The Ifo Viewpoints 2000

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Chaos in Nice*

A constitutional assembly can only properly function behind a “veil of ignorance”, with its members not knowing how they themselves will be affected by the individual regulations. If one attempts to write a constitution with the veil of ignorance already having been lifted, it is no longer possible to reach any general or non-partisan decisions unless the members display statesmanship and do not take their own situations into account. This was perceived by the philosopher John Rawls, and this also follows from Immanuel Kant’s categorical imperative. The undignified haggling over voting rights that took place in Nice made mockery of the fundamental principles of constitutional theory. The organisers of the conference knew all too well from which decisions they themselves would profit; they were far too anxious about their own benefits.

Before the Nice summit, many hoped that the European Commission’s suggestion of implementing a double majority would be considered. This proposal called for majority decisions consisting of both a simple majority of countries as well as a majority of the people they represent. A number of smaller countries with small populations would have had the same blocking majority as the few large countries with large shares of EU inhabitants. This would have brought about a situation similar to a two-chamber system in which the one chamber represents the population and the other the countries. The smaller member states would have been protected and the inhabitants of the large states would also have been treated equally.

This proposal was blocked by France with the argument that this would give too much weight to the population criterion and hence to Germany. Instead, the Nice summit host succeeded in pushing through his own concept, resulting in a barely intelligible two-phase voting system full of “twisted” and arbitrary numbers. The member states were allocated numbers of votes that rise disproportionately to population size based on no apparent regularity. Two countries, Germany and Romania, had to put up with considerable vote deductions, completely inconsistent with the other allocations, thus turning their inhabitants into second-class EU citizens. Two others, Spain and Portugal, received very generous treatment. Moreover, differing percentage blocking minorities were decided that make no sense, however hard one tries.

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* Published as “In Nizza wurden die Grundprinzipien der Verfassungstheorie verhöhnt,” *Handelsblatt*, no. 248, December 22/23, 2000, p. 2.

With regard to blocking minorities, there is still no clarity one week after the conclusion of the Treaty. It is clear that the blocking minority according to the population criterion is 38 percent, but the size of the blocking minority in terms of the votes criterion is still unsolved. Not only have leading newspapers given contradictory reports on this point; even the official English version of the Treaty offers a potpourri of possible numbers in the event of EU enlargement. In Annex II of the Treaty of Nice (Declaration on the Enlargement of the European Union ...) a majority of 258 votes is required for decisions, which, with 345 total votes, implies a blocking minority of 88. In Annex III (Declaration on the Qualified Majority Threshold ...) 73.4 percent is given for a qualified majority, which implies a blocking minority of 92 votes, and shortly thereafter the number of 91 votes is given explicitly. Only for the present EU is the voting criterion with a blocking minority of 68 votes or 28.7 percent clearly established; the rest is unclear. Pure chaos must have prevailed at the Nice summit.

Whatever the participants intended, the blocking minority based on the population principle is sharply degraded, if a considerably higher value (38 percent) is set for it than for a blocking minority based on the votes criterion, which depending on EU size and Treaty interpretation lies somewhere between 28.7 percent and 25.5 percent. Because of the arbitrary spread in the percentages, there are only few country constellations in which an effective blocking minority can be established on the basis of the population criterion. In most cases the blocking minority based on the votes criterion takes priority over the blocking minority based on the population criterion. Germany with the largest population in the EU was given an optical concession that alludes to the double majority proposal made by the Commission but which in reality is quite meaningless.

The European Union has emerged out of numerous compromises, which have often made little sense to critical observers. Those patched together in Nice eclipse everything that has come before. The petty tug-of-war over voting rights has yielded no general rules that meet the demands of common sense, not to mention the principles formulated by Rawls or Kant.

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Double Majority*

Europe's formal decision-making processes are complicated, being the result of historical compromises. In the EC-6 this was not a problem, in the EU-15 the decision-making processes must be taken seriously, and in a future EU-25 they will determine the course the Union takes. Also a country like Germany, which has generously held back in the apportionment of voting rights, must seek to influence the decision-making structures that will take effect after EU enlargement.

Germany will contribute 39 percent of the seignorage assets to the EMU, will receive 31 percent of the interest payments these assets generate and currently holds 12 percent of the seats in the Governing Council of the European Central Bank

Germany is the largest bloc in the European Parliament with 99 votes, before France, Italy and the United Kingdom with 87 votes each. But Germany's voting share does not match its population size. The weight of a French voter is 25 percent more than that of a German voter in the European Parliament.

In the European Commission, Germany has two members along with France, Italy, the United Kingdom and Spain; smaller countries have one each. Germany's share of commissioners is 10 percent although it accounts for 24 percent of the EU population.

In the Council of Ministers as well, which takes all important decisions in the EU in its ca. 100 annual meetings, the proportions are similar. The four largest countries have 10 votes, Spain has 8, and countries such as the Netherlands, Belgium, Greece or Portugal each have 5 votes. Even Luxembourg has 2 votes. Leipzig, whose population is similar to Luxembourg's, is represented in the Council of Minister with no more than 0.05 votes through its share of Germany's seats. An inhabitant of Greece has a voting weight that is 390 percent the voting rate of a German, and a French inhabitant has a voting weight of 140 percent.

The system is greatly distorted since it creates first, second and third class EU citizens. This is incompatible with the idea of fair cooperation in constructing the new European Union. The argument that the imbalance is a necessary protection for the small countries is no longer tenable – the imbalance is much too great and unsystematic.

* Published as "Falsche Gewichte," *Süddeutsche Zeitung*, no. 280, December 5, 2000.

There are good arguments for a bicameral system in the EU, as the German Foreign Minister has proposed. One chamber could resemble the German Bundesrat and represent the regions, accepting whatever imbalances may occur. The other would consist of the European Parliament, which would have considerably more functions than at present and would be a proportional representation of the European population. But the EU lacks the political will for such fundamental reform.

Action is necessary before EU enlargement, however. A linear extrapolation of the old system to an enlarged Union would lead to an impossible situation. Since the EU, in Estonia, Latvia and Lithuania, would have three new Luxembourgs, the influence of the large countries would be even more diluted and the democracy deficit would grow to be intolerable.

At Nice the EU countries are planning to take a small but important step. They intend to expand the area of majority decisions in the Council of Ministers, and, as a decision-making rule, to introduce the double majority. For a decision to be made, first the agreement of the majority of the countries in the Council of Ministers is necessary, and, second, this majority must also reflect the majority of the population in Europe. This is an important step towards more democracy and equality in Europe. Hopefully, this will not again be undermined by the implicit or explicit reweighting of some of the countries.

18

Why is the Euro Falling?*

Having started life at $1.18, the euro is now languishing below 90 US cents. Japanese and other capital investors, who initially had high hopes of the currency, have withdrawn disappointed after sustaining heavy losses. The euro has not made a good showing since its introduction as a virtual currency.

True, the exchange rate has not reached the low point of the D-Mark in February 1985, when the currency hit what today would be an equivalent euro exchange rate against the dollar of just 56 cents. Furthermore, the euro has not been more volatile relative to the dollar than the D-Mark was during the two decades before the euro was introduced.

But the euro's fall is still surprising. Eurozone countries export more to the rest of the world than the US does, and the US combination of vanishing private savings and a current account deficit of 3.6 per cent of gross domestic product is anything but reassuring. So why has the euro fallen?

Many people who have held European currencies until now are concerned with the concept of changing them into euros. There are two reasons for this. First, many are afraid because their old money is tainted and because banks must register the exchange of larger sums by name to prevent money laundering.

Second, many people outside the EU who hold European currencies do not realise that the currency union is already a reality. They hear that the European currencies will be abolished, supposedly to be replaced by a new currency. But they do not know how the mechanism will work, and are afraid of sustaining a loss. As a result they take what they consider the safest option and convert their money into tangible currencies such as the dollar or sterling.

When the euro was officially introduced, between 60bn and 90bn D-Marks were circulating outside Germany. These amounted to between 20 and 30 percent of the German monetary base and between 8 percent and 12 per ent of the joint monetary base of the 11 eurozone countries. The thousands of D-Mark notes stuffed in Turkish mattresses were just as much a part of this as the D-Mark holdings in Croatia, Slovenia and other eastern European countries. The sums involved are large by all means. They

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* Published in a shortened version as "Die Angst vor dem Geldumtausch lässt Euro-Kurs fallen," *Handelsblatt*, no. 214, November 6, 2000, p. 2.

are multitudes of the quantities the ECB used for its interventions or George Soros needed to crank the EMS in 1992.

The argument is often heard that the euro-dollar exchange rate reflects the poor earnings expectations of European stocks or that it reflects Europe's inability to carry out structural reforms. But this connection is much less important than generally assumed. Expectations about future real earnings are already reflected in equity prices, and these do not necessarily move in the same direction as the exchange rates, as a comparison of US and European share prices over the last year has demonstrated very clearly. Exchange rate changes are unnecessary to equilibrate actual to desired holdings of equities, since these can be adjusted by changes in prices.

Exchange rates do not reflect expectations of returns on equities but preferences for national currency stocks. Exchange rate adjustment is necessary, however, to equilibrate actual to desired holdings of cash and short term securities whose values in terms of dollars or euros are fixed and whose interest rates are controlled by the respective central banks. If people wish to hold less of their portfolios in euro-denominated cash and securities and more in dollar-denominated ones, the exchange rate has to fall until this wish disappears. That is exactly what happens if many foreigners who were once happy to hold D-Marks are now trying to exchange them into other currencies, because the euro is not yet available in physical form.

For years it was possible to expand the German monetary base much faster than German gross domestic product without causing stability problems because the excess money supply was absorbed by foreigners, primarily eastern Europeans. This process is now being reversed. The ECB should accept this and offer to exchange them for currencies from countries outside the eurozone. In other words, the ECB should, as it does, intervene to stabilise the exchange rate. The needed intervention will not be negligible, however: substantial parts of the 8–12 percent cash holdings in eastern Europe may have to be converted.

The euro's fall could largely have been avoided if the ECB had abolished uncertainty by introducing the euro in one fell swoop on January 1, 1999. The three-year delay between the proclaimed death of the old currency and the expected birth of the new was a construction fault.

The ECB should thus do everything in its power to bring forward the date for introducing the new currency, as far as this is technically possible. It should also announce clear exchange procedures for foreigners, in particular in those from eastern Europe. Once foreigners with D-Marks have exchanged them into euros their uncertainty will vanish. Only then can the ECB stop intervening.

17

Blind in One Eye?*

When the European Commission sets out to forbid coal subsidies in Germany, when it forbids Italy's aid to Fiat in the form of regional assistance, and when it rejects tax credits to benefit shipbuilding in Spain, this can only meet with approval. The state aid rules in Article 87 of the EC Treaty are justified, since it is fundamentally not the role of the state to support corporations and industries. It is thus all the more surprising that the European Commission has consciously avoided taking a position on the indirect subsidies to the telecom industries in those countries that give away their UMTS licenses or sell them for less than their value. In Germany a license was auctioned for € 8 billion, in France, which had set a fixed price, the cost was € 5 billion at a validity length shortened by one quarter, and in Italy a license went for only € 3 billion. Sweden was content with a low annual user fee of 0.15 percent of turnover. In Germany and the U.K. more than € 102 per capita was paid for a license and in France € 82. In the Netherlands it was only € 26 and in Portugal € 10. In Spain a license was to be had for a per capita cost of only € 3 plus a low user fee.

The auctions that were used in the U.K. and in Germany were a very sensible way of awarding licenses. Firstly, the state was able to gain revenues that would otherwise have to come from distorting taxes. Secondly, the danger of preference being shown to national companies was avoided. And thirdly, the auctions helped determine which companies were in the best position to utilise the licenses. Only a company that credibly shows that it can gain considerable profits from the license will be able to raise the capital it needed for acquiring the license. When the state tries to determine the right companies by holding a "beauty contest", as in Sweden or Spain, the selection is made by officials who cannot be held responsible for their potentially poor choices. Only when the selection is made by people who are personally liable for their mistakes one can be sure that the limited number of licenses has indeed gone to the best owners.

There is also no need to fear that the companies will pass on the auction costs to the users. The providers in any case will have to set prices which maximise the excess of revenues over operating expenses. If, in light of the license costs, they aim for even higher prices, they will only hurt themselves as this will drive away customers. They can of course regain the cost of the licenses through their operations, but they cannot

* Published in *Ifo Schnelldienst* no. 30/2000, p. 3–4.

gain any more than they would have if the licenses had been given away. The auction costs are sinking costs which shift the stock price gains, that would otherwise have been expected, to the state, nothing more.

Of course, the companies that did not have to bear the auction costs have a considerable initial advantage from saving equity capital. Their war chests are full and can be used for rapid attacks on the markets of other countries. The fact that the former state-owned Spanish Telefonica was able to successfully keep up with the 3G bidding group in Germany whereas Deutsche Telekom came away empty-handed in Spain clearly shows the asymmetries among the countries.

In enforcing its state aid rules, the European Commission generally takes a broad view of its responsibilities. It has declared, for example, that the sale of public land below market value violates state aid rules just as much as free-of-charge access to public infrastructure. The Commission's reason for excluding the free access to UMTS licenses from its state aid rules, in which, in contrast to many cases that have received its criticism, gigantic subsidies are involved, remains a mystery. Was the Commission influenced by powerful lobbyists or was it blind in one eye?

16

A Step in the Right Direction*

New impetus in the pension reform debate has come from the study presented in 1998 by the Scientific Advisory Council of the Ministry of Economics. The years of denying the demographic problems are now finally over. Germans have fewer children than they once had, so few that pension insurance will drift into crisis if nothing is done.

The looming crisis can only be avoided by reducing future benefits and by investing the money that was not spent on child rearing in the capital market in order to secure future pensions since we cannot expect this from the fewer children we have.

As proposed by the Council, the government is recommending an annual capital investment of 4 percent, a level which is only to be reached by 2008, however. At the same time, the increase in pensions benefits will be reduced. Benefits will be increasingly lowered for both old and new retirees over the course of time since the recommended capital formation will reduce the basis of assessment for calculating benefits. In addition, new retirees will experience special reductions vis-à-vis the older retirees.

The improved situation of the older retirees is welcome in keeping with the sense of justice between generations since those who retire before 2011 are still part of the generations that raised comparatively more children and who have not caused the pension problem. That the following generations will receive gradually lower benefits is logical since they have also gradually accounted for fewer children (Sinn and Werding, Schnelldienst 18/2000). It is also right that pensions will be differentiated according to the individual number of children. The socialisation of the pension contribution of one's own children, that was enforced by the old pension insurance system, will thus be reduced. In future, both the funded as well as the pay-as-you-go portion of pensions will depend on how much one has contributed to the financing of these pensions.

A somewhat disturbing aspect of the reform concept is the redefinition of net wages by the deduction of the recommended capital formation. This redefinition optically increases the "pension level" – which will only be 62 percent of net wages in 2030 – to the target level of 64 percent. Another problem is that the government still operates with a set of very favourable assumptions that give the impression that the contribution rate

* Published in *Ifo Schnelldienst* no. 28–29/2000, p. 3–4.

will only rise to 22 percent by 2030. According to calculations of the Ifo Institute, the rate in the year 2030 would be 23 percent, and by 2035 an increase in the contribution rate to 24 percent must be expected. If the recommended capital formation is factored in, the total burden adds up to 28 percent. This is the figure that would result without the reform and that politicians have wanted to avoid. The proposal of the Scientific Council to start earlier with a higher savings rate and to reduce this rate in the crisis years deserves just as much attention as the recommendation of the Ifo Institute, based on generational accounts, that the contribution rate be locked at 20 percent and that even farther-reaching cuts in the pay-as-you-go benefits be accepted.

Apart from this, the reform proposal is a step in the right direction and a good basis for a compromise with the hopefully bolder demands of the opposition.

Time is short. A structural majority still exists for a reduction in benefits, but this majority will shrink each year. Once the pension crisis has truly begun, it will be too late for reforms since the majority of voters will be among the losers of such reforms. Then the pension system will topple, and with it perhaps the country as a whole.

15

20 Percent is the Limit*

By the year 2035 Germany will have the oldest population on earth. For every ten Germans currently no more than seven children are born, and life expectancy is increasing by one year every eight years. In 2035 there will be twice as many elderly as today. A major crisis is brewing for the pension system (see Viewpoint No. 4).

A broad consensus among politicians has been formed that entitlement from the state pension systems must be reduced and supplemented by funded pension plans from an individual's own savings. But there is still no consensus as to how great the entitlement cuts should be and who should be required to save how much.

The responsibility for the pension crisis is attributable to the decline in births among those born after about 1955. They have reared, on average, too few children to guarantee the stability of the pay-as-you-go pension system. For this reason it is only fair that they bear the consequences of their decisions in the form of decreasing pension entitlements. The money that these generations did not spend on child rearing should be invested in capital markets as a form of retirement savings. With regard to the total burden on every generation from the pension system and child rearing, this is both reasonable and fair.

As the generational balances calculated by the Ifo Institute show (Schnelldienst, 18/2000), the total burden of all generations from the net pension burden and child-rearing costs is smoothed to the greatest extent if the social insurance contribution is frozen at its current level and the future demographic distortions are completely offset by corresponding reductions in pension entitlements. The generations that are both responsible for and affected by the pension cuts still have time to finance their retirement consumption by private savings. For this reason, the social security contribution rate should never exceed 20 percent. The alternative of imposing a lower limit for net pensions must be rejected since it would unduly favour the generations that bore fewer children.

Of course, all those born in a particular year cannot be treated in the same way, disregarding the number of children they reared. It is the number of children that distinguishes the contribution an individual has actually made to safeguarding future

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* September 26, 2000.

pensions and also the financial leeway that remains for supplementary retirement savings. For this reason, the amount of pension cuts that will be necessary in future from the freezing of the contribution rate, as well as the reasonable amount of obligatory savings in funded pensions system, should be graded according to the number of children.

14

The Battle with OPEC*

OPEC seems to be risking another power struggle with the industrial countries, following the conflicts of 1973–74 and 1979–81. The high energy taxes of the industrial countries are a great annoyance to OPEC since they either reduce the demand for oil or they lower the net price of the oil that is sold. With a conscious policy of temporary shortages, OPEC is now attempting to mobilise consumers to pressure their governments into reducing energy taxes

However, OPEC's power to increase prices is only temporary, since the higher the prices are now the less will be sold and the more must be put on the market in future at correspondingly lower prices. A supplier only has the power to defend the producer price when it is advantageous for him to reduce the quantity sold in order to absorb the declining demand resulting from the price increase. This condition, however, cannot be seen as being met for the oil suppliers in the long run since they in any case will want to sell their oil resources at some point in time.

In the final analysis, the energy taxes of the industrial countries must be borne by OPEC in that lower crude oil prices arise than would otherwise be the case. This explains OPEC's nervousness but implies at the same time that neither the $C0_2$ problem nor other environmental problems can be solved by this tax. At some time – and sooner than later with announced tax increases – the available oil resources will be burnt, releasing $C0_2$ into the atmosphere.

When a single country increases its energy tax on its own, this of course has a noticeable effect on local consumer prices. In this way the country can reduce the quantity consumed and control local environmental problems such as urban air pollution or road congestion. However, by reducing demand, it lowers the world market price slightly and thus shifts the reduced domestic consumption to other countries with all the negative results for their local environmental problems. In this case as well, the world production of C02 remains unchanged, but real income from Germany and from the OPEC countries is then given away to other industrial countries.

In light of this situation, a possible argument for energy taxes by individual states, is transferring pollution to the neighbours and the increase in tax revenue in itself. A better

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* Published as "Industrieländer sollten gemeinsam eine Wertsteuer auf Energie erheben," *Handelsblatt*, September 20, 2000..

solution is an ad valorem tax imposed on energy by all industrial countries jointly. To be sure, this will not benefit the environment, but it will give the industrial countries the possibility of sharing OPEC's oil revenues, without creating further burdens for local consumers.

13

Greencard, Goethe and Gates*

Germany currently has a shortage of 50,000 computer specialists, so there are good reasons for Chancellor Schröder's plan to allow 20,000 such specialists to enter the country from outside the EU on a new temporary residence visa – the German Greencard. The 900 specialists in all occupational fields who are currently given exceptional permission to work in Germany are indeed not sufficient.

However, the computer industry comprises barely 1% of the labour market. The bottlenecks in the computer sector cannot justify a general loosening of restrictions for migration from non-EU countries. Germany still has mass unemployment of nearly 4 million. And one must not forget the eastern expansion of the European Union which, with the accompanying freedom of settlement, may lead to mass migration from Eastern Europe possibly starting in 2004 (see Viewpoint 9).

It is absurd when hotel and restaurant owners now call for a Greencard solution similar to that for computer specialists; in this sector the qualifications of unemployed Germans are certainly sufficient. Employment bottlenecks in simple services must be eliminated by improving the incentive structures of the welfare system and not by liberalising immigration policies.

Easing the bottlenecks in the computer sector by immigration is a short-term solution. A better alternative for the medium term is to promote the next generation of German scientists. Doubling the number of trainees in IT-related occupations as well as the number of university graduates in computer science would supply the labour market with as many new IT specialists per year as will be allowed to immigrate into Germany under the new government plan. An immediate expansion of university places in this sector would eliminate the bottlenecks in only a few years.

The Greencard discussion has made it embarrassingly clear that Germany has long since relinquished the leading position it had in the natural sciences a hundred years ago. Young scientist are attracted in droves to the U.S. where they receive high wages and have opportunities not available to them in Germany. Not the limited immigration of specialists but the emigration of scientists is the real problem. Thousands of scientists who have been trained in Germany have been recruited for jobs in America, and

* July 4, 2000.

thousands of young Germans who have studied in the U.S. have not returned because of the lower earnings offered by German universities.

On the whole, Germany has been neglecting education. In the share of public spending on education in relation to GDP, Germany occupies the fifth last place among all 27 OECD countries and the third last place among EU member states. Even the U.S., where a major portion of university education is in private hands, lies ahead of Germany in public spending on education. Investment in human capital is being foolishly neglected in Germany.

This especially holds for education in the natural sciences. In Germany, academics in the humanities still look down on their colleagues in the natural sciences, and the schools are still dominated by teachers of languages and literature. The German educational system places more emphasis on Latin than on laptops, on Goethe than on Gates. This is not a formula for success in the competition for attracting foreign business and industry into the country.

12

A Transfer Economy*

The tenth anniversary of the Economic, Currency and Social Union marks the day of the prosperity miracle in the new Länder of east Germany. Ten years ago, real wages in the GDR were only about 30 percent of wages in the Federal Republic, and nominal wages, calculated on the basis of exchange rates, were only 7 percent. Today, nominal wages in east Germany are 70 percent of the western level and nominal household income is 80 percent. Retirement benefits from the state social insurance system per household are 10 percent of the western level.

However, what has arisen in east Germany is a transfer economy and not a functioning market economy. GDP in the new Länder is presently about DM 440 billion and total public and private consumption of goods and services – the absorption – is about DM 650 billion. One third of east German consumption, or some DM 210 billion, is financed by the west; of this amount DM 140 billion flows through public budgets and about DM 70 billion are private capital exports, of which, however, DM 10 billion are loans to finance the Länder budgets in east Germany.

These transfers were necessary since east Germany's catching-up process came to an abrupt end in 1996 after the expiration of the Law for State-Assisted Regions (Fördergebietsgesetz). The main reason for this failure was doubtlessly east German wages. The wages that were negotiated in 1991, between employer and employee representatives who were all from the west, were much too high. Today east German payroll costs are more than 70 percent of the level in the west compared to an east German overall labour productivity of only about 55 percent. The reverse is needed to create jobs and economic growth. Productivity must not lag behind wages, but lead them.

The rewards of wage restraint can be seen in Ireland, where overall productivity has risen from 27 percent of the west German level when Ireland joined the EU thirty years ago to 85 percent today. This robust growth was the result of wage increases lagging behind the expansion of productivity. Even today, wages are still 30 percentage points below productivity if we compare both variables with those of west Germany. The result is that Ireland has a current account surplus, and not a deficit amounting to 50 percent of GDP as in the new Länder in east Germany.

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* June 30, 2000.

The strategy of hasty wage harmonisation has been justified by unfounded arguments, such as the creation of additional demand or incentives for exceptional productivity gains in east German factories. A very misguided argument was that wages had to rise so rapidly to prevent a mass migration. First of all, the migration caused by wage-induced unemployment took place anyway, and secondly this was anything but bad. Instead of working in the east on outdated machinery or idly waiting for new jobs to be created, a temporary migration to the west and employment in productive jobs in the west was certainly the better alternative.

The current wage restraint that has been induced by market forces gives cause for hope. It is also surely needed if the economy in the new Länder is to remain competitive after EU expansion in Eastern Europe.

11

The Dilemma of Globalisation*

For many globalisation is a threat, for others it is a potentially new step in the development of mankind. Both are right. Globalisation improves the trade in goods, the exchange of labour, and the cross-border flows of capital, from which all countries will benefit. A surge in growth can be expected which will enlarge the welfare of each country..

Within a country prosperity will only rise on average, though. There will be winners and losers. The winners will be wealth owners and the highly skilled in the developed world, and most of the workers in the lesser developed countries. Among the losers will be many – if not most – German less skilled blue and white collar workers, who will not be able to defend their internationally high wages or, if so, only at the cost of additional unemployment. The free trade of goods and the movement of capital and labour will increase the size of the cake available to all Germans, but ordinary workers will receive a smaller slice of it. A reduction in the growth rate of real wages is unavoidable.

Globalisation will cause considerable problems for the social welfare state. The rich, who must give the state more than they receive, find it easier to escape the system by emigration, and more and more poor, who are net recipients of government funds, will be put in the position of seeking out the state with the most generous welfare benefits. It is true that our social welfare state is in need of fundamental reform. But we cannot expect such reform to be induced by competition between states. Even a well-constructed social welfare state that encourages self-initiative (see Ifo Viewpoint 6) cannot prevail under such competition. Countries that must expect a cross-border migration of capital and people will endeavour to frighten off net recipients of government resources and to attract net payers, and this tends to dismantle the social welfare state, not merely to reform it.

This is the true dilemma of globalisation in Western industrial countries. The need for protection by the welfare state is increasing due to world-wide low-wage competition, and at the same time the competitive pressure on social welfare systems is reducing the ability to provide this protection. Wage and distribution policies cannot change this trend without exacerbating the problem. There is little scope for useful reactions. Workers must become even more productive in response to the growing wage

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* Published in *Die Zeit*, no. 10, March 2, 2000, p. 30.

competition and governments must get used to relinquishing power and control mechanisms. The improvement of research and education, investment wages and employee savings programs, as well as a transition to a partially funded social security system are among the few ways for individual states to cushion and mitigate the distribution effects. All countries together can take counter measures such as a limited harmonisation of taxes and the application of the home-country principle in welfare benefits (Ifo Viewpoint 9), but even these measures will not really be able to put a halt to the development. The underlying forces are simply too strong.