



*Germany's Stalling
Economic Engine – How to
Get it Running Again*

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Germany's Stalling Economic Engine – How to Get it Running Again

Abstract: The German Economy, once the economic power house in Europe, is stalling. Unemployment has ratcheted upward since 1970, the social security systems can no longer be financed, even if the population were not aging, and with an average annual GDP growth rate at a low 1.3 percent since 1995, the economy almost stagnates. The lecture will analyze how to solve Germany's three major challenges. To undo the false incentives with respect to unemployment, the institutional design for wage formation has to be decentralized, the reservation wage to be readjusted and the tax on labor reduced. To make the social security systems sustainable, the level of social absorption has to be taken back. And, finally, to have a more dynamic economy again, new stimuli for growth have to be unleashed, including human capital formation and innovation which are vital for the knowledge society. The role of government has to be reoriented and the German social market economy has to be redefined.

A year or two ago, an economic weekly ran a cartoon showing Europe as a car in a repair shop being jacked up, some mechanics stand around and examine it, and the engine is lying on the garage's floor. Not difficult to guess what the engine is supposed to be: The German Economy, of course.

I would like to talk about the economic policy challenges that Germany faces. Being an optimist by nature, I would rather draw a rosy picture, especially when abroad and therefore would tend to agree with Giovanni Guareschi's famous saying: "Whenever an optimist sees a light where there is none, a pessimist is

eager to blow it out.” As an academic, however, I have to paint a realistic portrait. And my analysis cannot differ from whether I am at home or abroad. So instead of Guareschi’s famous words I am more reminded of a roofer whom Bismarck mentioned in one of his speeches in parliament, using the roofer – it was a French roofer – ironically against one of his opponents. The roofer is falling from a ten-story building. As he passes the third floor while falling down someone asks “Ca va?” And he answers: “Ca va, pourvue que ca dure.”

I.

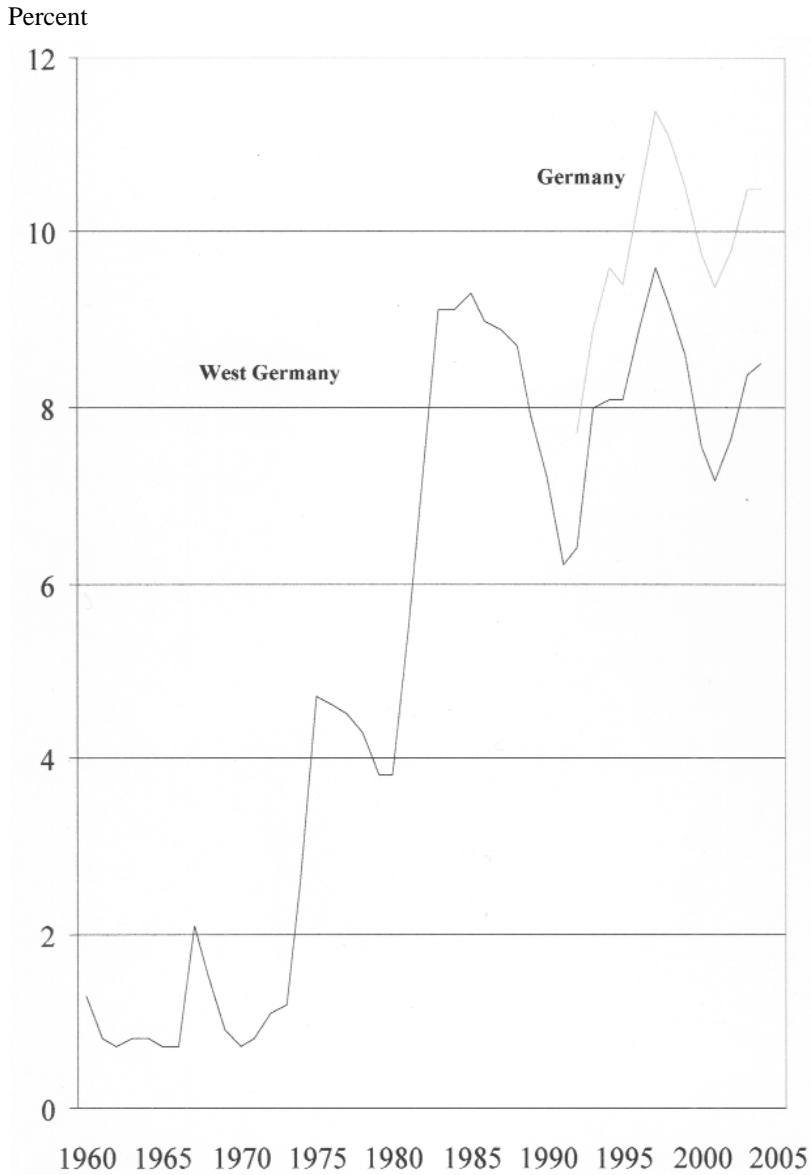
Germany faces three major challenges: First, unemployment is at 4.4 million or 10.5 percent of the labor force. In addition, another 1.6 million are in labor market schemes of different sorts. An important economic resource, labor and human capital, is idle. Unemployment has ratcheted upward in the last thirty years from below one percent (it was actually 0.7) in 1970 to a maximum value of 11.4 percent in 1997 dropping slightly to 10.5 in 2004 (*Figure 1*). In each recession, roughly one million were added to the unemployed in Western Germany; during the boom years, the high unemployment rates were not reduced in a noteworthy way so that each new recession started from a higher level of unemployment. With unification, the structural unemployment problems in Eastern Germany were added.

Second, the systems of social security can no longer be financed. They are already running at a deficit, although a fifth of their expenditures are tax financed. Linking the financing of these systems to the labor contract in that the contributions rates are paid half by employees and half by firms, has a similar effect as a tax on labor. This systematically weakens the demand of firms for labor and is one of the reasons for the high unemployment. It is a false incentive in the German social market economy.

Third, growth is extremely weak, nearly stagnating; the growth rate is declining (*Figure 2*). Since 1995, the average annual growth rate of GDP is as low as 1.3. Investment activity is weak, and the economy is less robust to digest shocks.

These three problems are becoming more difficult to solve in a changing environment. One new condition is the ageing population. The good news is that life expectancy increases considerably. The newly born males will live four years

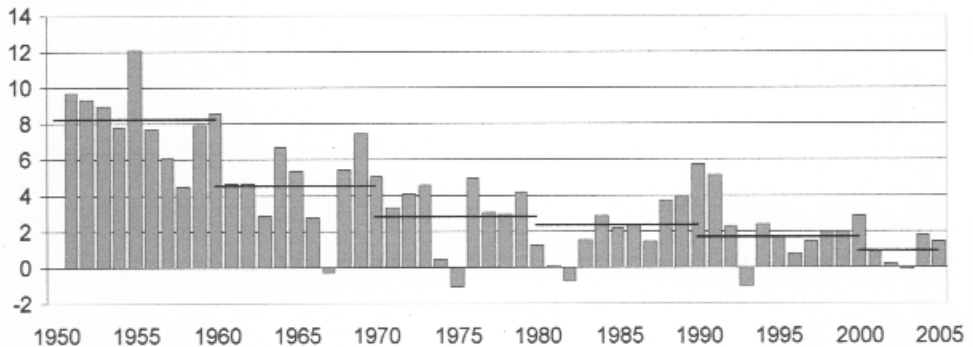
Figure 1. Unemployment Rate in Germany



^a Unemployed in percent of all civilian employees

Source for Data: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Annual Report 2004/05*.

Figure 2. Declining German GDP Growth Rate



Source for Data: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Annual Reports*.

longer, the females 5 years. The less good news is: the birth rate is too low. According to an official forecast¹, the German population will decline from 82 million to 75 million, even with an annual net immigration of 200 000. Under these conditions, the systems of social security are clearly unsustainable. Moreover, growth dynamics tend to be weaker in an ageing society for a number of reasons.

Besides the ageing problem, an open economy like the German one faces the tremendous speed of change in a globalized world. Germany is doing well with its exports, but the import content of exports has increased. The potential for pass-through of costs is reduced. Moreover, the issue is to what extent Germany loses competitiveness as a location for investment and jobs. There is no doubt that German firms are efficient and profitable but half their work force is in other countries. Thus, the efficiency of firms is no guarantee for job creation.

Last not least, German unification has changed the economic conditions. Transfers to East Germany require about 2 percent of GDP; transfers are partly carried out within the social security system and are financed by a tax on labor. The public debt

¹ Federal Statistical Office, 10th Official Population Forecast 2003.

has doubled since 1989 and the country has less room to manoeuvre in fiscal policy.

II.

How do we get the German engine running again? A major difficulty is that all three problems are interrelated. The high level of social absorption weakens the economic basis of the economy and affects employment negatively. Social absorption surpasses the capacity of the economy; this is almost a Latin American problem. Low growth is bad for employment, and high unemployment leaves an important resource idle, implying low growth. In turn, low growth and high unemployment makes it more difficult to finance the systems social security system. Thus, there is a knot of problems, and it is difficult to disentangle the many threads and to surgically isolate one problem and solve it.

Once a country finds itself in such a situation, the economy may spiral downward in a *circulus vitiosus* that is difficult to stop. This is exacerbated because additional issues emerge, in a way problems in their own right, that further compound the three main problems. One such issue is the poor performance of the public budget, due to higher expenditures on the social security systems and also due to lower tax revenue.

Another difficulty is that German people have become accustomed to the current high level of social absorption; West Germans due to the previous expansions of the welfare state; the East Germans due to the 1:1 mentality which has its roots in the chosen exchange rate in 1990. Thus, there is a gap between what people expect and believe to be entitled to and what the economy can deliver. Unfortunately, the expectation level determines voting behavior of people, and political parties anticipate how voters will vote. Consequently, politicians are cautious or even reluctant to tell the true story and to propose the reforms that are needed. This means that Germany is in a policy trap.

Let us look at what is needed from an economist's point of view. Needless to say that this is my evaluation, reflecting my thoughts and backed by having served 12 years as a member of the German Council of Economic Advisers.²

² For details see my book *The German Economy. Beyond the Social Market*.

III.

Germany's first major challenge is to undo the false incentives that are the root cause of the high unemployment. In order to achieve this, we have to change the institutional design for wage formation and decentralize the way how wages are formed.

German trade unions have not accepted what the German Council of Economic Advisers has proposed as an orientation for union wage policy: In a situation of high unemployment, wages should not be raised according to the observed trend in the growth of labor productivity but should remain below that trend in order to bring the unemployed into employment. To put it differently, the expected increase in labor productivity should not be calculated by dividing output by those employed but by also including the 6 million who are in official and hidden unemployment in the denominator of the productivity measure.

Germany needs more flexibility in wage negotiations, and it has to change the legal stipulations that protect the power of the trade unions. Quite frankly, a treaty such as the agreement of Wassenaar – the “*Centrale Aanbevelingen inzake Aspecten van een Werksgelegenheidsbeleid*” of November 1982 – will not be a possible solution for the German economy.

Let us look in more detail at only one of the legal stipulations, the *Günstigkeitsprinzip*, (the favorability principle, § 4 Sec 3 *Tarifvertragsgesetz*). This legal rule stipulates that the individual worker can, as a union member, deviate from the negotiated union wage contract if this is favorable for him. “Favorable”, however, is interpreted in a narrow sense by the labor courts, as a wage higher than in the union contract or as shorter working hours. The risk of becoming unemployed, i.e. the security of the job, cannot be a legally valid consideration in determining whether it is favorable to deviate from the union contract; this has been explicitly decided by the highest labor court (*Bundesarbeitsgericht*) in 1999. According to this decision, wages and working hours on the one hand and the security of a job are not allowed to be compared. This is striking, as any freshman of economics knows that the three variables: wage level, working time and job security are strongly interrelated in economic reality; moreover, all three variables can be expected to be argument variables in the utility function of workers. To stipulate that the risk of losing the job should be taken into consideration or that the individual worker should have the right to decide for himself whether he

wants to deviate from the union contract meets the strong opposition of the trade unions who fear to lose organizational power.

Another legal provision stipulates that firms cannot deviate from the union contract unless this is permitted in the contract itself (§ 77, Sec 3 *Betriebsverfassungsgesetz*).^{3,4} Admittedly, firms and workers have disregarded this stipulation to some extent, especially lately, when for instance Siemens found consensus with its employees to extend the working time to 40 hours per week in some of its plants. But legal battles in the courts have sustained the law that prevents efficient labor contracts. Again, trade unions oppose a change in this stipulation for the fear of losing power.

Besides wage formation, an important specific problem for unemployment is the institutional set-up of the lower segment of the labor market. A social market economy protects individuals who are out work, either because they are unemployed, unable to work in case of illness or out-of-work for other reasons. Germany had so far developed the following schemes: *unemployment benefits of type I (Arbeitslosengeld)* with benefits that varied according to age and lasted up to 32 months; *unemployment benefits of type II (Arbeitslosenhilfe)* which was paid when unemployment benefits of type I expired. This type of benefit was paid indefinitely. It was linked to the previous working income and required neediness; *social welfare benefits (Sozialhilfe)* which are payments to ensure the basic necessities to allow a life in dignity. These payments are defined by minimum requirements for living and are means-tested.

This set of government-provided incomes defines the reservation wage, a psychological variable. This is the wage that an unemployed on benefits requires is willing to go back to work for; it influences search intensity and the willingness to accept a job. The higher the income provided by government when people are not working, the higher the reservation wage. Empirical analysis of the unemployed in Germany shows that the reservation wage was 20 percent above

³ This provision even applies to firms which are not members of the employers' association. It thus *de facto* violates the negative "freedom of coalition" guaranteed by the Constitution, i.e. that no one should be forced into union membership.

⁴ Thus, even if the workers of a firm agree overwhelmingly to work longer hours per week or to accept a lower wage in order to make their jobs safer, this is *verboten*. This implies that efficient labor contracts are legally not feasible. This stipulation even applies to those firms that are not member of the employers' association.

the wage in previous employment (Christensen 2002). This is unusually high for someone who wants to find a job, and it is high in comparison to other countries. Empirical analysis also shows that the reservation wage is not reduced with the duration of unemployment. This means that job-search intensity is lower and that the willingness to accept a job is reduced. This also means that the supply side of the labor market eventually dries up.

At the same time, the described arrangements imply that neither workers nor their unions will accept a wage rate below the reservation wage. Thus, welfare benefits of the German type define a floor to the wage structure. Whereas the reservation wage is a variable defined for each individual, the wage floor is an institutional variable; it represents a *de facto* minimum wage. There is an implicit minimum wage without a minimum wage being formally defined. This means that wage differentiation is obstructed. The lower part of the demand curve for labor is truncated. There is no effective labor demand below the minimum wage. The economy loses the lower segment of the labor market and unemployment of the low-qualified is the consequence. Moreover, a minimum wage has an impact on the labor market equilibrium because it determines wage bargaining behavior of unions.⁵ Finally, since the minimum wage implies higher outlays of the social security system which *de facto* have to be financed by taxes on labor income it compresses the wage structure.

With respect to this minimum wage, Germany has now undertaken major reforms. The duration of unemployment benefit of type I has been reduced to one year and to 18 months for older workers over 55. Unemployment benefit of type II has been lowered considerably, more or less to the level of social welfare payments. Conditions of mean-testing have been made more strict. These reforms are likely to reduce the reservation wage and thus increase the willingness to work.

Moreover, those who are physically capable to work will now receive unemployment benefits of type II instead of social welfare payments. In this way, the two forms of previous tax-financed government transfers are integrated into one.⁶

In addition to these two institutional incentives, i.e., the wage formation and the

⁵ See German Council of Economic Advisers, 2002, Box 9.

⁶ On a serious new false incentive see my book *Der Kobra Effekt* (2003).

reservation wage, the demand for labor is systematically weakened for the following reason. The social security system is financed by contributions from labor income, paid by firms and by workers on a half and half basis. This implies a wedge between the gross and the net wage. It has the same effect as a tax on labor. When the tax on work income and the social security system contributions are taken together, the marginal tax plus contribution rate for the average earner amounts to 59.4 percent of gross income if he is married (with two children) and 65,3 percent for the single worker with an average income.⁷ This wedge represents a sizable efficiency loss including high unemployment. It has to be reduced.

IV.

Germany's second major challenge is how to reduce the tax on labor and how to make the social security systems sustainable. The core of the problem is that Germany's generous social security system, consisting of the old age pension system, nutured care, health insurance, unemployment insurance, unemployment benefits for the long-term unemployed and social welfare, and its additional benefits of the social budget can no longer be supported by the economic base. The superstructure of social protection affects the economic basis negatively in that the set incentives represent distortions and lead to efficiency losses, to a loss of economic dynamics and to high unemployment. Consequently, the level of social absorption has to be brought down; the expansion of the welfare state, most prominently taken place in the 1970s, has to be reversed. In tackling this task, Germany faces a similar problem as that of Sweden, but also as the two other larger continental economies, France and Italy. In that interpretation, Germany is an example of the issues that have to be solved in the larger continental European countries.

The guiding principles for this reform are:

- First, define which risks need to be covered collectively. Health insurance definitively covers a high degree of risk or uncertainty. When someone is born, we do not know which health risks he or she will face. So there is reason why

⁷ OECD. OECD Taxing Wages Database (2004).

this risk has to be borne collectively. This also holds for old-age nursing insurance and disability insurance. In contrast, to live a long life is not an uncertainty to the same degree. People can take precautions for their old age by putting money aside. Thus, in principle old-age protection lies with the individual. Similarly, the risk of becoming unemployed can at least be partly reduced by people's own efforts, such as acquiring skills or moving to where the jobs are. It is not the same risk as the health risk.

- Second, a distinction should be made between what are large risks and what are small risks for the individual. Large risks are those that cannot be borne by the individual, an example being a longer illness or disability. These risks have to be covered by society. Small risks such as having no income in the first days of unemployment or illness, however, can be borne by each member of society, for instance by precautionary savings. In my judgment, this distinction must be at the heart of the welfare state reform. It must be applied to all areas of social security. For instance, it should be applied to all forms of medical care as well, in order to delineate what is essential and what not.
- Third, the German system is a pay-as-you-go system. It does not contain a capital stock. This is most apparent in its pension system where the working generation pays for the retirees. Apparently, this system does not work now that people have a longer life expectancy and fewer future contributors are born. Thus, a capital stock has to be accumulated, not only for pensions, but also in health insurance to cover the health costs that rise with age.
- Fourth, uncouple the financing of the social security system from the work contract, wherever that is possible. This would mean that employees are paid out what the employer now pays in terms of social security contributions and then employees can partly decide how much protection they want themselves.
- Fifth, the social security systems represent an insurance with a collective risk allocation, but there is also quite a bit of income distribution inside the social security systems. Separate the insurance aspect from the distribution aspect. Redistribution that now is part of the different branches of social security has to be shifted to the tax-transfer mechanism.

To implement these principles, however, entails huge problems. It basically means redefining the whole social security system and reducing the level of social

protection. Let us briefly look at two different branches of the social security system.

In the current old-age pension system, the pension level of the public system is brought down by a new pension formula in which demography plays a role. Such a formula was already introduced into law, but when the Red-Green government came into power, they suspended the law and have now introduced a new formula becoming effective in 2005. This means that Germany has lost five years in the reforms. As a major institutional change, a private insurance has been introduced receiving government subsidies; this voluntary private insurance is to partly fill the void that is left when the level of the public system is being reduced.

With respect to health insurance, the political parties in Germany are still searching for a more efficient solution. The Red-Green government wants to continue with the given system and extend it to include additional incomes in setting contributions, such as capital income and rent payments for housing. The Christian Democrats propose having the same insurance fee for everyone independent of income, a proposal made by the Council of Economic Advisers. This would uncouple the financing from the labor contract.

V.

The third challenge is how to get a more dynamic economy. The first two challenges I looked at could be seen as ways to deal with hindrances or blockades. Doing away these blockades, will improve Germany's prospects of growth. But it does not answer the question as to how we could arrive at new stimuli so to get onto a higher growth of 3 percent or even 3 percent plus x.

An answer can be found by monitoring the production function of an economy and finding out which factors the GDP growth rate depends on. Apparently, the strategy of lowering working hours and thus reducing the input of labor was the wrong road to take. The labor supply should indeed be increased, but this is difficult in an ageing society with a declining population. By their strategy to reduce the weekly working hours, the trade unions attempted to distract the public's attention from their failure of keeping unemployment low. Perhaps they implicitly thought that by this strategy they could camouflage the impact of their wage policy.

A stronger capital accumulation is another important avenue. For this to happen, the government has to improve the conditions for investment – through business taxes that are competitive with other locations, through regulations that do not block investments and innovations, for instance in licensing new products, and through a generally favorable environment for firms. Such a favorable environment is also needed for a stronger technological progress, the third production factor.

With respect to investment, we must be aware, however, that Germany's catching-up process, or in other terms the process of convergence, is over. In convergence, a country with a low capital stock tends to accumulate capital more quickly, because of its higher marginal productivity of capital. Therefore it grows more quickly. For Germany, this process ended in the late 1970s. In addition, locational competition between countries requires additional efforts of government to keep capital at home or to attract it from abroad.

With respect to innovation and technology, Germany heavily specialized in medium-technology, with the level of technology being defined in terms of R&D expenditure relative to the product price. Machine building, car production and the chemical industry still have a high comparative advantage. But in the last two decades, the electro-technical industry has lost the “volume business” to Asia and the producers of telecommunication instruments and the optical industry have lost their comparative advantage. The pharmaceutical sector seems to be eroding as well so that Germany no longer can claim to be the “pharmacy” of the world economy. BASF has sold its pharmaceutical branch to Abbot Laboratories; Hoechst has ended up in the new firm Aventis, which is now Synofi. The traditional chemical sector does not seem able to be participating in the technological race for the pharmaceutical products of tomorrow. The new innovative IT and biotechnical products have to be imported.

Someone has to do the bundling of these factors of production – the entrepreneurs. They are the fourth factor of growth. Entrepreneurs have to be innovative, they have to be risk-takers, and, according to Schumpeter, they must implement new combinations of factors of production. For growth, you need the entrepreneur; you will not get a high growth rate against their opposition. But you also need conditions in a society conducive to entrepreneurial activities, which include a high regard of their activities, a positive attitude towards technology and the acceptance that profit making is the compensation for risk taking (with the

compensation being judged *ex ante* and not *ex post*). This means that economic dynamics also has a value dimension in society.

Looking at the dynamics of young, newly-born firms, it is nearly impossible to cite an example of a German garage firm that has turned into an international player; SAP is the only one.

Human capital formation is strongly linked to innovation. In a knowledge society, it is the most important factor of economic growth. According to international comparative studies on the educational system, such as the TIMSS and the PISA studies of the OECD, Germany's system is wanting. It has to be redone. This applies to the school system as well as to the university system.

Working at the "new frontiers" of society, a university system has to generate new ideas, The German university system today produces broadly qualified people; but it is not competitive in an international perspective. The younger generation vote with their feet against the system; the most dynamic German students go to the UK and to the US to study.

The German university system desperately needs revision. Up to now, the basic allocation approach of this public system is one of administrative planning at the *Länder* level with some federal restraints. Germany has to deregulate this system and to use competition as the guiding principle for its universities. This means giving universities the right to select their students and to charge student fees, accompanied by a generous stipend system so that society can use all its talents. Universities and the research institutes should not operate according to the labor market regulations and the rules of codetermination. This is a severe impediment to an innovative environment that is desperately needed in an economy with a low growth performance. In my evaluation, this is the most severe change that Germany has to undertake.

Another issue is the role of government in the market economy. Several aspects are relevant. A first aspect is a low and declining share of public investment in GDP, i.e., the consumptive nature of government spending. A second aspect is the high subsidies, amounting to 156 bill € per year, that is 7.5 percent of GDP or 35 percent of total tax revenues according to a survey of the Kiel Institute (using a wide delineation, Boss and Rosenschon 2002). A third aspect is the large share of government expenditure in GDP, absorbing half of GDP, if the social security

systems are included in the consideration. A fourth is the uncertainty that arises from the public budget, its deficits and the high level of public debt. The public budget has been unconstitutional lately, it also violates the Growth and Stability Pact of the European Monetary Union, and it spreads uncertainty to investors and consumers alike. Confidence is an important condition for growth. The fifth is Germany's distributive federalism, showing strong elements of equity (for instance by requiring similar conditions with respect to public infrastructure in the *Länder* of the country). This gives more weight to equity and prevents a competitive federalism where states compete for mobile factors of production and where locational competition points to the best solutions.

VI.

Besides reorganisation of the universities and of the state, there is another issue that needs attention, namely Germany's particular form of decision-making: the consensus approach in which the agreement of many groups of society is sought when important policy measures are taken. This is typical for the round tables and committees used by Chancellor Schröder such as the "Alliance for work" and committees like the "Hartz-Committee", but it is also typical for the two layers of decisions-making in the firms, that is codetermination in the board of larger firms as well as the workers' councils in the firms.

An important implication of this approach is that the status quo plays a central role. Major changes are not accepted when important groups of society are negatively affected by such changes. For instance, the trade unions have so far blocked major changes in the rule system for the labor market. In a way, the consensus approach is an application of the Pareto criterion according to which an increase in welfare presupposes that at least one wins and no one loses with the difference that in politics a relative loss is considered a loss as well. This implies that a standstill often is the outcome, and that economic dynamics is lost. Decisions tend to be blocked if the dominant method of decision-making is to look for consensus (and distribution).

An important shortcoming is that such an approach does not make use of the problem solving capacity of decentralized markets in which changes occur more or less automatically and where new solutions are discovered by the imagination of market participants.

In line with this, Germany has solved its structural adjustment mainly in the existing firms, not by means of new firms. Such an approach may be good at attaining marginal improvements, but it is deficient in leapfrogging to new approaches and new products. A related issue here is the role of corporate governance and the capital market where banks dominate in the controlling the boards of firms and where thus the incumbent firms have an advantage compared to the new firms.

VII.

Reviewing all these factors, Germany has to choose. If it puts more weight on social protection and equity as in the past, it is likely to stay in the position it is in now, more or less stagnating or maybe growing at one per cent per year. If it wants to grow at a higher rate, less weight can be put on social protection and on equity. Thus, a change of mentality is needed if Germany is to be a more dynamic country again. It is a choice that other European countries face as well. And it is a choice that the European Union also faces. Europe cannot become the most dynamic region of the world economy, as planned in the Lisbon process, if it defines itself in terms of social coherence instead of diversity and dynamics.

Thus, Germany's task can also be seen as a necessary redefinition of the "social market economy", attempting to reconcile efficiency and equity under the changed economic conditions in the globalized world and after the expansion of the welfare state has had its impact on the economic basis of the country.

To conclude, Germany faces quite a few severe economic policy challenges. At heart I am optimist, and of course I hope that Germany will find solutions for all its problems. Maybe the optimistic answer is that the Germans as a people are resilient, that in terms of economics they are good when they have their backs against the wall. To bring this strength forward (if it still exists), Germany needs a renaissance of the market economy. And it needs an American type of optimism. So let me close with what an American president, Calvin Coolidge, once said: "If you see ten troubles coming down the road, you can be sure that nine will run into the ditch before they reach you."

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Zijlstra was Professor of Economics at the Free University of Amsterdam before becoming Minister of Economic Affairs, Minister of Finance, Prime Minister, President of De Nederlandsche Bank, and finally, Minister of State. Jelle Zijlstra was also a member of the Royal Netherlands Academy of Arts and Sciences.

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