The Ifo Viewpoints 2004

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Seven Truths Regarding Immigration[*]

We called for labour, and people came. People who are proud of their home countries, who love their children and friends, and to whom Germany has remained a foreign country. In view of the country's economic weakness, discussions have revived about a multicultural society, guest workers and immigrants. But the following must be kept in mind.

1. Immigration is an enrichment for Germany.

Immigrants have enriched the cultural variety of our country and have made Germany more cosmopolitan. Life has become more colourful for Germans. Not only have gyros become a German favourite with total sales exceeding even McDonalds hamburgers. We would also not want to do without Polish doctors, Turkish retailers as well Greek and Italian restaurants.

2. Immigrants are industrious, create jobs.

The majority of immigrants work and are responsible and reliable people. They do jobs that Germans no longer want to do. One tenth of them are self-employed or collaborating family members. Many of them create jobs, also for Germans.

3. Immigrants are law-abiding.

Only a small part of the immigrants work in the underground economy, and those who do, do so because they have no work permit or because their certificates or diplomas are not recognized here.

4. Immigration makes us smarter.

The German research community benefits from the immigration of foreign researchers. Science is exchange. It cannot prosper in isolation. In this way, a lot of research knowledge was also imported into Germany.

5. Immigrants make us cosmopolitan.

Immigrants help open the world for Germany by not only creating support and understanding for us with their contacts to their home countries, but also helping to establish valuable trade relationships. German exports to Turkey rose by half during the first six months of 2004 alone.

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[*] Published as "Sieben Wahrheiten über unsere Gastarbeiter," Bild, no. 278/48, November 16, 2004, p. 2 and under the title "Sieben gute Gründe für die Zuwanderung," *Bietigheimer Zeitung*, December 4, 2004.

6. Immigrants were lured in by the welfare state.

It is also true, however, that in the past there was too much immigration of low-skilled people that was induced by the benefits of the welfare state. This should not be blamed on the immigrants, however. Rather, the problem was created by the politicians who failed to stop immigration into the welfare state.

7. Immigration must be formed.

The politicians are also to blame for the fact that during the past thirty years many low-skilled Germans allowed the immigrants to push them into the easy chairs provided for them by the welfare state. In order to create additional jobs for those immigrating, wages must fall, and in order for the low-skilled nationals to accept this and not suffer disadvantages, a system of state top-ups of wages is needed. The welfare state must spend its funds on participation instead of unemployment.

In short: We need immigrants, but we must change our welfare system in such a way that all of us benefit from immigration.

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Why Extending Working Hours Will Create More Jobs*

How can more jobs be created if we work longer hours for the same pay? This question is currently a subject of debate. Is the unions' claim correct that firms will then decide to do the same amount of work with fewer people and dismiss the unneeded workers?

This claim is not correct. With longer working hours, the productivity of individual employees rises. Since per-capita labour costs do not increase, it is profitable for firms to employ more people. With shorter working hours, workers were kept outside the factory gates because their work was worth less than what they cost. When working time is increased, many of these people would become profitable for a business because they would now offer more than what they cost. They would find employment because in this way firms would manage to increase their profits even more than only from the additional extra work of its present staff.

Some argue that economic theory is unclear on whether employment will increase. On the one hand, the extension of working hours without wage compensation will lead to lower labour costs per hour. This increases firms' demand for man-hours. On the other hand, more hours are being supplied. It is not proven, they maintain, that the net effect is positive, i.e. that the additional demand for hours exceeds the supply. However, this fear is unfounded, because, as the argumentation in the preceding paragraph shows, the theoretical effect is unambiguous: If we look at the number of people instead of the number of hours, it is immediately clear that the result will be an expansion in employment.

In economic terms, an expansion of working hours is exactly the same as technological progress that increases the productivity of every individual at given working hours. Whoever argues that an extension of working hours will lead to problems must also argue that technological progress does the same thing. One cannot, on the one hand, demand innovations that raise labour productivity in order to safeguard jobs in Germany, and, on the other hand, reject an extension of working hours with the argument that this leads to dismissals. The two positions are contradictory.

At its core, the fear of dismissals after an extension of working hours is as old as the fear that technological progress destroys jobs. This fear was already expressed during

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* Abbreviated version published under the heading "Warum wir länger arbeiten müssen," *Welt am Sonntag*, no. 46, November 14, 2004, p. 26.

the German Weaver Revolt in the nineteenth century. It was unfounded, however. Capitalism transformed the technological progress of the past two centuries not into mass unemployment but into a tremendous increase in the standard of living.

The extension of working hours will also bring about a similar increase in the material standard of living (which is not offset by the loss in leisure time and the associated loss in utility). Except for factories that already work in three shifts, machine running times can be increased and the use of available buildings can be improved. It is almost like a divine reward for the additional work in form of an increase in the capital stock. The result is an increase in GDP virtually in line with the percentage expansion of working hours. A tremendous boost to growth is the result.

But, the reader may ask, where will the demand for the additional output due to the increased working hours come from? It will come from two sources. Firstly, the unit cost of production will fall because of the higher productivity of the workers. This will enable firms to sell their products and services more cheaply. Demand is higher if prices are lower.

Secondly, the additional supply of products in itself creates demand. A market economy is an exchange economy. Whoever supplies something is at the same time a demander of something else. In concrete terms, firms whose profits increase because of the extension of working hours will have an increased demand for other goods and services. They will not hoard these profits like Dagobert Duck but will spend the money on consumer or capital goods. Possibly they will also invest their profits in the capital market, which enables other enterprises to buy more capital goods. In any case, the additional purchasing power exactly equals the value of the additional products and services supplied to the very last cent.

Of course, the purchasing power will not be reflected in purchases from one's own company, but will be distributed throughout the rest of the economy. From a single firm's perspective, the effect is thus negligible. But from an aggregate economic perspective it is important, because it prevents prices from having to fall in order to generate the additional demand.

In principle, demand from an extension of working hours will rise by the same amount as supply. To be sure, structural shifts between increased demand and increased supply can occur. However, such structural shifts lead to changes in relative prices which adjust the demand structure to the supply structure, but there are no systematic price reduction effects.

Admittedly, the process could involve some demand leakages, since a portion of the additional demand may shift to foreign suppliers. At flexible exchange rates, this would lead to a devaluation to the point that sufficient demand for domestic products is restored. Within the euro zone, where no exchange rate adjustments are possible, the result is a decline in the rate of inflation below that of the other countries so that in this way a possible demand gap can be closed. Since German firms spend their profits primarily on capital goods and since Germany is a country that specialises in precisely these goods, effects of this kind are likely to be small.

In order for many firms to experience a substantial demand effect, it makes sense that all extend their working hours simultaneously. Then, the average firm will have as much additional demand as its additional supply. For this reason politicians should not hesitate to tackle this issue and should initiate a concerted effort of all participants with the goal of a general expansion of working hours. Flexible solutions for individual firms would be less helpful in this case.

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Hartz V*

After Hartz IV there ought to come Hartz V, for, courageous as it may be, the reform does have shortcomings. Its greatest problem are the rules governing extra income to be earned by the recipients of the new second-tier unemployment benefit (Arbeitslosengeld II). For them, taking a job is hardly worth it. Out of each additional euro they earn, as a rule they may not keep more than 20 cents – mostly only up to 15 cents.

Particularly affected are those unemployment benefit recipients who currently have a low-income side job. Hitherto they could earn 165 additional euros a month or more without facing a reduction in benefits. Under the new second-tier unemployment benefit rules, this amount declines to only 50 euros. 85 percent of the additional income will be deducted from the benefits. Thus, a person earning 200 euros will retain only 73 euros, and another earning 400 euros would retain only 103 euros. Many of the unemployed will therefore give up their mini-jobs and try their luck in the underground jobs market.

The 85 percent to be deducted from benefits applies to incomes of up to 400 euros per month. Above that figure and up to 900 euros, the deduction from benefits and the marginal social security tax burden add up to an effective marginal tax rate of about 80 percent. For each euro in higher income, the effective marginal tax is around 90 percent. This applies to incomes all the way up to the limit under which the new second-tier unemployment benefit is to be paid, i.e. some 1200 euros for a single person and at least 1600 euros for married people or those with children, assuming typical housing subsidies.

The reduction in benefits constitutes for most an insurmountable obstacle to entering the labour market. This reduction gives rise to such high reservation wages that only very few jobs would turn out to be lucrative. For instance, an individual who requires a net income of 5 euros per hour in order to relinquish his leisure or underground job would need a gross wage of 33 euros in order to offer his services beyond the 50 euro limit, and a wage of 25 euros in order to extend his working time beyond a 400 euro mini-job. Those earning 900 euros would need a 54 euro gross hourly wage for an additional hour of work. Non-single individuals choosing between unemployment and a job paying a 1600 euro gross wage need a 28-euro hourly wage in order to get 5 euros net per hour. Such high wage demands can hardly be met. Amongst employers, firms

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* Published as "Wenn sich Arbeit nicht mehr lohnt," *Die Zeit*, no. 46, November 4, 2004, p. 23.

and private parties alike, there are jobs aplenty, but no jobs which would be profitable at such wages.

This problem can be avoided by applying the Activating Social Aid model developed by the Ifo Institute. According to this model, free extra income of up to 400 euros is allowed; even more, the first 200 euros earned are topped up with a 20 percent supplement. Above 400 euros, the marginal burden resulting from benefit reduction and taxes amounts to some 71 percent. Thus, a 200 euro job under this model yields a net income of 240 euros as opposed to the mere 73 euros under Hartz IV, while a 400 euro job leaves 398 euros net instead of the meagre 103 euros under Hartz IV. That translates into lower wage demands: In order to earn 5 euros net per hour in a 400 euro mini-job, you need only 5 euros gross instead of 19 euros as with Hartz IV. Non-single individuals aiming for a 1,600-euro gross wage would demand an hourly wage of 10.70 euros instead of the 28 euros under Hartz IV in order to get a net wage of 5 euros per hour.

The lower wage demands will, of course, cause wages to decrease for those already in low-skilled employment. That cannot be avoided under any job-creating programme. Under the Ifo model, this reduction in wages is compensated by lower transfer deductions and a wage subsidy.

Despite the wage reductions and the lower rates contemplated in the new second-tier unemployment benefit, thought necessary to spare the state additional expenditures, income of low-earners increases under the Ifo model. Combining the wages earned, the wage subsidy and social assistance, they will have more money in their pockets than in the case of unemployment that Hartz IV really cannot reduce.

The politicians are attempting to tackle the problem of excessive wage demands with so-called one-euro jobs: those who reject a suitable one-euro job may see their benefits reduced by 30 percent as a first step. Seen in this light, the possible income gain from working would be increased and the wage demand reduced. But it remains unclear which occupations are actually suitable in each particular case, how long these jobs have to be performed and how the competition with the private economy is to be avoided.

The Ifo Model avoids these pitfalls. The reduction in social assistance if someone does not work is clearly regulated, so that there is no need to provide proof of suitability. At the same time, communities are obligated to provide temporary leasing jobs at private employers to all those who cannot find employment in the private sector. The individuals affected will receive a wage from the community amounting to the social assistance they hitherto received, and the leasing job is set at a wage that would be interesting to the employers. The programme leads to full employment of low-skilled individuals, as there is a wage different from zero at which this interest can be aroused. The productivity of even the weakest member of society is greater than zero. Everyone is needed, for whatever he can contribute.

In terms of employment levels, national product, total income for low earners, performance of community jobs and, last but not least, legal certainty, the Ifo proposal is better than Hartz IV. There are no objections to using for it the name Hartz V, given that Hartz IV itself has more to do with the Ifo model than with the recommendations of the Hartz Commission.

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The Export Puzzle*

The world economy is growing at a brisk 5% in 2004, the highest rate in 28 years. And yet German economic growth continues to be sluggish, keeping the labour market in a state of crisis. Consumption and particularly investment are weak. The German economy lacks the dynamism of previous upswings.

German exports are being towed along by the world economy's fast growing investment. Exports will rise by about 10 percent this year, enabling Germany to defend its title as the world's second largest exporter. Still, the German economic research institutes expect GDP to grow by only 1.8 percent in 2004 and 1.5 percent in 2005. Germany thus continues to rank amongst Europe's economic laggards.

The German economy poses a puzzle. Why is it that the enormous surge in foreign demand for German products in 2004, which surpassed everything Mr. Eichel would have dreamt of achieving with even the boldest debt policy, did not bring about higher economic growth? Why are both the labour market and domestic demand so sluggish in the face of booming exports?

The answer is that German export companies are competitive, but German workers are not. While companies, as legal entities and brand bearers, can safeguard their competitiveness by producing a steadily increasing share of their product chain in low-wage countries, a significant part of German workers have already lost their competitiveness. That is the bazaar economy view.** Industrial value-added, employment, earned income and thus private consumption are increasingly decoupled from industrial production. Workers fretting about their jobs do not dare incur greater expenses, and companies do not have the nerve to invest in German jobs in the face of ever keener low-wage competition from abroad. If an investment is to be made, the low-wage East European countries lying on Germany's doorstep come into consideration.

The high German export surplus is, by definition, a capital export. As such, it is also an indicator of job exports to other countries. According to the German Central Bank's statistics on direct investment, no less than 4 million jobs have already been created abroad by German companies, without considering the many jobs created by German financial investment abroad.

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[*] Published as "Das Exporträtsel," *Süddeutsche Zeitung*, no. 252, October 29, 2004, p. 24.

It is true that the industrial value added increases with exports and gives an impetus to the German economy, but the growing disengagement between the creation of value added and industrial production lessens the force of this thrust. This disengagement can be observed in many countries, but in Germany it is taking place faster than in other European countries; indeed, from an economic point of view, it is proceeding much too quickly. Industrial employment is decreasing without sufficient jobs being created in the services sector to absorb the manpower set free. This process, which in principle can be regarded as a signal for improvement of the international division of labour, is excessive in Germany. While no less than 1.9 billion man-hours were lost in the industry sector (not including construction) between 1995 and 2003, merely 290 million hours were created during this period in the entire rest of the economy. The net loss amounted to 1.61 billion man-hours. The workers did not emigrate from industry to the other sectors of the economy but to the welfare state.

The responsibility for this lies essentially in the rigidity of wages for low-skilled jobs, which in turn is due to the collective bargaining law and the wage competition resulting from the replacement incomes the welfare state is paying. Simple industrial work in Germany is uncompetitive because it is too expensive. Labour costs per hour in Germany are higher than practically anywhere else, exceeding even the Swedish ones by one third. As long as this problem remains unsolved, exports will not be able to stimulate Germany's domestic economic activity.

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Seven Truths about Civil Servants[*]

Is Germany sick because it affords itself armies of tenured civil servants who work little, have a grumpy attitude towards the people, and enjoy their sinecures? No, at a closer look the facts are quite different from this stereotype.

1. At a share of only 12.5 percent of total employment, Germany has extremely few civil servants. In Denmark and Sweden about one third of employees work for the state, in Great Britain the share is 22 percent, and even in the United States it is 16 percent. Among the developed OECD countries, Germany ranks low regarding the share of civil servants, comparable to Luxembourg and Japan. Yet the work of German public offices is exemplary and the efficiency of German civil servants can stand up to any international comparison.

2. Only about one third of state employees are fully tenured civil servants and judges. Two thirds are workers and salaried employees, subject to normal collective bargaining rules. Dismissal protection of many private sector employees is almost as high today as that of civil servants. Those employed for 15 years can hardly ever be fired. Then too, one does not become a civil servant over night, but only after very long waiting periods.

3. Civil servants are not allowed to strike and must swear an oath of allegiance to the state. If need be, they may be transferred to another location at any time. They represent an always available, reliable base of the state, guaranteeing stability in the most difficult of times. Judges and policemen are civil servants, for example, because they must be independent and incorruptible. In the past, engine drivers, attendants at level crossings or flight controllers were civil servants because traffic was not to be interrupted by strikes. (Why teachers and professors must be civil servants, however, is more difficult to understand.)

4. Public employees work more. At an average 1708 hours per year, the collectively agreed working time of blue and white collar public sector employees is 3.5 percent higher than the average of private sector employees, who work 1649 hours per year. Civil servants even work up to 12 percent longer hours than private sector employees.

5. In mid-2003, gross wages and salaries of public sector employees were on average 5.5 percent lower than in the private sector, despite longer working hours and despite

[*] Published as “Die Wahrheit über deutsche Beamte,” *Bild*, no. 234/41, . October 6, 2004, p. 2.

the fact that public employees must on average have higher qualifications than private sector employees.

6. That civil servants are advantaged because they do not have to pay social security contributions is a fairytale. Since the state has always had to compete with the private sector, civil servants' net salaries, not gross salaries, must be compared with those of private sector employees. The amounts paid by others for social security contributions are not granted as salaries to the civil servants from the beginning.

7. Civil servant salaries, at least at the professional levels, have risen much more slowly than private sector salaries. During the 30 years from 1970 to 2000, the rise of gross monthly earnings of highly qualified salaried employees in the private sector averaged 330 percent, whereas salaries of professionals in the civil service rose only by an average 190 percent. During the same time, hourly wages of industry workers rose by 350 percent and the rate of social assistance by 450 percent

Conclusion: Civil servants are much cheaper and more industrious than their image. We ought to be happy to have them.

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Equivalent Standards of Living and Factor Price Equalization*

According to Article 107 Basic Law, there must be fiscal equalization among the federal states, and according to Article 72 Basic Law, the federal government has the right to assume legislative powers if it wants to create equivalent standards of living in different regions of Germany. It has, however, neither the duty to do so, nor have the regions or anybody else the right to demand the creation of equivalent standards of living. And, above all, they have no right to public funds for the purpose of creating equivalent standards of living. That is all to the good, for in a market economy the state lacks the instruments to achieve such a goal..

The market economy itself already provides for extensive convergence of the standards of living. Market arbitrage brings about a convergence of prices and incomes that is only limited by transportation costs. Capital moves to wherever wages are low and labour moves to regions where wages are high and where there are jobs. This process puts downward pressure on wages in high-wage regions and upward pressure on wages in low-wage regions. The result is what economists call factor price equalization. This may not suffice to create equivalent standards of living in a deeper ethical sense, but it already achieves a good deal.

The state must not do more than support this natural convergence process. If it tries to accelerate the process by financial means provided to the citizens in the weaker regions, it frequently achieves the opposite of what is intended. The beneficiaries now are induced to change their economic behaviour to receive more of these funds. Attempts to earn money by selling their own services to other citizens, which after all is the fundamental principle of a market economy, then take the backseat.

Most of the state funds that flowed to east Germany were spent on welfare benefits of various kinds. In this way the state became a competitor of business, pushing up wages, thereby making the establishment of companies more difficult and causing mass unemployment. With this policy, it has not supported the convergence of living standards but impaired it massively. Only infrastructure services and similar measures that raise productivity in the weaker regions can promote a convergence of living standards, but unfortunately most state funds do not flow there.

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* September 14, 2004.

Insofar, President Köhler’s warning is appropriate. It is easier to live with the small differences left by a truly free market than with the chaos and the inequality created by the attempt to produce uniform standards of living by fiscal measures.

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Germany, the Welfare Magnet*

There will be more migration in Europe, but it will be “bad” migration as well as “good”.

“Good” migration is driven by wage and productivity differences. “Bad” migration is driven by the generosity of the welfare state. Germany’s new immigration law, adopted last week, makes it easier for highly skilled people from outside the European Union to immigrate. They would earn above average incomes and would not be a burden on the state. That is good migration. But the new draft EU constitutional treaty and the new EU directive on freedom of movement, which took effect on April 29 and will have to be implemented into national law within two years, could open the gates for the “bad” kind – welfare migration.

Until now, there have been only two significant types of welfare migration in Europe. First, immigrant workers have participated in the host country’s redistribution of wealth from rich to poor. As low earners, their taxes and social security contributions have not covered the cost of the public transfers and the infrastructure from which they have benefited. Second, foreign workers have migrated indirectly into the welfare system by crowding out native-born workers, pushing them into unemployment. By providing unemployment benefits and welfare, EU states have fixed wages for simple labour above the market clearing level. That has stimulated excessive migration and prevented the decline of wages that would have created new jobs for the migrants. Native-born workers have preferred to sit in the easy chair the welfare state offered them instead of entering low-wage competition.

The directive on free movement will make a third type of welfare migration possible: the immigration of inactive people. Every EU citizen will have the right to a residence permit for up to five years in any member state. After that, he or she will receive the right to permanent residence, with full social protection. Although there are safeguards against welfare abuse in the first five years – migrants must prove they have health insurance and the necessary “resources” – there are none against claims after that period. At that point, migrants will have the right to permanent residence – and full welfare benefits – even if they have no health insurance or resources.

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* Published as “Teurer Sozialmagnet,” *Capital*, no. 15, July 2004, p. 3.

The country of residence will even make benefits available before the five years end if the immigrant falls on hard times for reasons beyond his or her control. The directive clearly states that needy people must not be expelled simply because they require welfare and that welfare recipients should not be expelled unless they become an unreasonable burden on the state.

The extension of these rights has coincided with the accession of the Eastern European countries to the EU, which is itself likely to affect migration flows. Today, the wage rate in these accession countries is one seventh of the west German rate and between one quarter and one third of west German social assistance for a family of four – now €1,550 ($1,924) per month. This gap will not narrow quickly.

As a result, some countries, such as Germany and Austria, have opted to prohibit labour migration during a transition period that is initially set at two years but may be extended up to 2010. However, this ban does not apply to inactive people. Germany, which in the past has absorbed two-thirds of all east Europeans entering the EU, is likely to become the primary destination for the additional welfare migrants made possible by the new directive.

The resulting situation is grotesque: immigration of working people is made more difficult in Germany and Austria, while immigration of inactive people is made easier – two more reasons for Western companies to relocate to Eastern Europe or elsewhere.

The likely consequence of immigration via these three channels is that the welfare systems of West European countries will be eroded. Benefits will be cut because none of these countries wants to become a destination for welfare migrants.

This outcome could still be averted if EU member states adopt a "workfare" system – where, except for the disabled, welfare is redirected to those who work – and a different constitution is agreed. This new constitution would limit the right to immigrate into the welfare system. It would allow workers to receive tax-financed benefits only after a delay, and oblige inactive migrants to receive welfare benefits from their home countries in perpetuity. Such an overhaul of the EU constitution is now possible only if the treaty is rejected by one or more countries.

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Directive on Free Movement: Free Ticket to the Welfare State*

Just in time for the Constitutional Summit in June and for EU accession of the Eastern European countries, the new EU Directive on Freedom of Movement, which had been passed by the European Parliament on 10 March 2004, became effective on 29 April 2004. It will have to be translated into national law within a period of two years. The directive will facilitate and make uniform the migration of non-working EU citizens between the countries of the Community, and it anticipates and makes concrete the rights proposed in Article II-34 of the draft constitution for immigration into the welfare state.

Heretofore, only employed and self-employed EU citizens had the right to reside freely in other EU countries and be included in their welfare systems. This will change now. According to the Directive, every EU citizen will have the right to a residence permit for up to five years in any Member State and thereafter he will receive the right to permanent residence. Even inactive immigrants will, in principle, be eligible for social welfare, just like nationals, although there are safeguards to limit the abuse of the system during the first five years.

The only safeguard that the new directive contains against direct immigration into the welfare state is proof of health insurance protection and the requirement of "resources" that must be shown when a residence permit is requested. These resources are calculated to last for the intended duration of the stay. They are to prevent the immigrant from claiming welfare assistance.

It is not at all clear what exactly is meant by resources. According to the preamble, the state cannot cite insufficient funds as a reason for refusing a residence permit. This would be inadmissible discrimination. The resource requirement must be tailored to the individual circumstances of the immigrant.

Whatever the required resources may be: Those concerned will find ways to prove them. One can already imagine how fast the required funds will circulate between the accounts of some immigrant groups.

The welfare state must make its services available if the immigrant loses his funds after having entered and received a residence permit. Only "unreasonable" claims can

* Published as "Freizügigkeitsrichtlinie: Freifahrt in den Sozialstaat," *Süddeutsche Zeitung*, no. 121, May 27, 2004, p. 20.

be refused, and the state bears the responsibility for proving unreasonableness. The duration of the residence permit may not be shortened because the immigrant becomes needy during his stay and claims welfare assistance. Once in, he is in. The welfare state cannot easily get rid of him.

Moreover, there are no safeguards against welfare claims after five years of residence. When the waiting period is over, the migrant has the right of permanent residence even if he has no health insurance and no resources to live on. He will then be fully eligible for welfare payments.

The incentives to make use of the new freedom of movement will be enormous for Eastern Europeans. Today the Slovak wage rate is one seventh of the German rate and a fifth of west German social assistance for a family of four. This will not change very quickly. Even if the wage convergence of Eastern Europe, at 2% per year, is twice as fast in the future as it was in Western Europe, the Slovak wage will reach only 40% of the west German wage by 2020.

Some countries like Germany or Austria have opted for a prohibition of labour migration during a transition period that is initially set at two years and may be extended up to 2010. However, this prohibition does not apply to self-employed and non-working persons. Germany, which in the past has absorbed two thirds of all Eastern Europeans entering the EU, will in all likelihood be the primary target of the welfare migration that the new EU directive will trigger in two years' time. Just as the Berlin taxi market is currently being taken over by small Polish entrepreneurs, Germany must prepare itself for poverty immigration from the far ends of Poland and the Slovak Republic.

This is truly grotesque. Immigration of working people is made more difficult in Germany, and immigration of non-working people is facilitated. Two more reasons for German companies to leave and relocate in Eastern Europe or elsewhere. The marginal groups of Slovak society will now be able to come to Germany, and the German automobile industry will relocate an increasing part of its production capacity to Bratislava. No wonder that the Slovak Republic fares well with a corporate tax rate of only 19 percent, while Mr. Eichel has sleepless nights despite high German rates.

The consequence of immigration into the West European welfare states will be an erosion of these welfare states themselves. The states will reduce their services in a competition of deterrence, because none of them wants to become a destination for welfare migrants. There will be one cut of welfare benefits after another, and in the end Europe's social welfare will resemble that of the United States.

This outcome can still be averted, but toward this end a different constitution would have to be agreed, one that would grant the right to free movement within the EU but not the right to immigrate into the welfare state. The home country would have to remain responsible for the welfare benefits to non-working immigrants. Maybe there will be a new chance for Europe after the British referendum.

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In the Debt Trap*

A dog does not hoard sausage. The German governments behaved likewise. When there was money in the till, they spent it. And when there was not enough money, they went into debt. This is how the German state slid into the debt trap in which it is now caught.

The first big leap into debt was taken by the Social-Liberal coalition of the seventies. The debt ratio (the ratio of public debt to gross domestic product) doubled from 20 percent to nearly 40 percent. Helmut Schmidt and Walter Scheel were eager to distribute the gifts of the welfare state, but they did not want to present the bill to the citizens. The second leap occurred under Helmut Kohl. He did not dare tell the citizens the truth about the costs of unification, preferring instead to finance the transfers to east Germany on credit. The debt ratio rose from 40 percent to more than 60 percent. It was so high that Theo Waigel, then finance minister, was unable to bring Germany into the currency union in a normal fashion, which would have demanded a debt ratio of less than 60 percent. Thereafter, even the totally indebted Italians could no longer be denied entry to the currency union.

Gerhard Schröder and Hans Eichel followed in their predecessors' footsteps. They raised the debt ratio from 61 percent in 1998 to 64 percent last year. This year they are pushing the debt ratio above the 66 percent mark, and next year they will approach 68percent. Next year, the public debt will exceed €1.5 trillion. This will be more than three times the amount at the time of the fall of the Berlin Wall.

Going into debt is fun at the beginning. The fun stops when one sits atop the debt and must pay the interest. In the past, the topic could be pushed aside by pointing to the wealthy future generations. But this is no longer an option. Firstly, since 1995, Germany has been the country with the lowest growth rate anywhere. Where then is the future wealth to come from? Secondly, the future generations are shrinking due to the Germans' low birth rates. There is probably no country in the world in which the number of births relative to the population is as low as in Germany. The baby-boomers that were born in 1964 are now forty years old. Not many people are coming after them. Even the age cohort of the thirty-year olds is 40% smaller, and the following age cohorts will be even smaller. No, the idea that future generations will help us out of the mess is ridicu-

* Published as "Schulden sind unsozial," *Stern*, no. 22, May 19, 2004, p. 194.

lous. We ourselves are the "wealthy future generations" of whom the politicians of the past were speaking. It is us who will have to pay the bill.

Interest on the public debt amounts to more than €68 billion this year, although interest rates are as low today as never before. When interest rates normalise again, the interest burden will rise by half and exceed €100 billion p.a. Even today, the interest burden is higher than the net borrowing of €65 billion permitted by the Stability and Growth Pact.

This is the true reason why the Government is ignoring the Pact and is violating EU law. It also wants to benefit from the debt, like its predecessors, and does not see why it should borrow less than the interest payments due. That is why the budget deficit is likely to amount to €80 billion this year. As always, there is not enough money, and instead of tightening its belt, the state once again writes a cheque on the future.

The Government uses the rationale that it does not want to destroy Germany by saving too much. In truth, it not only destroys Germany's credibility but also the willingness of investors to make long-term commitments in this country. Whoever who leaves his money in Germany must know that some day he will be asked to pay.

Its debt policy has made Germany the laughing stock of Europe. The European Commission has brought suit before the European Court to force Germany to pay the contract penalties. The presidents of the state auditing authorities and the federal auditing office have urgently asked the Government to cut spending, something unheard of in the history of the Federal Republic. All of this reeks of a larger state crisis.

The crisis must be averted. And the German state must learn that one cannot live beyond one's means forever. The share of gross domestic product that the state absorbs has risen by 10 percentage points since Willy Brandt's chancellorship, i.e. from 39 percent to 49 percent. The public sector share of national income has risen to 57 percent. Most of the money went to the welfare state that today amounts to €600 or 700 billion, depending on the definition. Companies, too, received many dozens of billions of euros in subsidies. 41 percent of German adults live on social security, state pensions, unemployment compensation, social assistance, and similar transfers. All of this must change if Germany is to have a future again. That is why most subsides must decline, and why, over the next years, social benefits must only be raised by as much as inflation. Real economic growth must be utilised for a reduction of the public sector share. This is the only way in which Germany will be able to gradually escape the debt trap.

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Low Wages, Wage Subsidies and Investment Wages*

Eastern Germany as well as the Bavarian regions close to the border with Eastern Europe face considerable adjustment pressure because of the eastern enlargement of the European Union. Labour costs in the Czech Republic and Poland are a quarter to a fifth of the costs in eastern Germany and a fifth to a sixth of the costs in Bavaria. German industrial firms have seized this opportunity to shift labour-intensive manufacturing to Eastern Europe. For German workers, however, a problem of major proportion has arisen. Their competitiveness will gradually erode if their costs remain so high.

The problem affects German industry as a whole but especially the Bavarian regions along the eastern border and eastern Germany, which is still suffering from the rapid increase in wages after German unification. To be sure, east German hourly wages of industrial workers are still only 72 percent of the west German level (with gross monthly wages standing at 77 percent, net monthly wages at 83 percent and real net monthly wages at 90 percent). Nevertheless, total productivity there has stagnated since 1997 at just 60 percent.

Unfortunately, there is no convincing economic scenario in which this wage situation can be maintained after the opening of the border to Eastern Europe without resulting in further increases of unemployment, which already has had catastrophic effects in many locations. Especially border regions like the east German Lausitz will continue to lose population if wages remain inflexible.

This is why wage structures must change. In particular wages in border regions as well as wages for unskilled labour will have to fall relative to average wages, because German unemployment and the low-wage competition from Eastern Europe is concentrated in these segments of the labour market. Wages need not fall to Polish levels. They are supported by a better infrastructure and a better legal system that still temporarily safeguard the productivity advantages. But wage declines are necessary to restore the competitiveness of the people in the affected regions.

Falling wages for people who already earn low wages is indeed a major social problem for Germany. For the lowering of wages not to become a lowering of earnings, the welfare state should compensate the loss with wage supplements. The Ifo welfare-

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to-work model, which was the basis of the Hessian Model introduced at the German Bundesrat, is a carefully designed, revenue-neutral model for such supplementary payments. It is compatible with the necessary wage flexibility – unlike the current welfare system – and it cushions the losses in income of low-wage workers. For the typical low wages in eastern Germany it will even lead to a clear improvement in earnings of those with small incomes.

The other instrument for compensating wage reductions, at least in eastern Germany, is worker participation in the productive capital of their companies. Investment wage agreements, which run over a longer period of time and compensate only the already employed workers through a company participation scheme, lower the wage costs of new employees. They offer an incentive for the creation of new jobs without placing current employees at a disadvantage.

The market does not guarantee social justice. But neither can justice be achieved by measures that run counter to the market by clinging to wage structures that do not reflect the competitive situation. Social justice can only be implemented by measures that do not hinder the effectiveness of the market. Welfare-to-work and investment wages are such measures. They are urgently needed in eastern Germany to prepare for Polish and Czech membership in the European Union.