The Ifo Viewpoints 2002

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More Big Government – The Ten Point Programme of the New Ruling Coalition*

Germany has been on the wrong track for thirty years. The government's share in GDP has risen from 39 percent to 48 percent. Unemployment has increased from 150,000 (West Germany) to about four million. These factors are connected, and a reversal of trends is not in sight for either. The most recent proposals of the Federal Government will take the country even further down the wrong track, since what is euphemistically designated as a “savings programme” is in fact a massive ten point tax increase programme..

1. The environment tax on energy will be raised again on the first of January. This is not the worst of all taxes, but it contributes to the already very high taxes that are crushing this country. For this reason it has no legitimisation.

2. The next stage of the already approved income tax reform would have offset the increase in the average wage and income tax burden caused by tax progression. The postponement of this stage will prevent this effect. Germany is and remains the country with the highest marginal tax burden on the value added by the average employee in the world, at approximately 66 percent.

3. A minimum corporation income tax is understandable in light of the negative corporate tax revenue observable in 2001 and in the first half of 2002. The government made a mistake when reforming the corporation tax. It failed to take into consideration that the distribution of old equity capital and the substitution of old, heavily taxed equity capital by new, low taxed equity capital would lead to a subsequent tax reduction on the entire equity capital stock of firms built up by retained earnings since 1977. The minimum tax on corporations is meant to correct this error. It is debatable whether this is the best way to react. However, the introduction of a minimum tax is a massive tax increase in any case.

4. The abolition of the (falsely designated) "speculation" period is in fact the introduction of a genuine capital gains tax, the likes of which Germany has never known. It also taxes the yield on long-term retirement savings. Capital gains on company shares arise from retained earnings for the purpose of in-house investment.

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The capital gains tax is a double burden on retained earnings. It discriminates against investments that are financed by retained earnings and it encourages profit distribution. It induces the opposite of what was intended with the tax reduction on corporations' retained earnings introduced two years ago.

5. The contribution rate for the pay-as-you-go pension system will be raised by 0.2 percentage points. Since this is not offset by higher entitlements for the paying employees, it is a pure tax increase.

6. The increase of the monthly income limit up to which payments are made to the pension system from €4,500 to €5,100 is a clear increase in the tax burden for persons in this income group, and is essentially a tax. Approximately 40 percent of the additional tax burden is offset by a rise in the present value of pension entitlements. This portion is a hidden additional government debt. The remaining 60 percent of the additional burden is a pure tax increase that is not offset by additional entitlements.

7. The increase in the monthly income limit for statutory pension insurance is accompanied by an increase in the compulsory insurance threshold for health insurance, which stands at 75 percent of this threshold. Persons whose monthly earnings range from €3,375 to €3,825 will now be obliged to pay contributions[**] to the statutory health insurance system. Even if the contribution rate remains based on the old threshold, this is still a hidden tax increase of considerable proportions since the services of the statutory health insurance system are the same for all, whereas the contributions depend on earnings.

8. Aviation petrol, agricultural products and other goods will be subject to the full value-added tax rate. Whether the different tax rates were justified or not, this, too, is a clear tax increase and not a savings effort of the government.

9. The tax on natural gas is a similar case in point. Adjusting it to the tax on petroleum could be justified on the principle of equal treatment of all energy sources, although favourable tax treatment of natural gas makes sense for environmental reasons. This, too, is a tax increase. Calling this the elimination of a subsidy is a confusion of terms.

10. The increase in the national debt by 0.13% of GDP as well as the increase in hidden government debt through the increase in the threshold for statutory pension insurance must be seen as indirect tax increases, since someone will have to pay the bill later when the debts are paid off and the additional pension entitlements are honoured.

[**] The idea has also been brought up that the monthly compulsory insurance threshold for health insurance should be raised to €5100, or 100 percent of the income limit for the statutory pension insurance.

These things taken together will raise the public sector share in GDP significantly and will continue to hamper economic growth. The problem does not concern the business cycle, as the money that is withdrawn from the circular income flow is also re-injected. But tax increases are poison for the growth of production capacity. To be sure, the tax increases will not ruin the country. But the potential risks have been raised. Past ruling coalitions in Germany did not have the courage to cut back big government. This coalition doesn't even want to.

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Getting Down to Work after the Election*

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

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

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

* Published as "Bildung statt Sozialausgaben," *Financial Times Deutschland*, no. 185, September 24, 2002, p. 14.

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

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

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

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

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

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Financing the Flood Damage*

Ten billion euros are to go to the flood victims, but where will this money come from? The basic choices are tax increases, spending cuts or an increase in the national debt.

Tax increases can be ruled out since lawmakers would lose face if they broke their solemn pledge to reverse tax-and-spend policies. Germany still has a very high public sector share of GDP. Too much money is poured into the welfare state and too much money is frittered away on subsidies. The recent tax reform has hardly helped the working population, and the little tax relief that is planned must not be jeopardised if the devastating, thirty-year trend of rising unemployment is to be reversed.

In terms of the marginal burden of taxation on the average employee, Germany tops the list of all OECD countries. No wonder that it brings up the rear when it comes to economic growth. These factors are linked, permitting no alternative to a policy of reduced taxes and social insurance contributions, even when the costs of a natural disaster must be met.

Tax increases, even those which come in the form of deferred tax reductions, are not in keeping with a healthy economy. The latest results of the Ifo Business Climate Index show a decline – and a considerable one – for the third time in succession. The recovery seems to be on hold, and we can be glad if it doesn't collapse completely.

It is better in this situation to choose the option of government debt. In Autumn 2001, the German economic research institutes recommended an earlier implementation of the next stage of the tax reform to boost the economy, with the revenue shortfall being compensated by additional debt. Since the economic climate is not much better today than last year, it certainly is ill-advised to take the opposite course of the institutes' recommendation. A postponement of the next stage of the tax reform would be the wrong reaction.

One problem, that was not so large at the time, was meeting the Maastricht criteria. New government borrowing for this year is expected to be between 2.5% and 2.8% of GDP, leaving little room for manoeuvre. On the other hand, only a small part of the money for flood relief will be spent this year, and the Stability Pact also explicitly excludes natural disasters. For damage compensation in these cases, new borrowing is

* August 28, 2002.

explicitly allowed. This is a strong argument for debt financing the measures to eliminate the flood damage.

In the long term, a reduction of government expenditure is still the best policy. Social welfare expenditures must be reconsidered along with government subsidies to enterprises, which now amount to between 100 and 150 billion euros. Across-the-board cuts would be an easy way to free funds for assisting the flood victims.

A combination of borrowing and spending cuts would be the best way. As long as the economic recovery is shaky, the necessary funds can be obtained by borrowing, but afterwards loans should be replaced by spending reductions. An accelerated debt repayment should then also be achieved by spending cuts.

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The Heart of Hartz[*]

If an economic research institute had submitted an expertise to the Ministry of Labour anything like the report of the Hartz Commission, the ministry would have sent it back. An analytical section is missing, and no financial calculations were made. Instead, there is a colourful potpourri of creative recommendations, many attractive colour graphs, but hardly any numbers. Policy advice has never been so simple!

Nevertheless, the proposals of the Hartz Commission are welcome in principle because they bring movement into the ossified political discussion in our country. The taboo that policy-makers had imposed on labour market issues has finally been broken.

The expertise is strong in its efforts to reform the Federal Labour Office and to make job placement more effective. It is reasonable that the new Job Centers take all the unemployed by the hand and help activate them by using a bundle of measures, including restricting the conditions under which a job offer can be refused and shifting the burden of proof to the job seeker.

The report is weak when it comes to fighting unemployment. Here, not much can be achieved through better job placement. The revolving door between the working world and unemployment is already turning very fast today. The proposals of the Hartz Commission would have it turn even faster. New hiring will increase but so will dismissals.

Jobs are in short supply, and more jobs will only be created if labour costs fall. The report does everything to avoid this simple truth. Entitlement wages, defined on the basis of unemployment assistance and social welfare benefits, are too high for low-skilled workers for sufficient affordable workplaces to be created at these wages. These workers constitute about 40 percent of the unemployed although they are only 15 percent of all employable persons.

Even though an analysis is missing, the Hartz Commission seems to accept the labour-cost problem in principle. The tax-favoured Ich AG (one-person "company") and the tax-deductible mini-jobs in private households (the old "housemaid privilege") are attempts to create jobs by way of lowering labour costs. Unfortunately the Commission does not say how it wants to offset income from an Ich AG or mini-job against the social welfare entitlements of former moonlighters. Under current law the proposals are

[*] Published as similar version in *Handelsblatt*, no. 158, August 19, 2002, p. 8.

largely ineffective since welfare benefits are cut on a one-to-one basis for any income from a mini-job or an Ich AG. A commission that does not manage to submit an integrated progression system for state transfers and taxes in the low wage area has failed to do its work properly.

The “heart” of the recommendations of the Hartz Commission lies, according to its authors, in the personnel service agency (PSA), which re-introduces the unemployed to the working world on a loan-employment basis. This proposal is borrowed from the Ifo study, “Activating Social Welfare”, that came out in May 2002. Unemployed persons must accept employment from a loan-employment agency or accept a cut in their benefits. During the six-month probation period, wages correspond to unemployment benefits, and after the probation period a PSA contractual wage is agreed that should amount to approximately 70 percent of the last gross wage. The loan-employment agency lends the worker to the private economy. During the probation period it does this free of charge, if necessary, and afterwards at a wage that is fifty percent below cost. The employment relationship with the PSA carries full legal protection, including security against dismissal

Assuming that the unions go along with the bargaining for the PSA wages, this proposal will certainly lead to a massive increase in employment since it will lead to a lowering of the hourly wage costs by two thirds for the workers affected (see p. 155). Here, the Hartz Commission only assumes that a few hundred thousand jobs will be involved. But in reality, this wage cost reduction would even lead to full employment since econometric studies demonstrate that a general lowering of labour costs of only 10 percent , and most definitely a lowering of 20 percent, would be sufficient to have this effect.

The real problem is the financing. The Ifo Institute's proposal limits subsidised, public loan employment, along with a subsidy for wages for a normal job in the private sector, to low-skilled workers. The Scientific Advisory Council to the German Ministry of Economics in its expert opinion, "Reform of the welfare state for more employment of low-skilled workers” of June of this year reached the same conclusion. With a limitation to the lowest sector of the labour market, the fiscal burden remains controllable. A full financing of the wage subsidy in the low-wage area is possible with a reduction of normal social welfare rates and the fusion of unemployment benefits and welfare payments.

We can only guess at how expensive the Hartz proposals will be since the Commission provided no financial calculations, but the costs will certainly go beyond what is feasible. The problem with all such proposals is the inevitable free-rider effect. Enterprises will dismiss non-subsidised employees and replace them with cheaper, subsidised workers. This process may take years, but it cannot be stopped. The Commission apparently has no intention of stopping it, since it has explicitly demanded that the Temporary Employment Business Law no longer apply, according to which the re-employment of previously dismissed persons is forbidden by means of loan employment (p. 157).

The Ifo proposal calculated that 4.5 million lesser qualified would have to be subsidised in the long run in order to create 2.3 million new jobs for the lesser qualified. According to the same logic, with the Hartz proposals we can expect to subsidise the entire private labour market in the long run. This would presently amount to 32 million persons, and, if we extrapolate from the costs mentioned by the Commission itself per PSA employee (fig. 23), more than €300 billion or two thirds of the tax revenue of the Federal Republic of Germany. Of course this is not found in the Commission's report, but the laws of economics still apply despite what the Hartz Commission would like.

The Commission will now probably counter that PSA employment must then be limited in time or restricted in some other way. This is possible but only without the desired employment effects. More jobs are only possible in the long run if labour costs are lowered permanently, and this will only work, without corresponding wage concessions, if wages are permanently subsidised.

The idea of subsidising labour in all qualification segments of the labour market via PSA employment will lead to creeping Socialism in the labour market as a whole and is not compatible with a free market economy. The heart of the Hartz proposal is unrealisable.

Only the proposals of the Ifo Institute and the Scientific Advisory Council, which are more modest and which focus specifically on the lesser qualified, can be implemented. The welfare state must provide permanent help for the lesser qualified whose value added is too small to earn a sufficient livelihood. But this should be done on the condition that those affected make a contribution themselves, and not, as is the case today, that they have no earned income. This is the logic of the proposals submitted by economists. If we follow it, a good deal of unemployment can be eliminated without any costs for the state.

Once the election is over, politicians will hopefully remember the serious concepts that had been presented long before the Hartz proposals.

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E.ON, Ruhrgas and the Consumer Protection*

After long deliberations, the German Ministry of Economics has made its decision: E.ON may acquire the majority interest in Bergemann AG and with it control over Ruhrgas. Ruhrgas is the major gas importer in central Europe, and the E.ON group with its many public utilities and local gas distributors is an important supplier for the end users in Germany. A new global player in the power industry has been created, comprising vertically integrated services from gas imports down to the ultimate consumer.

This will create more security in the European gas supply in light of the foreseeable crises and distribution conflicts that will unfold in the coming decades over shrinking supply and will retain profits in Europe that would have flowed elsewhere. The long-term, major investments with pay-off periods of more than fifty years, which are normal in the gas business, will become more controllable with vertical integration because they free customers and vendors of gas at the wholesale level from the danger of holding each other up after having invested in irreversible structures. The gigantic reserves of E.ON can be invested for the benefit of consumers in new gas pipelines, storage and other gas infrastructure projects.

Consumer protection organisations see this differently and have threatened to bring action against the decision. But they do not really know what they are doing, since they assume that the merger will lead to higher prices to the detriment of the consumer. The consumer protection advocates overlook not only that the merger will lead to more investment in the gas supply, higher amounts of gas sold and lower prices, but they also ignore the fundamental difference between vertical and horizontal enterprise mergers. Whereas horizontal mergers in fact tend to produce oligopolistic price increases at the consumer's expense, vertical mergers tend to have precisely the opposite result.

Nothing is worse for the consumer than vertical margin competition among enterprises in a vertical supply chain that set their prices independently of each other. Vertical margin competition leads to a final price that is higher than the one leading to the common profit maximum of the enterprises involved. The reduction of this vertical competition through mergers leads to lower prices.

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* Published as "Vertikaler Vorteil", *Financial Times Deutschland*, no. 130, July 9, 2002, p. 26.

The reason for this is unfortunately hidden from many true and putative competition specialists but is easy to understand. If an enterprise in the supply chain increases its prices, it does not take into consideration that the resultant sales reduction has a negative external effect on the other enterprises in the supply chain that must also accept lower sales or must reduce their own margins. A high-price policy that overshoots the joint profit maximum is therefore the result of vertical competition. This is the exact opposite of horizontal competition in which not a price increase but a price decrease of one enterprise has a negative external effect on another enterprise. In the horizontal context, a low-price policy that goes below the joint profit maximum is the result of competition.

If enterprises merge, competition is reduced and the external effects are internalised. The enterprises show consideration for each other in their pricing policies. In this respect there is no difference between horizontal and vertical competition. If horizontal competition is diminished, however, consideration of the others means higher prices, and, if vertical competition is diminished, it means lower prices. The lower prices expand the common sales of all enterprises in the supply chain and lead both to an expansion of profits and to an increase of benefits for the consumer.

The merger of E.ON and Ruhrgas is a clear case of vertical integration. In this merger there is a harmony of interest between the consumers and the enterprises involved, because both groups want lower prices and higher sales volumes. Only the other enterprises, which are competitors of Ruhrgas and E.ON at the various supply stages, face disadvantages because the new merger confronts them as a more aggressive rival. But this is always the case if the market is stimulated and achieves better results for the consumers. The political and legal protests of competitors are mostly irrelevant from the point of view of economic welfare. They are indeed a clear sign that policy-makers have decided in favour of the consumers.

Even if the Ministry of Economics has not used this argument, it is a positive sign that it overcame the narrow legal position of the cartel office and the monopoly commission and made a decision that will benefit consumers. For such a decision, based on the economic advantages of the fusion, the Ministry virtually had no choice according to Sec. 42 of the Law against Restraints of Competition (GWB).

Even in cases where competition is reduced, the economic advantages can predominate, and this is generally the case when a reduction of vertical competition is involved. Vertically integrated enterprise groups, that also still compete with each other on a horizontal level, are normal and desirable organisational forms in a market economy. Whoever rejects these mergers using competition arguments that stem from the discussion of horizontal enterprise mergers, commits a serious error of thinking. The consumer associations should take careful stock of what they are doing. Big business is not always a disadvantage for consumers.

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Why the Euro is Strong Again*

Last year I presented the thesis that the euro would remain weak until its introduction in physical form and would gain strength thereafter (Financial Times of 4 April 2002, p. 15). This is precisely what happened. The euro fell in cycles until February of this year, the date of the official end of the currency changeover, and in March it began to gain strength, recently almost achieving parity with the dollar

The argument I presented last year was that foreign currency holders, mainly in Turkey and Eastern Europe, moved out of D-mark cash into other currencies. Currency holders outside Germany, who held approximately a third of D-mark currency stocks in 1995, had heard of the planned abolition of the D-mark, but did not know what to think of its replacement, the euro. In any case they were afraid of sustaining losses from the exchange, and did not even know who would carry it out.

I also called attention to cash holders on the European black market who would not want to reveal the source of their funds when exchanging them at the bank counters.

Numerous indicators now support this theory, which initially was only buttressed by the anecdotal evidence of large amounts of cash flowing back to branches of the Bundesbank near the eastern borders. In a survey made by the Austrian central bank in May 2001 of thousands of currency holders in Eastern Europe, of those who had already formed an opinion more than forty percent did not want to shift from the D-mark to the euro. In an expert survey by the Ifo Institute, a majority confirmed that Eastern Europeans did not feel sufficiently informed about the exchange modalities and were worried about the exchange, which later proved to be justified because of the high fees charged by Eastern European banks.

The most important support of the thesis, even last year, was the very sharp decline in the growth of D-mark cash in circulation. The decline had begun in 1997, shortly after the abolition of the D-mark was announced at the Dublin summit, and from that time on the D-mark began to depreciate.

In the meantime the growth decline accelerated, and in the winter of 2000/2001 D-mark cash began to fall even in absolute terms. By February of this year, D-mark

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*Published as "Warum der Euro steigt," *Handelsblatt*, no. 129, July 9, 2002, p. 8.

currency in circulation had fallen, against the trend, by about €90 billion, from €160 billion to about €60 billion, an unprecedented change in money supply growth.

Parallel to this, total eurozone currency in circulation also began to fall. The decline, against the trend, amounted to about €120 billion by February of this year. This meant, in addition to the drop in the demand for currecny registered by the Bundesbank, another €30 billion in the other countries. If we assume that Germans hold no more illicit money than other Europeans, the only interpretation is that the D-mark cash returning from abroad comprised the lion's share of the money stock reduction. About €75 billion of the decline against the trend falls in this category.

The decline in the demand for cash began much too early to be attributable to technical factors in the currency changeover. Rather it was due to the fact that, in light of the declining liquidity preference, the Bundesbank had to reduce the money supply in order to defend its minimum lending rate and in compensation had to increase the amount of interest-bearing assets in the private sector, which was done in part through discount and repurchase agreements. This passive intervention succeeded in defending interest rates but provided only modest support to the exchange rate. In spite of the passive intervention the euro remained weak, for a time even falling below 85 US cents.

These explanations of the depreciation of the euro were rejected by many actual or putative experts. Initially they disputed the facts as such, and when this was no longer tenable, they claimed that the noted currency effects were too small to be able to explain the depreciation of the euro; indeed, the currency stocks involved were much smaller than even short-term foreign- exchange flows. These assertions miss the point because it is not short-term foreign-exchange flows that are relevant for exchange-rate movements but the long-term demand for currency stocks. Flows go in both directions and explain nothing despite what for ex dealers may believe. Fortunately, econometrics offers a clear answer as to the size of the observed effects. The observed reduction in the demand for euro cash of €120 billion implies a long-term depreciation of about 36 cents. That is enough to explain the actual depreciation from January 1997 to February 2002, and is also far more than the foreign-currency reserves held by the European Central Bank for foreign-exchange market intervention.

A counter-argument that is sometimes put forth is that the money supply M3 should have decreased if indeed there had been a movement out of the D-mark. This argument overlooks that Bundesbank intervention takes place within the broad money aggregate M3. The replacement of cash by assets for the purpose of interest-rate stabilisation, both of which are part of M3, would certainly not have changed this money aggregate.

It is interesting in this connection that the European Central Bank decided last year to change its M3 money supply definition, because in recent years increasingly larger parts of interest-bearing components of this broad money aggregate had moved into the hands of foreigners. According to ECB information and calculations of the Ifo Institute, assets worth about €100 billion were affected by this correction from January 1999 to September 2001. They presumably constitute the other side of the flight cash that was taken back to stabilise interest rates.

In the meantime the flight has ended, and the trend has reversed. Since March the euro has been rising, and at the same time the currency emitted by the ECB has begun to increase again. It is all a mirror-image of what happened before the currency conversion. The euro is well suited for illicit dealings and is finding new friends in Eastern Europe, Turkey and elsewhere in the world. According to a recent information of the ECB, cash of no less than €18 billion has moved to eastern Europe from January to May 2002. Gradually the euro cash stocks are replacing other currencies, which temporarily had found their way into the pockets of the money holders, and euro cash is in short supply. The euro is gaining strength, even though the ECB is now passively intervening by pumping new cash into the economy to defend its interest-rate targets.

Of course there are rival explanations of the strength of the euro and/or the weakness of the dollar. Some have pointed out that the weakening dollar reflects the fading confidence in the American economy. This sounds plausible at first glance, but cannot be supported in light of the confidence surveys among investors and consumers. Not only the surveys of the Ifo Institute in America but also many other surveys clearly show that confidence in the economic upswing in the US is considerably more robust than in Europe.

The often quoted thesis that the weak dollar mirrors the lull on the American stock exchanges is also not very sound. True, the Dow Jones Index has fallen since the beginning of the year, but the DAX and the Euro Stoxx Index have fallen much more. Relative to European equities, American stocks have thus increased in value this year, and that implies a strong, not a weak dollar.

Nowhere is the belief in false and completely untenable theories so wide-spread as in the foreign exchange markets. Superficial plausibility always prevails over economic analysis. The former can frequently win on points because false theories may be true for a time if everyone adjusts his purchasing behaviour accordingly. But in the long term the fundamentals prevail. The falling cash demand among Eastern Europeans and illicit currency holders up to the euro changeover and the rising demand thereafter is one of these fundamentals.

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Too Much of a Good Thing*

The German tax reform of 2001 was an important step towards improving Germany's attractiveness as a business location. It will help shift the tax bases of international corporations to Germany, attract direct investment, and reduce those investments that were planned for the sole reason of saving taxes. On the whole, the tax system has become more neutral and has lost some of its steering functions. Investments are again moving to where genuine profits are expected.

In a high-tax country like Germany, called-for tax reforms must necessarily lead to reductions in taxes and hence in tax revenue. Tax revenue must not be wiped out altogether, however, since the state needs some means to carry out its tasks. In terms of this trivial postulate, the German tax reform of 2001 was deficient. It not only reduced the revenue from corporate income taxes but effectively allowed it to become negative. Whereas in 2000 tax revenue of €23.6 billion was collected, in 2001 corporate tax revenue was negative, at minus €426 million. Regarding corporation taxes, the state ended up subsidising corporations in 2001 instead of taxing them.

This is an astonishing outcome that nobody could have wanted. How did it come about?

Of less significance was the announced exemption of capital gains, which induced companies to postpone the sale of equity interests, causing reductions in tax revenue even before the exemption took effect. More important was the fact that many companies were able, in 2001, to write off equity stocks of loss-making subsidiaries. This included spectacular write-offs of foreign equity holdings, implying de facto a continued international loss compensation, although this loss compensation was formally not intended. The weak economy, leading to shrinking actual profits and hence tax obligations, has of course also contributed to falling tax revenues.

The main reason for the reduction in tax revenues is, however, that the distribution fiction inherent in the German tax system, which requires companies to distribute first the most highly taxed stocks of previously retained earnings, led to a tax-reducing replacement of old by new equity stocks. A company, which in 2001 distributed earnings that had been taxed at 45% before 1999, and instead retained new earnings, was rewarded for the mere equity replacement, i.e. without any net retentions, with tax

* See also "Der Irrtum des Herrn Eichel – Zu viele Geschenke für die Konzerne," *Die Zeit*, no. 32, August 1, 2002, p. 26 (The author has not chosen this title).

savings of 15 percent on the replacement volume. The retention of current earnings changed nothing on their taxation at 25 percent, but the distribution of past, previously retained earnings reduced their tax burden from 45 percent to 30 percent. Somewhat lower were the gains on the distribution of retained earnings which had been taxed at 40 percent in 1999 and 2000. This rule is largely valid until 2016.

Although the tax reduction to 30 percent in case of distribution was also embedded in the old law, it was the change to the 25 percent tax rate on retained earnings which caused the tax on distributed earnings to fall de facto to 10 percent or 15 percent, respectively, as the result of distributing new earnings via old equity. By permitting, despite the tax reduction, a replacement of old by new equity, the tax reform – which, if one believes the policy statements, was intended to apply to newly retained earnings – was extended to earnings retained in past years. In practice, taxes were reduced on the entire stock of equity capital that German corporations had retained since the tax reform of 1977. German shareholders were handed genuine gifts.

The gifts to shareholders were unnecessary. If you want to promote growth it is irrational to reward the replacement of old retained earnings with new earnings by lowering taxes. Tax reductions on the exchange of equity will not have positive effects on growth. New, growth creating investments can only be induced by reducing taxes on the profits used for them or earned by the investments themselves

The objective of the tax reform was to encourage the retention of profits. Promoting the enterprises, not the entrepreneurs was the slogan. But various aspects of the transition rules had the very opposite effect, i.e. a greater distribution of profits following the reform. This weakened rather than strengthened the equity base of the companies, and weakened the firms' resistance to crisis.

In technical terms it would have been easy to design the tax reform differently with regard to the treatment of retained profits. Lawmakers could have declared taxes previously paid as definitive, similar to what happened in 1977 when the full tax imputation system was introduced. That would have raised legal questions, however. As an alternative one could have made the rule that retained profits which replace old equity are taxed at the same rate as these, and that only additionally retained earnings will enjoy the tax reduction to 25 percent. Easiest would have been a change in the order of distribution of the retained earnings. Instead of the distribution method according to the most highly taxed equity, one could have applied the LIFO method – last in first out. In that case the firms would not have been able to reduce their tax obligation by simply switching equity stocks. In a normally growing economy with rising stocks of equity, the tax gifts would have largely been avoided.

We will have to see how the corporation income tax revenue will develop despite the design flaws. Expectations for 2002 are poor. In Bavaria the alarm bells went off early, but North Rhine- Westphalia and Hesse were hit especially hard. Together they had to reimburse over €1 billion more in corporation taxes than they received in the first half of the year. The effects are not at all uniform in the various Laender. For the Federal Republic as a whole, the corporation income tax "yielded" minus €1.3 billion in the first half of 2002. During the same period of 2001, genuine revenue had amounted to more than €2 billion, despite the negative overall revenue in 2001 already mentioned. Many corporations seem only just now to be realising the new opportunities for exploiting the law and have until 2016 to use the tax-reducing equity switch. To be sure, from 2002 or in some cases 2003, it is no longer possible to use tax-effective write-offs on share holdings so that the tax shortfalls of 2001 may not be permanent. However, substantial losses may be repeated due to tax savings resulting from the distribution of old equity stocks.

The tax reform was good, but it was too much of a good thing. Instead of reimbursing taxes on replaced equity, one could have reduced the extreme disincentive to work caused by the personal income tax. And one could have extended better treatment to the unincorporated firms, especially small and medium-size firms. This would have been better for economic growth and overall efficiency.

33

Is the Euro a Price Booster?[*]

Everyone is upset. Consumer Protection Minister Renate Künast has even convened a "euro price-booster summit". The Chancellor shares the worries of the consumers. It seems that the worst fears have come true, that the introduction of the euro currency has led to a sudden boost in consumer prices. Is the euro a price booster?

By no means. In May the German cost of living index was only 1.1 percent above the corresponding previous-year level, the lowest value since November 1999 (1.0 percent). The European inflation rate in the year upto May 2002 was 2.0 percent, the same rate as immediately before the introduction of euro cash. A price boosting effect has certainly not occurred.

To be sure, the introduction of the euro has caused price adjustments. Since many price lists had to be reprinted for the euro transformation at the beginning of the year, previously planned price changes were concentrated on this date. Many price changes were deferred until the currency introduction, others were carried out in advance. Not all the prices were adjusted upwards. When prices were recalculated, many overdue mark-downs were implemented, and mark-downs planned for the future were realised ahead of schedule. As a result, in total very little happened. With regard to inflation the introduction of the euro was a non-event.

With the prices that did increase, there was a somewhat more rapid rise in prices for local services. These prices normally increase faster than prices for industrial goods because the wage increases that spill over from the industry sector can not be offset by corresponding growth in productivity. When euro cash was introduced, there was a slight price increase for these services. In the case of food products, which were 6.7% more expensive in January than in the previous-year month, the severe winter weather in south European growing regions for fruits and vegetables played a major role. In the meantime, prices here too have normalised; in May vegetables were 8.4% cheaper than a year ago. The prices for many industrial products, in particular in the area of entertainment electronics, also fell. Computer prices in May 2002 were more than 17% below their May 2001 levels. The net effect of all these variables was insignificant, as the unbiased statistics show.

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[*] Published as "Der Seelen-Teuro," *Süddeutsche Zeitung*, no. 150, July 2, 2002, p. 22.

The small scale of measured inflation is all the more remarkable since some administrated prices increases took effect in Germany on 1 January 2002, including the fourth phase of the eco tax and the increases in tobacco and insurance taxes. The sum of these effects is an estimated 0.4 percent. Without the increase in administrated prices, inflation from May 2001 to May 2002 would have been only 0.7 percent.

The discussion of the euro as price booster is largely in the realm of fantasy and subjectivity. It is a mixture of election campaigning and the summer recess, nothing more.

32

Germany's Anaemic Growth[*]

Germany has fallen behind in terms of economic growth and exports. Vis-à-vis the EU average of the past seven years, Germany has lost a good 6% of growth, and Germany's share of world exports has fallen from 10% at the beginning of the 1990s to only about 8%. This slippage has both internal and external causes. The internal causes have been operating for some time. They are the same factors that have led to an uninterrupted upward trend in unemployment since about 1970.

The increase in wages and wage-related expenses is the most important factor, since it has hindered job-creating investment. Real hourly labour costs in manufacturing increased by more than 40 percent in West Germany in the last twenty years. In the Netherlands, where a policy of moderate wage increases began in 1982 with the Wassenaar Agreement, the rise was only a little more than 20 percent, and in the United States it was about 8 percent. The result was that the number of working hours increased in the US by more than 40 percent and in Holland by around 20 percent, while West Germany only managed an increase of about 5 percent. The rule of thumb established in numerous econometric studies, that a one percent moderation in wage agreements leads in the long run to a at least one percent increase in jobs, is confirmed by a comparison of these countries.

The expansion of the welfare state contributed significantly to the rise in labour costs. On the one hand, it increased minimum wages through the expansion of wage replacement payments, and on the other hand, it increased the tax burden placed on the factor labour. At more than 65%, the marginal tax burden on value added that an average employee generates as the result of a qualification measure or more work in west Germany is by far the highest rate in the world. The next stages of tax reform will do nothing to change this because tax progression will offset the effects of the reform. Joblessness in Germany is becoming increasingly more lucrative, and holding a job increasingly more unattractive. It is no wonder that fewer people are employed and that growth is sluggish.

German unification also explains part of the weak economic growth. In economic terms, unification was a failure because it aroused the desire for harmonised wages before

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[*] Published as "Warum Deutschland Schlusslicht ist," *Frankfurter Allgemeine Zeitung*, no. 112, May 16, 2002, p. 14.

a convergence in aggregate productivity had been achieved. While GDP per person of working age in the former GDR is only 58% of that of former West Germany, labour costs have reached a level of more than 70 percent and average net household incomes a level of about 85%. Pensions, on average, are even ten percent higher than in the west. The result of the anticipatory income convergence and the associated high-wage policies is that east Germany never had the chance to become a competitive location. The forces that could have induced a convergence in aggregate productivity were weakened from the very beginning. Since 1997 the two parts of Germany have been drifting apart, as measured by their GDP gap, instead of growing together. Employment continues to decrease in east Germany at a pace of more than two percent a year.

The weak growth in the east contributes arithmetically to the low level of aggregate German economic growth. Further, it adds to the weak growth in west Germany because it necessitates permanent public transfers to east Germany and signals to investors that they must reckon with high burdens if they choose Germany as an investment location. The deficit on current account in east Germany is about 45 percent of GDP. The greater part of this deficit is financed through public transfers. The smaller part is covered by private capital imports. Never before in history has there been a region depending to such a great extent on resource flows from another region. Even Israel, Portugal and the Italian Mezzogiorno, three more classical transfer economies, lie far below, with values of 12–13 percent.

In addition to these internal, longer-term factors, a major external reason for weak economic growth is the intensification of competition following the fall of the Iron Curtain and European integration.

The euro in particular has led to the creation of a common capital market and to a dramatic convergence in interest rates. This has accelerated growth in the peripheral areas of Europe and has advanced economic convergence, but it has not helped Germany. Only seven years ago, interest rates in major EU countries were around five to six percentage points above German rates because high risk premia had to be paid to international investors as a result of exchange rate uncertainty. The interest-rate differences began to fade with the announcement of the euro, and by now they have practically disappeared. The euro has robbed German industry of its competitive advantage in the form of lower interest rates and led to the strengthening of growth forces in other European countries.

In order to speed up growth again, market forces, especially on the labour market, must be activated. If idle labour resources are mobilised, the national product will increase. The belief that growth creates jobs no longer applies in Germany. The opposite is the case: new jobs create growth.

The reforms should start with the welfare state, to reduce the impact that welfare has on the labour market in the form of high minimum wages. This can be achieved without dismantling the welfare state by paying wage supplements to the lesser qualified instead of wage replacement. This would eliminate the minimum wage level that is currently imposed by social welfare and it would induce the unions to accept lower wages. At lower wages additional jobs, which would normally not have been created, would become profitable. With the proper design, the new system would be less expensive for the state than the present welfare system, and at the same time the numbers whose earnings are above current social welfare would increase.

In addition collective bargaining and labour law must be fundamentally reformed. It is an absurdity that the unions can refuse to let employees of a firm accept lower wages to save their jobs. The case of Philipp Holzmann where the workers had made such offers but were stopped by the unions speaks volumes. Industry-wide collective agreements should in future only function as wage guidelines that a company can choose not to follow if the majority of its employees agree. The favourability principle in labour law must be interpreted such that the creation of jobs can be included among the measures that are "favourable" to employees. Laws offering protection against dismissal should be loosened to allow new jobs to be created, which is prevented by current rules. Protection against dismissal only safeguards jobs in the short term. In the long term it causes unemployment and job insecurity. Co-partnership for employees is better. If co-partnership is offered to employees in return for wage moderation, considerable mobilisation effects can be achieved.

A new pension reform is just as necessary as an extensive privatisation of health insurance and a fundamental reorientation of policies for east Germany that would increase self-responsibility.

Last but not least, education must be improved to lay the long-term foundation for a new surge in innovation. This is widely accepted, but it will not be enough. German economic growth will continue to lag behind its European partners unless the more difficult reforms are implemented, too.

31

The True Significance of the Euro*

The introduction of the euro was a necessary step in the political evolution of Europe. What, however, is the true significance of the euro for the economic development of the Continent and its regions? The ability to compare prices more easily and the elimination of currency exchange costs are obvious, but secondary, benefits.

By far the most important implication of the euro is the creation of a common European capital market freed from the barriers which were created by exchange rate uncertainty. As recently as 1995, yields on long-term government bonds in Italy or Spain were five to six percentage points higher than in Germany because international investors demanded high risk premia, and it was similar in other countries. Only Austria and the Netherlands had the same low yields as Germany. With the announcement and introduction of the euro, interest rates have converged almost completely.

As a consequence, the profitability requirement that real investments must satisfy is identical everywhere in Europe, and firms in peripheral countries can now receive loans at the same favourable conditions once enjoyed by German, Austrian and Dutch firms alone. This will lead to an investment boom in the southern and peripheral countries of Europe that will be reflected in an increase in the aggregate European growth rate. With the creation of a unified capital market, convergence in Europe will be accelerated and a sustainable growth stimulus will be created that could last a decade or longer.

For Germany, however, the implications are ambivalent. Presumably, Germany will continue to have the lowest GDP growth rates in Europe, among other things because of the euro. Whether this is an absolute or only a relative growth disadvantage is not clear. Currently interest rates are still so low that it is not possible to see any absolute disadvantages for Germany stemming from improvements in the situation of other countries. However, the high capital demand in the countries freed from risk premia could lift German interest rates to levels that would not have been reached without the currency union. This would indeed be an absolute growth disadvantage. This result is even relatively probable, considering that the euro has flexible exchange rates with the rest of the world, thus separating the international capital markets to some extent.

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* A more comprehensive version has been published as "Was der Euro wirklich bedeutet," (The implications of the Euro) in *Akademie Aktuell*, no. 1, 2002, p. 8–9.

Caution is in order, however, in evaluating this development as there are winners and losers in Germany. It can indeed be assumed that the factors of production that are complementary to the factor capital, and this is especially the factor labour, will be among the losers. With the slowdown of capital accumulation, labour productivity increases more slowly, and the scope for employment-neutral wage hikes narrows. In contrast, German savers, financial investors and real investors can safely shift their capital into formerly high-interest-rate countries and earn much higher returns than at home. Presumably the gains of the winners will more than compensate for the losses of the losers, as is usually the case when free trade is established. A possible result is that Germans on average will also earn more income, although the majority of Germans will belong to the losers.

The euro together with the fall of the Iron Curtain, which created low-wage competition at Germany's doorstep, have worsened Germany's competitive position. It can no longer be taken for granted that the German economy, backed by the privilege of an unrivalled stable currency, will remain the engine of European economic growth. Which makes it all the more urgent to overcome barriers to reform in education and on the labour market that also reduce competitiveness. The omissions and mistakes of the past, that up to now have been offset by other advantages, are becoming all the more evident and call for a courageous turnaround in economic policy.