibly, that there are two mechanisms to reduce (or 'mitigate') the build-up of carbon in the atmosphere. First we can extract and use less fossil fuels and second we can capture and store the carbon. His focus was on the former. He asked will our price and policy incentives lead to suppliers extracting less, i.e. he asked directly about the supply side, which all too few had been doing.

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His green paradox was the potential problem of hydrocarbon processes being incentivised to extract their resources more quickly in the near future, in the anticipation that policies on carbon would tighten in the future. Essentially a price on tax-based carbon policy involves creating a wedge between prices received by producers of hydrocarbons and those faced by users. The former must fall and the latter must rise if there are to be incentives to extract less and use more. Hence the problem arises of extractor-producers anticipating a future fall in the prices they receive for their products and trying to extract more now.

In these circumstances quantity-based policies should have a strong role. Thus cap-and-trade schemes would be a priority, where policy begins with a quantity target and prices for carbon are determined endogenously. He argued that effectiveness required that demanders come together to enforce the policies as a group. In so doing they could also influence resource-rents and the price that they pay; cutting the costs of the policies. One would, of course, expect resistance from those who would thereby have their rents reduced.

In many ways Hans-Werner anticipated the divestment discussions around the so-called 'keep it in the ground' campaign. Recent work by the Carbon Tracker Initiative with the Grantham Institute at the LSE and others (such as international bank HSBC), has shown that known hydrocarbon resources, if buried without carbon-capture and storage, would emit around three times as much carbon dioxide as is consistent with the international 2 degree Centigrade target (increase in average global surface temperature since the 19th century), beyond which the science tells us, sensibly, we have dangerous climate change as expressed in the assessment reports by the Intergovernmental Panel on Climate Change. The world is already on the edge of its temperature in the Holocene, the period since the last ice age, of our civilisations. We are headed way above 3 degrees, temperature not seen on the planet for 3 million years – *homo sapiens* has been here for only a quarter of a million.

Hans-Werner recognised the severe dangers. He showed us, very importantly, that we must focus on the supply side as well as the demand side, and brought out the policy dangers from focussing only on the latter. He pointed, too, to the importance of a focus on resource taxes, resource rents, this including the assets, portfolio and investment side. We now see many discussions of decarbonising the portfolio, or disinvestment. Over time the world, as on so many other issues, has followed the directions marked by Hans-Werner Sinn.

Casino Capitalism and Risk as a Production Factor – One Evening at a Restaurant in Paris

Clemens Fuest*

It was the evening of 24 October 2008 in the back room of a restaurant in Paris. This was the setting for a dinner following on from the Economic Policy Panel Meetings and hosted by the Banque de France. Around 50 economists were squashed around several tables. Over the course of that day our discussions had focused on academic articles. The main topic of discussion in the breaks, however, was the dramatic unfolding of events in the finance sector, with the collapse of Lehman Bank a month previously and the impending bail-out of the credit insurer AIG with billions in taxpayers' money just a few days later. Although a crisis was obviously looming after the collapse of the British building society Northern Rock in February 2008, the dimensions of the catastrophe that manifested itself in autumn 2008 came as a nasty surprise.

That evening the event organisers spontaneously arranged a small panel discussion focusing on the outbreak of the financial crisis. There were three economists on the panel, including Hans-Werner Sinn. Both of his discussion partners focused on describing financial products of differing complexity with abbreviations like CDS, CDOs, etc. Their message was that the crisis had arisen due to the excessive use of complex financial products, which entailed incalculable risks. Banking supervisory authorities failed to understand these products in many cases, but in the competitive arena of financial markets there were fears that prohibiting individual instruments would prove a disadvantage. It is often overlooked that complex financial products lead to multiple connections between banks, meaning that the failure of one bank can easily spark a wildfire.

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This explanation presents the crisis as a kind of accident caused by stupidity, recklessness or irrationality. Since the financial crisis international the stock markets have often been described as a chaotic system in which irrational players driven by greed chase astronomical sums around the world with no regard for the consequences. Warren Buffet has even described certain financial derivatives (CDOs) as 'weapons of mass destruction'.

Hans-Werner Sinn argued differently, explaining that the crisis was the result of a combination of limited liability and high levels of debt financing. If investors bear only limited liability and can pass on their losses to others such as lenders, they will take excessive risks. This tends to be alright for a while and investors rake in high profits. By virtue of the very nature of risky investments, however, losses will inevitably arise at some point. Investors who hardly use any of their own capital will not be affected by these losses. Others such as third-party lenders or taxpayers (if the state bails out banks) will foot the bill. Lenders need to be aware of these dangers and demand corresponding risk premiums. Taxpayers, on the other hand, cannot really defend themselves. This phenomenon, widely referred to as 'gambling for resurrection', plays a central role. In his book *Casino Capitalism* Hans-Werner Sinn subsequently explained this point in greater detail.

Today, after years of debate over the crisis, this analysis has been widely recognised as the basis for negative developments. The fact that Hans-Werner Sinn presented these arguments back in October 2008 is characteristic of him in two ways. Firstly, this episode shows the speed at which he can analyse complex economic events and grasp their very core. Secondly, it shows that he is not satisfied with citing the fact that people are irrational or cannot deal with complexity as an explanation for economic problems.

It is equally as typical of Hans-Werner Sinn that he warned against throwing the baby out with the bathwater, despite all the criticism of risk investments and limited liability once the crisis hit. There should be no objection to investors taking risks, as long as they bear the full costs of doing so. On the contrary, in his inaugural lecture at the University of Munich entitled 'Risk as a Production Factor' Hans-Werner Sinn explained that taking risks is part of our modern civilisation – many achievements of the modern industrialised society would not have been made without a willingness to take risks. Taking risks only becomes problematic when losses are passed onto third-parties like taxpayers.

The option of setting up companies in which the liability of investors is limited to the capital invested is hardly any less important to economic development. Limited liability enables modern companies to mobilise high sums of capital from a large number of investors. In his book *Casino Capitalism* Hans-Werner Sinn describes the history of institutions with limited liability and cites a speech by the then President of US Columbia University, Nicholas Murray Butler, made in 1911, in which he describes limited liability companies as the key discovery of the modern age, and as more important than the steam engine or the use of electricity.

I left the restaurant in Paris that evening with the impression that there were difficult times ahead, but also with the positive feeling of having gained a far better understanding of developments in the financial sector.

Economic Policy in the Financial Crisis

Kai A. Konrad*

The first major financial and economic crisis of the 21st century led to many disruptions, including a loss of confidence in the market economy and free-market institutions, and in the self-regulating and self-healing forces of the market. Do we now need 'less market'? Are the market mechanisms to blame for the systemic crisis? Do we need more *dirigisme* and political commissioners to reign in the market?

The market can only exercise its ordering and welfare-enhancing function if policy-makers properly establish the framework for this development. This they failed to do. In retrospect, the financial crisis was largely the result of policy failure. The question for the future is how framework conditions can be created that ensure the positive effects of the market and avoid its misalignments.

In recent years, many economists have exercised harsh judgement on themselves and their own discipline. Others have very rightly pointed out that their microeconomic instruments are quite excellent. The behaviour of the players that led to the crisis can be well explained by these instruments. Many microeconomic theories that assume that people are opportunistic as well as strategic and rationally proactive can explain the behaviour of the actors in the financial markets only too well. These theories also point to possible dysfunctions that could be corrected, at least in part, by competent framework conditions.

We need only think of the incentives of actors who have their backs to the wall and who have nothing to lose, or of financial companies who for other reasons are not able to bear the larger losses that result from their actions, for example, because when they are in trouble they cannot cover their own losses and must rely on government bailouts. These actors are unfortunately willing to take on bad risks: risks whose odds for winning lag behind the risk of losses. One economist who has long recognised and analysed this behavioural motivation is Hans-Werner Sinn, who already in his doctoral dissertation examined key aspects of this problem. In his economic analysis of the financial crisis (*Casino Capitalism*), he took a renewed look at the behavioural motivation of the financial actors.

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One of the consequences of this analysis is the call for correspondingly high capital requirements for banks so that capital is available to cover losses from banking operations. This demand has met with broad acceptance, even though the economic-policy implementation has been slow. These considerations are by no means new ideas in the wake of the Lehman Brothers bankruptcy just as theories on the vulnerability of bank capital and the ensuing incentives for balance-sheet reductions or theories on the development of bank runs are also not new. This is not surprising, because the crisis itself is not the first financial crisis that economists have studied and analysed.

But how do we prevent the on-going policy failure that leads to the non-implementation of these conclusions, particularly with regard to the design of financial markets? This is the question that still needs to be resolved. The remedies are available. Many economists like Hans-Werner Sinn have devoted their efforts to advising policy-makers, either directly or indirectly *via* public forums, in the same way as civil engineers, who like to see their knowledge put to good use. These economists hope, of course, that their policy expertise is correctly interpreted and optimally implemented. This, as we also know from economic theory, is unfortunately not so easy and sometimes even impossible. Theories convincingly explain why even slight differences in the objectives of experts and politicians can make the communication process enormously complicated. We also have good theories on how interest groups influence policy and the functioning of the political process.

This is perhaps the reason why, despite our basically sound understanding of the economics, there are still economic-policy failures and why, despite the enormous potential that a well-functioning market economy would have for the general welfare, this potential is not fully exploited. Perhaps the solution to the economic-policy dilemma is that economic experts become more active in the public forum. For many years, Hans-Werner Sinn has devoted much of his energy to just this. His message, aimed at enhancing the common good, often generated considerable headwinds, especially from various interest groups. But his efforts have also earned him much approval and widespread popularity. As he continues these activities in the coming years, I wish him all the strength and energy that he may require.

Hans-Werner Sinn on the Global Financial Crisis

Martin Wolf*

Hans-Werner Sinn possesses four qualities to an exceptional degree: courage, clarity, cleverness, and combativeness. This rare combination of gifts has allowed him to work as an excellent economic theorist, path-breaking policy analyst and powerful polemicist. He has also magnified his influence *via* his roles as President of the Ifo Institute and Founder of CESifo. He is not just an intellectual of astonishing energy, but a true organiser. He is not only Germany's most influential policy-oriented economist, but one the most influential in Europe. One does not have to agree with everything he has written to recognise the importance of his contributions. Indeed, the clarity with which he argues forces those who disagree with him to clarify their own arguments. That is really valuable.

His qualities are shown in full in his work on the global financial crisis, above all, in *Casino Capitalism*. This early study of the sources of the global financial catastrophe puts forward a simple and powerful idea: "the disaster happened because the bacillus of limited liability, non-recourseness, and irresponsibility spread throughout the world, infecting the financial markets without the regulatory bodies doing anything to stop it. Banks, hedge funds, special purpose entities, investment funds, and real-estate financiers were able to do business almost without any equity. Those having no equity are not liable, and if not liable, they feel free to gamble. They will look for risk wherever it can be found, because they can privatize the profits and socialize the losses. By cutting off part of the loss distribution, they can conjure returns out of mere risk".

A market economy can only work if decision-makers bear costs if things go wrong. Yet this principle is not absolute: that is why limited liability and bankruptcy exist. In practice, then, a balance has to be struck. In the case of the global financial system, that balance was struck in the wrong place, with far too little equity in lending institutions, far too little recourse against irresponsible borrowers, and far too much risk-bearing by the wider public. As Hans-Werner stresses, this debacle vindicated the central insight of German post-second world war 'ordoliberalism', namely, "that markets can only unfold their beneficial effects if the government sets the rules of the game. There is no such thing as self-regulation of markets, only self-ordering within a firm regulatory framework set by the state".

The idea that the institutional framework of financial markets was defective is correct. But not all the actors were aware of the risks they were taking. Many fooled themselves with the notion that 'this time is different'. But this does not mean Hans-Werner's analysis of incentives is irrelevant. Awareness that one would be protected from severe consequences tends to lead to 'rational carelessness', not so much a deliberate courting of risks as indifference to remote consequences.

From the correct perception of the nature of the incentives for imprudent behaviour, Hans-Werner drew a number of powerful and cogent recommendations. The most important by far is that financial institutions and other relevant actors need more 'skin in the game', with, above all, substantially higher equity requirements. Yet it is vital that, in the aftermath of a crisis, the additional equity not be supplied as a gift either from fiscal resources or via low interest rates. The right solution is direct equity infusions by government and consequent dilution of private shareholdings. If the banks are undercapitalised, they should either accept government equity or raise more equity themselves. Hans-Werner also suggests that breaking up banks might not make them safer. Indeed, more diversified banks are more likely to survive crises. Moreover, if a large number of small banks were to go under at once, they would still need to be rescued.

Casino Capitalism also argues in favour of common minimum regulatory standards, to limit the competition in laxity we saw before the crisis. It also argues for

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paying careful attention to flawed accounting rules and stresses the defects of risk-weighting of balance sheets. Higher risk weights should be imposed on anonymous securities than on conventional loans to borrowers who face a genuine bankruptcy risk. On all these points, Hans-Werner is right. Yet making such a regulatory regime work is going to be hard. Shareholders may continue to believe they will be rescued. Or they may become convinced they will not be. If they hold the first belief, banks will take too many risks. If they hold the latter, they will cut back loans and dump assets as soon as they come close to the regulatory minimum level of capital. This, in turn, might trigger a crisis.

Hans-Werner's analysis of the origins of the global financial crisis and the lessons to be drawn from it demonstrate his greatest virtues. The work is clear, accessible, intelligent and persuasive. It addresses a huge economic challenge in a sober and convincing manner. It draws, not least, on the best aspects of the German tradition of thinking on the underpinnings of a market order. We can all learn from this outstanding analysis.

Why, one wonders, is Hans-Werner retiring? German labour market rules still need some more flexibility.

Pleasant Dreams or Nightmares in Public Debt Scenarios?

Vito Tanzi*

Past and current views on public debt

In his recent book on 'The Euro Trap: On Bursting Bubbles, Budgets, and Beliefs' (2014), Hans-Werner Sinn worries that "nearly all [the EU countries have] increased their sovereign debt faster than their GDP" (p. 55). EU countries were not the only ones to do so, despite the poor reputation enjoyed by public debt for several hundred years up until the mid-20th century. Several famous historical personalities, including Cicero, George Washington, Napoleon and others, warned about the danger of public borrowing. Economists including Adam Smith and David Hume shared these concerns.

Naturally, there were situations or good excuses that, at times, seem to justify public borrowing. In the past, governments did not have modern tax administrations capable of collecting taxes when needed. In many cases loans could be obtained more quickly and more easily. So governments did borrow even in the past. The historical figures and economists of the past might have approved of public debt in situations that included: (a) fighting legitimate wars; (b) dealing with the consequences of great natural disasters; and, in recent times; (c) public borrowing during severe recessions. Some economists today may also approve of public borrowing to finance *a big push* in infrastructure creation. However, there is disagreement over whether *routine* public investment spending, that does not change much year on year, should be financed by borrowing rather than by taxes, as defenders of the so-called *golden rule,* have argued. Not all *public investment* is productive, and not all of it contributes to economic growth and to future tax revenue (Tanzi and Davoodi 1998). Furthermore, corruption often inflates investment spending.

Many modern economists would also agree that fiscal deficits, which arise during recessions from the action of 'built-in-stabilisers', can also justify public debt. However, many economists would disagree with the view, currently held by some very vocal economists, that when the growth rate falls below what they believe is the long-run trend, this fall justifies *large and sustained* fiscal injections. In all of the above situations, a country that has kept its public accounts in good order would have less difficulty in borrowing. This means that the *initial conditions* of a country's fiscal accounts are important in determining the fiscal policy that is feasible and desirable (Tanzi 2015a and 2015b).

The realisation that there can be Great Depressions or Great Recessions justifies (for many modern economists) the necessity of fiscal policies that may help to stabilise the economy. This led Keynes to propose the use of *time-limited, expansionary* fiscal policies in the 1930s, mainly associated with public spending on productive public works, financed by public borrowing. He also theorised that fiscal multipliers would create more employment and more output than the initial fiscal stimulus would have.

Concerns over high unemployment during the Great Depression in the 1930s also led Keynes to state that governments should prioritise short-run objectives, because, as he put it, "in the long run we are all dead". That statement has often been cited to suggest that the short-run should be the focus of counter-cyclical fiscal policies and that policy has paid little attention to the implications of high and growing public debt. Counter-cyclical fiscal policy should be symmetric over longer periods of time. It should generate budget deficits during recessions and budget surpluses during better times. It should not, however, lead to the accumulation of large public debts.

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Since the end of World War II, the industrial countries have not fought great wars; have not experienced major natural disasters; have not experienced Great Depressions; and have not engaged in major public investment programs concentrated in short-time periods, like, for example, China has done. Furthermore, spending on public infrastructure has been reduced in recent decades. Nevertheless, public debt has grown, hitting historical highs in some countries. In spite of these levels, some economists have urged governments to spend and borrow more. In their view, this course of action would stimulate the economy and enable the government to take advantage of the low interest rates that the central banks have made possible.

New Keynesian views on fiscal policy

Some economists have recommended (and some governments have adopted) such policies, which are described as 'New- Keynesian', although it is not certain whether they would have received Keynes' stamp of approval if he were alive today. They reflect a belief that, with enough public spending, any country can prosper and grow. Public spending is seen as the basic growth factor.

Changes in paradigms often start with changes in the meaning of some terms. This has happened in the discussion of fiscal policy. Terms such as 'austerity', 'recession', 'growth', and others have been subjected to some massaging of their meanings. These new definitions have accompanied new and, at times, even strange economic theories that seem to ignore obstacles to growth of a *structural or psychological nature.* The implicit belief of the New-Keynesian theories seems to be that very large fiscal multipliers exist and that more public spending can generate miracles. Large fiscal deficits can raise growth rates, especially in 'deeply depressed' economies. These high levels of public debt would not create difficulties, because the anticipated high growth rates would melt such debt.

Given these assumptions, it would be 'stupid' (Stiglitz' term) to worry about fiscal deficits and public debt. The media attention devoted to the few, highly vocal economists who hold these views, gives the impression that they now reflect the views of the economic profession. However, many leading economists do not share this belief.

As a result of the new theories, some research in the fiscal area has become more *creative* and less *intuitive*. Some economists have argued that traditional, orthodox, economic rules no longer apply, when the economies are deeply depressed, and when 'liquidity traps' are present. Some empirical studies have generated outcomes that orthodox economists find highly questionable and difficult to accept. The latter have found it increasingly hard to understand the channels and the mechanisms that can create the huge multipliers and the claimed large growth outcomes.

Public debt and its impact on economic activity

Various papers have advocated expansionary fiscal policies and a slower pace of fiscal consolidation on the part of countries with high fiscal deficits and large public debts. At the beginning of the financial crisis, some economists set the tone for the policies that advanced countries should follow to deal with the crisis. An important IMF paper called for the adoption of *large, expansionary* and *sustained* fiscal policies. Various countries introduced policies that increased their fiscal deficits to extraordinarily and clearly unsustainable levels in 2009–2010. These fiscal stimulus packages were withdrawn when the money budgeted for them was spent. However, the deficits remained very large. In 2012 they averaged over 6 percent of GDP in the G7 countries, but some economists nevertheless defined them as 'austerity' (Tanzi 2015a). Austerity has come to describe the policies of countries that did not maintain the fiscal deficits at the extraordinarily levels of 2009–2010.

The criticisms imply that the policies followed after the introduction of the large 'fiscal packages' of 2009 were too restrictive, and that governments should have maintained their large fiscal stimuli. As interpreted in a 2015 IMF study, the current fiscal and economic conditions of many countries would justify and allow them to introduce much *additional and sustained*, fiscal expansionary. Very large fiscal multipliers are now assumed (see DeLong and Summers 2012) and operate over much longer time periods (see Blanchard and Leigh 2013). Thus, in the views of the economists behind these new theories, the large, expansionary fiscal policies should be sustained for much longer periods to fight stagnation. These economists believe that we are now in a different fiscal world where old rules no longer apply.

The world risks drowning in an enormous pool of public (and private) debt, if the recommended policies fail to generate the fast rate of growth that those who propose them hope they will generate. In a 2015 report Mckinsey & Co. provided useful statistics on global public and private debt. Total debt worldwide has never been so high. This report warned that high debt levels have historically placed a drag on growth and have raised the risk of financial crises that could trigger deep, economic recessions. In a recent book, the author of this paper argued that large and growing disequilibria in the public finances of many European countries, some hidden by questionable and non-transparent fiscal accounts, or by faulty data, made the financial crisis more severe than it would otherwise have been (Tanzi 2013).

High public debt may depress growth through various channels. The most direct of these channels is that servicing public debt diverts public spending away from public investment. This relationship was first theorised and empirically tested in Tanzi and Chalk (2002) and was confirmed by later studies (Ostry *et al*. 2015; Chudik *et al*. 2015). Some economists have qualified the negative relation between public debt and growth. For example, Ostry *et al*. (2015) state that, despite the negative impact seen (of high debt on public investment and on growth), the analytical framework implies that, in general, it is better (for growth and welfare) to live with high debt than to try to reduce it through distortionary taxation. While this may be true, the 'distortionary taxation' may not be the only, or indeed the most desirable way to reduce a high debt in most countries. A better way would be to cut unproductive spending, as many IMF studies have found. In recent decades some countries successfully cut public spending (sometimes by very large shares of GDP) to deal with high and growing public debts (Tanzi 2011).

High public debt may reduce growth through channels other than the impact on public investment and on tax levels (Reinhart *et al*. 2012; Cecchetti *et al*. 2011). It can also depress growth by creating concerns about the sustainability of fiscal policy and the increasing likelihood of financial crises (Baker *et al*. 2013). A casual look at countries with high public debt levels reveals that they have not been blessed by high growth rates.

Debt statistics and future prospects

The Mckinsey report listed 23 countries, including the G7, which had ratios of total (public and private) debt of over 200 percent of GDP in 2014. In many countries private debt has shown a tendency to become public debt during crises. Increasing shares of public debt have been parked in the balance sheets of the central banks, as Sinn (2014) highlighted for the EMU. The consequences of these developments are difficult to predict.

While the data cited above are statistical facts, some economists have become less antagonistic to public debt, and have even turned public debt from a sin into a virtue. Central banks have encouraged this conversion by keeping the cost of short-term debt very low for governments. Today many countries have public debts that exceed 100-percent of their GDP. In 2014 the debts of general governments, as percentages of GDP, were: 246 for Japan; 177 for Greece; 132 for Italy; 130 for Portugal; 107 for Belgium; 108 for Cyprus; 105 for the United States; and 108 for Ireland. Several other countries (Canada, France, Singapore, Spain and Britain) had debt/GDP ratios of close to 100 percent (IMF Fiscal Monitor, October 2015). These debts grew in 2015.

The supply of credit to governments has become progressively more elastic due to the globalization of financial markets, the growth of shadow banking, the high saving rate of China, as well as the novel and more accommodating policies of central banks. Monetary policy has become increasingly more dependent on fiscal developments.

Some recent economic literature has attempted to define an *optimal or safe* public debt level, recognising that such a level is rather difficult to pin down precisely in practice. Ostry *et al.* (2015) has suggested that debt levels fall into three zones: a green zone, a yellow zone and a red zone. For countries in the green zone reducing debt is likely to be normatively undesirable, as the costs involved in reduced output will be larger than the resulting benefits. Those countries in the green zone, which covers most counties, have considerable fiscal scope for manoeuvre ranging from 100 to 200 percent of their GDP. Japan, Italy, Greece and Cyprus are the countries in the red zone that face inflexible debt limits: these countries should refrain from adding to their public debt levels. The countries in the yellow zone have fiscal space that they can still use debt finance, but must exercise some caution.

One can only wonder at these estimates, especially given their source. For example, is it reasonable to assume that the current fiscal space of Belgium is 124 percent of GDP, that of Spain is 118 percent, and that of France is 117 percent? What would happen if all the countries in the table decided to use their estimated fiscal space? We know that all of these countries will face significant age-related public spending in the future. Some have large, unfunded, pension liabilities that do not show in their official public debts statistics. If added to the official estimates of the public debt, these liabilities would raise the public debt level considerably. In addition, interest rates in recent years have been very low. These favourable factors are likely to change in the future, creating a far less favourable environment for countries with high public debts. For many of these countries the maturity of their debt is relatively short and their future economic growth rates are also likely to be lower.

A few years ago Standard and Poor's estimated the future impact of ageing on public spending in many industrial countries, under the laws that existed when the estimates were made. It found that all of the countries in the table will be severely affected by ageing. By 2050, several countries will need as much as ten or more percentage points of GDP in public spending to cover the increasing costs of ageing. Many of those living today will still be alive and retired in 2050.

Over the past two decades there has been growing resistance on the part of the citizens of OECD counties to pay higher taxes. Statistics provided by the OECD indicate that the highest taxes (expressed as a percentage of GDP) were achieved in the 1990s. Almost no country has increased its tax level significantly since then. The obvious question to ask must be: how will the countries be able to service their current, or even higher future public debts, at interest rates that seem likely to rise, while, at the same time increasing public spending, in some cases by very large amounts, to cover the costs of ageing populations, of infrastructure requirements, of climate change and other factors? An answer to this question is urgently needed.

Concluding remarks

This paper has dealt with the rise of public debt in recent years, and with the push, on the part of some vocal economists, for governments to increase public spending and to abandon what they call austerity, in the belief that this policy will promote *sustained* growth. The paper has discussed how attitudes *vis-a-vis* public borrowing have changed and become more relaxed; and how some economists have come to see higher public spending as a kind of miracle cure that will increase economic growth in the long run. The article has provided some arguments that highlight the extent to which public debt has become a pressing current and future problem.

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The Danger of Consensus

Gilles Saint-Paul*

Is consensus evidence of truth? While that may be correct in the natural sciences, in the social sciences consensus can easily be manufactured. In the absence of conclusive evidence, the returns on adhering to the prevailing opinion are high. The consensus view generally shapes the framework of public calls for research proposals, meaning one is more likely to get funding. And the biggest risk is to have been wrong like everybody else, which costs little in a world where academics are evaluated relative to their peers. The system of peer review in research naturally breeds consensus: reviewers who subscribe to the conventional wisdom have no interest in accepting new research that challenges it, as it would harm their career by rendering their own contributions obsolete. In a research community plagued by consensus, it is impossible for knowledge to progress dialectically, by rejecting paradigms and replacing them with more useful ones. Instead, knowledge only progresses horizontally, as a flow of aesthetic variations on the same themes is being produced.

It takes a great deal of courage for a prominent professor to disregard consensus; such a person provides an invaluable service to the research community at the risk of bearing high personal costs such as being ostracised or ignored. It is this service that Hans-Werner Sinn has given us throughout his prolific career.

Prior to European Monetary Union, many economists were sceptical about the single currency. Calculations suggested that the euro area was unlikely to be an optimal currency area. Countries diverged in their fundamentals and policies. Yet after the introduction of the euro a consensus emerged that EMU was irreversible. Discussions among European macroeconomists focused on how to improve the working of the monetary union through better fiscal policy coordination, structural reforms, or transfers. Challenging the whole scheme was a sure way to be treated as a maverick. It was generally considered that the costs of a given country of leaving the euro would be huge, although no such event has been observed yet, and despite the fact that a number of Southern European countries seem to bear a huge cost for staying in the euro area.

Consequently, this consensus generated substantial support among economists for policies that would commit to do 'whatever it takes' to maintain the common currency, such as OMT and other non-conventional measures. Issues such as the constitutional legitimacy of asset purchases, or whether implicit fiscal transfers were implemented between member states by a non-elected entity, were largely set aside. Similarly, not much importance was accorded to the distortionary effects of these policies on asset prices and the risk of initiating another bubble followed by another bust. The only thing that mattered is that asset purchases pinned down the value of public debt issued by troubled countries, thus allowing the euro area to buy time.

It is in this context that Hans-Werner Sinn wrote *The Euro Trap*. The book is an indictment of the whole euro project by a former enthusiast, who is not afraid to pour oil on the fire and making enemies in Brussels for the sake of intellectual honesty. In this book Sinn argues that European Monetary Union set the stage for catastrophe as capital massively flew from the richer euro area countries to their poorer counterparts. This capital inflow triggered a boom in countries like Spain, Greece and Portugal, which, in turn, led to persistent inflation differentials and a loss of competitiveness. This was impossible to combat with now abolished national monetary policy. And it continued as long as financial markets ignored the possibility of sovereign default and were willing to lend at the same low interest rate throughout the area.

This unsustainable golden age came to an abrupt end with the outbreak of the financial crisis. Sovereign debt spreads widened, fuelled by the expectation that

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some countries might leave the euro and by the recognition that adjustment would be very costly should those countries stay in the euro. The crisis was put to an end by the ECB, which essentially committed to buy the troubled countries' sovereign debt at some minimum price. The policy is viable as long as the value of the euro does not fall to a level that would trigger an inflationary spiral and a temptation to exit on the part of richer countries like Germany and Finland; and as long as the fiscal transfers imposed on taxpayers in the core countries are opaque enough and expected to vanish someday. Hans-Werner heavily doubts it when he writes: "membership of the Eurozone does not include the right to be propped up with transfers from abroad when a country loses its competitiveness. Letting distressed countries remain members of the Eurozone on permanent life support does not really help them".

Time will tell whether this obituary was a prophecy or the sign of excess pessimism. Recent political developments in Greece and Spain, however, suggest that Hans-Werner is likely to be right.

Hans-Werner Sinn's Origin Principle for Migration and the Welfare State

Giuseppe Bertola*

Redistributive social policies can remedy a lack of market insurance against labour income and health risks. Participation in such social schemes needs to be mandatory, but cannot be if they are funded locally within an integrated economy, because lucky individuals can walk away from high taxes, while unlucky individuals migrate towards generous subsidies. Migration choices are efficient if they respond to productivity differences. If they respond to taxes and subsidies, conversely, they trigger a race-to-the-bottom of both taxes and subsidies, and draw competing socio-economic systems towards the same inefficient lack of insurance as in *laissez faire*.

If choice is a problem, then choice should be prevented. One might assign to each individual an immutable set of rights and obligations, like those that stem from family ties, and stipulate an 'origin principle': needy persons should be assisted not by the community where they live, but by that from which they originated. This was the case before the industrial revolution (and until 2012 at least formally in Switzerland, which still records each individual's 18th century 'commune of origin').

In the past, economic integration was severely limited by tolls and duties levied at every bridge and city gate. Labour mobility was hindered not only by explicit rules, like those that tied serfs to a lord's lands, but also by the origin principle: migration is always risky, and less attractive if migrants may only count on the dubious support of faraway relatives. For this reason, modern economies' industrialisation processes were crucially supported by the development of national welfare states. Social policy frameworks make it possible for urbanised workers to relinquish the family and village ties that protect them from labour and old-age risks in agricultural societies. Such frameworks are still being developed in China and other emerging economies, but have been in place for a long time in all European countries.

Hans-Werner Sinn contributed early and lucid analyses of the problems entailed by the EU's attempt to integrate markets beyond the boundaries of national welfare states. Unless social contributions and benefits are suitably harmonised (through development of a political union and an integrated welfare state, or at least through explicit negotiations of binding supranational rules), mobility out of taxes and towards subsidies triggers a race to the bottom, and spells 'the death of the insurance state': an unbearable prospect not only for the competent public economists who see the advantages of the *Soziale Marktwirtschaft*, but also for all European citizens, who cannot accept economic integration if it leads to the demise of their welfare states.

To address this problem, Hans-Werner Sinn proposed origin-based social transfer programs. Of course, men and women do meet and procreate across natural and political boundaries. So his vision is not a nation-based version of pre-industrial birthright arrangements, whereby individuals would be endowed with a set of tax obligations and benefit entitlements determined by national ancestry. Initially, he pointed out that it might, in theory, be appropriate to enforce a young person's choice of a specific welfare scheme throughout his or her lifetime. Later he more practically and forcefully argued for 'delayed integration' rules, whereby migrants would remain attached to their national welfare scheme for a few years before accessing the destination country's welfare subsidies.

This is a clever and debatable solution to a crucial and difficult problem. It can be appealingly justified by simple public finance reasoning: in principle, just as taxation of investment income does not distort investment choices if tax rates are investor-specific, so migration choices are not distorted by taxes and subsi-

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dies that remain unchanged when a person moves across borders. In practice, however, perfect implementation of the origin principle would be very costly, and would entail thorny administrative problems. Needy migrants would have to either travel back to their country of origin, or rely on the willingness of the country of destination's administrative authorities to disburse benefits that should be reimbursed by the country of origin, but might not be in the absence of verifiable and enforceable criteria.

Han-Werner Sinn's nuanced origin principle aims to strike a balance between the costs and benefits of migration in the EU's imperfect policy framework. This can usefully prevent actual or perceived benefit-seeking migration from eroding either the viability of the destination country's welfare state, or the popularity of economic integration. Critics may point out that for individuals seeking employment, rather than subsidies, delayed integration partly deprives risky migration decisions of a useful safety net. Most migrants are indeed more than willing to contribute with their work and contributions to the country of destination's economy and welfare schemes. An excessive focus on benefit-seeking motives may distract the public and policymakers from duly considering the deeper advantages of economic integration, and from developing a suitably integrated and harmonised set of redistribution policies.

A Case of Institutional Entrepreneurship

Robert Solow*

Institution-building is a difficult and stressful process, as anyone knows who has ever tried to do it, or even observed it at close hand. My wife once had a T-shirt on which was inscribed a profound remark attributed to Jean-Paul Sartre: "in football, everything is complicated by the presence of the opposing team". I have no idea if the attribution is authentic; but I will add that institution-building must be more complicated than football because even the presence of one's own team often creates intended or unintended difficulties for someone trying to create or re-create an institution. That is why I have chosen to pay tribute to Hans-Werner Sinn's imagination, skill and determination in the creation of the CESifo we know today, and to remind everyone of the importance of this effort not only for economics in Munich but for German economics as a whole. Naturally I can only describe the view of an interested and sympathetic outsider, but that is not an unimportant or irrelevant standpoint.

I think back 20 years, to the mid-90s. Hans-Werner Sinn (HWS) is already professor at LMU, already ambitious to build something in economics. There are a few outstanding German economists, but no real center of active economic research with a clear footprint on the world scene. The Institut für Weltwirtschaft in Kiel has a long tradition, but it is not widely known as a source or meeting-place for new ideas. The Ifo Institute was known almost entirely for its business-cycle 'barometer' but contributed little or nothing to macroeconomics or business cycle theory.

If I remember correctly, HWS had already started a seminar series under the auspices of the newly-created Center for Economic Studies (CES), and had already begun to invite speakers, advisers and participants from other universities in Germany, in the rest of Europe, and, when possible, from even further away. In 1994 he started what became the series of Munich Lectures in Political Economy, and he started it with the brilliant choice of Avinash Dixit as the first Lecturer. This was not at all a routine act of academic busywork. It was in fact a piece of academic entrepreneurship. Astutely managed, it put Munich on the world map of economics. The fact that so many of the Lecturers were leaders in political economy and public finance only makes the personal influence of HWS easy to see.

Then, in 1999, he became President of Ifo and the opportunity arose to build a new combined institution on a larger scale. What followed was a truly innovative episode, a case of institutional entrepreneurship if ever there was one. The program of Ifo was reformed to encompass business-cycle research in the modern manner. The journal *CESifo Economic Studies* was created, published in English. The CESifo network came into existence to make Munich a legitimate competitor to the CEPR in London and the NBER in Cambridge. Munich joined Paris, Barcelona and Toulouse as a major Google-worthy center of economic thought on the continent of Europe.

It is impossible to imagine this transformation happening without the will, energy and intellectual force of Hans-Werner Sinn. It was not an accidental or naturally evolving process. I think that HWS had from the beginning an approximate vision of a goal, perhaps not in every detail, but something closely resembling the CESifo complex of today: an internationally effective, interlocking, vertically integrated set of activities ranging from basic academic teaching and research to public discussion of contemporary issues of public policy. And all this was accomplished while HWS continued to think about economics in general, the German economy in particular, and to take strong positions on debatable issues of public policy. It is a remarkable record of effort and achievement.

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Leadership by Example

Agnar Sandmo*

The paths of Hans-Werner Sinn and myself began to cross in the late 1970s, when he was still at Mannheim University, and the crossings became more regular when he moved to Munich and founded CES in 1991. I then became a member of the CES Council and continued in that role until 2009, the last eight years as Council Chairman. During that period I was able to witness the buildup and development of CES, a development that was closely associated with the academic profile and initiatives of its leader. Although my ringside position was later extended to a view of the whole CES-ifo system, I hope I may be forgiven for concentrating my remarks on CES.

The remarkable history of CES, both before and after its merger with the Ifo institute will no doubt be told in other contributions to this issue. Let me just note that the strongest feature of the CES as a research institute has been its commitment to combine fundamental research with the analysis of economic policy. Another striking characteristic of the growth of CES has been its development into a hub of European economic research. These developments would not have been possible without the strong leadership of Hans-Werner Sinn. This leadership has been dual in nature. A good leader can lead through wise management combined with a strong vision for the future of his institution. But he can also provide leadership by example. Hans-Werner Sinn has done both. In the following, I will focus especially on the second dimension of his leadership.

Watching Hans-Werner at work as an empire-builder – I use this concept in an entirely positive sense! – I have been filled with admiration but also, at least in the early years, with some surprise. For the young economist that I first met almost forty years ago did not seem to me to be destined for a career along these lines. Consider his early research interests: he wrote his diploma thesis on the Marxian Law of the declining rate of profit and went on to write his doctoral dissertation on the pure theory of choice under uncertainty. The choice of the former topic reflects the interest in Marxian thought that was strong in the 1960s and '70s. The latter was a hot topic of research among academic economists at the time, offering many challenges for further development to a gifted theorist. But none of them were areas that seemed particularly relevant as a preparation for a career as an influential actor on the scene of economic policy debate. They were topics that could create excitement among the participants in departmental seminars but hardly among a larger audience.

I had to revise this view of Hans-Werner's academic profile when reading his habilitation thesis on *Capital Income Taxation and Resource Allocation* (the title of the English version, published in 1987). This is still a book on theory but of a more applied and policy-relevant kind that his previous work, and it established his reputation as someone who produced results of the highest relevance for economic policy. This combination of theoretical study and policy application Hans-Werner brought with him to CES and later CESifo. Not only did he encourage the combination through the institute's choice of research topics and the selection of staff members and visitors, he also continued his own work along these lines by exploiting his skills both as a theorist and policy analyst in work on a series of highly relevant topics. Prominent examples of such contributions are his books on German unification (together with his wife Gerlinde), globalization, the euro crisis and the global environment. Although not all economists can aspire to write so many books and articles on such a broad range of topics, the example of someone who is not only enthusiastic about economic theory but also convinced that it has much to offer to those who wish to build a better economy and society is bound to be inspiring to the young economist.

While Hans-Werner has done a lot to encourage young economists, a notable feature of his activities is

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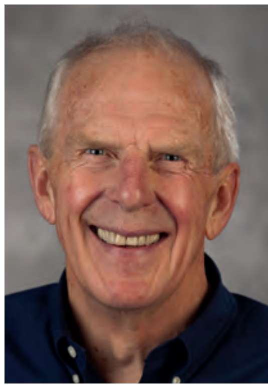
that he also has a keen eye for the contributions that older economists can make. In his books and articles this attitude is displayed in the attention that he pays to the work of previous generations of economists, and he has made CES an important meeting place not only for the young generations of researchers but also for interaction between the young and the not-so-young. A nice example of this is the 1998 conference that featured a discussion between two grand old men of public economics, James Buchanan and Richard Musgrave. They presented their alternative views on the nature of public economics and the proper attitude that economists should have to the state – supplemented by insightful comments both from the audience and Hans-Werner. The book that came out of the lectures (*Public Finance and Public Choice*, 1999) should be read by every public economist whose ambition is to become not only clever but also wise. It is a nice testimony to the impact of CES in promoting not only new results but also deeper reflection.

One of the interesting aspects of becoming older is that you see that the young people that you know are suddenly approaching retirement. In the case of Hans-Werner, however, I definitely take his 'retirement' with a grain of salt. One has to take note of his formal retirement from some of his positions. But that he should retire from economic research and debate is inconceivable!

Institutional Change and the 'Irresistible Force'

Robert Haveman*



It is rare that one is able to be an 'up close' observer of the radical transformation of an important institution. I have had that privilege. It started in the 1998-99 academic year when I – and my colleague/spouse, Barbara Wolfe – were invited to spend a few months as visitors at the Center for Economic Studies (CES) in Munich. CES, an Institute of the University of Munich (LMU), dedicated to bringing together scholars from around the world for discussion, was founded and directed then by Hans-Werner.

During that visit it was announced that Hans-Werner had been appointed to be the President of the Ifo Institute. That he had accepted this appointment was a surprise, as Ifo was not known to be an academic and scholarly research center. In fact, it was a large and rather dowdy center dedicated to churning out reports and data for the government and the business community. At that time, the status of the Ifo Institute was also downgraded from a research service provider to a center of policy analysis and research, and its budget was cut.

The appointment of Hans-Werner as President was a shock to Ifo's system; it was a classic example of an immovable object being struck by an irresistible force. One of Hans-Werner's first acts was to begin a research lecture/seminar series designed to reveal research results and to prompt discussion. Barbara Wolfe and I were invited to present the inaugural lecture at the 'new' Ifo. We presented our research on the work and well-being impacts of the Clinton welfare reform legislation in 1996. The large room was filled with then-Ifo staff. They were not young and were clearly cut from some bureaucratic mold. Unlike academic research seminars, this one prompted few, if any, questions and stimulated no debate – except for questions raised by Hans-Werner himself. My main thought was: "does this man know what he is getting himself into?" It was clearly the wrong question; it should have been "do these folks know what is about to happen to them?" Well, that was sixteen years ago. Since that time, Hans-Werner has transformed the Ifo Institute into a unique and high quality economic research organization.

In the period after 2000, I have been a visitor at Ifo, a Research Professor and a member and Chair of the Scientific Advisory Council (SAC). I witnessed first-hand the early selective downsizing of Ifo, and then the restructuring and growth that followed. Ifo has developed a strong research orientation and close connections with numerous domestic and foreign research institutes, and Ifo has transitioned to the status of a 'research institute'. This turn has elevated Ifo into its position as one of the most prestigious research institutes in Germany and one of Europe's leading economic think tanks.

Hans-Werner's leadership has led to the establishment of eight research areas, each headed by a recognized and distinguished department head. The positions of these young, though established and highly regarded, department heads are now combined with a chair at the LMU and thought of as equivalent in terms of prestige to university professor appointments. Each Ifo department is committed to applied, policy-oriented economic research. The research staff regularly publishes its studies in the leading international journals. In recent rankings, Ifo staff produced more publications than any other economics research organization in Germany. Ifo also ranked at the top of all of the economics institutes and faculties in the German speaking countries in terms of economists under the age of 40 years.

The original data collection/reporting/monitoring mandate is now carried out using modern research methods and the products of this effort are now publicized to the world community. The prominent Ifo Business Climate Index reflects state-of-the-art business cycle analyses. The Database for International

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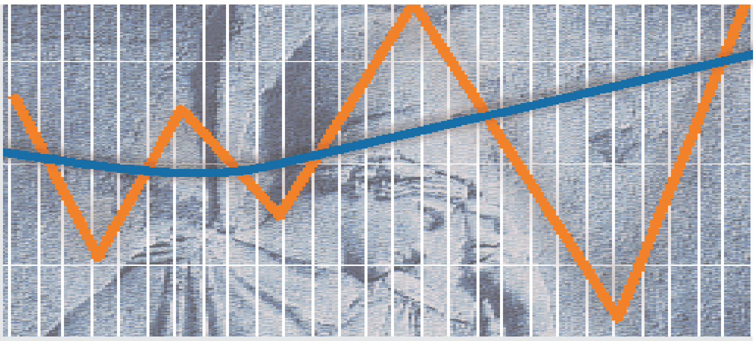
Institutional Comparisons (DICE) offers cross-country comparisons of systematic information on institutions and regulations.

While Ifo is known for its research contributions, most of these studies have their origins in on-going policy discourse in Germany and Europe. They stand as notable examples of how the latest theoretical insights and empirical methods of economics can illuminate and guide policies. At the same time Ifo's staff regularly participates in public debate. The Ifo stands as an outstanding 'bridge between academic research and public discourse'. Finally, Ifo serves an important educational function. Its doctoral program (and that of CES) hosts more than 40 doctoral candidates and provides them an environment conducive to writing outstanding dissertations and the opportunity to present research results in visible international venues.

Today, the Ifo Institute excels at research, policy advice, and doctoral training. During this radical institutional change cooperation between the SAC and both the Executive Board and the department heads was highly productive. The contribution that Hans-Werner has made to the transformation of the Ifo Institute must rank high on this list of his accomplishments.



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Wealth and Politics: Studies on Inter Vivos Transfers and Partisan Effects

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