The Ifo Viewpoints 1999

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10

Currency Boards for the New EU Member States*

By the year 2004, the first five Eastern European countries are expected to be granted EU membership. It is clear that they will not be given the euro at the point of accession, but how they will be linked to the euro zone is still unclear. An EMS III is under discussion in which exchange rate target zones will be agreed with the European Central Bank. But such a system will not effectively protect the national currencies from speculative attacks, as the 1992 West European currency crisis demonstrated, and the system will thus be accompanied by large risk premia in the national interest rates which will constrain the urgently needed influx of capital. The situation of the smaller Western European countries in the 1990s clearly shows where the problems lay. It was not until the fixed exchange rate system of the euro that the risk premia disappeared and that the risk-free movement of capital became possible.

Currency Boards are appealing alternatives in light of this experience. Currency Boards would mean that the new EU member states buy euros to back their own monetary bases and have these euros at their disposal to ward off any attacks on their own currencies. The exchange rate to the euro would be prescribed by law, and the national central bank would be obligated to change the national currency into euros at this rate at any time. In contrast to a mere agreement on target zones, currency boards would produce credible, fixed exchange rates and thus create the low interest rates which would allow an unconstrained export of capital to the acceding countries. If currency boards are introduced at the time of accession, a rapid convergence of the economies of the Eastern European countries to the Western level can be expected, and thereafter they can be given the euro as their own currency.

* December 23, 1999.

9

EU Enlargement: The Migration Problem*

The eastern expansion of the EU is almost as momentous as German unification. Whereas the latter led to a 26 percent increase in the population of the Federal Republic, the former will increase the population of the EU by 28 percent if all ten entry aspirants are accepted. No fewer than 105 million people are waiting for accession.

A special problem will be posed by migration. Wages in the applicant states are mostly about one-tenth of western German wages and one-fourth to one-sixth of German welfare benefits. In view of these figures, a massive westward migration can be expected after EU expansion. Using projections based on Turkish migration to Germany, we can expect four million immigrants from Eastern Europe, but in light of the free movement of labour that EU citizens enjoy, this number is only the lower limit of plausible estimates.

A temporary east-to-west migration up to the time that the eastern countries have created an efficient capital stock makes economic sense if it is driven by wage differences and meets with a flexible labour market (see Ifo Standpoint no. 6). Since wage differences reflect productivity differences, this migration will lead to an increase in the European social product which will be large enough to offset the migration costs.

Migration does not make economic sense, however, if, and to the extent to which, it is induced by the current social assistance systems, for this will lead to a decline of the European GDP. Moreover, welfare-motivated migration would create competition among Western European states to frighten off potential migrants, which would lead to an erosion of the traditional social welfare state.

If the EU plan incorporated a limitation of the free movement of labour, the beneficial migration would also be stopped. A better solution would be to limit access to the Western social systems, at least for a transitional period in order to filter out migration induced by differing social standards. An EU-wide application of the home-country principle used by Switzerland in the granting of social benefits would achieve this goal. The idea under discussion of limiting guest-worker employment to jobs on an independent contractor basis is in accord with this principle since it would allow employment in the West but hinder access to the Western social system. Other variants of the home-country principle are conceivable, too.

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* December 23, 1999.

8

Transrapid*

It will cost approximately DM 10 billion to build the dual-track magnetic levitation train, Transrapid, between Berlin and Hamburg. The federal government is to pay DM 6.1 billion of the costs and the federally owned Deutsche Bahn DM 3.7 billion, the latter sum being financed by a private operating company. The operating company will receive payment in the form of a fixed rent from Deutsche Bahn. The surplus of revenue over the variable operating costs will first be used for this rent; the remainder, if any, will be distributed in equal shares to the federal government, Deutsche Bahn, and the operating company.

The great uncertainty is the revenue surplus, since it is based on questionable passenger projections and on the price elasticity of demand. Many experts doubt whether the maximum possible surplus will be sufficient to cover the investment costs of the private operators. Deutsche Bahn and the operating company expect to make losses, and the government seems to have accepted the demise of Transrapid, having concluded from the private losses that Transrapid generates social losses, too.

Equating private returns and social returns is useful in general but not in the case of public goods, which are characterized by low variable operating costs, absence of crowding externalities, and comparatively high fixed costs, all of which apply to the Transrapid project. An optimal economic utilization of Transrapid calls for ticket prices that would just cover the variable (marginal) operating costs and which would then generally produce no revenue surplus that could be applied to the financing of the fixed costs. Setting a ticket price that is higher than this would not be economically wise since it would discourage passengers who would be prepared to pay more than the marginal costs they cause. In the case of public goods, fixed costs must not be distributed, a principle that everyone naturally adheres to in the use of streets, bridges, dams, the judicial system and the police force.

The conclusion is that new negotiations and an economic cost-benefit analysis are needed. Deutsche Bahn, as the operator, should be told to set prices that only cover the variable operating costs and the whole project should be financed by the government. Private investors are not required for the provision and financing of public goods. Transrapid is no exception.

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* December 1, 1999.

7

Opt-out Clauses*

In Germany sector-wide pay agreements are negotiated between unions and company representatives. The specific competitive conditions facing an individual enterprise are not taken into consideration and the agreements are binding for member companies of the employers associations. According to the German Workplace Labour Relations Law (Art. 77, Sec. 3 BetrVG) not even the companies that are not bound by the wage settlements are allowed to negotiate with their own works councils on working conditions already regulated by collective bargaining agreements. It should, however, be permissible for companies to opt out of sector-wide wage settlements, for when both employer and employees decide on lower wages than those established in collective bargaining to save a business it should be possible to implement this decision.

It is surprising that the unions have voiced criticism of the opt-out clauses since, contrary to a prevailing assumption, it is the workers who stand to profit. In the short-term and at present negotiated wage levels the opt-out clause saves jobs that would otherwise be lost, thus also increasing payrolls. In the long-term wage income increases because the unions will no longer have to adjust their wage demands to the weakest companies but will be guided by what the better enterprises can afford, given that the other companies can make use of the opt-out clauses and reach agreement on lower wages. If anyone should have objections to the opt-out clauses, it would be expected to come more from the employers´ organizations than from the unions. The public positions expressed by the two sides do little justice to the true facts of the matter.

Regardless of these distributional matters, wage differentiation that will result from the opt-out clauses will create additional jobs that would otherwise not be economical. The fact that the shifts in distribution would benefit labour more than capital does not change the fact that there will be welfare gains for the society as a whole. Opt-out clauses should be included in the Alliance for Jobs initiative.

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* November 22, 1999.

6

A New Welfare Concept*

In Germany the lowest wage is 70 percent of the overall average wage; in the United States it is 30 percent. This is basically why underemployment in the area of simple jobs is so great in Germany and so small in the US. Simple jobs cost more than they create in value, and this is why they are not so plentiful.

High pay for simple jobs is a result of the German social welfare system. Since entitlement to full welfare payments is only possible when no labour income is present, and since welfare payments are reduced in direct relation to labour income, the lowest wage cannot fall below welfare benefits.

Instead of designing welfare as a subsidy for inactivity, it would be better to convert welfare into a subsidy for activity, since this would lead to a disappearance of the lower wage level in the negotiated pay system. Welfare that would only be paid when the recipient takes on a job and which in addition would increase along with earned income up to a specified income level would create the incentive to take on low-paid jobs. Negotiated wages for simple jobs would decline, and new jobs would be created.

This would be more in accord with the goals of the social welfare state than the present system, since earned income would be joined with the money that the state provides as social welfare. Despite the lowering of wages, despite the unchanged social welfare budget, and because of a full free-rider effect, the incomes of low wage earners will be higher than is the case today. Moreover, the creation of new jobs will provide a stimulus to growth that will create new prosperity for everyone.

The earned-income tax credit in the US is an example of a social welfare system that has the characteristics just presented even though, from a German point of view, the level of American social welfare is too low. In addition to the 1986 tax reform, the earned-income tax credit has contributed to the American job miracle. It is not the level but the incentive structure of the American system that should be adopted in Germany in order to create a similar job miracle.

* November 15, 1999.

5

Tax Reform*

The tax reform proposed by the German government focuses on relief for retained earnings. Businesses will be induced not to distribute their profits but to retain them and invest them in domestic or foreign capital markets. This will only intensify the concentration of power of existing corporations and impede the formation of new businesses. In contrast to the significant relief for corporate leaders and their enterprises, the earnings of human labour will continue to be burdened by a strongly progressive tax scale. The reform will not help mobilize the labour market or promote investment in human capital.

The Ifo Institute has presented an alternative that removes the asymmetries of the government proposal. In the personal income tax, the Ifo alternative calls for only three marginal tax rates of 20 percent, 30 percent and 40 percent; corporate earnings should be taxed at a rate of only 30 percent, accompanied by a reduction in the local business tax (Gewerbesteuer) to effectively 10 percent. The maximum tax on all types of revenue is a uniform 40 percent. Despite the broadening of the tax base, which in itself would lead to increased revenue of DM 30 billion, the Ifo reform proposal would lead to net savings of DM 50 billion for taxpayers. This tax cut can be financed by reducing subsidies by 10 percent and cutting social benefits by 3 percent.

The tax regime proposed by the Ifo Institute is revenue neutral for enterprises, it is simple, clear and practicable, and investment will no longer be motivated by tax loopholes but will go where the highest real income can be earned. It will provide greater incentives to invest in education and training, it will reduce the shadow economy, and it will create new jobs since it will contribute to moderation in wage negotiations.

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* November 8, 1999.

4

Funded Pensions*

Germany can expect a major demographic upheaval. Even with an additional eleven million immigrants, as the German Statistical Office projects, the number of pensioners in relation to the working population will more than double by the year 2005, and by 2020 it will no longer be possible to finance pensions at the present contribution rates. In addition to growing life expectancy, another cause is the declining birth rate in Germany: currently 10 Germans will have no more than 7 children throughout their lives. With fewer children, there will be fewer social insurance contributors for each pensioner, and the social insurance crisis will worsen.

The solution to this problem can only lie in private supplementary savings, since the declining number of contributors must be offset by personal savings. This must begin immediately while there is still time. It is also not possible to finance these savings by social insurance contributions since the full amount of these contributions is needed for today's pensioners.

Supplementary savings would not be an excessive burden, since the money that would otherwise have gone for child-rearing is in principle available for capital investment. In the past, people in working age had to support both the old and the young; today they often only support the old. It is not unreasonable to require the presently working generation to participate in savings plans in lieu of not having children. The necessary earning power is there.

Supplementary savings cannot be left to individual choice, since in many cases the prospect of social welfare benefits weakens the incentive for private savings. Due to the demographic crises, average benefits from the pay-as-you-go pension system will hardly be greater than welfare benefits. Those who expect a below-average pension, due to a low income or a reduced pension as a childless person, would tend to view their own personal savings as useless: at least a portion of these savings would only reduce the welfare benefits they might have to rely on. An obligatory savings plan is necessary to compensate for the lack of savings incentives.

* November 3, 1999.

3

Ten Years of Eastern German Recovery*

The recovery in eastern Germany has made considerable progress over the past ten years. Hourly wages have gone from one third to now more than two thirds of wages in western Germany, welfare payments surpass the GDR standard of living, and eastern German pensions are higher than those in western Germany.

However, only about two thirds of the goods and services used in eastern Germany are covered by eastern German GDP. The major portion of the consumption overhang is financed by government transfers from western Germany. Since unification, a net amount of more than a trillion deutschmarks in public funds have been transferred to eastern Germany. This amount also corresponds to the growth in the German national debt in this period. Unification was thus financed at the cost of future generations already heavily hit by social security burdens.

The major failing of this policy was the rapidly forced equalization of eastern German incomes. Wage harmonization was agreed before privatization had taken place and before there were eastern German enterprises that could have joined negotiations on this point. Even without the influence of western German employers' representatives and trade unions, wage increases would have occurred over time, but not so rapidly. Lower wages would have attracted international enterprises and have enabled a speedy economic upswing. The shortage of labour would ultimately also have led to an alignment of eastern and western German wages.

It is not too late, however, to ameliorate the consequences of this misguided policy. Hardship opt-out clauses from sector-wide pay agreements can enable wages to be lowered if enterprises and employees both want this. Giving eastern German employees shares in their enterprises would be a possible compensation for such pay reductions. Another option is the privatization of the still-extensive amount of municipally owned real estate for the benefit of the citizens, which would also help compensate for moderation in wage agreements.

A mixture of lower wages and co-ownership of the existing means of production is certainly more congenial to a functioning market economy than financing via handouts.

* October 26, 1999.

2

Bans on Advertising[*]

Advertising is the life-blood of a market economy. It allows consumers to compare products and creates the competition essential for free enterprise. Advertising facilitates consumers' quests for information and encourages firms to improve quality, since they can present their customers with quality improvements and thus enhance their profits. Even advertising with apparently weak statements can be informative, since advertising only pays for firms that offer high-quality products and that hope to make regular customers out of first-time buyers.

There is of course aggressive advertising that is all-pervasive and misleading advertising that suggests non-existent product qualities. Advertisements for habit-forming products allegedly aimed at adults but which appeal to adolescents and children can counteract parents' educational goals, and parents have no real chance of preventing their children from being exposed to this advertising. To prevent the danger of misleading advertising, the scope of comparative advertising should be expanded and brought in line with US practices. Intrusive advertising such as ads via fax, email, loudspeakers and alongside highways should not be allowed. Advertisements for products that are harmful to health or those that are liable to have an undesirable influence on the moral development of young people should be restricted. Here, there are good arguments for the total ban on tobacco ads as planned by the EU. A comparison of OECD countries shows that a complete ban on tobacco ads can lead to a 7 percent decline in tobacco consumption. Private television channels that are readily receivable should be restricted in their broadcasts of commercial sponsored programmes that loosen taboos on sex and violence. Pay TV, which parents can choose to subscribe to or not, is the proper place for such programmes.

Otherwise, restrictions on advertising should be rejected to allow market forces to operate freely. Restrictions should be the exception to the rule and only in cases where impartiality prevails. Advertising restrictions aimed at protecting professional groups (doctors, lawyers, architects, etc.) – and also intended to limit competition within these groups – cannot be considered impartial and should therefore be abolished.

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[*] October 26, 1999.

1

State Pension at 60*

In connection with the Coalition for Jobs programme, the IG Metall trade union is lobbying for a state pension at 60 on a pay-as-you-go basis, with temporary intermediate deposits of the Tariffond contributions collected from employers and employees.

This proposal is a renewed attempt to conceal unemployment, which does little to solve the problems on the labour market; in fact it would only make them worse. Former Labour Minister Norbert Blüm made a similar proposal with his early retirement scheme. Early retirement helps eliminate older unemployed workers from the unemployment rolls, and also, to some extent, to replace older workers with younger ones. The result, however, is an increase in the tax on wages which makes labour more expensive and reduces the total number of jobs. This leads to additional unemployment which a future government will likewise seek to conceal with similar methods, leading again to an increase in the tax on labour and to a reduction of jobs.

The pressure to produce fast results in combating employment before the next election leads to a vicious circle of a constant decline in good jobs. More and more money is spent for idleness, and more and more burdens must be borne by the working population. The labour market shrinks with every reform measure.

Early retirement not only destroys jobs; it is the opposite of what is necessary to consolidate the German social security system.

The German population is ageing and fewer children are being born. In 35 years for every working-age person there will be twice as many elderly people, even without early retirement. In these circumstances not a decrease but an increase in the retirement age would be better suited to counter the growing fiscal burden placed on the working population.

* October 26, 1999.