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Ifo Viewpoint No. 21

Social Welfare Reform

The stronger German economy has led to a decline in unemployment. This however cannot disguise the uninterrupted trend towards greater unemployment in Germany since the 1970s, especially among the less qualified. This unemployment means a loss in GDP and is a major social tinderbox. Since millions of eastern Europeans will enter the German labour market after EU expansion, problems are inevitable. The labour market needs structural reforms, and social welfare reforms are certainly the most important.

German social welfare is tantamount to a minimum wage floor that prevents the creation of new jobs. No one is willing to work for wages below the level of welfare benefits. And no business will hire anyone whose wages exceed labour productivity. People whose labour productivity falls below welfare cannot find jobs for this reason. They are caught in the poverty trap.

The effect of social welfare is based on its wage substitution function, but this need not be so. Instead of providing payments for idleness, the state could insist that beneficiaries have some market income, so long as family or medical circumstances do not prevent this. This type of welfare has been practised in the United States for many years under the Earned Income Tax Credit programme. In Germany the state cuts welfare payments by seventy pfennig to one mark when the welfare recipient earns a mark on his own. In the U.S. the government provides an additional 40 cents for every dollar earned, up to a particular level.

The German social welfare system fixes a lower limit for wages. The American system makes wages flexible in the lower regions. If Germany adopted the U.S. welfare system, the conflict in Germany between the goal of a minimum standard of living and private-sector employment would be eliminated. Illicit work would lose its appeal and people would be prepared to work for lower wages since only the proof of their own earnings would entitle them to welfare benefits. In America the lowest wages are about 30 percent of the average wage; in Germany they are about 70 percent. It is no wonder that the U.S. has experienced a job miracle and that Germany has run out of jobs.

American social welfare differs from the German not only in its incentive structure but also in the level of the protection provided. Despite state support, the income of the less qualified is considerably lower than in Germany. To avoid the problem of the American working poor, the system must be much more generous than in the U.S. This has the additional advantage that the lowest collectively bargained wage rate will begin to erode more quickly, which will allow the creation of jobs for the less qualified. A general boost in growth would occur, and the distributable amount of goods and services would increase. Social policy performance would probably also improve. Those to be helped would have two incomes instead of one and with welfare and own earnings would have more income than before at the same amount of state social welfare expenditure.

Inherent in the U.S. system is the harsh treatment of those who could but refuse to work. This harshness is not contrary to the goal of helping the less qualified in a dignified way. On the contrary, this system is in a better position to reach this goal. The German welfare system makes people feel useless, encourages idleness, and creates habitual patterns for children who grow up in these circumstances. Neither a Christian- nor a social-democratic philosophy demands that assistance to the less qualified be conditional on idleness. It is hard to believe that this is the way the system still works.

A transition to an earned income tax credit may not be smooth. For this reason welfare benefits should be lowered gradually and the money saved should be used for supplemental wage payments. The needy should be gradually moved from their TV armchairs to the shop floors where their income should be bolstered.

The problem with the transition lies in increasing the acceptance for low-wage jobs in the private sector without at the same time forcing the needy who cannot find jobs into financial hardship. To solve this problem, the state must offer limited employment so that everyone is provided for and so no one can claim that jobs are not to be found. The wages for these jobs must be low enough so as not to compete with private-sector employment and high enough to ensure a suitable overall income.

Whoever doesn't work although able to can expect only limited help from the state. Whoever takes on a state job can receive in addition a wage that would lift him to the level of current welfare benefits. Whoever finds a job in the private sector receives both a wage and a wage supplement that increases his total income to a level above that from a state job. These are the ground rules for a new, incentive-creating welfare system that lets people free themselves from the poverty trap. This is the only way to make the labour market fit for the new economy, for globalisation and for EU enlargement.

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No. 37

The Heart of Hartz*

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

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

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

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

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

Even though an analysis is missing, the Hartz Commission seems to accept the labour-cost problem in principle. The tax-favoured *Ich AG* (one-person "company") and the tax-deductible mini-jobs in private households (the old "housemaid privilege") are attempts to create jobs by way of lowering labour costs. Unfortunately the Commission does not say how it wants to offset income from an *Ich AG* or mini-job against the social welfare entitlements of former moonlighters. Under current law the proposals are largely ineffective since welfare benefits are cut on a one-to-one basis for any income from a mini-job or an *Ich AG*. A commission that does not manage to submit an integrated progression system for state transfers and taxes in the low wage area has failed to do its work properly.

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

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

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

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

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

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

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

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

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

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* similar version reprinted in Handelsblatt No. 158, August 19, 2002, p. 8.

No. 58 Hartz V*

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

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

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

The reduction in benefits constitutes for most an insurmountable obstacle to enter the labour market. This reduction gives rise to such high reservation wages that only very few jobs would turn out to be lucrative. For instance, an individual who requires a net income of 5 euros per hour in order to relinquish his leisure or underground job would need a gross wage of 33 euros in order to offer his services beyond the 50-euro free limit, and a wage of 25 euros in order to extend his work time beyond a 400-euro mini-job. Those earning 900 euros would need a 54-euro gross hourly wage for an additional work time. Non-single individuals choosing between unemployment and a job bringing in a 1600-euro gross wage need a 28-euro hourly wage in order to get 5 euros net per hour. Such high wage demands can hardly be met. Amongst employers, firms and private parties alike there are jobs aplenty, but no jobs which would be profitable at such wages.

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

The lower wage demands will of course cause wages to decrease for those already in low-skilled employment. That cannot be avoided under any job-creating programme. Those claiming otherwise do not know what they are talking about. Under the Ifo model, this reduction in wages is compensated via the lower transfer deductions and the wage subsidy.

Despite the wage reductions and the lower rates contemplated in the new second-tier unemployment benefit, necessary to spare the state from additional expenditure, income of low-

earners increases under the Ifo model. Adding together the wages earned, the wage subsidy and the social aid, they will have more money in their pockets than in the case of unemployment that Hartz IV really cannot reduce.

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

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

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

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No. 64

Why Minimum Wages Hurt Germany*

Low-wage countries from all over the world are vying for German investment capital, and now east European low-wage workers are pushing into the country, directly competing with German workers. The German government wants to protect the country by introducing minimum wages. By expanding the EU directive on the foreign posting of workers from the construction sector to all branches of industry, it wants to force foreigners, who provide services in Germany, to work at German union wages. The government claims it merely wants to prevent wage dumping, but in fact it is hurting the country and driving it further along the wrong road that has been travelled for decades with an excessive wage policy.

The central argument against minimum wages is simple, but little known. If the Poles are willing to work cheaply for the Germans, German customers benefit. Crafts activities, services in restaurants and many other goods and services become cheaper. The real income of Germans rises, and many jobs that would have been left undone, can be done now. The economy grows. Of course, the domestic workers, who directly compete with the Poles, suffer a disadvantage because their wages come under pressure. But this is no disadvantage in the aggregate, as it is offset cent for cent by the identical advantage that accrues to the customers and employers of the domestic workers. Minimum wages would help the craftsmen, but they would block the advantages that Germany as a whole would enjoy from the cheap Polish workers.

Furthermore, the posted worker law is being circumvented anyway, because it is all but impossible to control the hourly wages of the assigned workers. Union wages are paid formally, but people work longer than stated. In the final analysis, minimum wages would reduce the supply of Poles in Germany a little and would allow them to sell their labour better, at the expense of their German employers and customers in Germany, than would otherwise have been possible. The Poles are being helped in a similar way as if they were permitted to form a big wage cartel at the expense of Germany.

If foreigners are forced to work at union wages in Germany, German firms are driven abroad even faster. Germany has the second lowest investment share in GNP among all OECD countries, and its capital exports amounted to almost 4% of GDP in 2004. Domestic investment shrank by 0.9%, although it should have grown by 8% in view of the booming world economy. This alarming development would only be accelerated. The increase in unemployment would continue and would risk running out of control.

If union wages were even declared generally binding by the government, as is being considered, east Germany, in particular, would suffer extremely. Union wages often play no longer a role there, and this is the very reason for the few green shoots. Submitting wages on a broad base to collective bargaining again by declaring union wages as generally binding would mean that entire regions in the east would deindustrialise.

Measures to increase wage rigidity remove an ever bigger share of employable Germans from the labour market and shift them to the welfare state. Germany has travelled this road for over 30 years because the growing welfare benefits have functioned like minimum wages. It cannot continue like this, as its economy is falling back, and the state already has no funds left. Politics cannot undo the laws of economics, as much as it may decry them. The SPD party leader Müntefering's moral indignation about the laws of economics could just as well be directed at the physical laws of gravitation. Each is equally unrealistic.

There is only one way: Accept the wage competition of the east Europeans, yield to the wage pressure and compensate the low earners by permanent personal wage subsidies. Activating social assistance, as proposed by the Ifo Institute and also recommended by President Köhler, points the way. Starting with Hartz IV, one would have to redesign unemployment pay II, Germany's new second-tier unemployment benefit system, in such a way that it becomes in fact a wage subsidy. The

income-benefit schedule must be designed so that one receives most of the money from the state if one works at least half-time in the private sector and not if one does not work at all. To offset the fiscal burdens, the government would, however, have to lower the benchmark pay rate a bit, which for social reasons can be done only if at least one-euro-jobs with the government are available. For one-euro-jobs one should receive the one euro and unemployment pay II at today's level if one is willing to work in the private sector as a loan worker. Only by paying wage subsidies can the state help the low earners to become competitive with the Poles without asking them to accept Polish incomes. There is no alternative to such a policy.

Politicians call the wage competition of the east Europeans dumping. That is a confusion of terms. Dumping is lowering prices below one's own costs, not below the competitors' costs. Only if the Poles were working more cheaply in Germany than in Poland, would this be dumping according to the economist's definition. Wage competition is the market economy's elixir of life. Will the Germans ever understand the rules of the market economy? How far does the country want to move downhill until they realise that there will soon be no stopping?

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No. 71

Six Principles of the Combi-Wage*

The plans for introducing wage subsidies, called “combi-wages” in Germany, are entering a final stage. After all three coalition parties have explicitly come out in favour of subsidised wages, the goal is clear. But caution is in order. Mistakes must be avoided and the plan must have a cogent economic design. Hence this review of the problem and its solution.

Given the qualifications of the workforce, the technological knowledge, the capital stock and the international wage competition there is a quasi natural spread of domestic wage rates, which would ensure full employment in all segments of the labour market. This wage spread would come about automatically with competitive labour markets, and it would be efficient because the available human labour would be exploited fully and the national product maximized correspondingly. However, the inequality would be immense. Many people would not be able to make a living from the resulting earnings.

This is the reason that the welfare state ensures a subsistence level by means of wage replacement payments, in particular in the form of social welfare and, in Germany, the new Unemployment Benefit II. These wage replacements compress the accordion of wage distribution from below, thus producing unemployment. Wages in the lowest level of qualifications must be at a certain distance above the wage replacement income, and all the rest of the wage distribution builds on this level. By means of a chain of substitution, low to medium wages are shifted above the market clearing level. The unemployment caused by the wage increase is greatest among the lesser qualified and decreases gradually into the area of the more highly qualified. Wages of university graduates are so far above the level of social welfare that the accordion effect is lacking here. No wonder that Germany with its high wage replacement level is the OECD champion in unemployment for the lesser qualified, whereas joblessness among the more highly qualified is average in an international comparison.

The shift from wage replacement payments to wage supplements or combi-wages allows the return to the natural wage spread because wage subsidies do not form any minimum wage claims. The outsourcing of simple labour is slowed down, fewer people are replaced by robots, fewer factors of production are forced away from the labour-intensive domestic sectors to the capital-intensive export sectors, and above all people can afford to acquire the services that others offer. At the same time poverty is avoided because low wage earners receive a state supplement to their wages. For these effects to occur, six basic principles must be followed.

First: The state must grant its wage subsidies permanently. Only in this way can the larger wage spread be made socially acceptable, which is the precondition for a permanently higher level of employment.

Secondly: The combi-wage must not be linked with statutory minimum wage constraints since it has its effect precisely because it eliminates the minimum wage constraint implicit in the replacement wage system. Wages for simple jobs will nevertheless not experience free-fall since at some point there are more vacancies than unemployed and employers compete for workers by offering higher wages. According to estimates by the Ifo Institute, wages for simple labour will fall by approximately a third if an additional 2.3 million lesser qualified are to find employment.

Third: It is impossible to create more jobs without lowering labour costs, and it is impossible to lower labour costs only for newly employed persons because otherwise there would be revolving door effects. Cheaper outsiders would replace more expensive insiders. For this reason combi-wage models that seek the reintegration of the unemployed with temporary monetary benefits make no sense. And for this reason combi-wages must also be paid to insiders with jobs when their wages fall.

Fourth: In order to identify the needy insiders, combi-wages must be oriented around personal income and family circumstances. The wage subsidy must therefore be designed as a negative income

tax. Mere wage subsidies to enterprises would lead to inequity, inefficiency and increased fiscal burdens. Utter chaos would be the result.

Fifth: A combi-wage that would be available to all previously unemployed persons is out of the question. This was the self-proclaimed core of the Hartz reforms. These reforms sought to reduce the labour costs of all previously unemployed persons, without time limits, down to 50% of negotiated wages. The idea was absurd. Its implementation would have cost gigantic sums. Only subsidies at the lower end of the wage scale are feasible.

Sixth: For such combi-wages to be financed, wage replacements must be correspondingly reduced. Today the state spends about €100 billion per annum for unemployed persons, including early retirees. A part of this money must be employed for combi-wages. Giving low-wage earners subsidies to their wages can be cheaper than continuing to finance the unemployed a hundred percent. According to calculations of the Ifo Institute, a combi-wage in the form of activating social welfare would cost approximately €5 billion less than the Hartz IV reforms. The state should spend its money for joining the labour force instead of for staying away, and it will not need to expend any more money for this than it already does.

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