

Monday, October 30th, 2006, 18:00 - 20:00

Sabotaging Capitalism?: France, Germany, Italy

Speakers:

Chair: **Prof. Stein Kuhnle**, Professor of Social Policy and Welfare State Reform, Hertie School of Governance Berlin

Dr. Eloi Laurent, Economist and Research Fellow at the Observatoire Français des Conjonctures Economiques (OFCE) and Lecturer at the Institute for Political Studies, Paris; co-author of *Integrity and Efficiency in the EU: The Case Against the European Economic Constitution* (co-organizer)

Prof. Marco Leonardi, Professor of Economics, Department for the Study of Labor, University of Milan

Prof. Dr. Ronnie Schöb, Professor of Economics and Management, University of Magdeburg, author of *Arbeit ist Machbar, die Magdeburger Alternative*

Transcript

Stein Kuhnle:

With this title, the organizers are suggesting that the big three have been doing badly for so long that they look like they're trying to sabotage capitalism. So to shed some light on this topic we have three speakers. I should introduce Eloi Laurent, a research fellow, and a lecturer at Science-Po in Paris. I have Marco Leonardi of Milan, and the last speaker will be Ronnie Schöb from Magdeburg. The overall focus of this session is on the successes and failures of large and small states in the EU. While small economies like Sweden, Finland and Denmark, all prosper in the EU, there are others that have performed poorly in terms of their economic growth and unemployment. There is more populism, and possibly more unstable government in the big countries, and especially since the Maastricht treaty came into existence some years ago. The EU can be said to be constrained by these performances. These countries represent 75% of the Euro GDP. It's hard for the EU to develop when Euroskepticism is growing. How and why there is a reform trap is crucial, and to understand different strategies is also important to understand which reforms have been undertaken to resolve these problems. We can see three main goals: to stimulate debate on the big three, and to what extent they can learn from looking at each other for inspiration; second, to look at which lessons, if any, can be derived from small countries; and third, how these problems can be solved. Thus the idea of this session is to bring together three representatives from the big three countries, and to offer an overview of the situation in past and recent reforms. We will start with Germany, then Italy and finally France, also with a European outlook included. I give the floor to Ronnie Schöb.

Ronnie Schöb:

When I read about the title ‘Sabotaging Capitalism’, I was puzzled. The immediate reaction was: “Who would do that consciously?” My feeling was that there is no one I can blame for that. I thought it would be safer to call it ‘the German Disease.’ One might be guilty because one has not been cautious enough, but most people avoid diseases consciously. I would like to present a few stylized facts about the German economy and present six reasons why the German economic decline started in the ‘90s and is still going on. This list is not exhaustive, since in 20 minutes I have to focus somehow. I will focus on the tension between rescuing the welfare state, on the one side, and having a free market on the other because these two elements characterize the German social market economy.

A few facts:

1) Germany’s growth rates are falling behind. In the early ‘90s, after unification, Germany performed quite well. After 1992, Germany was always behind the OECD countries and much further behind the US. So we have a growth problem. Is it enough to deal with growth to get back on track? In the 1970s, we were very close to full employment. Since then, we observe a stepwise increase in unemployment. Whenever we were in a recession, unemployment went up, but when the economy recovered, we failed to return to full employment. There are supply-side and demand-side effects. It’s important to see the demand side effect. Here the picture develops. Consider the last 12 years: setting employment in 1994 at 100%, we observe two facts. West Germany more or less kept to the same level of employment and did not increase. If you look at East Germany, things look quite different. In 1994, most of the restructuring has already occurred. In 1994, most of the restructuring of the East German economy had already been finished and employment has already been reduced dramatically. From the low 1994-level, employment fell by another 25%. Only in 2006 we have a very modest increase in the employment of workers in the East.

Unemployment hits people differently. For people with university degrees, the unemployment rate is always below 5%. For those with secondary education, we observe moderate unemployment rates between 6% and 7%. But we have a steadily increasing number of workers with no formal education and it is exactly this group which is responsible for the stepwise movement of the unemployment curve. What we observe is that in a recession, low-skill workers lose their jobs and will not return to their jobs again after the economy recovers. This is a particular problem of Germany. If you compare the general situation in Germany with other countries, you see that Germany is not doing very well, but it’s not doing so badly regarding aggregate unemployment. But if you focus on low-skilled unemployment, Germany falls far behind.

What are the reasons? Joining the Euro caused some problems. First, Germany lost the advantage of a low interest rate. Investing in Germany was attractive because the stable German mark kept interest rates down. After the introduction of the Euro, we observed a convergence of European interest rates, with Germany’s interest rate going up.

Second, Germany entered the Euro with an overvalued DM. Germany needed capital after unification to invest in the East. This led to an overvalued German mark. This too high value became frozen when the German mark entered the Euro. This lowered the competitiveness of the country, and thus, affected the growth rate negatively.

Unification put a huge burden on the German economy. But it is not the burden itself which caused the problems. Rather it is the way in which the burden was financed. Consider the development of the Social Security contribution. After unification, we see a sharp increase in Social Security contribution rates. A huge share of total unification costs has been borne by labor and especially by the Social Security system. While low incomes are exempted from taxation they are not from paying social security contributions. Thus, low wage incomes bear an over proportionate part of the unification costs. This raised low-skilled wages even further.

Third, we have an aging society. The problem is that if the Social Security system is financed by a pay-as-you-go system, then the burden will be carried by fewer and fewer wage earners while the entitlements will continue to rise. If we don't do anything, public pension contribution rates will rise up to 30% in the next years. And health insurance contribution rate will also rise in an aging society.

We have a huge unemployment problem and this interacts with problems of the social security system, so if we manage to increase growth, as the politicians tell us to do, the question remains: does growth create jobs? What we observe is that if the growth rate is low, short-term unemployment goes up. If the growth rate increases, short-term unemployment goes down. Growth creates jobs! But we also have jobless growth; this becomes apparent when we look at long-term unemployment. Looking at the development of long-term unemployment, you will see that the correlation breaks down completely. The best we can achieve with high growth rates is to stabilize low-skilled unemployment at a very high level. This strongly indicates where we actually have to put our focus to reform the German economy.

One issue which is at the core of the problem is the welfare state dilemma. The welfare state creates the problem that it was meant to solve. If you are unemployed you get unemployment benefits first from insurance, then from unconditional assistance. Public transfers are conditioned on not working. If you take up work, you face high transfer reduction rates. This is an implicit tax on labor and this tax destroys incentives. Indeed, we see implicit tax rates of up to 100% and in earlier years, even more than 100%. The second problem, which worsens this disincentive effect, is that the Social Security system is defined in a completely different way than the income tax system. The income tax is defined according to the ability-to-pay principle according to which the subsistence level of income is untaxed. To the Social Security system, you contribute from the very first Euro you earn. In order to earn more from working, you first have to receive a net of tax income which is more than the transfers from the government if you don't work, and the 42 percent social security contributions that, if you are unemployed, are paid by the

government. This determines the minimum productivity you have to achieve so that a firm is interested in hiring you.

This figure shows how the German system still works. As a single unemployed household and unemployed, you receive 675 Euro including housing costs. Then you can earn additional 100 Euros without transfer reduction. If you earn more, there is 80% wage tax in effect. There is hardly any incentive to take up a full time job. This is the welfare dilemma. The result is also striking if you compare Germany with other countries. On the horizontal axis, there is the wedge (tax + Social Security contribution) and on vertical axis we drafted the employment share in domestic services for simple tasks. A very low employment share in the domestic service sector goes along with a high wedge and Germany is at the south-east end of the line. The wedge seems to matter quite dramatically in the low-skilled sector.

Of course, German politicians are aware of that problem and there were a couple of policy measures implemented. Without going into the detail, let me distinguish three types.

First of all, the “invisibles”:

These are the most discussed.

- Publicly organized temporary employment: 11,000 gross new jobs
- Job floater
- “Ich AG” self-employment: roughly 200 000.

Second, counterproductive measures: These are the so-called mini jobs and the One-Euro jobs.

Finally, the necessary measures: first of all, it is important to note that we changed the welfare paradigms and moved from a Bismarck-type to a Beveridge-type welfare state. The Bismarckian type stipulates that if someone was well-educated and received high income, he should get compensated a high amount to keep his status. The Beveridge system is about the government keeping a minimum and doesn't care after that.

The other thing is to improve matching, but to make that successful you need jobs. Another possible solution is to have stricter income rules.

Let me add a few words about the counterproductives.

First of all, mini-jobs. If you look at the 2.6 million newly created jobs, that sounds like a success story. But these jobs are taken by the wrong people. What these do is to create additional competition for long-term unemployment.

And then the One-Euro jobs. It's not that you get paid 1 Euro for work. You are paid 1 Euro on top of the transfer you get. But in order to get such a job, which is subsidized by 100%, these jobs must be in the secondary labor market. They mainly replaced older

employment programs and because they are so costly, I'm pretty sure they won't survive the next election.

What are the consequences?

Low-skilled unemployment, and a growing conflict between the market economy and the welfare state. Is this unavoidable?

This brings me to the final point: this development has started to destroy expectations and this might start to make things work.

Compare Saxony-Anhalt, with a very high unemployment rate, and Germany. There is a striking difference, and I want to tell the following story, which is not more than anecdotal evidence, about this difference. You observe how expectations split the group of those achieving a first formal school degree. 1/4 tries to get up the ladder to get a job. 1/4 give up and drop out. In Saxony-Anhalt, we have 14% of pupils who leave school without any formal degree. The rest tries, but without very high hopes, to get a job. And the income perspectives are not much better. If a student compares the income he can earn as an apprentice, it is much less than if he was unemployed.

Marco Leonardi:

These days it is known in Italy that the budget laws pass every year, so it's a good time to talk about the structural problems that Italy goes through.

Basically, to put things in a framework, the main problem in the last 10 years has been a slow growth and a declining productivity growth. This is not due to the slow growth, nor is it due to price shocks. These two explanations you can easily rule out. The main problems are the specialization of the Italian industrial structure and the low education of its work force.

Now this is a very similar to the first slide that Ronnie Schoeb showed to you. This is the growth rate in the US and Italy in the last twenty-five years. In the early 80s Italy was doing as well as the US. But since the 1990s, it has been on a slow but steady decline. This is the productivity, the evolution of productivity in Italy, France and Germany and the US. Italy had the highest productivity in the 1960s but had the lowest in 2002.

Now someone might assert that this is because of the world's slow growth, but since 2003 growth is picking up in the world and Italy is still declining. One of the main concerns is, can we catch up with the world growth rate, and what about the high oil prices? A petrol price shock can be ruled out. If you look at oil prices, they are still very much lower than their peaks in the early '80s. So this is also not a good explanation.

What I want to focus on in this talk is how Italy's specialization in textile and furniture manufacture has not changed over time. This has been an obstacle to growth. The second issue is the low supply of a qualified work force. The overall low education level of the

work force, combined with the typical Italian very small firm size makes it very difficult for Italian firms in the economy to reap benefits of new technologies.

Italy specializes in furniture, clothes, etc., but this has not changed. If you did the same graph in France and Germany, you would see that they changed their specialization over time. This is Italy in the more advanced sectors: automobiles, office machinery, telecommunication and electrical machinery. You see here in terms of comparative advantage we are losing ground in all advanced sectors. This is wrong specialization. Developing countries have their own specialization in these same kinds of products. These are unit labor costs. This is a measure of the competitiveness of Italy with respect to other countries in Europe and the US. The red line is the measure of competitiveness of Italian products abroad. From 1995 to 2004 we lost 15 percentage points to Germany in competitiveness. This is due to slow productivity growth and to slightly higher wage growth. This graph is saying that Italy is losing competitiveness in terms of products abroad.

This is the second issue: the low education of the workers. The main reason to focus on low education, is that if you want to shift from traditional to more advanced sectors you need a more educated workforce. This is a vicious circle. You need an advanced sector to get people to invest in their education. So what comes first? This is the vicious cycle that we are still in. In any case, the situation is that our workforce is much less educated than in other countries. It's not clear that we can compare that well, since it's not clear how the university graduate in Italy compares with those in France or Germany. The Italian force is lower educated.

One of the main issues is that the age distribution of professors in Italy is skewed to the top. They are very old. What this brings about, at least some people think, is that there are particularly high levels of mismatch. If you ask students if they feel they learned in school or college what they need in the workplace, they respond in the negative. Apparently our education system is not very in tune with the world of work.

Now this is the education differential with respect to Germany, France, Italy and Spain. This is to say that Italy has a lower share of college graduates with respect to the US, Germany and France, and after 2005, Spain will be better off than us. And this is the age distribution of our professors. The mean is 57 or 59 or 60. I wouldn't be surprised if in other European countries and in the USA were much younger.

Another issue is again the very low share of services in the economy. Italy has a low share of services in the economy compared to France and Germany and competition in these services is low. None of the productivity gains are in the service sectors. And if you have a low share of services and a high share of manufacturing, you are unlikely to reap the productivity growth. The service sector in Italy is monopolistic in nature. The prices are shooting up just because these sectors are protected from competition much more than in other countries. So firms can set the prices they want. This has been hotly debated in Italy, since some of the insurance companies that used to be public were privatized in 1999, and yet the result of this privatization was not to liberalize, but it was to pass the

monopoly from public hands into private hands. So the benefits for consumers have not been much.

There is one positive fact, recently, and that is employment growth. One of the few reforms that have been made in the last years has been reform of the labor market. We don't have unemployment insurance like in Germany. We introduced temporary contracts ten years ago. The temporary contracts are much more exposed to low pay and to low pension contributions. There will be a big problem in the next ten to thirty years. One of the biggest concerns of Italian employment is the low share of female employment.

There is a term in economics, "jobless growth," i.e. GDP growth without much employment growth. We had the reverse recently, high job creation without much GDP growth. We call this "job-rich stagnation." This is very different from Germany. And of course, the employment went up by more than 1 000 000 from the year 2000 to now. So this is a positive side, a recent aspect of the Italian case.

Now this is the composition of the employment growth. What you can see is that temporary jobs gave a contribution to employment growth, but temporary contracts gave the contribution to employment growth. The consensus in Italy is that they contributed to employment growth. This is the not-yet resolved issue of female employment. Italy, Spain and Greece together are still doing very badly. It is around 40%. It should be around 60%.

In more recent history we have missed the train of reforms. After entering the Euro Club, Italy should have promoted key reforms in the private sector and public sector economy to respond to new competition from East Asia without the Lira devaluation strategy. This was in sectors like textile, shoes, etc. The devaluation of our currency seemed to be the standard strategy to deal with difficulties. We used to devalue the currency and realign the exchange rate. Now we have lost this to the Euro. Reforms were necessary but we didn't make them. One main problem is the duality of North and South in Italy. It's enough to tell you, unlike Spain that used to have similar problems with a dual and big regional problem; this has not changed in Italy. The gap in terms of GDP in south Italy is still 70% of the North. This has to do with many issues, including very low productivity in the public sector, with cultural issues, and with union resistance.

To give you a small idea of what happened: the second Left government from 1996 – 2001 did not make any reforms in the structure of the economy because that was a time of strong growth and they increased taxes to enter into the Euro. At that time they didn't think it was necessary to burden the electorate with much more.

The center right from 2001 to 2006 did not make the reforms because of slow growth. So what they focused on was to reduce taxes. They thought it was a problem of low demand, and not structural problems. But this was wrong, because many of these issues are structural. And the result was that the surplus balance was wasted and the only successful reforms, at least in terms of results, were the reform of the labor market. What will

happen with the new center left government no one knows because the majority is very dependent on the unions and the coalition is very broad.

Eloi Laurent:

I am going to talk about the state of France and the economics of size in the euro area.

First, let's take a look at the political state of France right now. Can we have a revival next year? Many think it's possible because we have a presidential election and a legislative election in 2007. What we have now is what we could call the "Sego-Sarko show". The two most serious candidates for the presidential election are Segolene Royal (left) and Nicolas Sarkozy (right) and together, even if they are opponents, they form a generational ticket, and I think it's important in France to generate this symbolic revolution.

Yet, the political situation is extremely unstable given the underlying social crisis:

The main concern is the unemployment problem (10% overall, 20% youth, 40% young men from segregated minorities). The 20% unemployment among the youth was at the heart of the student's unrest last spring. The 40% unemployment among young men from segregated minorities was at the center of the banlieues revolt in October-November last year. Right now, the banlieues could explode again.

Given this social crisis, the far right is in the political shadow of The French Republic. No one knows exactly how significant the far right is, and whether it can improve its performance in 2002. Unemployment is the key to this political uncertainty. Of course this social frailty makes the problem of economic growth crucial. As my German colleague said, economic growth brings unemployment reduction.

We have a French recovery right now, but in the US it would count as a recession. The OECD forecasts a 2.1 % increase in GDP for 2006, and this is a mostly due to private consumption and more generally to domestic demand. This leads us to a question of the economics of size. If you put France, Germany and Italy in perspective over the last ten years, you see that French growth was higher, and the reason for this is that France has had a consistently more dynamic domestic demand. You can see that France is clearly on top, and it's been the case for the last ten years. And if you look at domestic demand only, you can see that French growth reflects the growth of domestic demand and this is not very surprising. It means that the domestic market is more important than foreign markets for a big country. In Germany, for example, private consumption alone represents 60% of GDP, so that if private consumption is not working, you won't have economic growth. And right now, in Germany, private consumption has not picked up, at least not yet.

And now I come to Europe, where there is an obsession with competitiveness – what Paul Krugman called the "dangerous obsession of competitiveness", that results in looking obsessively at external competitiveness and overlooking domestic demand, both in

national and European terms. This is dangerous because if you reason in this way, you will have poor results in big countries and poor results for the euro area as a region. Take Germany: since 2000 you have a 10% increase of the exports share, from 30% to 40%, and yet growth is going downward and unemployment is rising. And one could add that this obsession with competitiveness has triggered a “competitive social disinflation” process in the euro area.

Let’s look at the evidence: since 2000, Germany has been experiencing wage stagnation, which has reduced private consumption and domestic demand. The result is a spectacular rise in external competitiveness in the euro area, so the current account surplus is now 9% of the German GDP, mostly because of exports shares taken to France, Italy and Spain. But, at the same time, you have a stagnant growth and unemployment. This is because Germany is carrying out a growth strategy for a small country, but it is a big country. In the euro area, all the talk about Italy going out of Euro is due to the fact that Italy is being pushed out of the Euro by German competitiveness. If you take a look at the respective labor costs in the “big three”, it looks like the European championship of competitiveness. The result is the reverse order of the last World Cup (Germany is first, France second and Italy last). I don’t think it does much good for the growth and cohesion of the Euro area.

Who’s to blame for this, if anybody? Germans blame the welfare state, Italians blame the education system, and French blame Europe. Seriously, I think this German economic policy is not Germany’s fault. The problem lies not with the players, like James Buchanan said, but with the rules of the game. The rules of the game, the European economic constitution, are the ECB-Euro monetary comprise, the SGP, the Single Market and the European budget. It’s the hierarchy between these institutions that is problematic. The incentive given to member states by these institutions is: behave like a collection of small economies. It leads to a strong but asymmetric integration of markets, a poor macroeconomic reactivity and the development of tax and social competition. But the European domestic demand is not taken care of. This strategy may be good for Ireland but Ireland only stands for 2% of the Euro area GDP. We have to think on a regional scale: when things are going bad for Germany, it’s bad for France, and eventually it will be bad even for the small economies that seem to be doing so well right now. If the big countries are going to die because of domestic demand apathy, the small countries will die eventually, only later.

I’m going to conclude with some optimistic thoughts. What can we do to fix the euro area growth problem?

The idea is very simple: Economic Europe is political Europe: it doesn’t get more political than sharing a currency. So Economic Europe has to work, efficiently and fairly, or else the European project will be jeopardized.

The first problem is how do we achieve economic sovereignty in globalization and in the EU? What strikes me is that EU countries outside the euro area are doing well and the world is blooming and everybody is doing economic policy except the euro area, which

has all the instruments for it. We have no exchange rate policy. We don't practice macroeconomic reactivity, as the USA and UK do. I think macroeconomic reactivity is a European public good, and we must improve it.

Why is the ECB the only body responsible for the exchange rate? Why doesn't the Stability and Growth Pact foster innovation? Innovation is a European public good. The European budget is almost nothing, 1% of GDP and half of it is taken by mostly French agricultural policy. Why don't we use the SGP to achieve energetic independence and environmental exemplarity, both are European public goods.

Some have hopes for the German presidency of the EU. On the 25th next March, we will celebrate fifty years of European integration since the Treaty of Rome, but the real issue for Angela Merkel is the fifty years ahead.