The Dilemma of Globalisation: A German Perspective

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THE DILEMMA OF GLOBALISATION: A GERMAN PERSPECTIVE

Hans-Werner Sinn[1]

ABSTRACT[2]**.** Globalisation means gains from trade, but not for everyone. As gains from trade come along with factor price convergence, substantial fractions of the working classes in the high-wage countries of the West are likely to belong to the group of losers. In this situation it is tempting for the welfare state to help out, but the difficulties are enormous. On the one hand, the payment of social replacement incomes makes wages sticky, preventing the gains from trade, causing mass unemployment and turning the economies of the West into bazaars with excessive outsourcing and offshoring activities. On the other, the taxes needed for compensation payments to the working classes can hardly be levied from the mobile factors of production, given that globalisation has increased their mobility. This is a double dilemma for the welfare state. The paper discusses the possibilities of mitigating the dilemmas by paying wage subsidies for domestic residents and encouraging private savings so as to give workers a capital income in the future.

JEL Classification: F16; J20; J30.
Keywords: Globalisation; Welfare State; Wages.

RÉSUMÉ. La mondialisation procure des gains, mais pas pour tous. Lorsque des avantages retirés du commerce apparaissent, parallèlement à la convergence du prix des facteurs, une partie importante des classes laborieuses dans les pays à salaires élevés en Occident est susceptible de se retrouver parmi les perdants. Pour l'État providence, il est alors tentant d'intervenir mais les difficultés à surmonter sont énormes. D'une part, le paiement de revenus sociaux de substitution rend les salaires rigides, empêchant les gains à l'échange, entraînant un chômage de masse et transformant les économies occidentales en "bazars" où se multiplient les délocalisations et la sous-traitance à l'étranger. D'autre part, les impôts nécessaires pour le financement de ces paiements compensatoires versés aux classes laborieuses peuvent difficilement être prélevés sur les facteurs de production mobiles, vu que la mondialisation

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2. The text is a translation of the author's Walter-Adolf-Jöhr Lecture University of St. Gallen on 11 June 2004 revised in January 2005.

accroît leur mobilité. L'État providence est donc confronté à un double dilemme. Cet article examine les possibilités d'atténuer ce dilemme par le versement de salaires subventionnés aux résidents et par l'encouragement à l'épargne privée afin que les salariés se contituent un revenu du capital pour l'avenir.

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Mots-clefs : Mondialisation ; état providence ; salaires.

The five shocks

Fear of globalisation has gripped the peoples of the West. The small Asian tigers have already caused enough problems. Now that China and India have entered low-wage competition with products that had previously been the domain of the industrialised countries things have become serious for Europe and America. In America, a violent debate is raging about protectionism, and here in Europe the voices are swelling of those who want to further fortify the "Fortress Europe".

Especially Germany has become afraid, for the forces of globalisation now combine with other exogenous shocks the country is now facing.

The euro has deprived Germany of the advantage of lower interest rates.

The European common market has helped the small European countries overcoming their disadvantage of being small, and it has taken away the German comparative advantage of increasing returns to scale in production. Today even Luxembourg has access to a large market.

EU Eastern enlargement has brought Germany low-wage competition at its own front door with wages that average only 14% of west German wages.

German unification is costing the German state huge sums of money. Since unification, on balance about 1025 billion euros of public funds have been transferred to East Germany until the end of 2004. This has forced the country to incur so much debt that it has been unable to fulfil the stability and growth pact that it itself had imposed on the other European countries.

Combined with globalisation, this makes for five shocks at the same time. To be sure, somehow they are good for the world, for Europe, and, let us assume, for Germany too. Nonetheless they are shocks that at the least imply structural change and force people to face big challenges.

The shocks have contributed to a sharp reduction of German growth. Since 1995 Germany has been the laggard among all European countries with the exception of some Eastern European countries that are not members of the EU. That Switzerland is also growing very slowly and is only just ahead of Germany is no consolation. Both countries suffer from similar problems.

The problems which beset Germany in this historic phase of development are reflected in particular in rising unemployment. In Western Germany, unemployment has been growing, since 1970, along a strictly linear trend, about which roughly ten-year cycles fluctuate. A slowdown of this trend is not foreseeable. During the past three years, too, unemployment increased strongly again. To be sure, politics is trying to hide the unemployed. No fewer than 230,000 persons have been taken out of the German statistics from the start of 2003 until the end of 2004. But despite this hiding game, even measured unemployment continues to increase. Since 1994, employment subject to social security seems to be in free fall, at a pace of markedly more than one percent per annum in Germany as a whole and more than two percent in Eastern Germany.

The bazaar economy

Among the effects of globalisation, the relocation of labour-intensive parts of the production process, either *via* foreign suppliers of intermediate products or *via* direct investment, is considered especially alarming. Outsourcing and offshoring are the concepts we have learnt for this process.

Back in the 1980s, big German industrial companies started to invest massively in Asia. According to Bundesbank figures, German direct investment has meanwhile created more than 4 million jobs abroad.

Since the mid-1990s, the small and medium size German firms (SMEs) have also gradually been leaving Germany. Some SMEs went to Asia, but Asia is far away and start-up costs are high. Most of them are moving to Eastern Europe, for the Eastern European countries have overcome their transformation crises, and most of them are already members of the EU or about to become members. What Asia was for big business, Eastern Europe is for the SMEs. The entrepreneur who has a firm there can drive his car there in the morning and be back home in the evening. The cultural proximity and the language skills of the East Europeans also facilitate business. According to a study by the Institute of the German Economy in Cologne (IWD), no fewer than 60% of German SMEs with fewer than 5000 employees have already established plants outside the old EU; a considerable number of them may be expected to have done so in Eastern Europe.

Germany is the country of the silent stars, the mid-size companies that are world leaders in their market segments and are nonetheless widely unknown. Germany has about 450 such unknown world market leaders. It is disquieting that the SMEs, the backbone of the German economy, are now also relocating increasing parts of their production chain to Eastern Europe, for now the matter is becoming serious.

Sometimes it is said that offshoring and outsourcing are safeguarding jobs at home. This may be true in the sense that those who does not move production offshore or do not buy parts from low-wage suppliers will go bankrupt if their competitors are relocating their production to low-wage countries. In this trivial sense, relocation does retain jobs in Germany. I think it absurd, however, to argue that without offshoring and outsourcing there would be fewer jobs in Germany today. No, that would be turning the truth upside down. During the eight years from 1995 to 2003, employment of German industry including energy has declined by 10% in terms of people and 14% in terms of hours.

Offshoring and outsourcing do not so much concern final production. Rather, they show up in a reduction of the production depth in Germany. Upstream activities are moved to other countries, and downstream activities close to the consumer stay at home. At 4%, real value added of German manufacturing industry has hardly grown from 1995 to 2003, although, at 18%, manufacturing production itself grew as fast as European GDP (Hild, 2004). The gap between value added and output is widening. This is primarily due to a rapid increase in imports of industrial intermediate products that rose by an incredible 45% in real terms. Only a small part of the reduction in the depth of manufacturing production may be traced to domestic outsourcing. The lion's share, that is four fifths, has been caused by offshoring, or outsourcing abroad.

This phenomenon is not limited to Germany. Production depth is declining in many countries, the UK being among the few exceptions. From 1992 to 2002 production depth significantly declined in Spain, Italy and France, for example. In the EU-15 countries, the manufacturing sector's share of value added in its own output declined from 35% to 31%. However, the tendency is stronger in Germany than in other countries, probably because of the proximity of Germany to Eastern Europe.

Neither is the phenomenon limited to manufacturing. It also applies to the export sectors themselves. From 1991 to 2002, the share of export-induced intermediate products and export-induced imports of merchandise in the value of exports increased from 27% to 39%. On average, an additional euro of real exports induced 55 cents of intermediate products and imported merchandise during this period. Thus the marginal effect on real value added in Germany of an additional unit of real exports was only 45 cents.

In 2003, largely due to the appreciation of the euro, Germany was world champion in the export of commodities, even ahead of the United States, and it was No.2 with regard to all exports, including services. But the export boom is increasingly based on exporting products, only a small part of which contain value added in Germany. The Audi, which is shipped from Ingolstadt to America, is largely produced with parts made in Hungary, Slovakia and the Czech Republic, but its full value goes into the German export statistics. It is similar with the Porsche Cayenne, which is exported from Leipzig. 88% of its value added was not produced in Leipzig at all. Rather, the almost finished car comes from Bratislava. Only the gear box and the steering are added in Leipzig. Yet, the car enters the export statistics with 100%. Such information explains why the marginal effect of exports on domestic value added is only 45%.

Nevertheless, export-induced value added has increased relative to GDP as in all countries participating in the process of globalisation. Growing value added in exports is what specialisation means, because the factors of production move from the sectors where a country has a comparative disadvantage to sectors where it has a comparative advantage, and this is true regardless of whether the sectors produce different final goods or different intermediate goods in vertical production chains.

Germany is gradually developing into a bazaar economy which supplies the world with attractive goods while producing an ever smaller share of their value added itself. The German companies that are bearers of the brand names under which the final products are sold remain strong. But it is doubtful to what extent German workers benefit from this. They risk being gradually rationalised out. This is highly disquieting, and not only for them.

Why outsourcing and offshoring are excessive

The fear is well founded, as the process of globalisation does not at all occur in the way the economic textbooks tell us or the studies paid for by the EU in order to prove the advantages of EU eastern enlargement. Indeed, outsourcing and offshoring can, in principle, be seen as an improvement in the international division of labour. They go too far, however. If they were signs of a healthy economic development, they would not be accompanied by a net increase in unemployment. Workers who lose their jobs in firms that dislocate their production would be reemployed elsewhere, in downstream production stages that remain in the country or in other sectors such as the service and construction industries. The process would be efficient if workers were laid off in manufacturing because they are urgently needed in the other sectors for activities that cannot be performed abroad. In that case, welfare gains would result like those predicted in the textbooks on pure trade theory. Germany and similarly Switzerland would withdraw from industrial production, because they could exploit their comparative advantage in local services, in research and perhaps also in managing the bazaar for the world.

But that is not the way it works. Developments since the mid-1990s have not been characterised by the emergence of new employment opportunities outside of manufacturing industry that would offer an alternative to the unemployed. It is true that other sectors of the economy have been creating new jobs, including of course the exporting firms, but their number was by far not enough to absorb the people set free in the firms that were relocating parts of their production abroad. The total number of hours worked in the whole economy has declined by 1.61 billion or 2.8%. This corresponds to about 1 million full-time equivalent jobs measured at the year 2003's work time.

Rigid Labour Markets and Gains from Trade?

What is going wrong here? Why are the textbook predictions wrong?

In my opinion, the unambiguous cause is the lack of wage flexibility. Without flexible wages and prices, which have the function of clearing the markets, there are no gains from trade.

To understand what I mean one must know what gains from trade are. Gains from trade result when there are different prices in two markets. In that case, traders can buy in the low-price market and sell in the high-price market. Initially they themselves earn arbitrage profits, but in their desire to earn them, they increase the supply in the high-price market and reduce the supply in the low-price market. As a result, the low price rises and the high price falls. Prices converge and in the ideal case they become equal. When prices become equal, gains of trade reach a maximum. While price convergence reduces the profits of the traders, it does not eliminate the welfare gains, but transfers them to other economic actors. Each of the participating countries specialises in the production of those goods that it can produce relatively cheaply, and thereby all countries reap gains. David Ricardo had already noted that two hundred years ago.

Price differences thus are the reason for potential gains from trade; but when these gains are realised, prices converge. Price convergence can thus be viewed as the very measure of gains from trade, of welfare gains from an improvement in the international division of labour.

To the extent that goods and services are affected by price convergence, it is not disquieting. Things are different when we look at the convergence of factor prices, because factor prices include human wages and thus our income. Wages are the most important prices of an economy, and of course they must also converge across borders if gains from trade are to be reaped.

International convergence of wages will also come about if labour markets are not linked by processes of migration. Given that technological knowledge spreads across countries, free trade with goods and services and free movement of capital suffice. Under certain circumstances even one of the two suffices. This is the factor price equalisation theorem, the cornerstone of the pure theory of trade. If product prices converge by way of goods trade, and even more so if capital movements contribute to a convergence of the rates of return on capital, wages must also converge. Goods trade and capital movements implicitly create a common labour market between the participating countries, and in a common labour market there can no longer be big wage differentials.

The mechanism behind the factor price equalisation theorem is as follows. Before trade the price of capital intensive goods in terms of labour intensive goods is low in the rich countries and high in the poor countries. When trade is opened the prices converge. This induces the rich countries to specialise on capital intensive goods and the poor countries to specialise on labour intensive goods. Outsourcing labour intensive parts of the production chain is part of this process. Because of the specialisation labour demand falls in the rich countries and rises in the poor countries, such that the wage rates converge.

Convergence is accelerated when capital can also move. Offshoring is an example for such capital movements. Capital will move from rich to poor countries because there it can earn a higher rate of return. This also reduces the demand for labour in the rich countries and

increases it in the poor countries so that wages in the rich countries fall, while they rise in the poor countries. If the technological knowledge is the same in the trading countries and if there are no transportation costs, factor price convergence will be perfect. With knowledge differences and transportation costs there will not be a perfect factor price equalisation, but still a convergence, given that the initial differences in factor prices resulted from the artificial constraint that the Iron Curtain had imposed on international trade.

In concrete terms this means: In order to realise gains from trade with China and Poland, the wage difference between these countries and Germany must shrink. Currently the Polish wage cost per hour is one seventh and the Chinese is about one twenty-fifth of the west German level. These differences cannot persist. We must accept that Chinese wages will rise toward ours and that our wages will slide in the direction of China. Only if we permit that, will offshoring and outsourcing be done in the right amount, only then will the service and construction sectors grow and absorb the labour released by industry: only then will there be gains from trade. If we try to prevent factor price equalisation, in other words, if we defend our wages, then too much production will be relocated to low-wage countries. The exporting firms as well as growing internal sectors, such as services and construction, will not be able to absorb all the people set free by way of outsourcing and offshoring labour intensive parts of the production chain.

To date, we are still defending our wages. There are the labour unions fighting wage reductions tooth and nail, wage reductions that are the prerequisite for gains from trade. And there is the welfare state also standing in the way of wage convergence. By providing wage replacement benefits to the unemployed, it sets a wage floor below which market wages cannot fall. Especially social assistance is the problem here, as its level is independent of labour productivity. This impairs the necessary wage adjustment, at least for unskilled workers whose wages are close to the level of social assistance. As a consequence, globalisation creates unemployment instead of gains from trade.

All of this is a true dilemma. We would best like gains from trade and full employment without a wage reduction. But that, unfortunately, is impossible.

If we prevent a reduction of wages, there will be no gains from trade. Instead, mass unemployment will continue to rise.

And if we want to prevent mass unemployment and permit the required flexibility of wages, then there will be gains from trade, but at the same time considerable losses for many. While the cake, which can be distributed to everyone, becomes bigger, many people will get an absolutely smaller piece. The winners of globalisation receive the entire gains from trade and in addition part of the losers' pieces of the cake.

The winners of globalisation

Who are the winners? Unambiguously, the owners of companies and capital! They profit from trade and outsourcing to low-wage countries. Of course, they benefit from producing in Poland at a sixth of west German labour costs while still being able to sell in the entire European internal market, if not the world market. They also profit from continuing to produce here if wages come under pressure.

The workers are the losers. Those who offer labour, which the firms can acquire much cheaper abroad, cannot belong to the winners of globalisation.

Unfortunately, very many people are affected by this development. Losers will, in particular, be the less skilled industry workers, for whom the unions had extracted very high wage increases in the past, making west Germany the country with the highest hourly labour costs in the world. As competitors of Chinese and Polish workers, they bear the burden of wage adjustment. They have the choice of defending their wages at rising unemployment or keeping their jobs at declining wages.

Only highly skilled employees, who are rather complements to the many people who are offering their labour worldwide at very low wages, may belong to the winners like owners of companies and capital. One cannot even be sure about them, however, as neither East Europeans nor the Chinese are fools. In the end, all workers will face competition.

The line in skill levels between those who at least temporarily benefit from globalisation and those who suffer from it can still not be determined empirically. However, according to a study by Geishecker und Görg, not only the unskilled workers belong to the losers, but also people with high-school diplomas or completed occupational training (Geishecker and Görg, 2004). If this study is right, the number of losers will be huge, including the "average man in the street".

The second dilemma

In view of the distribution gains to be expected for the owners of firms and capital and the losses of wage earners, it appears sensible to look for potential compensation by way of higher taxation of capital income and reduced taxes on wage income. On the basis of equity considerations, one cannot argue against this.

Open borders, however, prevent this solution. Attempts to raise taxes on capital income will cause capital flight to other countries, and the scope for income redistribution in favour of wage earners will shrink so much that workers will suffer. They would even suffer from this policy if the revenue from capital taxes were given to them alone.

This is the second dilemma that globalisation implies for the Western style welfare state. The forces of factor price equalisation, which it sets free, change income distribution at the expense of labour, and the state would normally have to step up income redistribution via the budget in order to counteract it. The need for social balancing is growing. But because of globalisation, the state cannot act. It finds itself between a rock and a hard place without a way out.

Are there ways out?

This does not mean, however, that in this situation there is no need for policies as everything is for naught anyway. Such a fatalistic view of things is unwarranted for the sole reason that there are in fact ways to improve the past growth trend of our economy. At least the first dilemma can be resolved, i.e. the conflict between high employment and income maintenance of the poorer strata of society.

This conflict is mainly caused by an inefficiently constructed welfare state that uses wage replacement to meet its redistribution goals. Wage replacement in the form of unemployment compensation and social assistance is supposed to cushion the consequences of unemployment. It itself creates unemployment, however, by establishing minimum wage demands (reservation wages) that industry cannot meet in an increasing number of cases in view of foreign low-wage competition from all over the world. By changing this wage replacement into wage subsidies, the redistribution goals of the welfare state may be defended without having to raise taxes on capital. Wage replacement turns the welfare state into a competitor of private business that pushes up wages and destroys jobs there. Wage subsidies make the state into a partner. They do not establish minimum wage demands and create the very flexibility in wage setting that is required for reaping the described gains from trade. At the same time, they prevent incomes from falling when wages decline.

The Ifo Institute has developed a reform programme for the German labour market under the name of "Activating Social Assistance" that succeeded, in October 2003, as a draft statute of the state of Hesse, to gain a majority in the Bundesrat, Germany's second Chamber, and has left its track in the German Hartz IV reform. This programme is the rational response to globalisation. It overcomes the first dilemma described above, as it does not need additional funding compared to the present system and maintains the income of the poorest despite low-wage competition from all over the world.

To be sure, while it helps a lot, this system will not be able to cushion the income losses of the entire working population. It provides support at the low end of income distribution, but is no solution to the broad-based losses of wage earners at large. In the final analysis, such losses cannot be prevented because capital is not available to finance ever escalating redistribution.

The only way I can see to reduce income losses of wage earners at large is saving. Those groups of society of the Western welfare states that in the past have depended only on wage income must try, by way of saving, to acquire that factor of production that is the winner of globalisation. The workers in these countries need a second leg to stand on in order not to falter when the seas get rough. Capital earnings must join wages as a second source of income. This argues for a policy of wealth formation by workers and equity co-ownership in the firms.

In the 1970s, the German labour unions had posed the question of whether to put their collective bargaining chips on co-determination or on co-ownership. As is well known, they chose the former. This decision was, as is clear today, fundamentally wrong. If German employees had started 35 years ago to accumulate true wealth, they would now belong to the winners of the historical process that we call globalisation. It is not too late to make up for lost time.

Fortunately, it seems that the idea is gaining new momentum in the context of the pension crisis. The pension crisis results from the fact that the German population has underinvested in human capital by not having enough children. Real capital could fill the underinvestment gap and ensure coverage of pensions that the small number of children, when adults and working, will not be able to shoulder alone. Germany has therefore introduced the Riester savings plan. As this plan is voluntary it has not been very successful thus far. Only a small fraction of the population is participating. However it may only be the beginning. In view of the demographic problem and the forces of factor price equalisation, it would be wise if this and similar programs were developed further to ensure that the working classes will save more and gradually accumulate at least some wealth, from which they could draw some of their income in old age.

Final remark

This, ladies and gentlemen, is my view of things. I have no encouraging messages to offer on the topic of globalisation, because even the good news that economists can contribute on gains from trade is bad news for many people. The fundamental dilemmas of globalisation cannot be overcome by wishful thinking. I nevertheless hope that you share my opinion that there is need for policy action in order to react at least as well as possible to the challenges of these difficult times. I would be happy if, by explaining the true state of the problems, I could have contributed to making the correct policy responses a bit more probable.

H.-W. S.

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