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Chapter 9: "Rethinking the Welfare State: A Reform Program"

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to the children of Europe, who will inherit the liabilities of the welfare state unless today's adults take action now

9 Rethinking the Welfare State: A Reform Program

Options for Europe and Germany

Not only have Germany's attempts to achieve social objectives by going against the rules of the market economy failed; many other West European welfare states, too, have been bent on attempting this untenable feat and have bloodied their noses trying to achieve it. These countries are suffering from deep structural crises that result from their inability to cope with the forces of globalization—forces that are not compatible with the older rules that, in a less open world economy, helped foster the generous welfare states of old.

The German welfare state is at the center of attention here, because Germany is by far the biggest European economy and because many Western European countries have modeled their social systems on it. With a few exceptions (among them Ireland and Great Britain), all Western European nations have in one way or another been influenced by the social developments in Germany. Germany is the country where socialism was invented and where its milder form of social democracy originated. It is the country where politicians first tried to appease the masses by developing the social welfare state and where later the welfare state was pushed to its limits. It is little wonder that the problems of the aging welfare state are becoming visible in this country with particular force. Germany's current predicament is the tip of an iceberg with which the European ship could collide should it continue on its current course.

In the so-called Lisbon agenda of 2000, a program to foster growth in Europe by means of government intervention in the innovation process, the heads of state of the EU-15 countries had proclaimed that by 2010 Europe would "become the most dynamic and competitive knowledge-based economy

in the world, capable of new economic growth with more and better jobs, and greater social cohesion."[1] At this writing, with the ten-year period more than half over, there is not the slightest glimpse of this predicted success. From 2000 to 2005, China grew by an annual 9.5 percent rate, the Middle East by 4.9 percent, Asia absent China and the Middle East by 2.7 percent, Africa by 4.7 percent, central and Eastern Europe by 4.3 percent, the United States by 2.4 percent, Latin America by 2.4 percent, and the old EU-15 only by 1.6 percent. Even the enlarged EU grew only by 1.7 percent, much less than any of the world's other big regions.[2] Instead of showing signs of becoming the world's most dynamic region, Europe has turned out to be its laggard.

The reason behind the embarrassing failure of European policy is that the politicians have focused on the wrong priorities (and in fact have done very little even to pursue the priorities on which they focused). Emphasizing the roles of research and innovation, they have ignored Europe's labor-market problems and its demographic problems, the two most important impediments to growth.

Innovations are necessary. However, they must be carried out by private business rather than by government, and the gains disperse quickly to the rest of the world. Although many innovations can be patented, no one can stop the owner of a patent from exploiting his knowledge in a low-wage country. The competitive pressure on European workers can hardly be mitigated by simply throwing EU money at the innovators. More important for an improvement in the competitiveness of the European population are government actions in the field of education. Indeed, the human capital stored in the minds of people enables them to sell their services at higher prices on the world labor market. Moreover, good education policy provides equal starting conditions and helps a country satisfy equity goals. Unfortunately, however, education policy will have its effects only in the long term. It takes a full generation until a sizeable impact on the labor market materializes. Thus, to solve Europe's imminent competitive problems, there is hardly an alternative to liberalization of the labor market coupled with reform of the social welfare system.

The strong winds of globalization have brought international low-wage competition from the formerly communist countries and India to Western Europe. This greater competition has effected more rapid structural adjustments than ever before in the peaceful eras of Europe. While European wage scales are pulled down by the forces of factor-price convergence threatening to produce more inequality than Europe's democratic systems are willing to tolerate, the countries of Western Europe are desperately searching for viable policy responses that maintain the living standard of their lower income strata and avoid social unrest.

Despite their similarities, the countries of the western hemisphere have sought different responses to the forces of international low-wage competition. Four different approaches can be defined, and the counties of Europe must make up their minds which one they want to pursue further:

1. the Franco-German way of permitting strong union power and paying voluminous wage-replacement incomes that keep wage scales compressed, crowding out jobs that would otherwise exist,
2. the Thatcherite-British way of full liberalization of the labor market with a fight against unions, a widening of wage distribution and a downscaling of the welfare state,
3. the Scandinavian way of social cooperation with the unions that results in keeping the demand for labor high by employing those who cannot earn enough in the market economy in the government sector,

or

4. the American way of supplementing a liberal labor market with the payment of wage subsidies.

The Franco-German way is an attempt to overcome the forces of factor-price convergence. Thus far, to be sure, it has been successful in terms of maintaining the incomes of the unskilled. However, it leads to more and more unemployment, which, apart from pushing an increasing part of the population to the offside und causing social unrest and violence, will not be financially feasible in the long run.

The Thatcherite way succeeded in achieving more employment and growth, but it failed to avoid the problem of poverty. Because it asks Europe to give up its social objectives, and because it jeopardizes the achievements of a century of social development, it does not find much support on the European continent . Britain itself has watered down Margaret Thatcher's model by implementing major corrections to satisfy social objectives. (See chapter 6.)

The Scandinavian way keeps the wage distribution scale compressed, avoids the problem of social exclusion, and provides the less-motivated part of the population with at least some useful work. However, it looks better than it is because in the OECD accounting system the wages paid by the government sector are considered contributions to GDP even if these wages could not have been earned in the private sector. Like the Franco-German way, the Scandinavian way is financially problematic, to say the least, as the high government share of GDP of the Scandinavian countries proves. It neglects the

forces of international factor-price convergence in a way similar to that of France and Germany, because it forces artificially augmented wage demands on the private economy. Moreover, it probably misallocates the available labor force, because the government hardly knows better than the market where scarce human labor can be made to work most efficiently.

This leaves the American way, as exemplified by the Earned Income Tax Credit. Although American social standards do not satisfy European objectives, Europe could copy the incentive structures of the American welfare system, first introduced by President Clinton in the 1990s, but could make it more generous to fit European social preferences—something that has been discussed in Germany under the rubric of "an activating social welfare state." The advantage of this approach is that it decouples income distribution from wage distribution, satisfying social objectives while employment and growth stay high and the financial burden on the state remains limited.

This chapter makes the case for implementing reforms that liberalize the labor market as in Britain and go in the American direction concerning the incentive structure of the government welfare program (although Britain's working family tax credit should not be forgotten in this regard). Using the German economy as an example, it describes how these could be implemented without violating Europe's social standards and without costing more tax money than is absorbed by the present welfare state. These reforms are also advisable for other countries that have similar wage-replacement systems, including France, Austria, Belgium, the Netherlands, and Luxembourg. Moreover, these reforms may be advisable for the Scandinavian countries, because they bring about the efficiency gains of having a high employment level in the private economy while satisfying Europe's social objectives.

The reform proposals focus on implementing a better incentive structure in the labor market and making the wage distribution more flexible. This chapter suggests a number of policy measures that complement the move to an activating welfare state and help marry efficiency and equity objectives in an arguably better way than has so far been the case in Europe. Although the policy recommendations have been tailored to the German case, these are highly relevant to many European countries and even to the new emerging economies in Asia and elsewhere that have to set up their social systems from scratch.

The German Case

Arguably, Germany's labor market is one of the most defective in Europe. While most German firms seem to adjust well to the forces of globalization,

expand worldwide and make good profits, German workers suffer from mass unemployment that has grown at an exceptional rate for the past 35 years. Germany's firms stay competitive, but Germany's workers do not. In fact, German firms stay competitive only because they find ways to do business by eschewing non-competitive German workers.

But human labor remains the fundamental source of a country's wealth and prosperity. If the domestic labor market no longer functions, soon nothing will function in Germany. Thus, economic reforms must focus on conditions in the labor market. The effects on the labor market of population growth, immigration, and the government's redistribution activities must be taken into account in this program of reforms.

High labor costs and aspirations to a high standard of living are Germany's most important problems. Except for national taxes, labor costs are the only relevant costs for location decisions in international business competition. In order to prevail in this now global competition, one can be more expensive only to the extent to which one is superior. Whether German workers are superior to those of other countries is doubtful. In any case, however, they are more expensive. Germany's manufacturing industry had the highest hourly labor costs in the world in the 1980s and the 1990s and was only recently overtaken by Denmark's. Unskilled labor, in particular, is extremely expensive in Germany, and the country's wage spread is extremely narrow by international standards. That Germany has the highest rate of unemployment among unskilled workers and that it has the second-lowest net investment share among all OECD countries are obviously due to Germany's high labor costs for industrial workers. In turn, Germany's high labor costs are due in part to the German labor unions' unrestrained cartel policy. Equipped with the right to make binding sector-wide wage agreements, unions extracted as much as they could for the employed workers at the expense of the unemployed, whose number has grown steadily. The rest of the explanation can be found in the welfare state's attempts to cushion the consequences of unemployment by offering increasingly generous wage-replacement benefits, including unemployment compensation, social assistance, and early retirement. These once well-intended measures have been counterproductive, because they operate like competitive counter-bids in the labor market, creating high minimum wage demands that the private sector has been unable to satisfy in an increasing number of cases. In the global economic environment, low-wage competitors from all over the world harass German companies in their product markets. The welfare state, as a high-wage competitor, harasses them on the domestic labor market. German jobs are being gradually squeezed out by this double competitive bind.

Unemployment has risen in West Germany according to a linear trend for 35 years, and there is no end in sight. There is, however, no way for the country to survive an extension of this trend for another 35 years. The German economic model, underpinned by a generous welfare state, has come to its historical and logical end.

German firms have successfully tried to escape from the high wages by buying robots instead of people. Their owners have used their capital for a rapid expansion of capital-intensive export industries or sent it abroad via the financial system, creating a huge export volume and a large current-account surplus. Many German firms have reacted to the country's high labor costs by moving part of their production to other countries. In most cases the structural change has been smooth, but in many cases it has involved bankruptcy. The number of bankruptcies reached a postwar record in 2005.

In spite of record unemployment, high wages for unskilled work produced by the wage competition of the welfare state have attracted many immigrants to Germany. But these same high wages have prevented German businesses from providing additional jobs. That is why there has been migration into unemployment, albeit in an indirect manner. While the foreign immigrants took the low-paid jobs, the German workers preferred to rest in the easy chairs provided by the welfare state. The downward adjustment of wages that would have been necessary to create new jobs for the immigrants was impossible because of the replacement incomes offered by the welfare state. Germany has not yet found a way to integrate immigrants into its economy in a meaningful way by creating additional jobs for them instead of providing them with the existing jobs of the domestic workers. EU eastern enlargement and the still-enormous wage differences between Eastern and Western Europe will likely induce additional immigration into Germany's overly rigid labor market.

Despite immigration, Germany's population is shrinking and aging as fewer and fewer families are started and fewer and fewer children are born. In Germany, the age group that tends to set up firms and conduct innovative research is shrinking rapidly, and as a result fewer and fewer new competitive jobs are created. At the same time, pension claims are mounting, and in 30 years these will be difficult to meet for lack of jobs and for lack of employable people.

After a temporary lull resulting from Gerhard Schröder's tax cuts, the public sector's share in GDP may again rise faster than aggregate output, as a result of increasing unemployment and an aging population. Such an event would require a further increase in tax rates, and indeed the new German coalition government under Angela Merkel enacted quite a number of tax increases

since it came to power in 2005; the largest of these increases is in the value-added tax (three percentage points). Today, the value added produced by Germany's industrial workers is already subject to the highest marginal tax burden among comparable advanced countries. Many Germans escape the high taxes by moonlighting or by withdrawing from working life, while young people lose interest in obtaining education and other training because there are no discernible rewards for these efforts.

Germany must be liberated from the vicious circle in which it has been caught for more than 30 years. Germans should not stand idly by while their country falls behind and becomes a land in which retirement homes and holiday parks prosper, financed by a dwindling stock of private wealth and evaporating public resources.

Germany must at last come to terms with the laws of the market and give up its idealistic illusions regarding the potential of the welfare state. The "crash test" of the market economy that the Social Democrats proclaimed in the 1970s has failed, unequivocally. Even Willy Brandt, former German chancellor and president of the Socialist International from 1976 to 1992, would agree with this assessment, were he still alive to render an opinion. During the 1970s, a period that seemed to affirm the country's successful postwar rebuilding, all of Germany was too naive regarding economic issues. Politicians and the elite neglected the laws of economics and underestimated the harm the development of the welfare state did to the economy. The mistakes they made turned out to be even more destructive as the winds of global change became stronger in the 1980s, when the Asian Tigers appeared in the markets, and turned into a storm in the 1990s, when the formerly communist countries freed themselves from the fetters of central planning.

Germany needs a system in which the natural incentives for people to create wealth and security for themselves come to the fore once again. In the past few decades, these incentives were massively distorted by state intervention, with the result that the dynamism of the postwar period was lost. A program that is consistently aligned with the demands of the global market economy, that relies on the self-healing forces of the domestic economy, and that induces people to once again take greater responsibility for the consequences of their own actions without sacrificing Germany's social objectives will succeed in laying a firm foundation for the country's recovery. The necessary reforms may be painful in individual cases and will not have immediately realized effects, as these changes are a long-term structural solution, not a short-term cyclical response to current economic conditions. A truly effective turnaround will take time. But it will be successful, generating more growth and more employment while preserving Germany's social standards in the sense of

maintaining the living standard of the poor. The laws of economics work slowly, but when invoked they work persistently and powerfully.

The six items below summarize the political demands that follow from this book's analysis of Germany's economic problems. They do not exhaust the roster of necessary reforms, but they encompass the most important ones, at least with respect to economic considerations. There is another program with regard to East Germany, which is especially urgent but not really different since it builds on the recommendations for West Germany. Therefore, this is a "6 + 1" program.

Item 1: A U-turn in Collective Bargaining

Working Longer Hours

In order for German workers to regain their international competitiveness, hourly wages must decline. By how much is unclear in view of the rapidly changing global economic environment. A good beginning point of reference is a comparison with the Netherlands, which 25 years ago had problems similar to Germany's and solved them by means of long-term wage moderation, initiated with the 1982 Wassenaar Agreement. If the German wage differential relative to the Dutch that accumulated from 1982 to 2005 is to be offset, Germany's employer contributions to pension and unemployment insurance will have to be assumed by the employees, or wage increases will have to lag one percent behind productivity gains for 11 years.

Happily, the same objective may be achieved more quickly and more simply just by lengthening weekly working hours without imposing the wage offset. If Germans worked 13 percent longer at the same wage, the wage gap with the Netherlands, which has accumulated since the employment-generating Wassenaar agreement of 1982, could be closed. Statutory weekly working hours would have to be raised from 38 to 43 (the number at which they stood 25 years ago). Germans would still be working fewer hours than the British or the Irish, and about the same as the Italians. Evidently a 43-hour working week is still compatible with "la dolce vita."

An increase in working hours permits a better utilization of firms' capital stock. The increase is similar to labor and capital augmenting technological progress and triggers a similar growth surge. Raising the productivity of every single worker by extending individual work time, given his or her labor costs, also induces firms, in a second step, to create additional jobs.

Agreeing on longer working hours is the responsibility of the bargaining parties and not the state. But the German government can encourage the bargaining parties to make a favorable compromise. If they fail to react,

the government can threaten to eliminate some holidays instead. The Wassenaar Agreement between the Dutch bargaining parties was brought about by the Dutch government's threat to impose legal limits upon wage increases.

In this respect the German government should not be too cautious. Germany unambiguously finds itself in a serious state of emergency that does not permit any regard for particular interests. The long-term economic welfare of the nation must be placed above short-term political calculations.

Investment Wage Instead of Cash Wage, Co-Ownership Instead of Co-Determination

Additional wage reductions could be agreed to in exchange for workers' co-ownership in their firms. This would require longer-term collective wage agreements. If co-ownership were available only to those people now employed as compensation for wage moderation, whereas newly hired employees were excluded, a positive employment effect would result without present workers suffering any disadvantages. Such agreements would correct the historical mistake made by the unions in the 1960s when they decided in favor of co-determination and against investment wages.

Investment wage models have already been successfully implemented in thousands of German firms. These include such well-known companies as Bertelsmann, BMW, Altana, and Otto (Germany's biggest mail-order company), but also many unincorporated small firms. The know-how of co-ownership in large and small firms is amply available in Germany, and the practice could easily be extended to other companies.

Once again, agreeing on co-ownership is up to the bargaining parties. However, the state could promote such agreements by improving the legal framework for protecting employees and subjecting investment wages only to ex-post or cash-flow taxation.

Item 2: Less Power to the Unions!

More Firm-Level Bargaining

German unions have used bargaining autonomy to implement wage cartels with respect to employers and indirectly also with respect to consumers. By raising wages beyond the level that would balance supply and demand, unions have created more unemployment than otherwise would have resulted. This excessive unemployment rate is the very proof that a cartel policy succeeds in bringing about higher wages than those the market would establish by itself if left alone.

Bargaining autonomy must not be understood as cartel power. It should be interpreted in such a way that it is compatible with firm-level competition in labor and product markets. Companies should be put into a position to underbid the prices and wages of their competitors, if necessary, without their competitors' or a unions' being able to prevent this action.

The bargaining partners should therefore be obliged by law to include effective opening clauses in their agreements that would enable a firm's workforce to deviate from the pattern bargaining contract by way of a voluntary firm-level agreement with management. The opening clauses must include the possibility of such measures as an extension of working time and/or a wage cut that prima facie are unfavorable to employees, but allow employees to safeguard their jobs. A two-thirds majority of the workforce should suffice for deviating from union-mandated wage agreements. This rule would not change the system of pay setting in normal cases and would not require firms to negotiate future wage increases, but it would permit backdoor adjustments should these be necessary. Opening clauses would strengthen bargaining autonomy by granting a firm's employees more say in pay setting.

In view of the high number of bankruptcies among German companies, firm-level opening clauses are an urgently required emergency measure to avoid an even bigger disaster. Thousands of company bankruptcies could still be prevented if legislation were passed quickly to grant employees the right to help their firms by agreeing to voluntary wage moderation.

Free Choice of Dismissal Protection

Statutory protection against dismissal is one of the unions' most effective weapons in the bargaining game. It forces private business to continue hiring labor even when it has become too expensive, and it shares responsibility for the unions' aggressive wage policy, which led to high unemployment. Dismissal protection has not created secure jobs for German workers; rather, it has reduced job security by inducing excessive wage demands by unions thus increasing unemployment. Nothing creates more job security than a high employment rate and a well-functioning labor market.

Not only should statutory protection against dismissal be abolished for small firms, as it has been; it should be abolished for all firms, regardless of size. Employers and employees should be permitted to sign work contracts according to their own preferences, be these contracts for a limited time, for an unlimited time, or with full dismissal protection with the wage rates varying inversely with the degree of protection. The state should not restrict individual freedom of choice. In practice, contracts for an unlimited time without

dismissal protection will prevail in the majority of cases. Each party must then remain content with the ongoing employment relationship, and if one party is no longer content it will have the right to end this relationship in line with the contract. After all, an employment contract is not a lifelong marital agreement.

Abolishing enforced dismissal protection will encourage German unions to practice wage moderation, which will then induce firms to create more jobs. In addition, it will encourage firms to risk hiring more people even at the prevailing wage rates, as they will be able to react more flexibly to unexpected changes in their business conditions. Finally, doing away with legal dismissal protection will strengthen work incentives, as employees will fear getting fired for laziness. As German wage costs are too high relative to labor productivity, abolishing statutory dismissal protection is a contribution to regaining competitiveness. Allowing more freedom in the choice of labor contracts will save very many jobs in Germany. Job security will rise.

Of course, the reform must be implemented with care. Initially, it is advisable to abolish only the statutory dismissal protection of newly hired employees in order to prevent a breach in the system, as otherwise pent-up dismissals could be implemented all at once with adverse short-term economic consequences. By limiting dismissal protection to newly hired employees, natural employee turnover will allow a gradual transformation of the economy. Statutory dismissal protection should not be abolished only for private-sector employees. As a rule, civil servants do not need such protection either. Surely, their enthusiasm for work can also be boosted.

Item 3: Less Money for Staying Out of the Game, More Money for Participating

Activating Social Assistance

As was mentioned in the introduction to this chapter, of central importance for the recovery of the German labor market are steps that lead from wage replacements to wage supplements. Wage replacements in the form of unemployment compensation, social assistance, and early retirement are the main reasons for the malfunctioning German labor market. By providing wage-replacement income, the state becomes a competitor to private business in the labor market. If a person does not work, he receives income from the state, and if he does work, state income support is halted. A person will, therefore, demand that a potential employer pay at least as much in wages as the state pays for doing nothing. An employer who wants to avoid losses, on the other

hand, will not hire anybody who costs more than they produce. Thus, all those who are unable to produce more than the wage-replacement income provided by the government will remain unemployed.

The generous wage-replacement system has been responsible for the fact that immigration to Germany during the past 30 years has essentially resulted in indirect migration into unemployment. Domestic workers, who were able to rely on the state's wage-replacement benefits, preferred being pushed into unemployment over entering into low-wage competition with immigrants for scarce jobs. As a consequence, wages did not fall, jobs remained scarce, and the immigrants simply replaced domestic workers in the same jobs.

The biggest problem was among the unskilled workers, as social assistance pushed their wages above the market-clearing level the most. In past decades Germany had more immigration even in relative terms than other big countries, and now it also has far higher unemployment among unskilled workers. It brought millions of people into the country and then prevented wage adjustment to foster their employment by providing wage-replacement benefits. Wage-replacement benefits were expanded in the 1970s and the 1980s primarily to solve social problems at the margins of a well-functioning market economy, but since then the wage demands these policies produced have caused mass unemployment. A policy that was meant to help the poorer strata of the population has, in fact, deprived them of the right to be integrated into the working society. German politicians seem to be gradually realizing that this was the wrong approach. The Schröder government rightly shortened to 12 months the period when unemployment compensation is paid and merged the second-tier unemployment system with social assistance, but this was far from enough. Social assistance is much too high to be compatible with a functioning labor market for unskilled workers. Social assistance puts an absolute floor on the wage scale that prevents the necessary wage dispersion and upsets the entire wage structure in the low-wage range.

Despite some easing of the rules on additional earnings, the effective marginal tax burden on recipients of social assistance (Unemployment Compensation II) resulting from transfer withdrawal when an income is earned is still in the range of 80–90 percent, and in some income ranges even 100 percent and more.

The Ifo Institute has developed an alternative to wage replacement called Activating Social Assistance. With Activating Social Assistance, the benefit levels for employable persons who are not gainfully employed are reduced by about one-third. The funds saved are redistributed to low-wage earners who take a paying job. For incomes up to 500 euros per month no social assistance is withdrawn, in contrast to today's system. On the contrary, the state even

supplements self-earned income up to 200 euros at a rate of 20 percent. Above an earned income of 500 euros per month, more generous additional earnings are possible without social assistance being withdrawn at today's excessive rate.

Persons who cannot find a job may be employed by their local community's loan employment program at a wage rate equal to today's social-assistance rate. The local community then leases their labor to private businesses at the highest possible fee they can get, which however may be close to zero in particular cases. As long as the communities collect at least some money, this scheme is better for them than paying the social assistance without receiving anything in exchange. Moreover, people do work and make a contribution to GDP that otherwise would not have been available.

Local businesses will benefit from this measure, as Activating Social Assistance is a program for integrating moonlighting workers into their firms. First, these businesses will have more customers, as the recipients of social assistance will no longer have time to offer their services in the underground economy. Second, the persons concerned will be available as affordable labor to the local firms, either directly by way of subsidized employment or indirectly by way of loan employment.

The Activating Social Assistance program will create many jobs by making labor cheaper, so that an increasing number of the potential jobs that employers have in mind become profitable for them. Labor employed directly in the private sector will become cheap because the abolishment of the transfer withdrawal rate will reduce people's reservation wages to the natural level determined by the lost black-market income. Labor offered by the local communities and the loan agencies will become even cheaper because the required pay will be decoupled from individual reservation wages. At a sufficiently low wage rate, it will be possible to find demand for nearly all the loan labor offered.

The effect of the reform will extend beyond the group of employable social-assistance recipients directly affected, as the entire range from low to medium wage rates will be lowered. The economy as a whole will therefore experience an increase in employment that will be accompanied by an increase in aggregate supply and demand, boosting economic growth. According to conservative estimates by the Ifo Institute, not yet taking this secondary employment effect into account, the long-term increase in jobs to be expected as a result of abolishing unemployment assistance and introducing the Activating Social Assistance program will amount to about 3.2 million.

Despite lower wages for unskilled workers, past recipients of social assistance will be better off than before. The sum of self-earned wages and

supplemental social assistance will yield a higher income than such a person receives today in the form of social assistance. And the state will be no worse off. The program is constructed in such a way that the government will save about 8 billion euros per year in the short run and 21 billion euros per year in the long run relative to the current system of unemployment assistance.

With Activating Social Assistance, a more rational welfare state may be constructed than the one that exists today. The help that the new system will provide is best described as a change from government help to self-reliance. In the existing system, a person receives maximum state assistance only if he or she does not work. With Activating Social Assistance, maximum state assistance will be provided only for those who work. Everyone will be required to work according to his ability to receive an adequate income, and if one does not earn enough from one's job one will receive supplemental support from the state.

With this reform, Germany would no longer be the leader in unemployment among unskilled workers. The reform would also put an end to indirect immigration into unemployment, which results from the fact that wage-replacement incomes push up the wages of the unskilled, attracting more immigrants to a shrinking labor market, from which they crowd out the nationals. As the Activating Social Assistance program would clear the labor market, immigration no longer would crowd Germans out of employment. In view of the additional immigration that can be expected to follow liberalization of labor migration after EU eastern enlargement, there is no alternative to implementing this reform. The Activating Social Assistance program will help Germany to extract benefits from immigration and to summon the strength for new economic growth.

Work during Early Retirement

Besides the current system of unemployment compensation, Germany's early-retirement programs also have the effect of rewarding idleness at the expense of fostering productive labor-force participation. Those who take advantage of part-time retirement are able to raise their hourly wage rate by 60 percent, and those who retire before reaching age 65 need not fear any actuarially adjusted pension reduction. Someone who retires early receives, at present value, a higher pension payments from the state until death than someone who retires later, but the proviso is that the recipient leaves the labor market permanently, and may not continue working even part-time.

Early retirement also raises wage claims on the employer and increases unemployment. By reducing low-wage competition among workers—competition that would lead to wage moderation and job creation—it creates

the conditions under which it appears to be a useful policy measure for managing unemployment.

If jobs are to be created, paid idleness must not be rewarded and working for relatively low wages must not be punished. This maxim must also be considered in the overhaul of the current pension system.

In the future, early retirement should be granted only with actuarially fair pension reductions that are also fair to employers and the state and therefore do not cost extra money. In exchange, those who decide to retire early despite the pension reductions should have the right to continue working while receiving their pensions, albeit under new labor contracts, without being able to transfer dismissal protection from their previous jobs. As has been the case in Japan and Italy, a second labor market with low wages will develop in which people who have ended their primary careers will still be active. At low wages, economic activity will arise that will contribute to Germany's aggregate income and wealth.

Item 4: Turning Off the Immigration Magnet

Delayed Integration and the Home-Country Principle

In addition to high wages for unskilled workers, artificially pushed up by the wage-replacement incomes offered by the government, Germany's direct redistribution of income to immigrants attracts more of them than are needed. The German welfare system functions as a magnet because the state pays immigrants, who have below-average productivity and earn below-average wages, a migration premium. The state demands fewer taxes and contributions from the immigrants than it returns to them in the form of public services, including the freely available infrastructure and similar in-kind services. According to calculations by the Ifo Institute using the German socio-economic panel, in 1997 the migration premium amounted to almost 2,400 euros per year for immigrants who had been in Germany less than 10 years. For a family of five, this corresponds to an advantage of 118,000 euros in 10 years.

Such migration premiums should not be offered. Every EU citizen who wants to migrate to another EU country should be allowed to do so. Immigration from the new EU accession countries in Eastern Europe ought not to be restricted, but no gifts should be distributed that distort the decision to migrate relative to the incentives that the market alone would have provided. Only undistorted migration is advantageous to all countries concerned. That is why migrants should be fully integrated into the host country's social welfare system only after a waiting period. To be sure, immediately after their

arrival they should participate in those welfare benefits that are financed out of their own contributions, and they should also have access to most state services. But tax-financed benefits not paid for by the immigrants should temporarily be restricted to such an extent that immigration does not become a net fiscal burden for the host government. Housing allowances, free access to social housing, allowances for children that remained abroad, and similar benefits are among the things that could be taken off the list to make sure that immigrants receive only the benefits for which they pay. Full integration should be granted only after a waiting period that is long enough to ensure that the immigrant's fiscal status is balanced.

Inactive immigrants from other EU countries should not be included in the welfare system of the host country. They should direct their claims against the country of origin, which has satisfied the EU's entry standards. Welfare recipients should be free to consume their benefits in the EU country of their choice, but this cannot mean that that the host country should provide these benefits.

No European Social Union

In this context, a warning is warranted against a European social union as defined in the new EU draft constitution that failed to pass the French and Dutch referendums, and in the Directive on Free Movement that became binding on May 1, 2006. According to the directive, non-working EU citizens may choose to reside in any member country, and, after a waiting period of 5 years, during which they must support themselves, they may claim social assistance and other benefits just as local residents may. Active EU citizens who are employed or self-employed are even included after only a year, at which time they have the right to permanent support in the host country.

A European social union based on such rules will not work. German social assistance is a multiple of the net wage rate of an industrial worker in Eastern European EU countries and is even much higher than the net wage paid in some regions of Portugal, Spain, and Greece. Expanding the inclusion rights of migrants will result in a strengthening of migration flows and will aggravate the problems of the German welfare state and the German labor market.

A European social union will have problematic consequences not only for Germany but for all Western European-type welfare states. The European welfare states will be forced to enter a competition of deterrence aimed at rerouting migration around their nation in order to control costs. Every country will want to be a bit less generous than the neighboring ones; however, as each country reduces its benefits, the European welfare state will gradually erode.

In this situation, calls for harmonizing welfare standards at the EU level will become louder, as it will be hoped that leveling benefits will prevent a race to the bottom. Such a harmonization of welfare standards would be in line with the draft constitution. However, in view of the differences in economic performance among Europe's individual countries and regions, harmonizing social-assistance rates would be fatal. Harmonized social replacement incomes, which are still acceptable to the rich countries, would determine wage floors in the poorer countries and regions that the latter could not cope with, and would ruin their economies. As was noted in chapter 8, there would not be two but twenty Mezzogiorni in Europe. The richer countries would then be asked to pay more in order to finance unemployment in the poorer countries. The German unification experience would be repeated at the pan-European level. In order to prevent this, the European social union cannot be constructed as laid out in the Directive on Free Movement and in the draft constitution. Real economic convergence of the European states would have to advance much further to avoid the devastating consequences of welfare harmonization. Any attempt to speed up real EU economic convergence via a legislated social union would end in a labor-market disaster. For this reason, the corresponding sections of the draft constitution should be changed in such a way that the individual states have the right to differentiate between the local population and the immigrant population in regard to their welfare benefits. Doing without a social union is an essential precondition for a uniform internal market with free labor mobility and for a prosperous Europe in which living standards will eventually converge.

Item 5: A Leaner Tax System

Less Government and Less Taxation

Since the social-liberal coalition took office in Germany (more than 35 years ago), the government share of gross domestic product, which was less than 40 percent in the early 1970s, has risen substantially. At present it is 47 percent, and a further increase is in sight because of various tax increases recently enacted. Related to net domestic product or the sum of all incomes earned in Germany, the government share has already reached 55 percent. That is more than is compatible with a well-functioning market economy. The taxes and fiscal charges that finance public-sector spending hamper private-sector activity and deter people from pursuing productive undertakings, because avoiding a larger tax burden becomes the paramount aim. This incentive can trigger deleterious changes in the behavior of international and national investors, savers, and workers, and useful economic activity is lost.

The explanation for the large government share of GDP is not that Germany has an unusual amount of public-sector employees relative to other nations. Indeed, the opposite is the case. Germany even ranks behind the United States in government employment share, and it does not apply the Scandinavian accounting trick of boosting GDP with an excessive government wage bill. The education sector is not to blame, either. Germany spends proportionately less on education than most other OECD countries. Rather, the government share is so high because Germany has extremely high welfare expenditures. Besides interfering with the labor market and distorting migration flows, the benefits provided by the German welfare state cost a lot of money.

The welfare state tends to reinforce itself. An estimated 41 percent of German voters receive their income primarily in the form of pensions or other social benefits. Thus, there is already a large group of voters that tends to oppose any change to the status quo. The expected increase in the future share of retirees will further raise the proportion of voters who receive state benefits. The chances for fundamental reforms in Germany may therefore be waning. Only if and when the beneficiaries of the state realize that the disincentives present in an excessively generous welfare state will ultimately pull everyone down will a political turnaround in Germany be possible.

Relative to other European countries, Germany's average burden of tax and social security contributions is not excessive. However, the marginal tax rates are extremely high. The value added of an average manufacturing worker bears a marginal tax burden of about two-thirds. No other European government deducts so much from the workers' paychecks when they increase their income by additional effort or additional training. A reduction in income taxes, especially a flattening of the progressive tax rates, is urgently needed.

At the same time, capital income should be taxed less, as a capital income tax causes massive evasive reactions by international investors. These evasive reactions are at the expense of German workers, whose high wages are essentially made possible by the large capital stock available to them, which generates a high measured labor productivity. In addition, taxes on capital income clearly violate the postulate of horizontal equity, because those who intend to consume their wealth later are forced to sacrifice a higher percentage of their consumption than those who prefer to consume their income immediately.

A Dual Income Tax

An income tax system incorporating horizontal equity in a very simple form and providing an incentive to keep mobile capital in Germany could look like this: There would be only four tax rates (0 percent, 15 percent, 25 percent, and 35 percent) and four tax brackets for jointly assessed source income from labor

and similar sources. Capital income, including the implicit return on capital contained in firm profits, which is not source income, is excluded from the general assessment and is taxed at 20 percent. With lower taxation of the explicit and implicit returns on capital, this proposal imitates the dual income taxation practiced in the Scandinavian countries.

Profits of corporations and unincorporated firms exceeding the pure return to capital are uniformly taxed at 35 percent, of which 10 percentage points go to the local communities as the trade tax, the essential function of which is to give local communities an incentive to provide urban space for businesses. The German "half earnings procedure" for distributed profits is retained, albeit at reduced rates.

The fiscal offset for these measures may be sought in a radical reduction of subsidies that do not have any place in a market economy, beginning with subsidies to the agriculture and coal mining industries. In addition, the welfare state must be reduced, for it consumes gigantic sums and, as has been explained throughout this book, imposes many disincentives on the willingness of transfer recipients to offer their labor in the market. The aim must be to reduce the size of the government budget and to strengthen private-sector activities.

Item 6: More Children, More Retirement Income, More Progress

Learning from France

The most difficult and most important long-term policy problem facing Germany is the extremely low number of births relative to other countries. In fact, Germany has fewer newborn children relative to its population size than any other developed country. A big demographic crisis is therefore inescapable. Ever since the Nazis abused population policy, the topic has been taboo in Germany. But it is too important to be ignored any longer. Like any other country, Germany needs children in order to maintain its society, to preserve its social security system from ruin, and in general to safeguard its future.

For policy ideas on raising its birth rate, Germany can look to France. France's population had declined relative to Germany's in the nineteenth century, but since losing the 1870–71 Franco-Prussian War France has succeeded in raising its birth rate with the help of state incentives.

In contrast to Germany, France has an excellent system of all-day kindergartens and elementary schools that helps working women decide in favor of having children. It also provides great financial incentives for having a second and a third child. Those incentives exceed Germany's even for lower-income families, and they increase net family income for each additional child more than is the case in Germany.

Of special note is France's "family splitting" policy of income taxation, a device that assesses children, similar to the spouse in the German tax system, jointly with the income earners. Family splitting reduces the tax progression considerably and provides incentives—especially to middle-income families—to decide in favor of having several children.

The Child-Funded Pension Scheme

Because of the demographic crisis, retirement pension insurance should be fundamentally redesigned. In today's pay-as-you-go system, retirement pension insurance can be seen as an obligation that ensures that children support their parents in old age. At the same time, it can be seen as insurance against childlessness, as those who cannot have children of their own are put in a position to be supported by other people's children. Socializing part of the children's pension contributions is the rational decision of a society that wants to protect its members from the economic consequences of individual childlessness.

Yet socializing the children's contributions eliminates the link between individuals' child-raising efforts and their pensions. For a comfortable living standard in old age, it suffices if other people raise children. Having children of one's own is not necessary. One's pension claims do not depend on one's children; they depend only on one's contributions to financing the pensions of one's parents' generation. As a consequence, the natural economic motivation for having children to get old-age support from them has been completely eliminated from the minds of young people. This has contributed to the drastic decline of German birth rates since the introduction of retirement pension insurance under Bismarck. Pension insurance itself is among the factors that have caused to the demographic crisis from which it suffers today.

Full insurance against childlessness, as offered by the pension system, has not stood the test of time. It should be replaced by partially funded pension insurance that will still insure an individual against the consequences of childlessness to some extent but will leave part of these consequences to those who decide not to have children. Everyone's responsibility for the decision whether to have children should be strengthened.

To put this idea into concrete terms, one could react to the impending 50 percent reduction in the number of contributors relative to the number of retirees by introducing a retirement pension system based on three pillars.

The first pillar is the existing statutory retirement pension system. It should be preserved as a basic insurance scheme, but the state should not keep pumping ever more money into it. The contribution rate is fixed, and so is the percentage of federal subsidy in excess of non-insurance benefits. Because of

demographics, pensions will rise more slowly than they would under present law.

The second pillar is a new child-funded pension system for parents. It will be granted independently of whether these parents have worked, and it will be available to civil servants, to the self-employed, and to non-working spouses. A supplemental pension will be paid per child up to a maximum of three children. The size of the pension per child will depend on how long one cared for the child. This second pillar will be financed by a general contribution of all people who are employed including the self-employed. The pension is designed in such a way that the average earner with three children receives the same amount of retirement pension from it and the first pillar that he would have received according to present law.

The third pillar consists of a wealth-funded pension for the childless. Young people entering the labor market must save part of their income in order to fund a pension that comes in addition to the first pillar so that today's protection level is maintained during the pension crisis expected by the mid 2030s despite the dwindling of the statutory pay-as-you-go pension. When the first child is born, one-third of the accumulated savings is released and one-third of the current savings obligation is waived, and similarly with the second child and the third. The missing wealth-funded pension is successively replaced by the child-funded pension according to the second pillar. This new retirement pension system is equitable, as the working generation must bear two burdens as it has throughout human history. It must, first, support its parents by paying contributions to pension insurance. Second, it must make provisions for its own old age. It does so by either raising children (i.e., forming human capital) or by saving and forming financial or real capital, or by some combination of the two.

The new system will safeguard pensions despite the demographic crisis. Furthermore, it will restore some of the natural economic motives for having children, which the state has destroyed by fully socializing the children's contributions. If Germans start having more children, there will be higher pensions as well as more economic progress and growth. The country will once again have a future,

Item 6 + 1: New Dynamism in East Germany

The policy recommendations of the first six items also apply to East Germany. But the question "Can Germany be saved?" is even more urgent there than in West Germany, and as a consequence the need to act is also greater there. Since 1997 East Germany's economy has been growing more slowly than West

Germany's, even though West Germany's growth rate was the second-lowest in Europe during the period 1995–2005. The ratio of East German to West German aggregate labor productivity has been stuck at 60 percent since 1996. Per capita investment in machinery and equipment is substantially lower in East Germany than in West Germany, although it should be higher if East Germany is ever to catch up with West Germany. The number of employees subject to social security has been declining by 2 percent per annum during recent years.

It is no contradiction that East Germany's standard of living has already reached 90 percent of West Germany's in real terms. This fact is due mainly to West-to-East transfers via social security, the federal states' fiscal equalization scheme, and the federal budget. More than 15 years after unification, East Germany's absorption of goods and services by private households, investors, and the state still exceeds East Germany's production by half. One in three euros spent in East Germany originates in West Germany. Of this euro, 75 cents is a gift and 25 cents is a loan. Even from an historic perspective, it is hardly possible to find another region in the world that is as dependent on outside transfers in percentage terms and where the excess of purchasing power over production has taken on such gigantic magnitudes. East Germany has become a transfer economy that could not survive without the funds from West Germany. As 47 percent of East German voters receive their main income from the state in the form of social benefits, there is a great inclination to continue this state of affairs.

The historical reason for the obvious failure of German unification is found in the fact that wages in East Germany rose more quickly than productivity. And this fact is itself due to long-binding collective bargaining agreements, forged in 1991 and since renegotiated, in which West German competitors represented East German employers and West German unions represented East German workers. Another reason for the failure of German unification is the social union that imposed the West German wage-replacement system on the East German labor market, building up wage claims that the market was unable to satisfy. People wanted too much too fast, and as a result the 14-year lead that East Germany had over its formerly communist partners that only recently joined the European Union was wasted. Now East Germany has to catch up to the dynamism of its fellow formerly communist nations, amid a much harsher international macroeconomic climate.

Activating Social Assistance as Protection against Formerly Communist Friends

General unemployment in the East German Länder, at about 20 percent, is as bad as unemployment among West Germany's unskilled workers. And the

causes are similar. Although East Germany's formal skill level is high, and there are hardly any unskilled workers there, labor productivity is still very low because of substantial deficiencies of other soft and hard factors, ranging from geographic location to the infrastructure to the social acceptance of entrepreneurship. Because of low productivity, wages that have been equalized at a high level are a problem shared by the unskilled workers in West Germany and the skilled workers in East Germany, as dissimilar as these two employee groups may be in other respects.

While East German aggregate productivity is about 60 percent of the West German level, wage costs per hour stand at about 73 percent. This mismatch is the problem.

At present, the high East German wages are due primarily to the wage-replacement benefits of the welfare state. Collective bargaining agreements are playing a smaller and smaller role as more and more firms leave the employers' organizations. With social assistance as the basis of their wage claims, East Germans keep waiting in vain for the establishment of firms that are willing to pay more. Their excessive demands cement a lamentably low level of industrial employment—a rate comparable to that in the Italian Mezzogiorno.

Politicians cannot set wages, but they can determine the framework that permits market forces to work. To eliminate the high-wage competition posed by the welfare state, the Activating Social Assistance program, as described above, must be introduced by the East German Länder unilaterally if the Western Länder object to a nationwide solution. Today's social assistance blocks the road to lower wages, with which one could fend off the competition by the new EU countries in Eastern Europe. The funds that today flow to East Germany in the form of unemployment benefits and social assistance may continue to flow, but in the future these will be needed for co-financing wage incomes instead of paying for idleness. If the state opened its pockets for those who earn low wage incomes and kept them closed for those who could work but do not, the East German labor market would start recovering. Reservation wages, and with them actual wages, would decline, and as a result employers would offer more jobs in Germany. Rather than move production to Krakow, Posen, or Pilsen, they would invest in Zwickau, Chemnitz, or Magdeburg.

There is no realistic alternative to this reform if East Germany is to withstand the competition from other formerly communist countries that have been members of the European Union since May 1, 2004. Poland and the Czech Republic, East Germany's immediate neighbors, are attracting investors with wages that are only small fractions of East German wages and even much lower than German social-assistance rates. One need not be an economist to see that East Germany has no chance of coping with EU eastern enlargement

in economic terms if the social-assistance system and the wage floor it creates are left unchanged.

It must be emphasized that the Activating Social Assistance program is designed in such a way that recipients of social assistance will be no worse off financially than they are today and, as a rule, will enjoy even higher incomes. At the present level of social assistance, they will at least be able to find jobs with the state, which will lease their labor to the highest bidder in the private sector. They will do better, however, if, provided with a wage supplement, they look for a job in the private sector, where they will earn as much in a half-day job, despite the wage reduction, as in a full-time job with the state. The poorer population groups in East Germany will do markedly better financially than they would in the absence of the reform.

Co-ownership in Exchange for Wages

East Germany needs investment wage schemes. Lower wages in exchange for co-ownership granted to those employees covered by the collective bargaining agreement will cushion the necessary wage reduction in East Germany. Besides strengthening the competitiveness of East German firms, this will correct the fundamental economic mistakes made by the unification policy that did not give the new citizens shares in the old state enterprises but instead promised them high wages. In view of the high social transfers that came with the high wages, the mix was more than fair to the new citizens, yet it was inefficient. Lower wages were needed in order to stimulate investment, and asset ownership by East Germans was needed to help them safeguard their future and establish their own businesses. Sharing in the productive assets in exchange for reduced wages would allow some ex-post correction of past economic mistakes.

Furthermore, ownership participation by the citizens of East Germany would fulfill the mandate of Article 25, Section 6 of the Unification Agreement, which provides for the distribution of securitized shares in the former socialized assets to the former citizens of the GDR. After all, this mandate has a constitutional status, because the Unification Agreement itself has this status.

This is the reform agenda that Germany really needs. It goes far beyond Gerhard Schröder's Agenda 2010, as necessary as that was. As the election results of 2005 showed, however, the Germans are not yet convinced that they should go further. Although Angela Merkel had adopted a significant share of the proposals of this book in her party platform before the election (and had given the author a chance to help formulate that platform), her near-failure in

the elections has changed the balance of power in her party and perhaps even changed the balance of priorities in her mind. Merkel seems to have forgotten her courageous campaign, and there are influential party members who even want to step back from the Agenda 2010 in the direction of a renewed expansion of the old welfare state based on replacement incomes, because this promises to win more votes in the upcoming Länder elections. The opportunism is breathtaking. If Germany does not want to condemn its children to suffer as guinea pigs of history, it must act now. The necessary reforms are time consuming, but Germany has no time. The rest of the world is not waiting, industrial sectors that go astray will never come back, and the German Baby Boomers who are now about 40 years old will soon lose their energy. There is no alternative for Germany, and none for the rest of Europe.

19. To be more precise, the "marginal congestion costs" of using impure public goods should be included. Assuming that the local communities and provinces that provide these goods are of optimal size (long-run minimum average cost), one can show, using a theorem of Mohring and Harwitz, that the marginal congestion cost equals the average fiscal cost of providing the goods. See H. Mohring and M. Harwitz, *Highway Benefits. An Analytical Framework* (Northwestern University Press, 1962).

20. See Sinn, "The Value of Children"; H.-W. Sinn, "EU Enlargement, Migration and the New Constitution," *CESifo Economic Studies* 50, 2004: 685–707; A. Razin and E. Sadka, "Net Fiscal Burden as a Measure of Migration's Economic Impact on the Welfare of the Native-Born Population," *CESifo Economic Studies* 50, 2004: 709–716.

21. See the section on Activating Social Assistance in chapter 4.

22. According to a poll conducted by the market research institute Forsa for the German news magazine *Stern* (May 10, 2006), Germans continue to support the project for a European constitution in principle. Of those polled, 61% were of the opinion that the EU needed a unitary constitution.

23. R. Kanitz and P. Steinberg, "Grenzenloses Gemeinschaftsrecht? Die Rechtsprechung des EuGH zu Grundfreiheiten, Unionsbürgerschaft und Grundrechten als Kompetenzproblem," *Europarecht* 6, 2003: 1013–1036. See also S. Damm, "Bürgergleichheit in Europa—Zur wechselbezüglichen Entwicklung von Unionsbürgerschaft und europarechtlichem Gleichheitsschutz," in *Europa der Bürger? Nach der Euro-Einführung und vor der EU-Erweiterung—Zwischenbilanz und Perspektiven,* ed. R. Scholz (Hanns Martin Schleyer-Stiftung, 2002).

24. See in particular article 39 of the EU Treaty, articles 10–12 of Regulation (EEC), no. 1612/68, and articles 43 and 49 of the EU Treaty.

25. European Court of Justice, Rec. 1998, p. I-07637, Case C-274/96, esp. Rz. 14ff.

26. See the Directive of the European Parliament and the Council regarding the right of EU citizens and their families to move and reside freely in the territory of the Member States, passed by the European Parliament on March 10, 2004: Directive 2004/38/EG of April 29, 2004 (Official Journal L158, p. 77ff.).

27. There is a legal ambiguity hereto the definition of resources. On the one hand, the directive specifies that subsistence may not be a fixed amount but must be determined according to the individual's circumstances (article 8.4). It says that no person seeking entry may be discriminated against on the basis of insufficient assets (preamble 31). German communities normally do not control whether these requirements are met but satisfy themselves with mere declarations of the immigrants.

28. The purchasing-power parities considered here are from http://www.oecd.org (June 8, 2006).

29. Pensions at a Glance (OECD, 2005), p. 163.

30. See Sinn, *The New Systems Competition*, and references cited therein.

31. See M. Thum, EU Enlargement, Fiscal Competition and Network Migration, working paper, TU Dresden, 2000.

32. See Wissenschaftlicher Beirat beim Bundesministerium der Finanzen, Freizügigkeit und soziale Sicherung in Europa, report 2001 (http://www.bundesfinanzministerium.de); Sinn et al., "EU Enlargement and Labour Mobility."

Chapter 9

1. Presidency Conclusions, Lisbon European Council, March 23 and 24, 2000, p. 2.

2. Sources: http://www.imf.org, http://devdata.worldbank.org, http://epp.eurostat.ec.europa.eu, Ifo Institute calculations.