A joint initiative of Ludwig-Maximilians-Universität and the Ifo Institute for Economic Research

CESifo Forum

Spring 2003

Volume 4, Special Issue No. 1

The Laggard of Europe

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www.cesifo.de

CESifo Forum ISSN 1615-245X
A quarterly journal on European issues
Publisher and distributor: Ifo Institute for Economic Research e.V.
Poschingerstr. 5, D-81679 Munich, Germany
Telephone ++49 89 9224-0, Telefax ++49 89 9224-1461, e-mail ifo@ifo.de
Annual subscription rate: €50.00
Editor: Heidemarie C. Sherman, Ph.D., e-mail sherman@ifo.de

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Paper presented at the Academy of Sciences of
NorthRhine-Westphalia on 13 November 2002

Munich, 10 April, 2003

THE LAGGARD OF EUROPE

HANS-WERNER SINN

PAPER PRESENTED AT THE ACADEMY OF SCIENCES OF NORTHRHINE-WESTPHALIA ON 13 NOVEMBER 2002[1]

In the post-war period right through to the 1970s, Germany was the growth locomotive of Europe. That period is long past. Today, Germany brings up the rear in terms of Europe's growth. Unemployment has reached alarming proportions, the number of business failures has shot up to a record level and the financial sector is mired in the deepest crisis of the post-war period. Investors are staying away from Germany and are looking for opportunities elsewhere.

The winds of competition are howling more fiercely than ever. Globalisation and European integration, in particular the creation of a single capital market with the introduction of the euro, have levelled the playing field for competition between rival business locations, and the eastward expansion of the EU will shortly add a further dimension to this levelling process. The defects of Germany's economic system and its resulting weakness as a business location are now clearly evident and will retard the country still further. The necessary corrections cannot hope to be more than an exercise in damage control.

This paper will marshal the facts in order to issue a warning and to point out ways of reforming the economic system. First it will present the relevant findings. Then it will examine the question as to what can be learned from the oft-quoted comparison between Germany and Japan. Next, it will analyse the particular role played by the euro and finally it will look at the home-grown reasons for the weakness of Germany's economy. After all, economic policy must start from this basis.

[1] This paper is a based on Hans-Werner Sinn, Die rote Laterne, Die Gründe für die Wachstumsschwäche und die notwendigen Reformen, *ifo Schnelldienst* 55, 2002, No. 23, 17 December 2002, special issue. Some of the material is also contained in condensed form in European Economic Advisory Group at CESifo, *Report on the European Eonomy* 2003, Ifo Institute for Economic Research: Munich 2003, chapter 1, appendices 4 and 5.

This article is not concerned with business cycle questions. It will focus exclusively on those aspects of the economy which are of importance for the development of our country over the longer term. Even if the economy were soon to recover, Germany's problems will not disappear, but will be at most temporarily concealed. In the event, the opportunity must be seized to carry out the reforms which are urged in this paper.

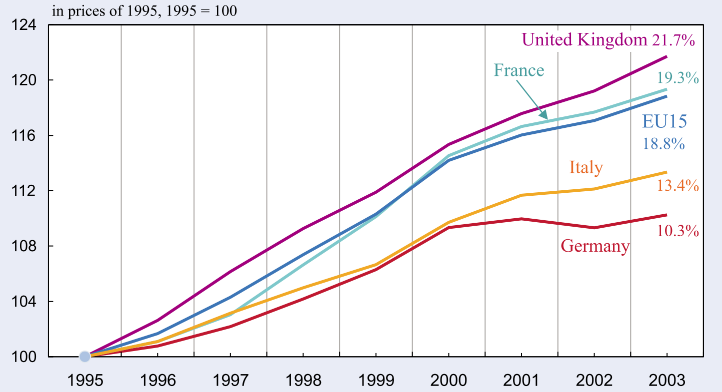
The findings

Germany has been growing more slowly than the European average, particularly since the mid-1990s (see Fig. 1).Whereas Great Britain and France achieved 22 and 19 percent growth, respectively, above the European average in the period from 1995 to 2003, Germany managed a mere 10 percent during the same period, far behind everybody, including Italy. Even if the list of countries were to be extended to encompass all the member states of the EU, one would see the same picture confirmed: Germany is the laggard of Europe.

The latest growth figures show no changes in this trend either. In 2002, Germany's output grew only by 0.2 percent. During this time, average growth among the EU countries still managed to reach close to 1 percent.

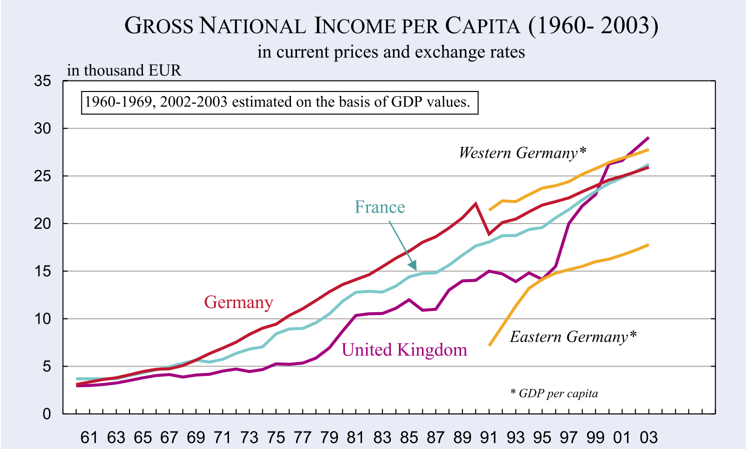
Figure 1

REAL GDP GROWTH IN SELECTED COUNTRIES OF THE EUROPEAN UNION



Sources: Eurostat, Federal Statistical Office, calculations and forecast by the Ifo Institute (March 2003).

Figure 2



Sources: OECD (2002); National Accounts, Arbeitskreis Volkswirtschaftliche Gesamtrechnungen der Länder (Jan. 2003), Deutsche Bundesbank (2003): calculations by the Ifo Institute.

A lower growth rate would not constitute a problem if it merely reflected the process of European convergence. If Germany's growth were to slacken compared with its European neighbours only because it had already achieved the high income per capita which the others were still hoping to reach, there would be little cause for concern. After all, convergence is the great aim of European unification, and is also an accepted part of German policy.

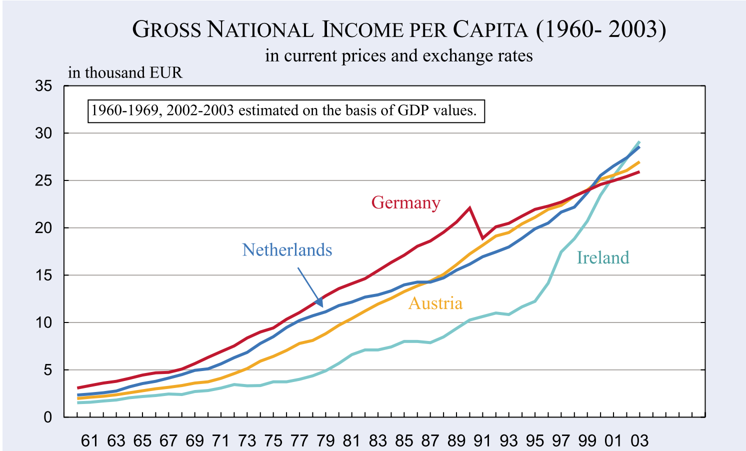
However, the reality looks rather different. In 2002 France overtook Germany's GDP per capita and Great Britain did so in 2000 (Fig. 2). As recently as the late 1970s, per-capita GDP in Great Britain had only just reached half the German figure. Admittedly, the high GDP per capita recorded for Great Britain is skewed by the over-valued pound, but it is remarkable that Britain still continues to grow at a comparatively fast rate despite the prolonged high exchange rate of sterling.

The comparison with Great Britain is important because the country was, after the war, in a similar situation to Germany today. Having won the war, Britain felt assured of its prosperity. The welfare state was set up with confidence and there was widespread pride in the country's unquestioned superiority. Before long, however, many other European countries, and particularly Germany, had overtaken Great Britain. It took a long time before the British public was prepared to admit what had happened and even then it was a while before the British crisis could give rise to the cultural revolution which Margaret Thatcher pushed through during her period of office from 1979 to 1990. The Thatcherite revolution not only crushed the British trade unions, it also helped market forces break through in many other sectors of the economy. The costs of this revolution were considerable for the state and society, and one must certainly warn against a blind acceptance of the British model. But it must be recognised that ten years after the British reforms, the country embarked on a period of vigorous economic growth in whose course it managed to overtake Germany again. Tony Blair is now reaping the fruits sown by Margaret Thatcher.

Among the larger countries of the EU, today only Italy is in a similar situation to Germany. The Italian economy has also grown very slowly in recent years, and the country's per-capita output is still significantly below that of Germany. However, it should not be ignored that a large part of Italy's domestic product remains invisible because it is produced in an extensive underground economy. The true circumstances in Italy are considerably better than expressed by the official statistics.

Germany has also been overtaken by a number of smaller countries, as shown in Figure 3. The development of Ireland, a country which entered the EU quite late, must be particularly highlighted. It has experienced a truly dramatic boom supported by

Figure 3



Sources: OECD, Annual National Accounts, Deutsche Bundesbank (2003); calculations by the Ifo Institute.

massive capital imports and intensive foreign trade overtaking Germany in the process. There is evidence that Ireland's high economic growth rate is the result of a restrained wages policy. Even today, Ireland's hourly wage rates in the manufacturing sector are a third lower than those in western Germany. The country continues to be a highly attractive business location for internationally mobile capital.

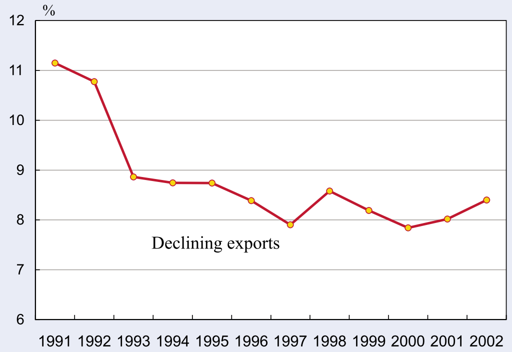
The Netherlands, too, which suffered a major slump in the late 1970s and early 1980s and consequently changed course with a new incomes policy enshrined in the Wassenaar Agreement of 1982, reaped the reward a decade later with a resurgence of growth. As a result, the country's per-capita income now exceeds that of Germany. Even Austria, which has traditionally limped behind, has now overtaken Germany in terms of per-capita income.[2]

One sometimes hears that Germany's exports have continued to do well. True enough, the German automobile industry managed to gain market share in the early 1990s thanks to a dramatic streamlining and modernisation drive. It is also true that the share of exports in Germany's aggregate demand has consistently increased over time. However, none of these factors must blind the observer to the fact that the exports of many other countries have grown much more dynamically. Figure 4 shows that Germany's export share has dropped from over 10 percent to 8 percent within just a decade.

It is unemployment which is the main problem troubling the German economy. Just three years ago, the government was still extremely optimistic that it could cut unemployment. But this optimism was not based on any facts which might have suggested a sustained turnaround in the trend, but merely on the assumption that the economic upswing then under way would continue unabated. It was a mistake to equate a cyclical development with long-term structural evolution.

Figure 4

GERMANY'S SHARE IN WORLD TRADE



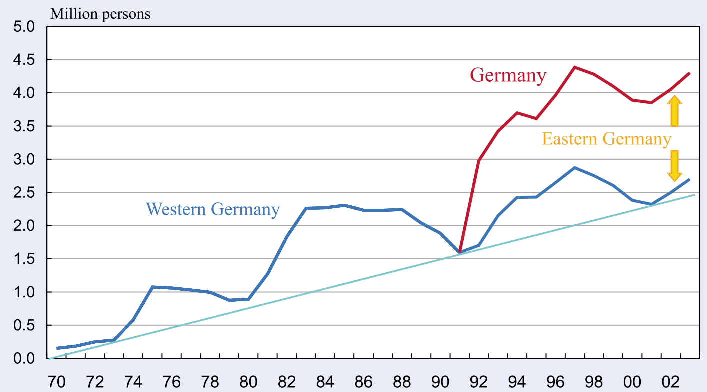
Sources: IMF, Direction of Trade Statistics, Yearbook 2002;
Export share in %, basis value in US $; calculations by the Ifo Institute.

Figure 5 shows with utmost clarity how dramatically unemployment has risen in Germany in the last three decades. The country had only 150,000 unemployed in 1970, but this figure has now exploded to over four million. Even if one leaves eastern Germany out of the picture, the rise in unemployment has been unbroken. As the diagram shows, the western German figures follow a linear rise whose end is still nowhere in sight. These figures show that Germany is suffering from fundamental economic problems which remain to be solved. Unemployment means forgoing the productive activity of human beings. A valuable resource is excluded from the production process. Aggregate output is less than what it might be.

The number of unemployed shown in Figure 5 is only the statistically measured figure. Many unemployed are not recorded at all because they fail to report being out of work or are hidden in early-retirement or retraining programs. The new Job-AQTIV law as well as the pre-retirement provisions imply that half a million people who are in reality out of work are no

Figure 5

UNEMPLOYMENT* FROM 1970 TO 2003



*From 1991 western Germany without Berlin, eastern Germany including Berlin.
Source: Federal Labour Office; 2003: Forecast of the Ifo Institute.

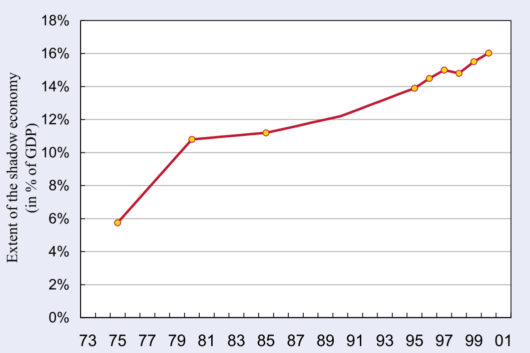
[2] The Scandinavian countries of Denmark, Sweden and Finland are also ahead of Germany. These countries are not easily comparable, as they have an extremely high employment share in the public sector compared with Germany, associated with generally high participation rates. Salaries in the public sector are financed via taxation by the value added of the private sector. They augment the national product according to the rules of national accounting without necessarily implying higher output.

longer recorded as such. To this we must add a large part of those who receive welfare benefits, now numbering 2.9 million, who are mostly not considered as being unemployed for diverse reasons at various levels of plausibility. So the real picture is far more dramatic than Figure 5 shows.

In parallel to the rise in unemployment, there has been a widespread increase in unreported employment in Germany. Figure 6 illustrates this development. Whereas in 1974 the proportion of the shadow or underground economy represented only 6 percent of the official added value, this figure has now risen to 16 percent. The shadow economy is currently the only sector still showing vigorous growth.

Figure 6

EXTENT OF THE SHADOW ECONOMY



Source: Mummert und Schneider, "The German Shadow Economy: Parted in a United Germany?", Finanzarchiv 58/3 2001, 286-316.

Is Germany in danger of succumbing to the Japanese disease?

Key characteristics of the developments in Germany resemble those which have already been observed in Japan over the last decade. Japan is mired in a permanent crisis from which it is apparently unable to extricate itself. The Japanese economy has hardly grown at all over the last ten years. According to OECD data, the country's overall real GDP grew only 6.6 percent during the seven years from 1995 to 2002, and the economy even shrank by about 1 percent in 2001 and 2002.

Japan had reached a level of development similar to Germany, and both are ageing industrialised nations. There is a danger that Japanese conditions will also spread to Germany. That is why it may be useful to take a closer look at Japan in order to note the similarities and differences and to identify dangers in good time which may then perhaps be averted.[3]

After the devaluation of the dollar following the US tax reform of 1986 and the Plaza Agreement, Japan found itself with an overvalued currency. This considerably weakened the competitiveness of its economy relative to the newly resurgent Asian Tiger states. Orders for Japanese goods declined, followed by a slump in the economy which in time merely got bogged down still further in a fundamental structural crisis as a result of purely Keynesian responses.

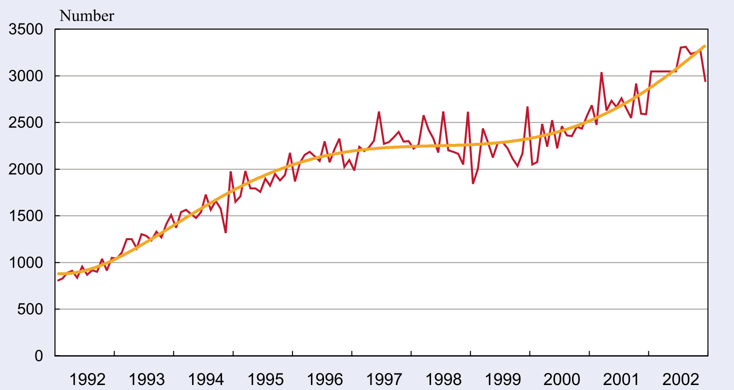
Banking crisis

The Japanese structural crisis is particularly evident in the enormous problems suffered by banks. Because of a growing number of business failures, the banks have accumulated an ever larger share of bad loans and have, year by year, slid deeper into a crisis which they are now almost incapable of resolving on their own.

This aspect of Japanese developments must give rise to concern in Germany, whose banks and life insurance companies have also entered a crisis without parallel in the post-war period. It was triggered by the growing number of business failures, which are particularly concentrated in east Germany (see Fig. 26) and have now reached a record level. As shown in Figure 7, the number of

Figure 7

BUSINESS FAILURES IN GERMANY



NB: From 1999 inclusive small businesses; from 2002 higher reporting rate due to changed insolvency law. 37,579 business insolvencies in 2002.

Source: Federal Statistical Office.

[3] See H.-W. Sinn, "The Japanese Disease", *Ifo Viewpoints* No. 26, June 2001, as well as ibid. "Der japanische Patient benötigt mehr als nur Strukturreformen", *Handelsblatt* No. 112, June 13 2001, p. 12.

business failures is currently three times as high as even a decade ago.

These insolvencies mean that the German commercial banks must undertake very high valuation adjustments for bad loans (see Fig. 8). In conjunction with the drop in share prices in the period between 2000 and 2002, these valuation adjustments oblige German banks and life insurers to restrict their new loans to the private corporate sector as well as the acquisition of privately issued bonds generating close to a general credit crunch. Similarities to the situation prevailing in Japan in the years 1990 and 1991 are all too obvious, as then, too, the Nikkei index suffered a dramatic fall similar to the recent collapse of the DAX. Figure 8 already shows considerable problems for the years 2000 and 2001. The year 2002 turns out to have been even worse in this respect.

However, the Japanese crisis had also assumed such dramatic dimensions because not only share prices but also real-estate prices had collapsed in Japan at that time. This development is unlikely in Germany if only because the culture of long-term mortgage lending and financing them by issuing mortgage backed securities implies a much greater stability of the financing cycle in this country.

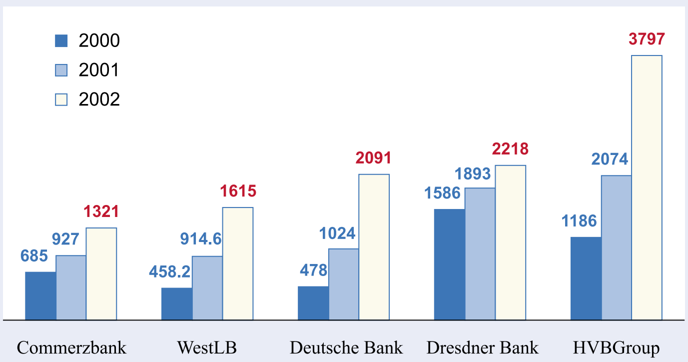
Secular stagnation

The bank crises in Japan and Germany are symptoms of a deeper malaise plaguing both countries rather than causes.

In order to identify the underlying causes, other characteristics of these crises must be highlighted.

Figure 8

RISK PROVISION OF SELECTED CREDIT INSTITUTIONS
(Million euro)



Source: Various annual reports.

In the case of Japan, this includes the following circumstances:

– the country has had a deflationary economy since 1999, in which goods prices have been falling,
– short-term interest rates have remained close to zero for several years now, and
– the national debt has been inreasing rapidly. (It rose from 60 percent to 155 percent of GDP within a decade.)

These characteristics correspond quite closely to what Keynesian economist Alvin Hansen called “secular stagnation” back in 1951.[4]

Secular stagnation is a situation of chronic underdemand for a country’s goods and services. The underdemand is revealed by saving exceeding investment. Saving withholds money that would otherwise be spent. If saving exceeds investment by the corporate sector, the sum of investment and private consumption is too small to take up overall output. Economic problems can then only be avoided if the savings surplus goes to the state or is placed abroad, so that the lack of demand is compensated by the state or foreign countries. Either the state must live beyond its means and run up debt, or foreigners must run up debt in the country by buying more goods there than they sell, resulting in a current account surplus of the country in question.

In Japan, the savings surplus is 8.3 percent of GNP. This results primarily from the exceptional circumstance that companies are net savers. As a rule, the corporate sector is a net borrower. Households’ savings flow to the companies and are converted into real investments. In Japan, the situation is reversed. Companies are not investing. Instead they supply the financial markets with net funds in the same way as the households do. Only a small part of these funds leaves the country via a current account surplus: Japanese prices are no longer attractive to foreigners, who are unwilling to buy sufficiently more than they sell there and to run up deficits in the required volume. The lion’s share of the surplus savings is therefore absorbed by the state, which thus goes more deeply into debt each year.

[4] A. H. Hansen, *Business Cycles and National Income,* Norton: New York 1951.

In 2002, Japan's budget deficit was 7.2 percent of GNP, or 4.2 percent higher than the 3 percent threshold set for Europe by the Maastricht Treaty. Only because the state lives beyond its means is it possible to stabilise overall demand and avoid the worst in the short term. But the consequence is a fast-growing national debt. This produces a high interest burden which in the long term generates a considerable financing problem for the state leading to correspondingly high taxes which paralyse the economy. Japan will not find it easy to emerge from this impasse.

One would normally expect interest rates to fall in a situation of weak demand and reduced money demand, which would then allow the problem to heal itself via higher investment. But Japan is already caught in the liquidity trap with short-term interest rates close to zero. Monetary policy has become ineffective because it could only work by reducing interest rates.

The situation is aggravated still further by the deflation of goods prices generated by the savings surplus and the associated demand deficit itself. Deflation implies a rise in the real labour costs of the companies. Strong psychological barriers preclude nominal wages from falling in order to offset this effect. A very low inflation rate already presents a problem for a nation's economy, because there are always individual companies or sectors of the economy whose worsening situation requires greater reductions in real wages than can be achieved by very low inflation. Deflation aggravates this problem to a considerable degree.

Deflation also increases the real value of business loans and thus the real interest repayments by the companies. Such increases in real rates of interest are inevitable if deflation occurs unexpectedly and real interest-rate conditions are subsequently aggravated. But even if deflation had been anticipated in the credit agreements, real interest rates will rise when the economy is caught in a liquidity trap so that nominal interest rates can no longer fall. This effect also increases business costs and aggravates the already precarious position of the companies. A rise in bankruptcies and a further reduction of investment is the consequence. Because investment is too low, the savings surplus increases still further. Deflation increases, real interest rates continue to rise and the resulting effects are reinforced.[5]

A conceivable way out of this vicious circle would be to print new money in order to buy dollars and thus devalue the yen. This would increase exports and thus stabilise overall demand, make the Japanese economy competitive again and break the deflationary spiral. Real interest rates would fall and investment would revive.

Current policies stand in the way of this solution, however. The majority groups in parliament also represent the country's savers who have built up their pension provisions with bonds secured at nominal value. Understandably, the savers have no particular objection to the current price deflation, as it does appear to make them richer by the year.

Fortunately, Germany is still pretty far from the secular stagnation which appears to have gripped Japan. Table 1 compares the key data of Germany and Japan. Germany has low growth, but its economy has not yet begun to shrink. Companies are net borrowers instead of net savers. The savings surplus is a smaller fraction of GDP than in Japan. The government's net borrowing is also significantly lower. Above all, the debt ratio, which has reached 155 percent in Japan, is stable in Germany at close to the Maastricht limit of 60 percent. Interest rates are also still very much higher than in Japan.

Characteristics of secular stagnation as described by Alvin Hansen can be discerned in Japan, but not in Germany. Nevertheless, there is one reason why one must keep these characteristics in mind. That reason is the euro. As will be shown below, the euro is causing adjustment problems for Germany and is constraining Germany's economic policy. This situation shows surprising parallels to that of Japan.

[5] When nominal interest rates are flexible, national real interest rates always tend to approach the level of those in the global capital markets. However, this trend is interrupted when the economy is caught in a liquidity trap. The national interest rate will then rather tend to drift upwards away from the global level.

Table 1

Comparison of Japan and Germany (December 2002)
in %

	Japan	Germany
Inflation 2002	– 1.4	1.4
Real GDP growth 2002	– 0.5	0.2
Companies are	net savers	net borrowers
Savings surplus/GDP 2002	8.3	5.0
Budget deficit/GDP 2002	7.2	3.8
Debt/GDP ratio 1992	60.0	43.1
Debt/GDP ratio 2002	155.0	60.9
Central Bank rate 2002	0.1	2.75

The euro: an opportunity for Europe, a risk for Germany

The euro will bring Europe many advantages. It creates price transparency in the markets, reduces transaction costs for international trade and above all creates a unified European capital market by freeing cross-border capital movements from exchange-rate risks. All this will mean progress for Europe. Nevertheless problems of transition can be expected as Europe adapts its economic structures to the euro, and these will affect Germany in particular.

Taking the dangers of deflation seriously

Among the possible transition problems that must be discussed is deflation on the Japanese pattern. Another important parallel between Germany and Japan lies in the fact that the German government has given up control of monetary policy, and in accordance with Maastricht debt rules has for all parctical purposes lost any scope for an independent fiscal policy. In Japan, the combination of high debt and the liquidity trap limits the central bank's room for manoeuvre. In Germany the voluntary submission to the EU rules has a similar implication. The German government would therefore be powerless to stem deflation if it were to come.

The entire responsibility for controlling German economic activity and avoiding the danger of deflation now lies in the hands of the European Central Bank and ist interest rate policy. For a very long time, the ECB stuck fast to a high short-term interest rate of 3.25 percent while its American counterpart had cut interest rates to 1.75 percent and then to 1.25 percent. Following the US Fed, the ECB cut its rate to 2.75 percent in early December 2002 and to 2.5 percent in early March 2003. The central bank, however, has given no indication of being willing to work proactively against deflation, which affects only a part of the euro area.

Germany has not yet experienced any deflation in the prices of consumer goods. However, the inflation rate is extremely low. The consumer price index rose only by 1.3 percent in 2002, and the prices of manufactured goods even declined by 0.5 percent against 2001. It is still too early to draw conclusions from these figures, but we must be alert. In any case, there is absolutely no truth in equating the euro with inflation, a widespread response by a dismayed German public shortly after the introduction of the euro. The dangers lie entirely elsewhere.

Deflation would be problematic for Germany, because rising real interest rates and real wages would further increase the already alarming number of business failures. Low inflation is harmless, whereas low deflation would be a catastrophe. This asymmetry is sometimes overlooked.

The Balassa-Samuelson effect

The danger of deflation exists in Germany due to the Balassa-Samuelson effect. Germany has a structurally lower inflation rate than most other countries, whose wages and prices are still in the process of catching up.[6] As Figure 9 shows, France is in a similar situation to Germany. Countries with lower wages have low prices for local services and other non-traded goods so that their average price levels are also lower. In the course of the real economic convergence to be expected in Europe over the next few decades, prices and wages in all the countries concerned will also converge. For this reason, their inflation rates cannot be the same. In the first three years of monetary union, the German inflation rate averaged about 2.3 percentage points below Ireland's and some 1.5 points below Portugal's. The gap between the French and Irish inflation rates was as high as 2.7 percentage points. These gaps will narrow at some point, but the euro countries will have to continue living with them for the foreseeable future.

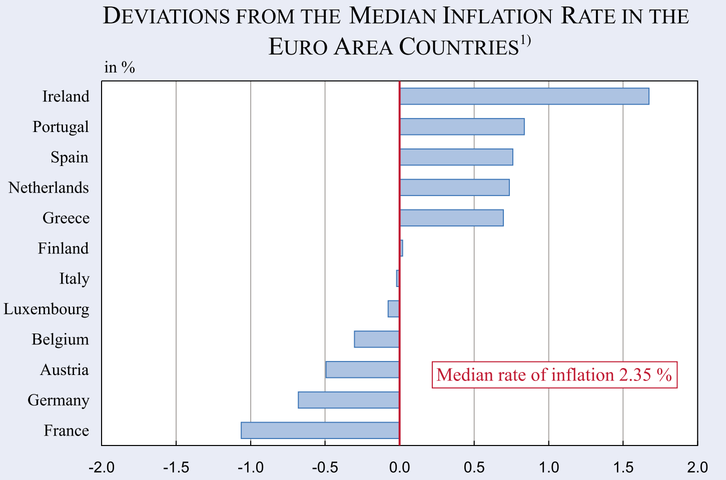
The convergence of prices and wages does not merely run in parallel with real economic convergence, it is even caused by the latter. Because the economically less advanced countries have higher growth rates of labour productivity than the more developed ones, real wages rise more quickly there, too. The rise in real wage rates is passed on to the national inflation rate via corresponding rises in the prices of local services and rents. As shown below, the unified capital market created by the euro also contributes to the acceleration of real convergence by causing interest rates to converge. To this extent, the introduction of the euro increases the differences in the inflation rates of the various countries, which are the underlying cause of the danger of deflation for Germany when the ECB targets the average inflation rate.

Problems for the policies of the European Central Bank

The structural differences in the inflation rates of the European countries mean that no monetary policy

[6] The danger of deflation for Germany was discussed by H.-W. Sinn and M. Reutter, "The Minimum Inflation Rate for Euroland", *CESifo Working Paper* 377, December 2000, and "Die Mindestinflationsrate für die Euro-Länder", *Ifo Schnelldienst* 53, 2000, No. 35-36, pp. 23–26.

Figure 9



1) Inflation rates: Average of the years 1999-2001.

Sources: IMF, calculations by CESifo.

could in principle assure price stability for all of them. Although "one size fits all" must be the slogan of the European Central Bank's governing council, structural conflicts between the various national representatives are evident. The public announcements of harmony among the members of the ECB's governing council have become part of the European reason of state, but they are not convincing.

Each member of the ECB's governing council has one vote irrespective of the size of the country which he represents. This arrangement means that the position of the French representative can already be countered by that of his Irish colleague, despite the fact that Ireland has less than a fifteenth the population of France. Under these conditions, the decisive weight in the voting is exercised by those countries lying close to the mid-position. As shown in Figure 9, in terms of inflation rates these are currently Italy and Finland. The number of countries which have a higher inflation rate than these two is just as large as the number having a lower rate. Assuming that all countries have the same inflation target, a monetary policy will be selected which suits the median countries, as there is no majority for any other policy.

From a German point of view, there is justified concern that the European Central Bank is oriented too strongly toward the interests of the smaller euro area countries like Ireland, Portugal or the Netherlands, which are trying to bring their structural inflation under control. From a German standpoint, the disproportional weight of the small countries then leads to an overly restrictive interpretation of the ECB's stability targets. Officially, the ECB has set the upper limit of the tolerated average inflation rate at only 2 percent. This is too low for Germany and France, as it pushes these countries too close to the brink of deflation. That is why some economists call for this value to be increased by at least half a percentage point.[7]

The ECB should abandon its policy of looking only at the mean inflation rate. The process of economic adjustment of the countries within the European Monetary System is still far from complete. During this adjustment process, it makes sense to exercise a considerable degree of tolerance with respect to inflation in countries such as Spain, Portugal, Greece, Ireland or the Netherlands, whose wages and prices are still catching up. If these countries have higher inflation rates than the average, this is no reason for concern, but merely a sign of a necessary adjustment of relative prices across national borders. An upward deviation from the average European inflation rate is nowhere nearly as bad as a downward deviation. As long as it is based on the Balassa-Samuelson effect and not on an overheating of the economy, it should be allowed to continue for allocative reasons. The asymmetry of the economic consequences of an upward and downward deviation prohibits keeping one's gaze fixed only on averages and pursuing ambitious stability targets. Orientation on mere averages may well make sense later on when the European countries have converged more strongly and no longer exhibit such large differences in their inflation rates as is still the case today. But Europe is still very far from having reached this stage.

This applies in particular when considering the extension of the single currency to the countries of eastern Europe which. will happen in the foreseeable future. The Balassa-Samuelson effect will then become even more significant. Germany and France would very likely be forced into deflation if the new-

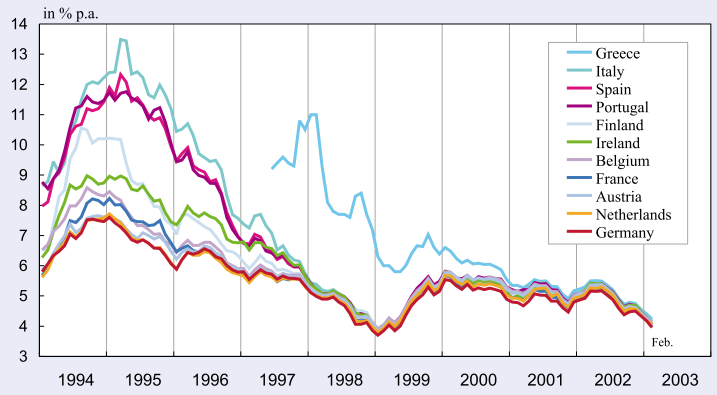
[7] See for example P. de Grauwe, "The Euro at Stake? The Monetary Union in an Enlarged Europe", CESifo Forum 3, 2002, , pp. 58-62; European Economic Advisory Group at CESifo, *Report on the European Economy 2002*, CESifo: Munich 2002, Chapter 4, as well as Sinn and Reutter op. cit.

comers were to enter EMU quickly and the ECB were to insist on stability targets oriented on average inflation.

Incidentally, the impending eastward enlargement of the EU makes it urgently necessary to change the internal decision-making structure of the ECB even before then so that the voting rights of the large countries on the ECB's governing council correspond to their economic weight. A rotation of the smaller member states or the principle of a dual simple majority are current suggestions.[8]

Figure 10

TEN-YEAR GOVERNMENT BOND YIELDS IN THE EURO AREA



Source: National Central Banks.

Interest-rate convergence

Among the real effects of introducing the euro in Europe, the creation of a single capital market and the associated convergence of interest rates is probably the most important. Figure 10 illustrates this development. Whereas long-term interest rates in Europe still differed from each other by 5 to 6 percentage points in the mid-1990s, they have now converged almost completely. The convergence already began in the run-up to monetary union and had reduced the gaps between interest rates to a few dozen basis points as early as 1998.

Before the euro was announced and introduced, a considerable degree of uncertainty prevailed regarding the exchange rates of some countries. This had led to high interest rates in the capital-poor countries because lenders had to be compensated in the form of high risk premia in the interest rates for their willingness to make funds available. The introduction of the euro and the elimination of exchange-rate uncertainty have led to the disappearance of these risk premia.

This is a great advantage for those countries which had been disadvantaged by high interest rates. They have now gained access to the more favourable financing conditions which had previously been the sole preserve of German companies. This levelling of the playing field of competition is a desirable result of European integration and a prerequisite for prosperity and growth in Europe. Scarce investment capital can now migrate, unhindered by exchange-rate barriers, to where it can earn the highest return and thus make a maximum contribution to European GDP. For this reason the euro will boost Europe's growth.

Desirable though this growth boost may be, we must be aware of the fact that with the introduction of the euro Germany has been deprived of an important competitive edge in the form of its low interest rates. The growth boom will occur in the more peripheral and hitherto disadvantaged countries, but will bypass Germany. Depending on how effectively the euro area remains separated from the rest of the world by any remaining exchange-rate uncertainty, Germany must even fear that a considerable part of the capital invested in the periphery will not migrate there from the rest of the world, but will originate from savings which would otherwise have been invested in Germany.

This case is illustrated in Figure 11 by a simple model.[9] It is based on a given European capital stock available after ten years. The abscissa shows capital invested in Germany from right to left and that in the rest of the euro area from left to right. The downward sloping curve represents the marginal productivity of capital (MPK) in the rest of the euro area and the upward sloping curve (which actually slopes down from right to left) MPK in Germany.[10] Companies in each of these areas invest up to the point where the marginal produc-

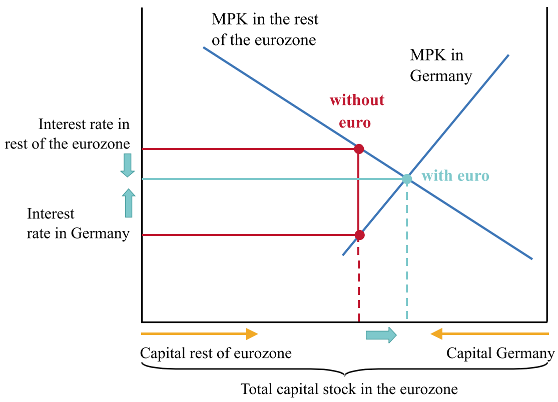
[8] H. Berger, "The ECB and Euro-Area Enlargement", *IMF Working Paper* 02/175, October 2002; P. de Grauwe, loc.cit.

[9] See also H.-W. Sinn and R. Koll, "Der Euro, die Zinsen und das europäische Wirtschaftswachstum", *Ifo Schnelldienst* 53, 2000, No. 35-36, pp. 46–47.

[10] The marginal productivity of capital corresponds to the maximum interest rate which just allows an additional real investment project to remain profitable. The marginal productivity curve declines with increasing investment because available projects are ranked by the maximum interest rates which each of them can just tolerate. The marginal productivity is defined here inclusive of the own return on the capital invested in the form of the rate of price increase of the capital goods. Cf. R. Dorfman, R.M. Solow and P.A. Samuelson, *Linear Programming and Economic Analysis*, McGraw-Hill: New York 1958.

Figure 11

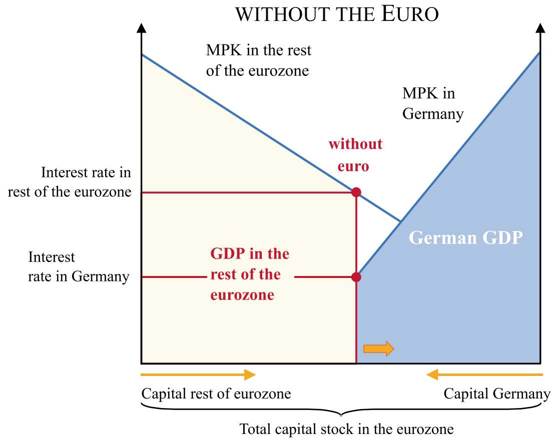
EUROPEAN CAPITAL MARKET
WITH AND WITHOUT THE EURO



* MPK: Marginal Productivity of Capital.

Figure 12

FRAGMENTED CAPITAL MARKET
WITHOUT THE EURO



* MPK: Marginal Productivity of Capital.

tivity of capital equals the interest rate. That is where earnings are maximised.

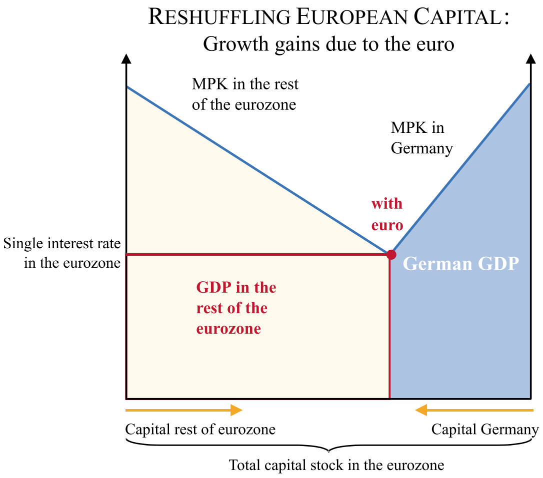
In the absence of the euro, the capital stocks of the various countries would still have been subject to different profitability requirements because of divergent interest rates. An allocation of European savings very favourable for Germany would have continued. Low interest rates would have kept considerable capital tied up in Germany. This would have benefited the factors which complement capital, in particular labour, which would also have been able to achieve high rates of remuneration. By way of contrast, the introduction of the euro leads to the formation of a single rate of interest, as is shown in Figure 11 by the blue arrows. This was shown empirically in Figure 10. The convergence of interest rates also leads to the convergence of marginal capital productivities in the various countries. More will be invested in those countries in which interest rates fall and less in Germany than would have been the case without the euro. The financial markets ensure that funds are allocated accordingly. This process of reallocating the capital stock can currently be observed on a large scale in Europe. It will be the determine the development of the euro area economy during the next decade.

It is already apparent today that Germany's large institutional investors are increasingly transferring their funds to formerly disadvantaged countries. Whereas the volume of credit is shrinking in Germany, Spain for example is experiencing rapid growth in bank loans, and markets for long-term fixed-interest loans are developing there for the first time. The stipulations of the German regulators that German life insurance companies may invest their funds only in the same currency area have acquired a completely new meaning with the introduction of the single currency. Investments in Spain, Portugal or Ireland now automatically belong to the category of permitted investments. This shift of investment capital creates obvious drawbacks for the incomes of the production factors complementary to capital in Germany. Employees, especially unskilled workers, will be among the losers of the process of European integration.

Nevertheless, one should not draw the conclusion from all this that the introduction of the euro is disadvantageous for Europe. The opposite is the case, as can be easily seen from Figures 12 and 13.

The areas under the marginal productivity curves equal the relevant values of GDP. In the absence of the euro, European interest rates would remain different: the yellow and blue areas show schematically how large GDP would be in Germany and the rest of Europe with this distribution of the capital stock. With the introduction of the euro, in contrast, a part of the capital which would otherwise have been invested in Germany is shifted to the other European countries. This increases GDP there and reduces it in Germany – always compared with the level of GDP otherwise attained in a decade. As can be seen in Figure 13, the yellow area becomes larger and the blue one smaller. As GDP growth in the other euro area countries exceeds the decline in Germany, on bal-

Figure 13



* MPK: Marginal Productivity of Capital.

ance there is a net growth boost for Europe as a whole.[11,12]

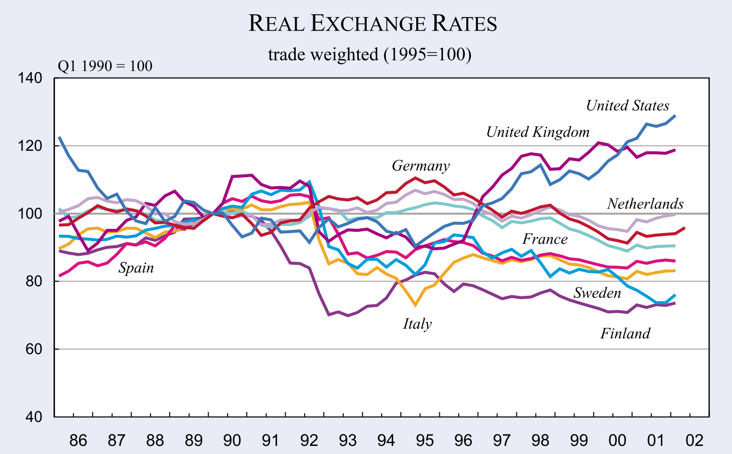
The effects illustrated in this way will be of considerable quantitative importance for Europe and will boost its growth for many years. Economic convergence will be promoted by the introduction of the euro, and growth will accelerate in a sustained way. The euro will contribute to creating the flourishing Europe envisaged by the founding fathers of the European Union. The only blemish in this picture is that Germany will share in this flourishing Europe only to a very limited degree, if at all.

Did Germany join the euro with an overvalued currency?

As already mentioned, Japan's problems were triggered by the devaluation of the US dollar in the wake of the tax reform of 1986 and the Plaza Agreement. No less a personage than Milton Friedman has recently espoused the thesis that Germany suffers from a similar overvaluation of its currency.[13] In his view the exchange rate of the euro is too high for Germany, which is the main reason for the country's economic woes. This problem can be linked to reunification. Germany needed the currency revaluation of 1992, as it was the only way of creating a current account deficit which permitted the import of the resources needed to supply the needs of the country's new citizens.[14] However, the revaluation should only have been temporary. In the longer term, after domestic production had recovered and the situation had normalised, the value of the deutschmark should have been adjusted downwards, but this step was forestalled by the introduction of the euro. Because the latter was too hasty, an inappropriate exchange rate was permanently fixed. Today Germany suffers from excessively high prices and wages and is consequently losing its competitiveness.

Figure 14 shows that this view is not unjustified. In fact, the decline of the trade-weighted real exchange rate of countries like Finland, Sweden or Italy, which occurred in the wake of the EMS collapse in 1992, has not been corrected. Within the euro area, German

Figure 14



1) The curves show the development of the real exchange rates of these countries weighted by their share of trade. The first quarter of 1990 is set at 100. Consumer price indexes were used to eliminate the effects of price inflation.
Source: IMF, calculations by CESifo.

[11] The analysis assumes that German interest rates will rise in the medium term because flexible exchange rates between the euro and the rest of the world effectively isolate the capital markets and Europe's capital stock remains unaffected by the euro. To the degree that the German interest rate is kept constant via an interest-rate link with the world outside of Europe instead, the introduction of the euro is followed by inward migration of capital from the rest of the world. In the extreme case of a constant interest rate, this migration means that the left vertical line shifts to the left together with the marginal productivity curve of the other euro area countries until the intersection of this curve with the marginal productivity curve for Germany reaches the previous German interest-rate level. The rise in European GDP is then even greater and German GDP does not fall. The introduction of the euro results in a relative but not absolute disadvantage for German competitiveness. The reality lies between the extreme of a constant interest rate and the other extreme of a given capital stock for the euro area countries.

[12] It should be stressed in this context that the capital shifts reduce only German GDP, not GNP. The capital which Germans now invest abroad yields income which is also part of German GNP. However, the factors complementary to capital, in particular labour, do not benefit from this income.

[13] See M. Friedman, "Deutschland braucht eine Dosis Deflation", Interview, *Süddeutsche Zeitung*, November 27, 2002, No. 274, p. 25.

[14] See also H.-W.Sinn, "International Implications of German Unification", in: A. Razin and E. Sadka (editors), *The Economics of Globalization*, Cambridge University Press: Cambridge 1999, pp. 33–58.

goods are more expensive today compared with those of other countries than in the period before 1992. This has worsened Germany's competitive position.

It should not be overlooked, however, that Germany's competitive position relative to the Netherlands and especially France, Germany's most important trade partner, has hardly changed at all. In fact, Germany has been able to gain price advantages vis-à-vis other countries, especially the United States and United Kingdom, whose currencies have greatly appreciated since then. No particular effect can consequently be discerned with respect to Germany's trade partners as a whole, as the figure shows. The effective real exchange rate is still lower than in 1990 even in the second quarter of 2002, i.e. after the appreciation of the euro in the first half of the year.

It is true, nevertheless, that the overvaluation thesis may gain credibility if the euro continues to strengthen. In view of the euro's growing popularity as a currency for international transactions and the extremely high American current account deficit of about 4 percent of GDP, this development can even be expected. The consequence could well be deflationary problems of the kind currently plaguing the Japanese economy.

Quite apart from that, overvaluation definitely applies to Germany's wage levels. The analysis will now turn to this topic.

The home-grown reasons for weak growth

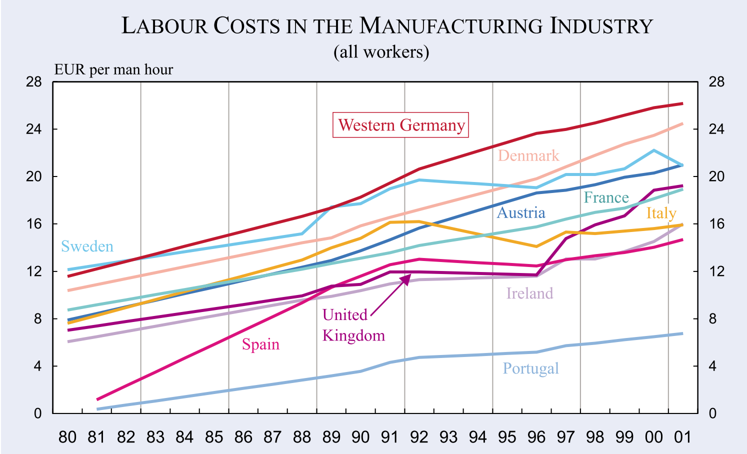
Germany can no longer influence the exchange rate of its currency directly, and it would be pointless to mourn the competitive advantage which the deutschmark had given German companies in the capital markets. The beneficial effects of the creation of a unified European capital market cannot be questioned by a good European even if Germany is unable to profit from it. So it is important to clarify the home-grown reasons for Germany's weak growth which are still amenable to influence. These circumstances may perhaps have been tolerable before the introduction of the euro, European integration, the eastward enlargement of the EU and globalisation gave a much keener edge to the winds of competition. The circumstances have changed.

The problem of high wages

Wage levels are usually among the main reasons for a country's poor growth performance. A particular business location will grow only if it promises profits to investors, and profits are created only if production costs are sufficiently low. The most important costs are labour costs. They account for the lion's share of the location-dependent costs of a country's business sector. The costs of intermediate products that appear to be important from a business perspective are also to a large extent determined by domestic labour costs and to the extent they are not they reflect the cost of capital and the cost of imports that are roughly the same for all competing countries.

German labour costs are at the top in an international comparison. Figure 15 shows the development of hourly wage rates for workers in the manufacturing sector in Germany and its main neighbouring countries, all calculated at the prevailing exchange rates. The labour cost curve for western Germany lies at the upper end of the range of all the curves. Hourly rates of pay in the manufacturing sector are higher in Germany than anywhere else in the world, including all those countries not shown in the graph. Even Switzerland does not have higher hourly wage rates than

Figure 15



Source: Institut der deutschen Wirtschaft.

Germany. The high incomes enjoyed by workers there are largely earned by working long hours.

Important competitors such as France or Great Britain have labour costs which are about a quarter below German levels, although these countries have now caught up with or overtaken Germany in terms of GDP per capita (see Fig. 2) and do not have undervalued currencies in comparison to Germany (see Fig. 14). Other competitors such as Sweden and Italy have been able to achieve considerable labour-cost advantages by devaluing their currencies in 1992 and 1993. This is the effect which Milton Friedman had referred to.

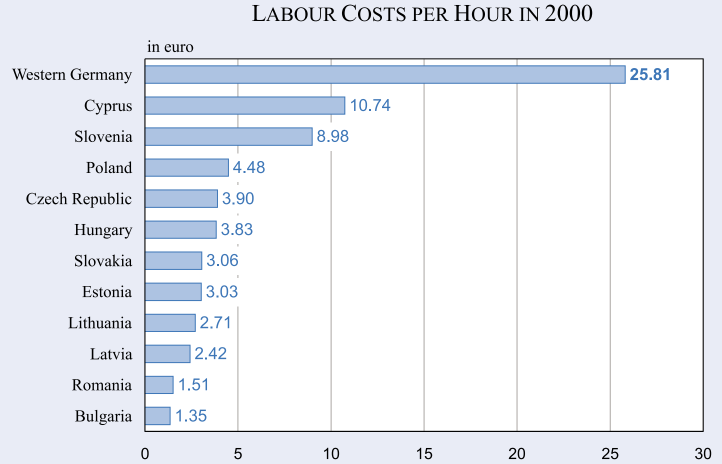
It is particularly remarkable that Ireland, which has already overtaken Germany in terms of GDP per capita, still has labour costs which are nearly 40 percent lower. This is likely to be the main explanation of the Irish economic miracle. Eastern Germany, in particular, can learn from the Irish example regarding the origin of its growth problems.

A country can successfully compete for investment despite high labour costs if these higher costs are exactly balanced by higher productivity. If the productivity of the companies at a German location exceeds that at foreign locations by precisely the same amount as German wages exceed foreign ones, then the high level of German labour costs can be defended and there is no cause for concern. It is doubtful, however, that this condition still holds.[15] High unemployment sends out an unambiguous message: the unemployed are not competitive because they are too expensive relative to their productivity.

This does not mean that Germany no longer has any productivity edge over its competitors. The close interdependence of German industry, the country's good infrastructure, the language and an effficient legal system can explain and justify certain differences in productivity and wage levels. But its competitors are catching up and it is becoming increasingly difficult for Germany to defend its old wage differential. When west German companies establish themselves elsewhere, they bring their know-how along with them and can often operate at their new location with the same productivity they achieve in Germany. The migration of companies from Germany is the oft-bemoaned consequence.

Germany could justify its high wages at a time when it was able to enjoy the benefits of its large domestic market. Thirty, even twenty years ago, Germany was an incomparably better location for industrial mass production than Belgium, the Netherlands or Ireland, because these countries did not have the market size which allowed productivity gains to be achieved by means of large-scale industrial production. With the creation of a single European market, however, this edge is long gone. Every location within the EU today can benefit from a large domestic market, and the small countries benefit particularly from this situation. One of the main reasons for Germany's productivity edge has gone, but unions and management do not seem to have noticed. The location problems of Germany due to high wages will get worse when the European Union is enlarged by another ten countries in 2004. As shown in Figure 16, most of these countries have extremely low labour costs of not even a sixth of the west German level. Apart from that, they have a well-trained pool of skilled workers and are located in Germany's immediate neighbourhood. One does not need to be an economist to recognise that Germany's inability to attract investment will grow into an extremely

Figure 16



Sources: Eurostat, Western Germany: Institut der deutschen Wirtschaft.

[15] In the development of unit labour costs (hourly pay rates divided by labour productivity) Germany also has moved quite significantly above the European average. However, unit labour costs should only be seen as a useful indicator of competitiveness if the labour productivity used to calculate them is adjusted by the change in productivity due to lay-offs. This is that part of the rise in labour productivity which can be explained by the fact that wage increases destroy less productive jobs and force companies to replace human labour by machines. Comparisons of unit labour costs tend to abound in analytical arbitrariness.

troublesome structural crisis of the entire German economy if no immediate and far-reaching measures are taken to build greater flexibility into the German labour market. A large part of the poor investment performance already observed in Germany is probably due to the fact that companies do not expect such a move towards greater flexibility and thus draw the consequences at an early stage.

If Germany wants to compete successfully with the accession countries of eastern Europe, the country's wages need not drop to a sixth of their present level. But they will have to decline to some extent, especially in the area of unskilled and semi-skilled work, and no-one knows exactly by how much. Only if the process of wage-determination is made more flexible can the labour market find the right balance here.

If the labour market does not become more flexible, we can expect three kinds of reactions. All of them would have more unpleasant consequences for German employees than more flexible wages.

Firstly, foreign workers will enter the country and edge German workers into unemployment. Bavaria is already experiencing this effect as a result of intra-German migration. The Bavarian unemployment rate, still the next lowest after that of Baden-Württemberg among all western German states, has recently risen rather sharply. This rise is almost entirely due to migration. The flow of migrants from the eastern German states, above all Thuringia and Saxony, is particularly large. A similar picture will be repeated throughout the Federal Republic when migration from the Eastern European accession countries begins.

Secondly, shifts of manufacturing facilities by German companies to the new EU member countries in the East will increase, in order to take advantage of lower labour costs there. Germany's mid-size companies have already established themselves in Eastern Europe and their investment projects are waiting only for the starting shot of the EU's eastward enlargement. The capital which is invested in the East is lost to the Federal Republic.

Thirdly, the East European countries will also focus their own energies on the production of labour-intensive goods in order to exploit their lower labour costs to their competitive advantage. High-tech companies in Germany need not fear this development, but the country's labour-intensive enterprises will come under particularly high pressure and unemployment will rise for these reasons, too.

None of this would happen, or at least not to the same degree, if wages in Germany were to decline. In that case unemployment would not rise, and business locations would remain attractive to mobile international capital. Although declines in real wages would not spare German employees the negative implications of this redistribution, we would not see the chaotic and crisis-like developments which threaten as the result of widespread unemployment.

In the long term, Germany can exploit its geographic position to create new growth and a flourishing economy. The advantages of such a development will then also become apparent to the labour force at large. The prerequisite for this scenario is an energetic turnaround in wage policy.

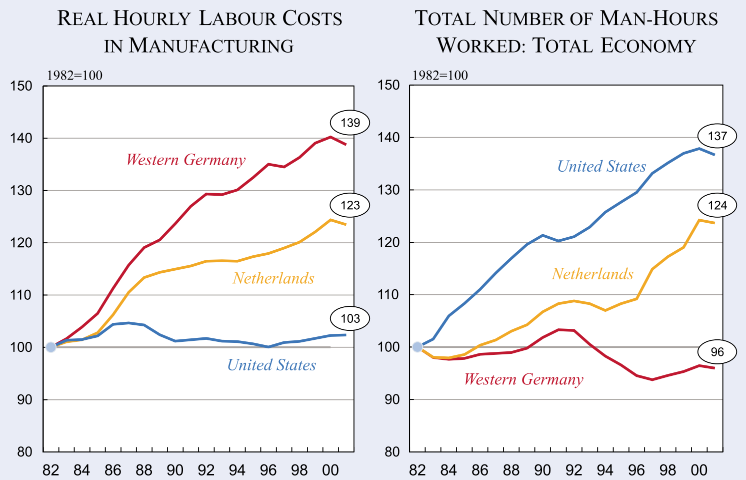
It is sometimes argued that higher rather than lower wages are needed in order to revive the economy and thus create jobs. This is the purchasing-power argument. The higher the wages, it asserts, the greater the demand of private households and the higher the demand for products of the business sector. More can be manufactured and thus more jobs are created by the firms.

The chain of argument enjoys a certain popularity in naïve discussions. But it is wrong and misleading because it neglects the fact that higher wages mean reduced profit expectations of the business sector and thus a reduced demand for capital goods. In most cases, this response over-compensates the positive effect of higher wages on private consumption.

The chain of argument is also misleading because it creates the impression that unemployment depends on demand effects in the long term as well. In reality, the long-term development of a nation's economy is determined only by an increase in the supply of goods, which essentially depends on investment. The reduction of investment because of higher wages means that fewer jobs are created and production capacity is expanded less quickly. Unemployment and reduced economic growth are the consequences.

Figure 17 illustrates this relationship by comparing long-term economic developments in Germany, the Netherlands and the United States. 1982 was selected as the reference year, as that was the year when the Wassenaar Agreement was concluded

Figure 17



Sources: German Council of Economic Advisors, OECD, Institut der deutschen Wirtschaft; calculations by the Ifo Institute.

between the collective-bargaining partners and the Dutch government introducing a policy of long-term wage restraint.

Within a period of almost twenty years (the last reporting year in the diagram is 2001), real labour costs in the Dutch manufacturing industry rose by about 23 percent, whereas the German rise was almost 40 percent and US costs had remained practically constant. The growth of labour volume (measured by the number of total hours worked) followed an exactly inverse pattern. Whereas the labour volume rose by about 37 percent in the United States and by 26 percent in the Netherlands, western Germany suffered a contraction of 3 percent. This also confirms the rule of thumb confirmed by econometric studies that a 1 percent reduction in wages relative to another country means at least a 1 percent increase in employment over the long term.

As regards the impact on employment, it is less important whether the results of a particular year's wage negotiations exceed or fall below the usual target, defined by the sum of productivity and price increases, by one percentage point. Such small changes are insignificant. But if the target is exceeded by a percentage point every year for twenty years, then a problem arises, as can be seen in the diagram. As slowly as the problem grew to its present dimension, as great will be the difficulties to resolve it by wage restraint. In view of the new competitive conditions, however, there really is no alternative.

Only a course of modest restraint in future wage negotiations resulting at least in lower increases but perhaps even in a reduction of real wages, can prevent the shift of business locations and capital flight. Such a course can only be implemented by changing the institutional environment of the labour market, and it would certainly be facilitated by the willingness of the European Central Bank to interpret its inflation target in a somewhat broader way than hitherto. This has already been discussed and the relevant action urged. In contrast, a monetary policy which exposes Germany to the constant danger of deflation would impair the healing of the German disease.[16]

A high tax burden

It is a well-known fact that one reason for Germany's high labour costs is the high tax burden levied on labour. The tax burden on capital has been sharply reduced by the tax reform of 2000, but the tax burden on labour continues to be high. Although the planned reduction of income tax rates, as enacted in 2001, would have eased the burden somewhat, it was deferred because of the flood damage in east Germany.

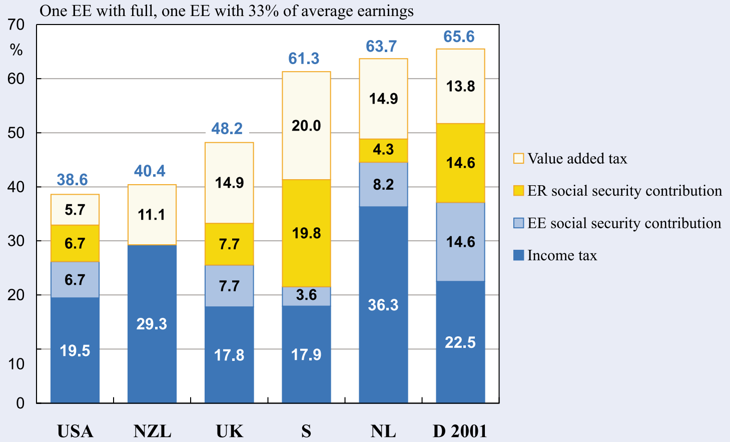
The marginal value added produced by the average German employee must bear a marginal tax rate of almost 66 percent. Two thirds of whatever he produces by additional effort goes to the state. If the extra effort of a skilled worker creates €1,000 of additional output which his employer can realise by selling it, and if the employer makes no further deductions for other purposes, then employer and employee together must pay €656 to the state and just €334 are left in the employee's pocket. No wonder that unreported work is gaining ground and do-it-yourself markets are booming. When customer and tradesman get together they save €656, and if the customer does the work himself, he can take three times as long as the tradesman before the job becomes uneconomical for him.

[16] The policy of wage restraint can be interpreted as a real devaluation of the German currency, as Friedman urges. The analogy to devaluation is, however, imperfect to the extent that a true currency devaluation may not reduce real wages in units of domestic production at all. A devaluation has no effect on the labour market if goods prices are determined abroad via the international interrelationship of prices and the unions defend real wage targets. Employment can only rise if real wages are reduced. This aim can only be reached if the institutional environment of the labour market and the welfare state is changed and will be difficult without the aid of an accommodating monetary policy.

Figure 18

MARGINAL TAX BURDEN ON LABOUR (IN PERCENT OF VALUE ADDED)

Family with two wage-earners and two children:
One EE with full, one EE with 33% of average earnings



Sources: Calculations by the Ifo Institute.

Germany has probably the highest marginal tax rate of all the OECD countries. Even welfare states such as Sweden and the Netherlands impose a smaller tax burden on labour. Figure 18 compares the German situation with conditions in the United States, New Zealand, the United Kingdom, Sweden and the Netherlands, i.e. with countries with liberal economic systems and those known to be welfare states.

The marginal taxation imposed on the value added is in all cases calculated in the same way. It consists of the income taxes payable by the employee, the employee's and employer's social insurance contributions and the value added tax or equivalent taxes like the US retail sales tax. Such indirect taxes must be included because they are levied on the employer and are a charge against the value added generated by the additional input of labour. Just like direct taxes, they drive people into unreported work or to the do-it-yourself markets.

The German public sector share in gross domestic product (GDP) has risen in parallel to the high tax burden. This ratio measures the proportion of total government expenditure in GDP. Figure 19 shows that it still stood at 39 percent in 1970 and then rose to almost 50 percent at the time when the coalition of social democrats and liberals was in power. In 2001 it was a little above 48 percent. Considering that GDP contains the depreciation of a country's capital stock, this figure already corresponds to a public sector share of over 50 percent in distributable net national product.

The new decisions taken by the recently re-elected government coalition have increased taxes in many points and aim to increase government revenues still further. Although a certain reluctance can currently be expected due to the Maastricht limit, it is to be feared that in the medium term this will also increase the government share in GDP.

The education problem: false priorities

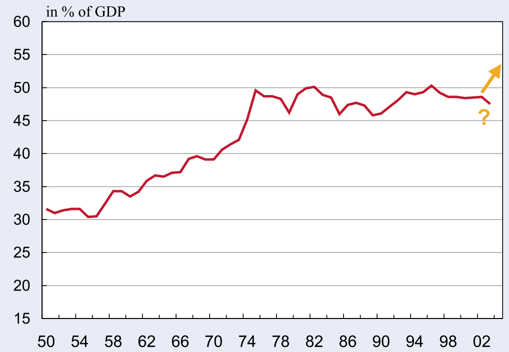
A well-known explanation for the problems of the German economy is neglect of education. If education is poor, labour productivity will also be low, and low labour productivity associated with ambitious wage targets leads to unemployment. In addition, neglect of the educational system slows down technological progress, which has immediate consequences for economic growth. Germans must upgrade their performance if they are to be justified in being as expensive as they are.

The urgency of this problem was clearly revealed by the PISA study run by the OECD. Germany spends far too little on education and thus performed poorly throughout all categories in the international comparative tests. Figure 20 shows how little Germany spends on education. Germany even lies below the OECD average, with a share of government spending on education of only 4.3 percent of GDP. In terms of public education expenditure, Germany even lags behind the United States, whose educational system is organised to a much larger extent on a private basis.

The overly low spending has obvious implications for the quality of German scholastic performance.

Figure 19

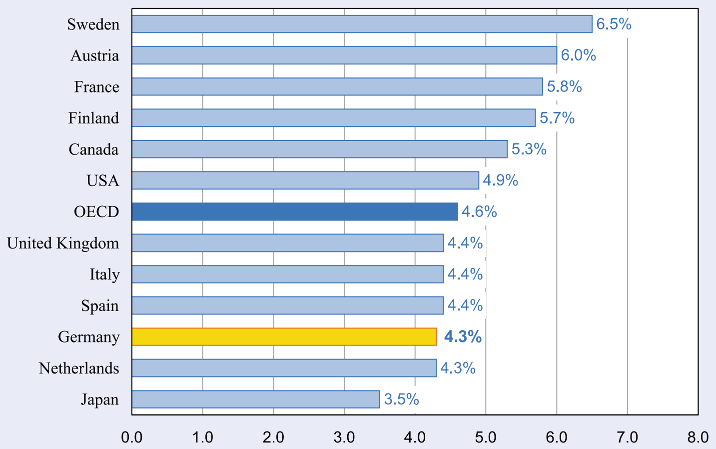
PUBLIC SECTOR SHARE (1950 - 2003)



Source: Federal Statistical Office; 2003: Federal Ministry of Finance (2002), Finance Report 2003.

Figure 20

SHARE OF PUBLIC SPENDING AS % OF GDP IN 1999



Source: OECD (2000); Education at a Glance, Tab. B2. 1a.

Figure 21 shows the result of a performance comparison in mathematics, a subject whose results are least distorted by cultural differences and language barriers. As can be seen, the nation of poets and thinkers has slid to one of the bottom positions, not only in terms of education spending but also regarding the level of educational performance achieved with this funding, which is significantly below the average of all the OECD countries.

The poor scholastic performance is probably affected by the insufficient integration of immigrants. For nowhere else was the gap in performance between the best and worst students as large as in Germany. The great problem lies in the non-selective nature of some secondary schools at which most of the children of immigrants are educated. If Germany does not succeed in integrating the children of immigrants into its high-performance society by assuring them a good education, it creates an encumbrance for the future and a social problem of the first order.

Important though the improvement of education is, one should not overlook the fact that it will take many years before it makes a noticeable impact on the labour market. Indeed, it will take decades before quantitatively significant effects will emerge from which faster economic growth for Germany can be expected.

Nevertheless, Germany must reconsider its public spending priorities. Does it really make sense to spend no more than 4.3 percent of GDP on investment in the country's human capital, while 27.3 percent flows into social expenditures? And does Germany really want to be positioned way below the OECD average in terms of its share of education spending in GDP, while at the same time being at the very top in terms of the share of social spending (Fig. 22)?

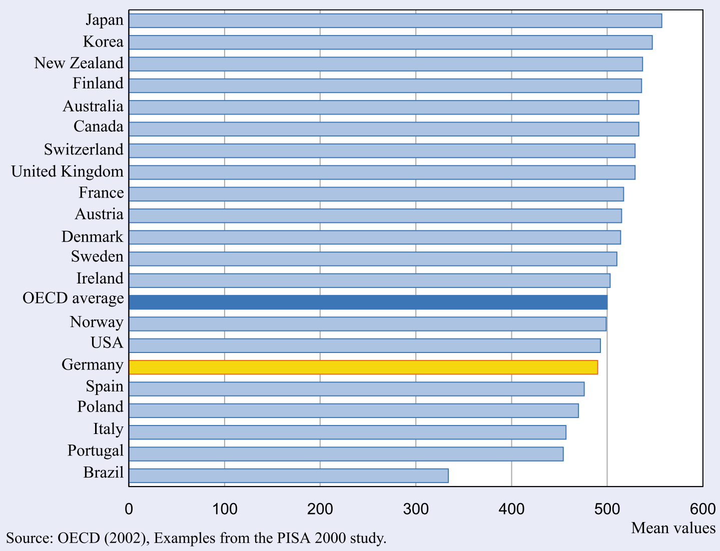
The demographic problem

To neglect education means to invest too little in human capital. To invest too little in human capital may also mean having too few children. And this, too, is a German problem.

Germany is particularly affected by the demographic problem which is giving all industrialised countries a headache. Life expectancy is rising and the number of births declining. The dramatic nature of the situation is evident from Figure 23, which compares the age pyramid at the time of Bismarck with the pyramid in 1999, which no longer deserves its name. Instead of a pyramid one would have to speak about a bush-like figure which bears a distant resem-

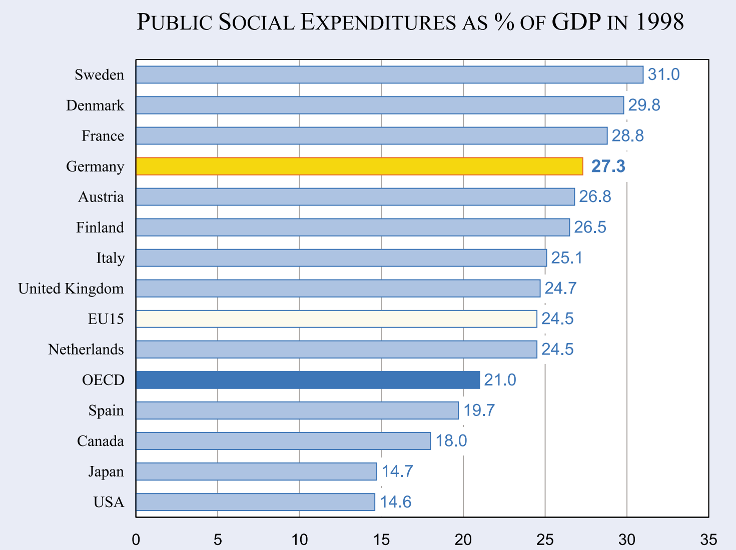
Figure 21

EDUCATION ACHIEVEMENT IN AN INTERNATIONAL COMPARISON: MATHEMATICS



Source: OECD (2002), Examples from the PISA 2000 study.

Figure 22



Source: OECD (2002), 1980- 1998: 20 years of social expenditures - The OECD Database, p. 6.

blance to a Christmas tree. The thick branches of the tree extend outwards at the cohorts approaching forty. These are the most heavily populated age groups. In 30 years, they will have reached retirement age, and it will then be difficult to meet their pension claims. The cohorts which follow are extremely small. The size of the cohorts between 20 and 30 years of age is around 40 percent below that of the cohort approaching forty.

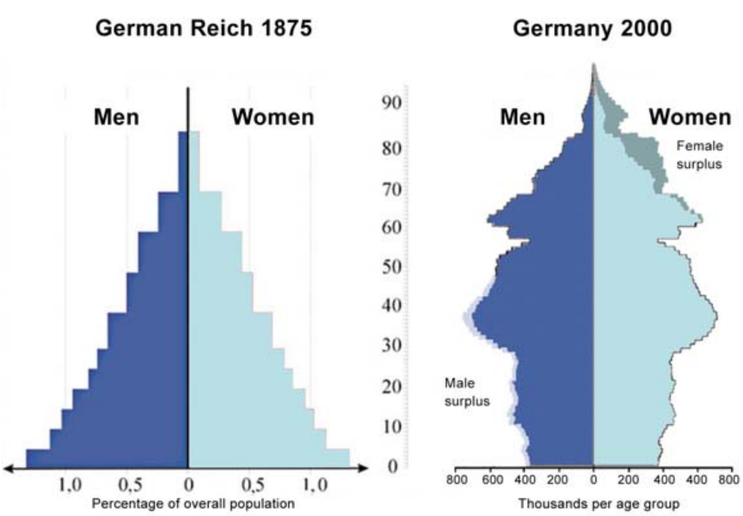
In 30 years' time, the ratio of old to young will have at least doubled, irrespective of where one decides to draw the age limit. The contribution rate for pension insurance would have to increase from 20 percent to 40 percent if pensions were kept constant in relation to gross incomes in accordance with the pension formula that was applicable until 1992. And vice-versa, pensions would have to be cut by half if the contribution rate were to be kept at its present level of around 20 percent. The government will have to pick a point within this range. But whatever is done, a major crisis of the pension insurance system cannot be avoided if it continues to be based solely on contributions by the young to support the old.

In recent years politics appears to have focused on asymmetrical pension reductions under the slogan of "a basic pension", which means that those who have paid above-average contributions will be particularly hit by pension cuts. The drawback of such a reform is that it abandons Germany's system of individual accounts and introduces a new redistribution element. The high pension contribution rates were hitherto at least partially accepted by the employees, because they knew that they would result in higher pension claims. The incentive of changing from regular to unreported work was countered by the wish to secure pensions. All this would be jeopardised with the changeover to a system of basic pensions, because the contributions would then represent pure taxes with no equivalent benefits in return. Reference to Switzerland, which has such a system of basic pensions, is not a good justification either, because Switzerland also has very low taxes. What low-tax Switzerland can afford could easily become a fiasco in Germany.

The fact that Sweden has recently abandoned its basic pensions system and has undertaken a major program of pension reform, introducing German-style contributions equivalence as well as a partial funding, should be further food for

Figure 23

Age pyramid at the time of Bismarck (1875) and 2000



Source: Federal Statistical Office (2002), Statistical Yearbook 1997, Kaiserliches Statistisches Amt, Statistisches Jahrbuch für das Deutsche Reich 1878.

thought. It would be ridiculous for Germany to swap places with Sweden and do precisely the opposite of what Sweden considers to be the right course of action to deal with its demographic crisis. It is far better to continue on the correct path of funded private pensions that Germany has taken with the Riester reform and to make the necessary pension reductions in the pay-as-you-go system in accordance with the underlying causes.

In more definite terms, the necessary pension reductions should be made inverse to the number of the contributor's children, and as compensation the reductions should be cushioned by partial funding along the Riester model. Only those who raise children truly make a contribution to assuring the size of their pensions. Those who do not raise children can save the money which parents spend on bringing up their children and can invest it in the financial markets in order to offset the pension cuts in the pay-as-you-go system. Although such a reform must not affect already built-up pension claims, the new pension claims created by additional contributions can be graduated inversely to the number of the contributor's children. If the new pension formula is announced early on, young people would be free to make a choice between children and a supplementary private pension. The constitutional court has shown itself to be open to such a reform and has rejected the opinion that it represents a differentiation of pensions which is alien to the system.[17]

The growing financial burdens on the welfare state to be expected in view of the unsolved pension problems already make Germany an increasingly unattractive location for investors. Investors who wish to settle or stay in Germany would have to fear that the returns on capital will one day be called upon to help finance the country's welfare programs. The call for widening the basis for assessment of the pension insurance system to the entire value added, is heard all too well by entrepreneurs and investors. It contributes to a climate of redistribution which is hostile to investment and encourages investors to look elsewhere.

The ageing of the German population will mean a decline in the country's economic dynamism. Young entrepreneurs who dare to follow new paths will be in as short supply as young engineers and workers who are willing to roll up their sleeves and do what needs to be done. In only 15 years, today's 40-year olds will be 55 and will be far more interested in their pensions than in entrepreneurial activity. All this is already becoming apparent in Germany's weak economic growth and loss of attraction as a business location.

The failures in economic reunification

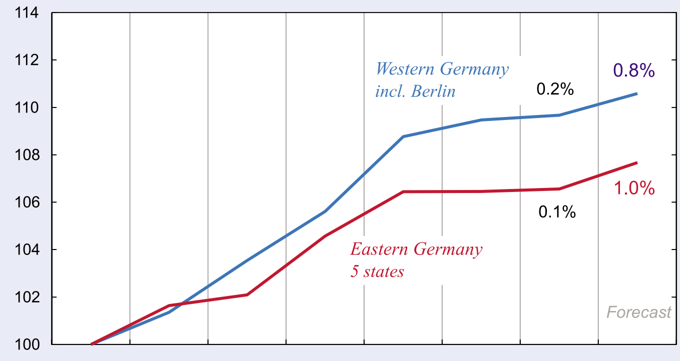
In examining the reasons for Germany's weak growth, the problem of German reunification cannot be ignored, for the liabilities of this reunification in the form of high taxes and national debt exceed anything that was feared at the time. Oskar Lafontaine, the former finance minister, was ostracised for suggesting that the resulting fiscal burdens could be in the region of 150 billion deutschmarks in the long run. In reality, they are now in the order of 1,000 billion euros, more than twelve times this sum.

The leading politicians of the time had hoped that a self-sustaining upswing would begin in just a few years. Their hopes were illusory. To be sure, a temporary boom did occur until 1996, kindled by the regional development law. This law was effective because it subsidised capital costs in eastern Germany to more than 100 percent.[18] But as soon as this law expired, the boom ended abruptly. Figure 24

Figure 24

ECONOMIC GROWTH[1)] IN WESTERN AND EASTERN GERMANY

Real GDP in prices of 1995; 1996 = 100



1) 2003: Forecast by the Ifo Institute (March 2003).

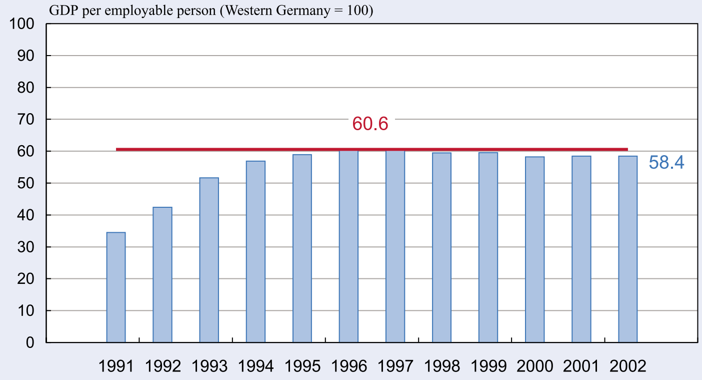
Source: Arbeitskreis Volkswirtschaftliche Gesamtrechnung der Länder (Jan. 2003).

[17] See for example the ruling of the Federal Constitutional Court of April 3, 2001 (1BVR 1629/94) on reducing the contributions to social care insurance for parents as distinct from employees without children.

[18] H.-W. Sinn, "Schlingerkurs: Lohnpolitik und Investitionsförderung in den neuen Bundesländern", in: G. Gutmann (editor), *Die Wettbewerbsfähigkeit der ostdeutschen Wirtschaft*, Annual Meeting of the Verein für Socialpolitik, Jena 1994, Duncker & Humblot: Berlin 1995, p. 23–60. See also H.-W. Sinn, "Staggering along. Wages Policy and Investment Support in East Germany," *The Economics of Transition* 3, 1995, pp. 403–426.

Figure 25

EAST-WEST RATIO OF AGGREGATE PRODUCTIVITY: STABILISING BELOW 60 PERCENT



Source: Federal Statistical Office, calculations by the Ifo Institute.

shows that economic growth in eastern Germany has been lower than in western Germany since 1997. Rather than narrowing, the gap in economic growth between eastern and western Germany has widened: there is no sign of the "flourishing landscapes" which were to have come in "three, four, or five years", or of "self-sustaining growth", to cite Chancellor Kohl.

As shown in Figure 25, GDP per employable person in eastern Germany was 60.6 percent of the corresponding western level in 1996. This value has now dropped to 58.4 percent. Although passable industrial growth has now been achieved, it started from the very low level reached after the collapse of the east German enterprises. It will take a very long time before the positive impulses emanating from this development offset the decline elsewhere. Even the much-vaunted IT and high-tech clusters in Dresden, Sömmerda and other locations currently do not even employ 2 percent of eastern Germany's labour force. The high-income high-tech ideology trumpeted by leading politicians in the east has fed illusions which blocked the view to an obvious fact: an economy can only grow and recover on the basis of broad-based activity across all sectors, and especially the ordinary and unspectacular activities pursued beyond the high-tech world described in the glossy brochures.

The main reason for the plight of the east lies again in labour costs. Wages in eastern Germany are between 65 and 75 percent of western levels while the region's aggregate productivity fails to reach even 60 percent. These figures do not match. High wages are incontestably the main reason for east Germany's lack of competitiveness and for its comparatively low growth.

In this context it is instructive to take a look at Ireland. As was shown in Figure 15, in 2001 Irish hourly rates of pay were some 60 percent of west German ones, even below the east German level. Despite this, Irish GNP per capita already exceeds the German average significantly, as was shown in Figure 3. This illustrates quite clearly how wrong the armies of lay preachers are who believe that high wages promote growth. Convergence and productivity adjustment can only take place if wages follow economic performance, and not if they precede it, as happened in east Germany after reunification. Only if wages follow economic performance can companies expect to earn the profits which induce them to make the investments indispensable to economic growth.

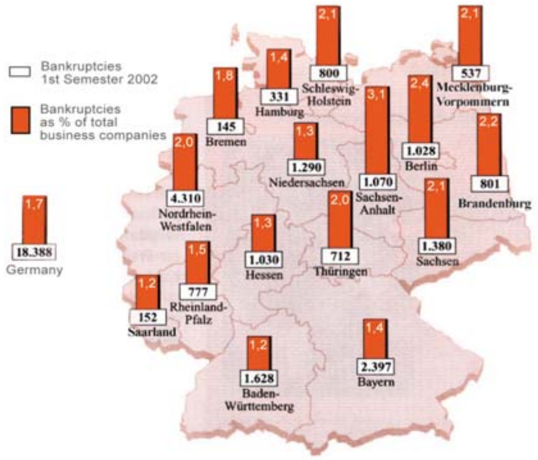
Preceding wage increases resulted from the fact that, long before privatisation, west German competitors had stipulated in long-term bargaining agreements concluded in 1991 how much the east German companies should pay their employees. From the outset, they wanted to prevent potential foreign investors from acquring east German companies in order to operate them with labour costs only a third of west German levels and subsequently overrun west German markets. They therefore thought it necessary to bring eastern wages up to western levels as quickly as possible. It is obvious that this strategy has worked only too well.

The shambles of this policy can be seen today. In the current economic downturn, east Germany accounted for an over-proportionate number of bankruptcies (see Figs. 7 and 26). The current crisis of the German banking system has been caused largely by loans to east German companies which are now non-performing.

As a result of the effective halt of investment caused by the high wage settlements, unemployment rates in some east German regions have reached 20 percent and more, and the number of employees paying social contributions is declining constantly. Figure 27 shows the recent acceleration in the decline observed since 1994. Employment in eastern Germany (as measured by social security statistics) has been falling by almost 2 percent annually.

There has been no social unrest and the situation remains politically under control because incomes in

Figure 26
Bankruptcies in Germany
First Half year 2002 by federal state



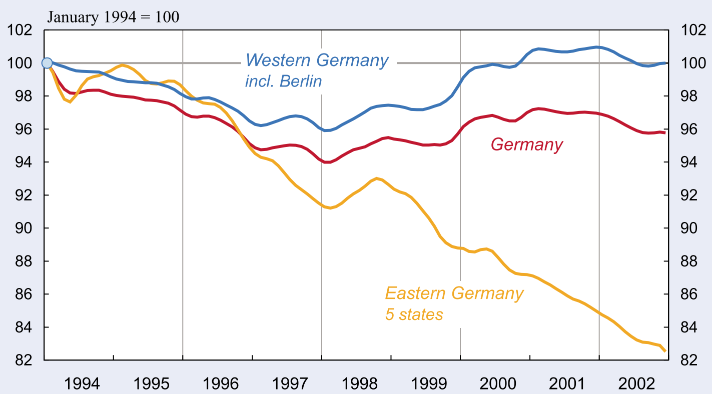
Source: Institut der deutschen Wirtschaft (2002).

eastern Germany have reached a relatively high level thanks to extensive transfers of social benefits. Nominally, net household incomes now average some 80 percent of the west German level if wages, pensions and all social benefits are included.[19] Indeed, because of the low costs of many goods, especially rents, incomes in real terms are even 90 percent of the west German level. Pensions alone are a nominal 110 percent of their west German equivalent per pensioner (in real terms: 120 percent). This favourable development is only in part the merit of East German economic performance. It has also been sustained by the still rising level of the transfer of resources via the public budget.

The absorption of goods and services by the public sector, investors and private households in eastern German states greatly exceeds their own production. The Ifo Institute estimates absorption at about €365 billion, whereas local production is valued at only €253 billion (Fig. 28). This represents a huge current account deficit of €113 billion. About €85 billion of this deficit is financed by public transfers, and about €28 billion is accounted for by private capital flows from western to eastern Germany. However, part of the latter also goes into government bonds raising east German debt per capita far above the western level.[20]

Figure 27

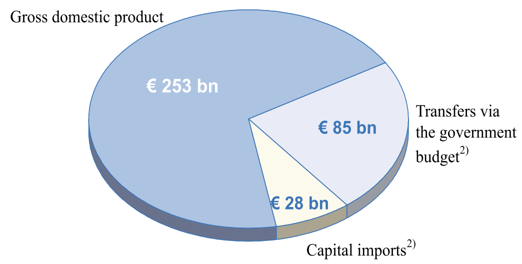
EMPLOYMENT IN WESTERN AND EASTERN GERMANY[1)]



1) Employees subject to social security contributions; seasonally adjusted monthly data.
Source: Federal Labour Office.

Figure 28

ABSORPTION AND PRODUCTION IN THE NEW GERMAN STATES - 2001



1) Private investments, public expenditures on goods, services and private consumption.
2) Estimates by the Ifo Institute.

Source: Ifo Institute.

Eastern Germany is a transfer economy whose consumption is largely financed by a shift of resources from western Germany. Every third euro spent there on final goods comes from the west, either as a unilateral transfer or as loans in the form of a flow of private capital.

Figure 29 compares the east German situation with that of other countries and regions. The region's absorption surplus or current account deficit is 45 percent of GDP. This is very much higher than in other regions, such as Italy's southern regions, the Mezzogiorno, where this figure is only 13 percent, or Israel and Portugal, where it is about 12 percent. There has probably never been another region in history which was dependent to such a high degree on an inflow of resources from other areas.

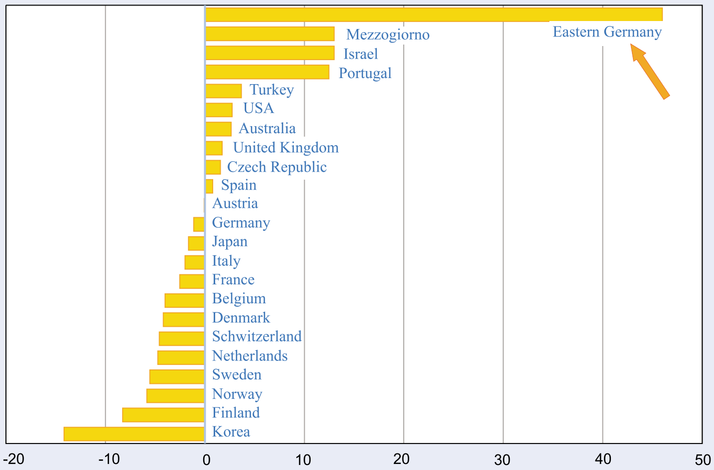
Incidentally, these circumstances again confirm impressively what

19 See W. Meister and W. Nierhaus, "Einkommensverteilung in Ostdeutschland", *Ifo Schnelldienst* 54, 2001, No. 24, pp. 60–63.
20 Cf. H. Seitz, *Zur Nachhaltigkeit der Finanzpolitik der Bundesländer*, draft version, February, European University (Frankfurt/Oder) and ZEI (Bonn), 2002, p. 33, Table III.1.

Figure 29

CURRENT ACCOUNT DEFICIT[1)] AS % OF GDP 1999

A comparison of various countries and regions



1) Difference between imports and exports of goods and services.

Sources: OECD, National Accounts 2000 Nr. 1 and CES.

has already been said on the role played by wages as a purchasing-power and cost factor. The purchasing power of the east German states exceeds their own output by almost 50 percent. According to the purchasing-power theory of wages, its economy should really be flourishing and there should be no employment problems. But precisely the opposite is true. For whereas the demand of the new German citizens, fed by their high purchasing power, is distributed over the whole world, their high labour costs remain tied to the local economy scaring away potential investors. The consequence is unemployment combined with a comparatively high standard of living.

The economic reunification of Germany has been a disastrous failure. A fateful mixture of economic-policy naivety and selfish abuse of power by unions and employer organisations has heavily mortgaged Germany's economic future.

The political implications

The fall of the Iron Curtain, globalisation, the euro and many other factors have irrevocably aggravated Germany's competitive position. High labour costs have already largely choked off the upswing in eastern Germany and are now threatening to do the same in the western part of the country. These costs owe their origin to decisions made in tax, wage and social policies which seemed to be reasonable at the time but can no longer be justified from today's point of view. Germany's economic policy needs a course correction by changing the underlying institutional conditions.

As already explained, it would be helpful if the European Central Bank were to refrain from pursuing an excessively restrictive monetary policy. It would be problematic if the bank were to set targets for average European inflation so ambitious as to drive Germany into deflation. But easing monetary policy alone is by no means sufficient. In addition, fundamental reforms of the German economic system must be carried out to solve the home-grown problems described earlier.

As was pointed out above, low economic growth is associated with rising unemployment. Unemployment reflects the country's inability to attract investment. It is the result of the labour-cost-raising policies of previous decades which caused valuable investment capital to leave the country or diverted it into excessively capital-intensive and labour-saving production processes. But unemployment simultaneously implies the under-utilisation of a valuable economic resource. People who could create something meaningful are prevented from making use of their skills by the lack of jobs. That is why growth policies must start with employment policies. Germany must again be made attractive for investment which creates jobs and the incentive to invest in excessively capital-intensive manufacturing processes must be reduced. This is the only way of ensuring the desired boost in growth.

It seems that the simplest thing to do would be to ease the tax burden on labour, which currently produces a high degree of wait-and-see and an incentive to work in the underground economy. The problem with this approach, however, is that the funds which will then be lacking in the public budget will no longer be available to cushion the social consequences of the country's economic plight. If Germany were not constrained by the Maastricht deficit criterion, tax cuts could be financed in advance and one could hope that the country would develop enough economic punch for at least a part of the initial tax shortfalls to be recovered. But this is no longer an option. The deficit cannot be raised. Reduced public spending is now the only alternative way of financing tax cuts. Subsidies, which exceed €100 billion, and social security expenditures, which amount to €664 billion, are prime candidates for linear cuts. Even small percentage cuts would greatly help the budget. The political resistance to such a course would be considerable, however.

Quite apart from this, an attempt can and must be made to spur the economy by structural reforms which do not affect the budget. A side-effect of such reforms would be rising tax revenues which would then allow further tax cuts to produce a secondary acceleration effect.

Almost all economists concur in insisting that such structural reforms must start with wage and welfare policies aimed at breaking up rigid wage structures and even reducing labour costs.[21] Irrespective of possible differences of detail, a large consensus now prevails among economists as to what must be done to put the German economy back on a growth path.

Reform of wage bargaining

Germany's collective-bargaining law with its industry-wide wage accords, which was long regarded as exemplary by many economists, at the latest lost its innocence by being abused in east Germany. The industry-wide wage accord comes perilously close to a cartel agreement which allows the unions to ban competition among workers and firms and to effectively fix prices. Like every cartel, the wage cartel also tries to push through quota restrictions while keeping prices high. Unemployment is the result.

In the urgently needed reform of wage bargaining, priority must be given to reformulating the industry-wide wage agreement regulated by Art. 77 (3) of the Company Constitution Law (BetrVG). According to prevailing law, the negotiated wage rate applies in principle to all companies belonging to the employers' association and cannot be altered at company level. This presents a problem for companies on the verge of bankruptcy. For even if the majority of employees of such a company were willing to accept a cut in pay to save the company, they would not be permitted to do so.

An example from the recent past is the bankruptcy of the Philipp Holzmann company. Its employees wanted to avoid this outcome by taking wage cuts but were not allowed to do so. Interestingly, not only the union but also the employers' association came out against such a step. Apparently the company's competitors had the upper hand. The events connected with the Philipp Holzmann case had little in common with the behaviour one might have expected in a competitive situation between the supply and demand sides of the labour market.

In a judgment on clauses referring to rates of pay below those fixed by collective-bargaining agreements (JZ 2000, 42), the Federal Constitutional Court ruled that the objective of fighting unemployment had constitutional priority. As the loss of jobs due to bankruptcy can be avoided by including opt-out clauses in the wage agreements at company level, the guarantee of freedom of association enshrined in the German Constitution must not be interpreted such that bargaining agreements de facto assume the character of cartel accords backed by the state.

In order to avoid a future repetition of the deplorable circumstances which pushed Holzmann into bankruptcy, the bargaining parties' right to veto individual company agreements (Art. 77 (3) BetrVG) should be abolished and the collective-bargaining law should contain the binding stipulation that every wage agreement must have an effective opt-out clause. This clause must be formulated to permit the majority of the work force to come to an agreement with the company management and the employee council to opt out of specific wage and working-time stipulations of the nationwide bargaining agreement. Such a decentralisation of decision-making powers in bargaining agreements would considerably strengthen bargaining autonomy because the preferences of the local employees concerned would be expressed much more effectively than is currently the case.[22]

[21] Cf. German Council of Economic Advisors for Appraising Aggregate Economic Developments,: "Twenty points for employment and growth", *Annual Report 2002/03*, November 2002. Advisory Council to the Federal Ministry of Economics and Technology, *Appraisal Report: Reform of the welfare state to promote employment in the low-skilled labour sector*, August 2002. Documentation of the Federal Ministry of Economics and Technology No. 512. German economic research institutes, *Joint forecast: the state of the global and German economies in autumn 2002*, October 2002.

[22] On this point and in the following see also W. Franz, M.J.M. Neumann and H.-W. Sinn, "Mehr Beschäftigung durch umfassende Arbeitsmarktreform", *Frankfurter Allgemeine Zeitung*, September 23, 2002, No. 221, p. 17.

Opt-out clauses are not only required in the long term to ensure the adjustment of wage structures which can make Germany competitive again. In the current economic climate they must also be understood as an acute emergency measure. At present, the number of bankruptcies is rising month by month, and with them the number of non-performing loans which are driving the German commercial banks into crisis. The immediate modification of the Company Constitution Law with the aim of introducing company opt-out clauses could probably still prevent many bankruptcies at the last minute.

Other regulations which aim to extend the range of application of the industry-wide bargaining agreements must also be abrogated, at least during the period of mass unemployment. Thus the effect of the bargaining agreement should lapse when a company leaves the employers' association and declarations of general application should no longer be issued by the Minister of Labour. Laws obliging the bargaining parties to honour collective agreements of the kind discussed and partially introduced at state level, cannot be tolerated because they prevent fair competition between the suppliers of labour and specifically also discriminate against east German suppliers of labour. The so-called favourability principle (Art. 4 (3) Collective-Bargaining Law) must be interpreted differently than in the past. According to current rulings, it cannot be "more favourable" for an employee to accept lower wages even if he saves his company or his job by doing so. This narrow interpretation of the principle must be abandoned. It must be understood to mean that unemployed persons may negotiate entry-level wages for a limited period and that already employed workers have the right to reduce the risk of losing their jobs by making concessions on wages and working hours. Furthermore, the unemployed should be allowed to accept temporary employment of significantly longer duration than is the case today, and employees should be allowed to agree to reduced employment protection in return for higher remuneration or higher compensation for dismissal.

All these are obvious economic implications of the contractual freedom which should be granted in a market economy as a matter of principle. The fact that at present the German legal system has excluded them merely shows how far this system has moved away from the reasonable rules of economics and how large the backlog of necessary reforms is.

Reform of the welfare state

Even more important than the reform of bargaining policy is a fundamental reform of the welfare state. The welfare state was created to prevent poverty, but in practice it works specifically to prevent the poverty caused by unemployment. Government benefits are available to those who are not working and not to those who are working. The government pays wage replacement in the form of unemployment compensation, unemployment assistance and supplementary welfare benefits. Early retirement options can also be interpreted in a broad sense as a wage replacement policy.

The problem of social welfare based on wage replacement is that these benefits themselves produce the unemployment whose consequences they are designed to cushion. That is because wage replacement benefits generate minimum wage claims against the market economy, as almost no-one is willing to work for a wage which is less than the income granted by the state for not working, and these claimed minimum wages, because of their low productivity, often exceed what employers are able to pay.

The maximum wage that an employer can pay without making a loss is the value added that the employee can produce. In contrast, wage replacement benefits represent the minimum wage for which an employee is prepared to work. If an employee's potential value added is below or insufficiently above this benefit, no jobs will be offered. Because of their low productivity, people who fall into this category can simply not be employed under the prevailing system of social welfare. Consequently, the system of wage replacement benefits must be called into question if any headway is to be made in tackling unemployment.

The prevailing situation can be illustrated with the help of a simple labour market as shown in Figure 30. The red line is the demand for labour curve of the firms. It represents the potentially available jobs together with the value added which the employees can produce in them. The curve is downward sloping because the potential jobs are arranged according to their value added. A firm only creates jobs which are economically viable, i.e. whose labour costs are less than their potential value added. The position of the blue line indicates the existing potential labour force.

In the absence of state intervention, a competitive labour market generates a wage rate at which the number of profitable jobs (demand for labour) is exactly equal to the number of people looking for work (supply of labour). In the diagram, this wage rate is represented by the intersection G of the demand and supply curves. If the wage rate is lower, the number of profitable jobs exceeds the available volume of labour so that wages will be bid up to competitive levels by the employers who wish to fill them. If, in contrast, the wage rate is higher, the number of profitable jobs drops below the number of people who wish to fill them. The result is unemployment, employees will bid against each other and labour costs fall until the number of profitable jobs rises to the level of the potential labour force. Left to itself, therefore, the labour market, in which the various partners act competitively, is free of unemployment.

This ideal situation of the labour market is disturbed by a welfare state which pays wage replacement benefits. Because the net wage after all deductions must be sufficiently above the wage replacement level to offset the loss of this payment as well as the possible inconvenience of working (or the loss of illicit earnings), the net wage and thus the labour costs are pushed up. It is now no longer possible for the employees to underbid each other to work for lower wages. This would no longer be worthwhile, as wage replacement income is available to them as an alternative. The tendency for wages to fall, which normally occurs in the event of unemployment, is blocked. Unemployment is caused by the wage replacement benefits themselves.

Unemployment means a loss of output. The resulting loss in GDP is symbolised by the yellow area in Figure 30, which represents the potential value-added produced by all those additional people who would have been employed in an undisturbed or free labour market. This area represents the loss in output to be expected from the repercussions of the welfare state, or vice-versa the gain in output which would have been achieved if unemployment had been eliminated.

In reality, the insidious effects of wage replacement benefits on the labour market are concentrated on the sector of low-skilled workers. Figure 31 shows that the problem of unemployment in Germany is largely a problem of those without vocational training. The unemployment rate in this sector has risen from 5 percent to 20 percent within 25 years. In contrast, those with vocational qualifications and university graduates have experienced only a modest rise in unemployment.

Unskilled workers make up over 40 percent of the unemployed in Germany, although their share of all those gainfully employable is only 15 percent. That is why measures to combat unemployment must in the first place start with those having a low level of qualifications.

The Ifo Institute has estimated how many of Germany's low-skilled workers could be placed in

Figure 30

THE EFFECTS OF REPLACEMENT INCOMES

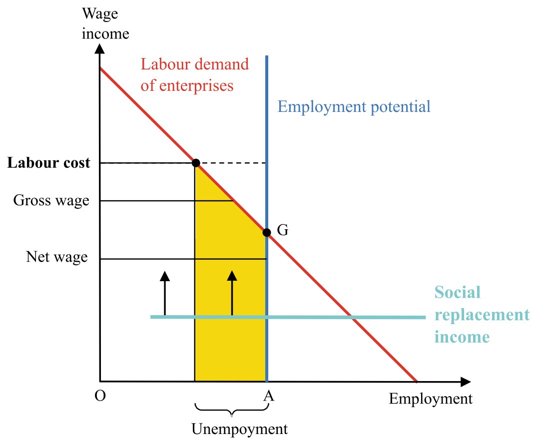
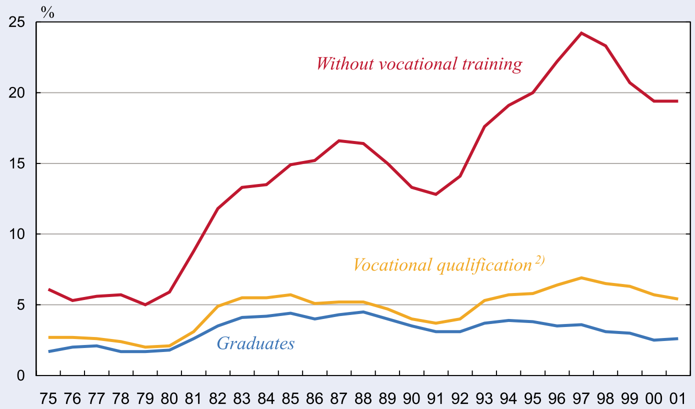


Figure 31

UNEMPLOYMENT RATE SPECIFIC TO QUALIFICATIONS [1)]



1) Unemployed as a % of all civilian earners (excluding apprentices and trainees) with the same qualifications, men and women, western Germany.- 2) Vocational qualification: in-house-training, vocational and technical colleges, apprenticeships.

Sources: Institute for Employment Research of the Federal Labour Office.

jobs.[23] This group of workers is found among the registered unemployed, those participating in job-creation (ABM and SAM) schemes and recipients of welfare benefits. In sum, the potential for additional employment of hitherto unemployed low-skilled workers can be put at 2.7 million people. If 20 percent frictional unemployment is deducted from this figure, a total of 2.3 million remains. Germany must endeavour to change the social welfare system in such a way that jobs can be created for these 2.3 million people over the long term.

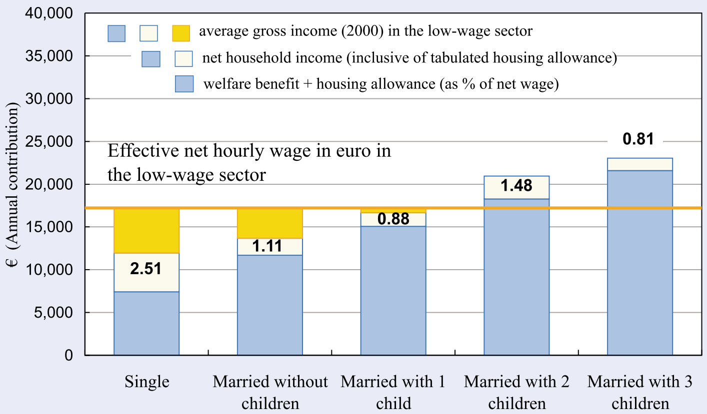
The options available to political action can be best demonstrated on the basis of welfare benefits. In fact, welfare benefits can be seen as the essential reason for unemployment because, in contrast to unemployment compensation and unemployment assistance, they put an absolute wage floor into the entire wage structure and thus prevent the necessary differentiation of wages at the lower end of the scale. However, very similar considerations also apply in principle to unemployment compensation and unemployment assistance.

Figure 32 shows how close the level of welfare benefits is to actual wage income and how strong the forces must be which set the floor of the wage structure.

Average gross earnings in the low-wage sector are represented by the red horizontal line, while the yellow areas show the deductions. In principle, the deductions consist of the employee contributions to social security and personal income tax less any supplementary social welfare as well as other state benefits which are paid to low earners depending on their family circumstances. The blue columns show the compensation

Figure 32

WAGE DIFFERENTIAL FOR LOW-SKILLED WORKERS IN WESTERN GERMANY

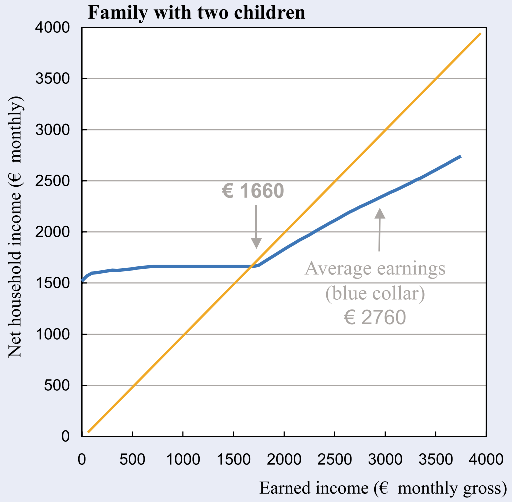


Source: Federal Statistical Office; calculations by the Ifo Institute.

Figure 33

NET INCOME AS A FUNCTION OF GROSS EARNINGS

(Earned income, welfare benefits, child allowance, income taxes, employee contribution to social insurance)



Source: Ifo Institute.

claims in the form of welfare benefits and housing allowances if the persons concerned do not work. The white areas represent income in excess of welfare. The figure shows clearly that net income in excess of welfare is extremely small in all cases. If one assumes that a month consists of 150 working hours, one can calculate the effective hourly wage rates corresponding to this income in excess of welfare. Singles would earn an effective hourly wage of €2.50 by joining the labour market, couples without children would earn €1.11, and couples with one child €0.88. Couples with two children would earn an extra €1.48 and couples with three children €0.81. Obviously, it is not worthwhile to switch from social benefits to regular paid work for such small sums. Illicit work is the consequence. Therefore, these wage classes are not occupied to a significant degree by people who are entitled to draw social welfare benefits. If such low-paid jobs are filled at all, it is largely by spouses, students and pensioners, all of whom are not entitled to the alternative of welfare benefits.

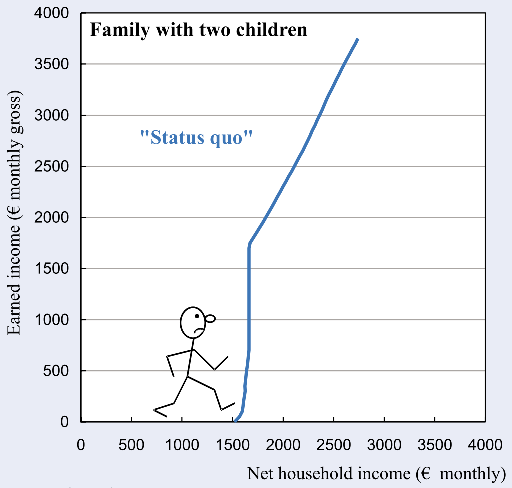
The problem is presented from a somewhat different angle in Figure 33. This shows the net-income curve for a family with two children in Germany as a

[23] H. W. Sinn, Ch. Holzner, W. Meister, W. Ochel and M. Werding., "Aktivierende Sozialhilfe – Ein Weg zu mehr Beschäftigung und Wachstum", *Ifo Schnelldienst*, Special Edition, 55, 2002, No. 9.

Figure 34

THE NORTH FACE OF THE EIGER: PERNICIOUS EFFECTS OF THE WAGE COMPENSATION SYSTEM

(Earned income, welfare benefits, child allowance, income taxes, employee contribution to social insurance)



Source: Ifo Institute.

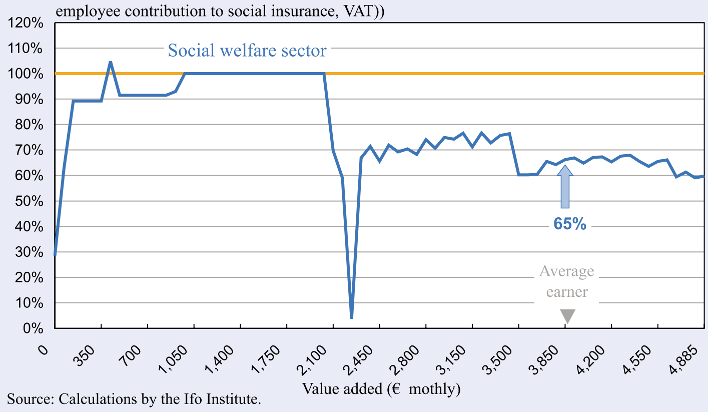
function of gross earnings from gainful employment. Up to gross earnings of €1,660 net income practically does not change at all in response to changes in gross earnings. At first a little more net income is obtained if one earns more gross, but there follows a long horizontal section in which net income remains unchanged as gross earnings increase. The reason is that the marginal rate of deduction of transfers reaches 100 percent there. For every extra euro earned, the employee loses one euro in welfare benefits. The curve begins to rise only when welfare payments cease, which is the case at €1,660. From here on employee contributions to social security and income taxes drive a wedge between gross and net income.

Figure 35

MARGINAL DEDUCTIONS AS A % OF VALUE ADDED BY LABOUR:

MARRIED (1 EARNER) WITH TWO CHILDREN IN WESTERN GERMANY

(Welfare benefits, child allowance, housing allowance, income taxes, employer and employee contribution to social insurance, VAT))



Source: Calculations by the Ifo Institute.

Now, higher performance and higher gross earnings do in fact translate into more net income.

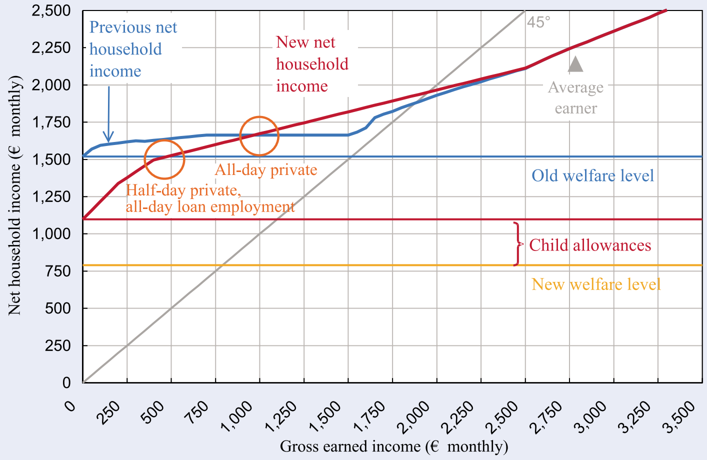
The implications of this situation for the labour market are illustrated in Figure 34. Here the axes of the previous diagram are transposed: net income is now plotted on the abscissa and gross income on the ordinate. It is obviously everyone's endeavour to maximise their net income. But to do so, one must work more in order to increase one's gross earnings. This is like climbing a mountain. The institutional structures of the welfare state generate the vertical edge shown in the diagram. The aspiring employee must climb this "North Face of the Eiger" in order to gain a foothold on the labour market. However, many people are unable to do this. Only after having overcome this steep section do they succeed in moving further to the right in the diagram where they increase their net income by earning a higher gross income.

Figure 35 shows the same situation in a more prosaic form by depicting the entire curve of marginal deductions for our typical employee levied by the German tax and transfer system. It can be seen that the average employee must bear a marginal deduction of about 65 percent. This corresponds to the result already presented above. In the particularly problematic segment of welfare benefits, marginal deductions reach 100 percent across wide areas.

In May 2002, the Ifo Institute developed a model of activating social welfare which avoids these problems. Its core elements are presented in Table 2 and Figure 36. According to these, second-tier unemployment benefits and basic welfare benefits should be combined and reduced far below today's welfare levels, by about 30 percent for a family with two children. For those capable of gainful employment, basic social welfare will now only cover the housing allowance at its present level plus child benefits independent of income. Anything beyond this will only be available as remuneration for work. Up to a monthly income of €200, only employer contributions but no employee contributions will need to be paid. The employer contributions will be reimbursed to the employee up to an income of €200 in the form of an income-

Figure 36

THE IFO PROPOSAL:
MARRIED (1 EARNER) WITH TWO CHILDREN IN WESTERN GERMANY



tax credit. The reimbursement will be constant in the income segment from €200 to €400, and the basic welfare benefit will not be reduced up to this point. After this, at higher incomes, both the reimbursement and the basic welfare benefit will be gradually phased out and finally carried over to the income tax schedule so that the marginal deductions resulting from taxation, social contributions and loss of transfer payments remain constant.

In the aggregate, this scheme results in a net income curve rising in line with gross earnings (Fig. 36). A higher net income is always achieved if more gross income is earned. Figuratively speaking, as illustrated in Figure 37, the overhang on the North Face of the Eiger has been blown off and the falling material has been used to build a gentler slope which may actually be climbed.

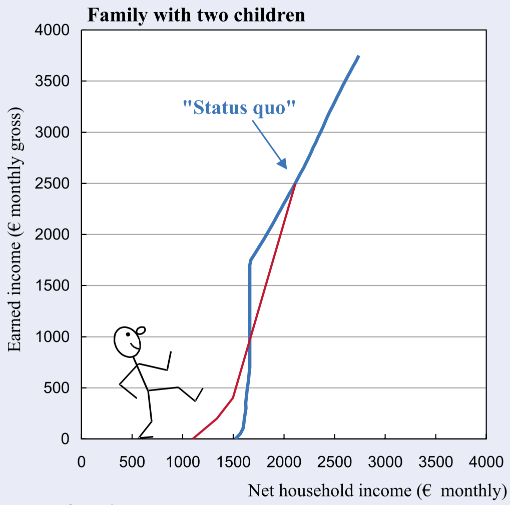
The change in the tax and transfer system described above will dramatically invigorate the labour market, not only by increasing incentives to work but mainly because the wage floor in the pay scale largely disappears. Those who do not work receive only a low level of welfare benefit, and those who work do not lose this benefit but even get it topped up to a certain level. There will no longer be any economic reason to reject low-wage jobs. On the contrary, there will be an incentive to accept such jobs because the employee then becomes entitled to income-tax credits.

Calculations by the Ifo Institute show that wages in the low-wage sector would drop by about a third as a result of this scheme. Companies and private households will then offer more jobs which had previously been unprofitable for employers because of high wage demands. Up to 2.3 million additional jobs may well be created in the long term, which would translate into a 1.9 percent increase in GDP.

As shown in Figure 36, the system is designed in such a way that, despite the expected wage reduction, an employee working half-time in the private sector will already earn an income from the sum of his earned income, the earned income tax credit and social welfare that is as high as today's welfare benefit. And those who work full-time in the private sector will earn significantly more than that.

Figure 37

SMOOTHING OUT THE NORTH FACE ON THE EIGER
(Earned income, welfare benefits, child allowance, income taxes, employee contribution to social insurance)



Source: Ifo Institute.

Table 2
The Ifo model of activating social welfare

1. Harmonising second-tier unemployment assistance and basic welfare benefit payments by the local authorities
2. Reduction of basic social welfare (only housing allowance and child allowance independent of income) by about one third
3. Income tax credits for those employed in the private sector, like the US Earned Income Tax Credit, and larger income range where basic welfare is not reduced
4. Old level of welfare benefit as income earned from loan employment organised by the local authorities

Despite the expected positive effect of this change in the welfare benefit towards an activation of the labour market, not all those concerned are expected to find jobs in the short term and perhaps also in the long term. Some time will certainly be needed for companies and private households to react to the new situation. The question then arises as to how we can make sure that these people's income does not fall below their previous level of welfare benefits. The answer given in the Ifo model is that those who fail to find a job in the private sector will be offered an alternative in the public sector. They can earn an income equal to today's welfare benefit if they undertake to make themselves available to the public sector for a loan-employment scheme which in principle would already be possible under current law. They would be given an employment contract with their local community, which then has the right to hire out their services to the private sector on the basis of fee contracts via private loan-employment agencies. As long as the fee paid for their services is greater than zero, it is more efficient to take this route than to spend public money without getting any work in return. The loan-employment proposal has been accepted by the Hartz Commission and has subsequently also become popularised in public discussions.

The living conditions of the former recipients of welfare will of course become somewhat less comfortable if they remain in the public sector and must work there. This is an intended effect which aims to nip illicit work in the bud. However, it should be stressed that those concerned will normally earn more from the sum of public money and their earned income than they currently obtain from welfare benefits. And this does not even mean extra costs for the public budget. To this extent, the proposal represents a gain in efficiency which results from the gainful employment of those who were previously unemployed. The standard of living of the poorer sections of the population is then substantially improved.

In addition, those concerned have an incentive to obtain qualifications, to make greater efforts and to leave the low-income sector as soon as possible by going for better-paid jobs. The current situation in the low-wage sector in the Federal Republic of Germany is so hopelessly inefficient that it would be easy to devise a reform which would produce improvements for all concerned.

The calculations underlying this proposal were made on a very cautious basis. Although relatively pessimistic assumptions were made about the free-rider effects of the program and its possible mobilisation effects, it does not involve any additional costs for the the public budget. Under more optimistic assumptions, it will even yield budget surpluses. In addition, the growth effect will be significantly larger than calculated because the calculation did not take into account the fact that the change in wage determination practices associated with the implementation of the proposal would lead to an increased willingness to invest in Germany.

It may be added that this proposal has been accepted with only minor modifications both by the Advisory Council to the Federal Ministry of Economics and by the German Council of Economic Advisors.[24] It is now time to implement it.

Conclusion

Germany's poor growth performance and unattractiveness for investors have reached ominous dimensions. Unemployment has risen for thirty years and growth is stymied. In terms of per capita income, Germany is being successively overtaken by one EU country after another. The euro has deprived the German economy of the interest-rate advantage which it had enjoyed under the protection of the deutschmark, and the economic failure of German reunification continues to be a serious burden on the country. Only little time is left before the progressive ageing of the population depletes the country of the energy required for a new upswing. Japanese conditions have not yet arrived, but they are looming on the horizon. The growing number of bankruptcies and the banking crisis are inauspicious harbingers of the problems which may yet eventuate. The European Central Bank has the responsibility to protect Germany from deflation, but such a policy alone is by no means sufficient to get the country back on its feet.

National measures to revive economic growth must in the first instance start with employment. In the medium term there is no alternative to mobilising the labour market. Growth can be attained by more employment, because more

[24] Cf. Advisory Council to the Federal Ministry of Economics, op. cit. and German Council of Economic Experts, op. cit., p. 372 ff.

employment means more output and because employment growth would be an unmistakable sign that it is once again worthwhile to invest in Germany.

Apart from rents, labour costs are practically the only company costs which are linked to location. For this reason, a strategy which makes Germany competitive again in the medium term and generates new investment must begin with labour costs. Other possibilities which might contribute to a solution of Germany's problems have been largely exhausted or would come too late. Educational reform must certainly be initiated in order to overcome the poor showing in the PISA comparison, but one should not be under any illusions. Educational reform will only bear fruit in the very long term, after one generation.

The centrepiece of a meaningful policy of reviving the labour markets is a reform of the collective-bargaining law and of the welfare state, as both elements are responsible for the wage rigidity which is the main cause of German unemployment. The system of nationwide wage agreements must be relaxed by adding company opt-out clauses and must be reduced to a system of wage guidelines to apply until an alternative is agreed at company level by a majority vote. Partial decentralisation of the bargaining process would strengthen bargaining autonomy and eliminate the whiff of cartel accords.

The welfare state must be successively transformed from a system of wage replacement payments to a system of wage supplements. The watchword must be that everyone should work according to his abilities, at whatever wage this is possible. If the wage level does not correspond to the expectations of society, the state must top it up so that the desired income is achieved from the sum of earned income and public moneys. It is inefficient as well as contemptuous of human beings to make the support provided by the community available only under the condition of being idle, as is the case in Germany today. The step from a welfare state that keeps people passive rather than encouraging them to be active is long overdue.

The aim is not to dismantle the welfare state but to transform it so that everyone can find his place in society without being condemned to inactivity. Everyone should be able to play a productive part in the division-of-labour economy so that he earns the recognition of the wider community. If this aim is reached, Germany will gain ground again.

The reforms of labour law and the welfare state cannot be delayed. In 2004 the borders of the EU will be opened to 75 million Central and East Europeans, and no administrative barrier will then be able to stem the forces of competition. German companies will be up against a growing number of low-wage competitors, capital will migrate to the low-wage economies to the east and economic migrants will enter the country. Under present circumstances considerable labour market problems must be expected, in particular a rapid rise in unemployment in Germany. The east German economy is particularly exposed to these phenomena. It is in danger of being crushed between the high-productivity economy in the west and the low-wage regions of the east. There is only one way to reduce these dangers and that is by making the labour market more flexible by implementing market-based reforms. How this can be done has been presented here.