

Globalization and the Welfare State: A Review of Hans-Werner Sinn's *Can Germany Be Saved?*

DENNIS J. SNOWER, ALESSIO J. G. BROWN, AND CHRISTIAN MERKL*

What are the challenges that globalization makes on welfare states and how should welfare states respond? How should welfare states be designed to enable countries to reap the benefits of globalization? These are the main themes of Hans-Werner Sinn's book, Can Germany Be Saved? We view Germany as a case study of how a welfare state can go wrong in reacting to the pressures of globalization. We present two views of globalization—the “specialization view” (of Sinn) and the “Great Reorganization view” (ours)—and examine the policy implications of each for the welfare state design.

1. Introduction

There is broad agreement among economists and policymakers that the forces of globalization create new challenges for welfare states. What are these challenges and how should welfare states—with their objectives to provide social insurance, redistribution, lifecycle transfers, and access to services subject to market failures (such as education and health services)—respond to these challenges? How can welfare states be designed so that they enable countries to reap the benefits of globalization? How can these benefits be spread sufficiently widely to dissuade voters from supporting protectionist policies

that would halt globalization? These are the basic questions inspiring Hans-Werner Sinn's book—*Can Germany be Saved? The Malaise of the World's First Welfare State* (MIT Press 2007)—and motivating this article in response to it. The title—*Can Germany Be Saved?*—is a misnomer, since it is not just a book about Germany, but more generally about the danger of conflict between welfare states and globalization and what to do about it. Germany can be seen as a case study of how a welfare state can go wrong.

The globalization process creates winners and losers, thereby creating a powerful challenge to the welfare state. To stave off protectionism, the welfare state must protect the losers and enable sufficient numbers of voters to benefit from globalization. In doing so, however, the welfare state may destroy people's incentives to be productive and thereby undo globalization's benefits. Sinn's book deals with the problem of how to

* Snower, Brown, and Merkl: Kiel Institute for the World Economy and Christian-Albrechts University. We would like to thank Roger Gordon, as well as Alfred Boss, Dennis Goerlich, Rolf J. Langhammer, and other researchers at the Kiel Institute for the World Economy, for useful comments.

respond to this challenge. This is a problem of epic proportions, relevant not just for mature industrialized countries like Germany but also for emerging economies such as Brazil, China, India, and Russia.¹ The response of these countries will have an important influence on how fast the world economy will grow and how this growth will be shared among nations and their citizens.

Dealing with this challenge requires, first, a vision of what is driving the globalization process and, second, an account of how welfare states should respond. Accordingly, this article is organized as follows. Section 2 describes two views of the globalization process—Sinn’s and ours—and the two corresponding challenges for the welfare state. Section 3 deals with the policy prescriptions arising from these two views. Section 4 concludes.

In Sinn’s view, globalization and technological change are skill-biased, leading to a fall in the demand for unskilled labor relative to skilled labor. Accordingly, a major challenge of the welfare state is to support the living standards of the unskilled without reducing their work incentives. In our view, however, globalization and technological change were unambiguously skill-biased only so long as the advances in IT, telecommunications, and logistics were used to do the existing tasks in the old ways. But in the past decade, we argue, there has been a widespread and fundamental change in the organization of production and work, leading to a radical geographic decomposition of value chains, an increasing flexibility, heterogeneity, and versatility of work, and a rising importance of tasks involving personal relationships. These developments lead to new, more complex patterns of winners and losers from globalization, calling

for a new response from the welfare state. What is now required of the welfare state, we suggest, is not simply supporting the unskilled in work, but enhancing people’s adaptability, so that they—whatever their skills—can turn themselves from losers into winners through their own efforts.

2. *Two Views of the Globalization Process*

The current literature contains divergent views about the nature of the globalization process, and these views have different implications for welfare state reform. For our purposes, it is useful to distinguish between two: we will characterize Sinn’s position as the “specialization view” of globalization and our position as the “Great Reorganization view.”

2.1 *The Specialization View*

The specialization view² approaches the globalization process from the perspective of the Heckscher-Ohlin theory.³ Since the developed countries’ relatively abundant factors are skilled labor and capital, they export goods and services that are relatively intensive in these factors and import those that are relatively intensive in unskilled labor. As a consequence, the demand for skilled labor rises and the demand for unskilled labor falls in the process of globalization. Then, under free markets, wages of skilled workers would rise and the wages of unskilled workers would fall, so that full employment could be maintained. For the period from the mid-1970s to the mid-1990s, the rise in the relative wages of skilled to unskilled workers,

¹ See Sinn (2007a, p. 27 and p. 287). In what follows, we refer to Sinn (2007a) whenever we make no other attributions.

² An early exponent of this approach was Paul R. Krugman (1994), who wrote since globalization reduced the relative demand for skilled to unskilled labor, “the European unemployment problem and the U.S. inequality problem are two sides of the same coin . . .” (p. 37).

³ See chapter 2—“How German Workers Lost Their Competitive Edge,” particularly pp. 46–47.

occurring roughly alongside a rise in the relative employment of skilled to unskilled workers, has been widely documented for many countries.⁴ The problem, according to Sinn, is that the German welfare state prevents this adjustment and thereby generates unemployment.

This view of globalization has been massively influential. As long as the increased trade flows and new technologies had no fundamental influence on the organization of production and work, it was possible to identify “sunrise sectors” that benefited from the technological advances and “sunset sectors” that did not. Broadly speaking, the sunrise sectors tended to offer relatively secure, high-wage jobs to the domestic skilled workers, whereas the sunset sectors offered more insecure, low-wage jobs to the domestic unskilled workers. So skills, wages and job security tended to be associated with sectors.

A problem concerning this view of globalization is that while an overall fanning out of the earnings distribution between the mid-1970s and mid-1990s is well documented, there is evidence that since the mid-1990s the evolution of the earnings inequality appears to have taken a new course, summarized below. Furthermore, most empirical economists have found the impact of trade on the earnings distribution has been minor.⁵

⁴ For the United States, for example, see McKinley L. Blackburn, David E. Bloom, and Richard B. Freeman (1990), John Bound and George Johnson (1992), Lawrence F. Katz and Kevin M. Murphy (1992), and Murphy and Finis Welch (1993). For other OECD countries, see Steven J. Davis (1992), Freeman (1988), Freeman and Katz (1994), Katz and Ana L. Revenga (1989), Katz, Gary W. Loveman, and David G. Blanchflower (1995), Stephen Machin (1996) and OECD (1996a), among others. The rise in relative wages of skilled to unskilled workers is reflected in the skill premium, often measured in terms of the education, experience, and nonproduction premia (e.g., Peter Gottschalk 1997; Eli Berman, Bound, and Zvi Griliches 1994; and Berman, Bound, and Machin 1998).

⁵ For example, Krugman (1995) argued that it accounted for only about one tenth of the widening gap between the wages of U.S. skilled and unskilled workers.

This issue has been revisited by a number of economists recently and they reach the conclusion that the measurable effect of trade on inequality has risen, but remains small.⁶

2.1.1 *The Welfare State as an Obstacle to Globalization*

Sinn argues that welfare state support (such as unemployment benefits and associated welfare entitlements) sets an effective wage floor, since no one is willing to work for less than what the welfare state offers the jobless.⁷ “There is no lack of jobs in Germany. There is just a lack of well-paying jobs which can compete with the wage-replacement income offered by the state” (p. 106). On this account, unskilled workers may become unwilling or unable to work for their market-clearing wage. Thus, as the demand for unskilled labor falls, more and more unskilled workers may leave employment and join the ranks of the unemployed. The root cause of the problem is that state support is conditional on being unemployed. “The state does not primarily assist those who have suffered misfortunes and whose productivity is so low that they cannot earn a socially acceptable income by working, as any reasonable reading of the term ‘insurance’ suggests. Rather, it assists those who do not work” (p. 106).

In this way, the welfare state makes the globalization process much more costly than under free markets. In the standard free-market analysis, the potential gains of the winners from globalization are assumed to exceed the losers’ potential losses, and thus globalization raises the average standard of living. When the welfare state sets a wage floor, this result doesn’t materialize, because (1) the unskilled workers stop producing

⁶ See, for example, Josh Bivens (2007), Katz (2008), and Robert Z. Lawrence (2008). Krugman (2008) argues that the effect of trade on inequality may be large, but is hard to capture with the existing data.

⁷ See chapter 4—“Competing against the Welfare State.”

output and (2) they require state support that must be financed by taxes on the skilled workers, who consequently produce less. Thus the winners' gains turn out smaller and the losers' losses turn out larger than under free markets. So a globalization process that raises the average living standard under free markets may lower this living standard under the welfare state (p. 61). Sinn argues that Germany suffers from this unfavorable outcome, sending the country into a downward spiral of stagnation and redistribution.

To this diagnosis, Sinn adds his "bazaar hypothesis."⁸ He claims that, due to generous job security legislation and wage push from the trade unions (about which there is more below), Germany's welfare state leads to wages that are excessively high across the skill continuum, not just for unskilled workers. The excessive wages, in turn, lead to international outsourcing, causing a progressively larger share of the country's value added to be produced abroad, so that Germany becomes like a "bazaar," using foreign imports to produce goods that increasingly flow abroad.⁹ This, Sinn argues, explains why Germany is such a successful exporter, despite its high wages and the resulting high unemployment rates.

Germany is of course a particularly good example of the potential conflict between globalization and the welfare state, because it is heavily exposed to global competition (due to the creation of the EU internal market, interest rate convergence in the Euro area, and EU enlargement (pp. 50–56)) and has a welfare state that generates relatively weak employment incentives (due to relatively

high passive unemployment support, early retirement incentives, high product market regulation, etc.).

2.1.2 *Trade Unions*

For Sinn, the trade unions are at the heart of Germany's malaise,¹⁰ and the welfare state is "the union's secret accomplice" (p.100). He argues that the combination of high replacement rates (unemployment benefits relative to wages) and stringent job security legislation allows unions to behave very aggressively in wage negotiations. This enables unions to achieve excessive wages across the board, although the problem is particularly serious for the unskilled, low-wage workers, since these have relatively high replacement rates. Furthermore, high job protection improves the fall-back positions of the employees and worsens the fall-back positions of the employers in wage negotiations, so that unions have less to lose from inflated wage demands.¹¹ Wide coverage of collective bargaining agreements (so that union wage negotiations affect far more workers than the union's membership) spreads the damage from excessive union power.

In addition, Sinn argues that union activity also leads to excessive reductions in working hours (p. 84). He points out that only Dutch and Norwegian workers work fewer total average annual hours than Germans.¹² (Average annual working hours of the full-time employed present a different picture, however: Germany finds itself in the mid-range among European welfare

⁸ See p. 36. In Sinn (2007b) the Bazaar economy hypothesis is explained in greater detail.

⁹ The phenomenon of a rising share of imported intermediate inputs is not unique to Germany. A study by the Ifo Institute (Michael Reinhard and Hans Schedl 2007) shows that the percentage of intermediate goods in the industrial production has also increased in many other European countries such as Italy, France, or Spain, except of course for the break in the data due to German reunification (see especially figures 2.3 to 2.9 in Reinhard

and Schedl 2007). Germany and its neighboring countries have had comparable trajectories of industrial gross value added, overall industrial production and industrial employment.

¹⁰ See chapter 3—"Trade-Union Capitalism."

¹¹ Sinn writes: "According to research by the Ifo Institute, Germany's current rate of unemployment could have been largely avoided had wages of skilled workers stayed 10–15 percent below today's level and that of unskilled workers about one-third below current levels" (p. 64).

¹² See figure 2.1 on p. 85.

states,¹³ while Anglo-Saxon countries such as Britain have significantly longer working hours. Once again, Sinn's critique of the German welfare state is relevant for a number of European welfare states.)

Sinn's critique is related to a debate between Olivier Blanchard (2004) and Edward C. Prescott (2004) on what a desirable number of working hours might be. Prescott blames high taxes for deficient working hours and correspondingly low living standards in Europe relative to the United States, while Blanchard argues that Europeans have the right to choose lower working hours, together with lower GDP per capita, if they wish. Sinn's critique favors Prescott's position, since Sinn argues that trade unions do not represent the interests of the entire workforce. Rather, they represent primarily their members, who tend to be employed and have relatively high seniority. Thus, wages turn out to be excessively high, causing unemployment, which shrinks the tax base and requires tax rates to be raised in order to provide the requisite unemployment benefits and welfare state entitlements.

2.1.3 *Taxes and Transfers in a Globalized World*

According to the specialization view, globalization increases the dispersion of earnings between skilled and unskilled workers, and thereby leads to political demands that the welfare state redistribute more income. This sets in motion a round of tax-induced negative externalities: As more income

is redistributed from the skilled to the increasingly unemployed unskilled workers so that the work incentives of both groups decline, the tax base shrinks. This leads to yet higher tax rates to finance the rising levels of unemployment support, and so on. As taxes rise, moonlighting and rent-seeking by transfer receivers becomes more common, which shrinks the tax base even more.

Sinn indicates that the marginal tax burden for average income earners in Germany is among the highest in the world¹⁴ and he argues that the German tax system is excessively progressive.¹⁵ He contends that too much of the German government's budget is devoted to passive social transfers (thereby leading to excessive debt levels),¹⁶ relative to education and other growth-enhancing measures, such as early child care.

Moreover, the free flows of financial capital under globalization imply that high taxes on capital and skilled labor lead to capital flight and a brain drain.¹⁷ Excessive capital taxation hinders capital accumulation and thereby make all people worse off.

2.2 *The Great Reorganization View*

The Great Reorganization view distinguishes between two recent stages of globalization. In the first stage—extending approximately from the mid-1970s to the mid-1990s—entrepreneurs devoted their efforts primarily to making the new machines do the old jobs. This gave rise to the age of skill-biased technological

¹³ Peter Bofinger (2005, pp. 45–46) points out that Sinn's figure 3.1 compares total average working hours in different OECD countries, thus not taking into account that more people work part-time in Germany than in other European countries.

¹⁴ See chapter 6—"Taxes and Transfers: The Endless Loop."

¹⁵ See p. 196, particularly figure 6.6. In fact, however, the German income tax and social contribution system is very complicated: it is highly progressive for low and

medium income people, but regressive for high income earners due to a social security contribution ceiling (starting at 150 percent of the average income for single income earners, see OECD 2008).

¹⁶ See p. 181. Again, Sinn describes a development that many welfare states have in common. Although France did not have to shoulder the burden of reunification, the public debt to GDP ratio developed very similarly during the last fifteen years (see OECD 2007).

¹⁷ See chapter 6—"Taxes and Transfers: The Endless Loop," particularly p. 202.

change. The new information and telecommunications technologies favored the skilled labor in each developed country, since the workers using these technologies tended to be skilled and resident in the developed world. Similarly, the process of globalization was skill-biased as well, as firms in the developed economies reshuffled their old jobs geographically, locating some of the old unskilled jobs offshore and retaining many of the old skilled jobs at home.

But since around the mid-1990s, according to the Great Reorganization view, the globalization process has entered a new stage, in which enterprises have begun to discover the organizational implications of the nexus of new technologies, logistics systems and trade opportunities. The new organization of production and work gave rise to new patterns of winners and losers from globalization, mirrored in new patterns of earnings inequality.

Recent empirical studies indicate that changes in the distribution of earnings are no longer captured by an across-the-board increase of earnings dispersion between skilled and unskilled workers. What appears to have been happening over the past decade and a half in the United States, as well as some other countries such as Great Britain and Germany, is that the distribution of earnings has not simply fanned out, but rather has split into several segments, with each segment following a different trajectory. Whereas inequality among the rich has increased, it has fallen among the poor.¹⁸ Recent evidence also

suggests a “polarization of work,” whereby the employment shares of the high- and low-wage jobs have expanded at the expense of the middle-wage jobs in the 1990s.¹⁹

The Great Reorganization view addresses these developments by focusing on the reorganization of production and work. This new organization has three particularly striking features: (1) the geographic decomposition of value chains, (2) the rising importance of personal relationships, and (3) the increasing flexibility, heterogeneity and versatility of work.

2.2.1 *The Geographic Decomposition of Value Chains*

The new advances in information and telecommunications technologies, together with huge improvements in logistics, are enabling firms nowadays to decompose their various stages of production geographically into clusters of tasks, locating each task cluster in the countries and regions where it is most profitable.²⁰

An important consequence of the geographic decomposition of value chains is that global competition is occurring at a lower level of disaggregation. In the first Industrial Revolution, international competition was primarily among countries; by the second Industrial Revolution, transportation costs had fallen sufficiently to induce a marked increase in competition among multinational companies, transcending national boundaries. Now the new wave of globalization is leading us into a new world where individual workers, performing similar tasks in different

¹⁸ Focusing on the United States, David H. Autor, Katz, and Melissa S. Kearney (2006) document an increase in upper-tail inequality since 1980, but a divergent trajectory for lower-tail inequality, which increased in the first half of the 1980s and stabilized or decreased thereafter.

¹⁹ These phenomena have been documented by Autor, Katz, and Kearney (2006), Autor, Frank Levy, and Richard J. Murnane (2003), and Claudia Goldin and Katz (2007) for the United States; Maarten Goos and

Alan Manning (2007) for Great Britain; and Christian Dustmann, Johannes Ludsteck, and Uta Schönberg (2007) for Germany.

²⁰ This has become possible on account of the vast expansion in the goods and services that became tradable. Alan S. Blinder (2006b) made this point succinctly when he wrote that tradable goods used to be whatever you could put in a box, whereas nowadays anything that is electronically transmittable has also become tradable.

countries, are brought into direct competition with one another. This means that a team of workers in one country may suddenly lose their jobs because a team of workers in another country may now be able to offer a more profitable combination of human capital to wages.

This change in the organization of production has two important implications:

(1) Sectors are becoming increasingly irrelevant in determining job security. It is no longer the case that jobs are relatively secure in the growing sunrise sectors and relatively insecure in the shrinking sunset sectors. The reason is that jobs in the growing sectors can be outsourced and offshored. Sectors are no longer the relevant entities for determining the geographic security of jobs.

(2) Skills required for the performance of routine tasks—regardless of whether they have traditionally been associated with high-skill work—are no longer a guarantee for rising wages and job security. The reason is that such tasks may be electronically transmittable and thus internationally outsourcable.

The empirical evidence for these developments is growing steadily.²¹

2.2.2 *The Rising Importance of Personal Relationships*

Independently of comparative advantage, three types of tasks appear secure from international outsourcing:

(1) *Physical delivery tasks*, involving physical delivery to customers: For example,

retail sales personnel are required where the customers are making their purchases. Waiters are required in the restaurants where customers are eating their meals; construction workers are needed where homeowners wish to place their houses. Similarly for gardeners and taxi drivers.²²

(2) *Noncodifiable tasks*, which cannot be defined in terms of routine procedures: People engaged in creative and leadership tasks—for example, managers or researchers working on common projects—often require physical contact to be effective.

(3) *Personal relationship tasks*: The work of psychotherapists, nurses, school teachers, social workers, and many other tasks involves building personal relationships and these also require physical presence with the recipients of these services.

The new advances in information and telecommunications technologies enable firms to gather much more detailed, differentiated information about their customers' preferences and to exploit economies of scope among complementary customer needs. Satisfying these often requires building personal relationships. Furthermore, as routine white collar work in advanced industrialized countries is increasingly offshored or performed by computers, increasing emphasis is placed on noncodifiable tasks. In these ways, the new technological advances are promoting tasks with personal-relationship content. Recent literature provides empirical evidence for this phenomenon.²³ The offshoring of routine white-collar work, together with the personal-relationship content of many unskilled tasks, can

²¹ The geographic decomposition of value chains has been overviewed by Richard Baldwin (2006) and described in detail by Mary Amity and Shang-Jin Wei (2005), Mitsuyo Ando and Fukunari Kimura (2005), Gordon H. Hanson, Raymond J. Mataloni, and Matthew J. Slaughter (2005), and Kei-Mu Yi (2003). The "unbundling" of production stages between the United States and Mexico has been documented by Jesus Cañas and Roberto Coronado (2002) and Robert C. Feenstra and Hanson (1996). The offshoring of labor-intensive Japanese manufacturing to other East Asian nations is examined by Kyoji Fukao, Hikari Ishido, and Keiko Ito (2003) and Shujiro Urata (2001).

²² Due to immigration, however, this does not mean that the domestic workers currently performing these jobs are sheltered from competition by foreign workers.

²³ The importance of personal relationships is investigated by Blinder (2006a, 2006b). Desirée Van Welsum and Xavier Reif (2005) and Van Welsum, Reif, and Graham Vickery (2006) examine the offshorability of jobs in terms of electronic transmittability, personal interactions, IT intensity, and task codifiability.

help account for evidence of polarization of work.

It is clear that the three sets of tasks above cut across the divide between the sunrise and sunset sectors, and between skilled and unskilled workers. Thus these recent developments imply new fault lines of social fragmentation, not merely dividing the skilled from the unskilled, but pursuing a more complex course influenced by such factors as the electronic transmittability, codifiability, physical deliverability, and personal-relationship content of tasks.

2.2.3 *The Increasing Flexibility and Versatility of Work*

As a growing body of empirical evidence attests, the organization of work in advanced, industrialized countries is changing in both manufacturing and services. The command-and-control style of management—where authority flows from the senior executives down through middle management to the workers in the functional departments—is being replaced by flatter organizational structures, in which customer-oriented teams report to the central management with few, if any, intermediaries. These teams frequently require multitasking, job rotation, and sharing of multiple responsibilities.²⁴

²⁴ The move toward more flexible work organization in Nordic countries—in terms of increased delegation of responsibility, accelerated acquisition of versatile human capital, and the rise of team work, job rotation, and multitasking—has been documented by NUTEK (1996, 1999). Empirical studies along analogous lines for various European countries include the European foundation (1997) and the OECD (1996b). Duncan Gallie et al. (1998) consider evidence of work reorganization in the United Kingdom. Eve Caroli and John Van Reenen (2001) explore the relation between work reorganization and skills in the United Kingdom and France. Timothy F. Bresnahan, Erik Brynjolfsson, and Lorin M. Hitt (2002) explore the relation between work reorganization and skills for the United States. Masahiko Aoki (1990) examines new forms of work organization in Japan. Paul Osterman (1994) and Edward E. Lawler, Susan A. Mohrman, and Gerald E.

To succeed in the skilled labor market nowadays, people need more than competence in their specialized occupation.²⁵ They also need to combine their occupational skills with social competence, the ability to take responsibility for one's own work, knowledge of other jobs (so that they can deal with customers and communicate effectively with other members of their team), as well as the ability to adapt their skills to changing customer needs. Increasingly, they require versatility across tasks, the potential to acquire multiple skills, and the ability to learn how the experience gained from one task enhances productivity in other tasks.²⁶

The recent empirical evidence on wages—that the wages of unskilled workers has risen relative to those in the middle reaches of the income distribution and that wage inequality has risen in the upper reaches of the distribution—is consonant with the hypothesis that the recent advances in information and telecommunications technologies complement the work of high-wage workers doing creative, noncodifiable tasks or flexible, versatile work in customer-oriented teams, while having relatively little effect on the low-skill, low-wage work. Insofar as personal services are luxury goods (so that their demand rises faster than income), we would also expect the earnings of some unskilled workers (namely, those engaged in personal

Ledford (1992) focus on the restructuring of work in the United States. Other studies of the economic implications of the organizational change include Eileen Appelbaum and Rosemary Batt (1994), Daniel J. B. Mitchell, David Lewin, and Lawler (1990), and David I. Levine and Laura D'Andrea Tyson (1990). This evidence also attests to the increasing flexibility, heterogeneity, and versatility of work.

²⁵ Further theoretical studies of the reorganization of work include Susan Athey and Armin Schmutzler (1995), Gary S. Becker and Murphy (1992), Patrick Bolton and Mathias Dewatripont (1994), Michael Kremer and Eric Maskin (1995), Paul Milgrom and John Roberts (1990), and Xiaokai Yang and Jeff Borland (1991).

²⁶ For analyses of multitasking, see, for example, H. Lorne Carmichael and W. Bentley MacLeod (1993), Bengt Holmstrom and Milgrom (1991), and Assar Lindbeck and Dennis J. Snower (1996, 2000).

delivery and personal relationship tasks) to rise relative to other low- and middle-wage workers.²⁷ Moreover, the new technologies may substitute for middle-wage workers performing routine tasks or they may promote the international outsourcing of such tasks.

3. *Policy Prescriptions*

The two views of globalization outlined above have radically different policy implications. If, on the one hand, the main influence of globalization is to raise the demand for skilled workers and reduce the demand for the unskilled, then clearly the reform of the welfare state should involve supporting the incomes of the unskilled. If, on the other hand, globalization gives rise to a more complex, changeable, often unpredictable unbundling of value chains and a rebundling of tasks and skills, then the welfare reform should be primarily about increasing adaptability and versatility, for whichever population groups happen to be affected.

3.1 *Sinn's View*

The main challenge of the welfare state, according to Sinn, follows directly from his view of globalization. Specifically, the welfare state needs to counteract the globalization-induced fall in the demand for unskilled workers. Since the decreased demand reduces the unskilled workers' wages below the socially acceptable minimum, the welfare state is required to support their incomes. And since the decreased demand also reduces the unskilled workers' chances of finding employment, the welfare state needs to improve these job prospects.

²⁷ For evidence, see Francesca Mazzolari and Giuseppe Ragusa (2007).

²⁸ See chapter 4—"Competing against the Welfare State."

²⁹ See chapter 9—"Rethinking the Welfare State: A Reform Program" and especially p. 125 in Sinn's book

On this account, Sinn believes that the welfare state needs to "activate" the unskilled by increasing their incentives to work and simultaneously increasing firms' incentives to employ them. When the unskilled work, they generate output and thus require less state support.²⁸ The fundamental problem of Germany's welfare state is that it does not fulfill this requirement. It is too "passive," in that it generates excessive wages and supports those who consequently become unemployed. This passivity of the welfare state towards the unskilled is what makes globalization a problem rather than a boon.²⁹ Once again, Germany is an instructive case study, since it shares this problem with other economies such as Belgium, France, Italy, and Spain.

In addition, Sinn calls for a variety of institutional reforms to bring down the excessive wages and reduce the labor and product market rigidities that prevent the reallocation of labor across sectors in response to globalization. Sinn argues that his policy proposals are particularly important for East Germany, whose problems he views as an extreme case of the West German ones.³⁰ After reunification, West German unions (with the collusion of West German firms) pushed East German wages far above East German productivity, leading to an implosion of employment there. Meanwhile massive transfers continued to flow from West to East Germany, so that if East Germany were a separate country, its trade deficit would be in excess of 40 percent of GDP (see figure 5.5, p. 152).³¹

where he discusses reform proposals in light of the globalization.

³⁰ See chapter 5—"The Withering East."

³¹ Snower and Christian Merkl (2006) formalize the underlying economic mechanisms. Furthermore, they show that East Germany has fallen into various labor market traps, which are difficult to overcome, see also Merkl and Snower (2008).

3.1.1 *Employment Policy*

Sinn proposes a policy of “activating social assistance,”³² which is a combination of a wage subsidy for low-wage (low-skilled) workers³³ and a reduction of the unemployment benefits in the form of social assistance.³⁴ Whereas the fall in social assistance³⁵ reduces the expected income of the unskilled workers (since they are prone to unemployment), the wage subsidy raises their expected income by improving their wages and employment prospects.³⁶ The wage subsidy is meant to be just high enough to compensate the worst-off of the unskilled workers for the drop in their expected income from the fall in unemployment benefits. Thus, at the bottom of the income distribution, workers should find themselves no worse off in income terms than they were previously,³⁷ provided that they avail themselves of the wage subsidies by accepting whatever work becomes available. In addition, Sinn’s activating social assistance also involves workfare: those who are unable to find a private sector job can obtain the uncut level of social assistance if they offer the local community eight hours of work a day in exchange.

By driving a wedge between the wage the worker receives and the wage the firm pays, activating social assistance maintains the incomes of the unskilled while raising their

employment rate. This policy is clearly more effective than passive unemployment benefits in supporting the unskilled, in the sense that the same level of expected unskilled income can be achieved through a lower level of tax receipts under activating social assistance than under the passive unemployment benefits. Nevertheless, since some of the unskilled would not take up any work and consequently experience a reduction in their social assistance, the policy would increase the degree of income inequality, which would be politically unpopular in Germany.

3.1.2 *Pension Policy*

Germany, like many other advanced industrialized countries, suffers from a dramatic drop in fertility rates since the early postwar period, thereby endangering the finance of its unfunded pension liabilities.³⁸ Sinn observes that Germany is severely affected by this development, since its fertility rate declined several years earlier than in other countries. Immigration flows, within politically tolerable limits, can only deliver very modest relief.³⁹

Sinn’s suggested policy response is meant to address a deficiency of the welfare state, one that is magnified by the globalization process, seen from the specialization view. As the welfare state has evolved over the postwar period, it has increasingly taken responsibility for lifecycle transfers away from private citizens and given it to the state. As long as this responsibility was still in private

³² See p. 127 for details and p. 297.

³³ The low wage subsidy part is similar to the policy prescription of Edmund S. Phelps (1994).

³⁴ The German unemployment benefits system has two pillars. The first pillar (“Arbeitslosengeld”) is financed through contributions and the pay-outs are proportional to the previous wage. The first pillar expires after a certain time period (maximum: twenty-four months), depending on the contribution time and on the age. The second pillar (“Arbeitslosengeld II”), which we call social assistance, defines the subsistence level and is means-tested. Analogously, the wage subsidy in Sinn’s proposal is also means-tested.

³⁵ “In order to balance the government budget, transfer to employable people who are not working will be cut by about one-third” (Sinn 2007a, p. 128).

³⁶ The more of the subsidy is captured by employers in the form of reduced labor costs, the greater the rise in unskilled employment and fall in unskilled unemployment. Conversely, the more successful the unskilled workers are in capturing the subsidy, the greater will be their earnings and thus the greater the reduction in working poverty.

³⁷ Note, however, that since a lower social assistance changes the fall-back position of all workers in the wage-bargaining, this policy reform would also put downward pressure on the wages of those who are not eligible for social assistance.

³⁸ See chapter 7—“The Birth Dearth.”

³⁹ See p. 234, especially figure 7.8.

hands, people had two main ways of providing for their old age: raising children who would later support them or saving for retirement themselves. Once the welfare state absorbed this responsibility, people gained a further—financially attractive—option: to free ride on the other contributors to the pay-as-you-go (PAYG) pension system. As globalization (specialization version) reduces the unskilled labor demand,⁴⁰ the unskilled workers make progressively smaller contributions to the PAYG pension system, thereby necessitating either increased pension contribution rates or lower pay-out rates. In this way, the combination of the PAYG method of pension finance, the drop in fertility and the labor market implications of globalization can create a pension crisis.

Sinn addresses this problem by attempting to restore the fertility incentives that the welfare system has blunted and to ensure that the globalization-induced reallocations of labor put less pressure on the finance of the pension system. Specifically, Sinn advocates abolishing all early retirement incentives, while imposing actuarially fair benefit reductions for those who nevertheless wish to retire early (pp. 300–301).⁴¹ Furthermore, Sinn insists that early retirement should only be possible for those who would receive a pension above the level of social assistance, so that such retirement would generate no additional fiscal burden.

Most importantly, Sinn proposes reforming the German pension system in accordance with the following three-pillar structure (p. 250). The first pillar is to serve as a basic insurance scheme (with a fixed contribution rate, namely, 19.5 percent of gross wages, so that the demographic shifts lead to lower basic retirement benefits). As the resulting

pension would be below the social assistance level for many retirees (with about 36 percent of the previous gross earnings in 2035), this first pillar is to be complemented by two others. A second pillar is to be a PAYG child-funded pension for parents, where the maximum second pillar pension can be obtained by raising three children. And a third pillar for those who are childless is to comprise a mandatory fully funded pension. As people have more children, they shift from the third to the second pillar. Specifically, for each child (up to three children) one third of the future contributions to the third pillar are waived and the respective share of accumulated past contributions are rebated. Sinn argues that to finance a PAYG pension system, people have to produce either human capital (i.e., the children who will pay for the pensions of the next generation of retirees) or physical capital (through the third-pillar savings that can be used to finance investment).

Note that under this proposal the risk–return profile of people’s pensions would change when people get children: they move from the fully-funded third pillar (in which returns depend primarily on returns in capital markets, whose growth is relatively volatile) to the second PAYG pillar (where returns depend on the growth of earnings, whose growth is relatively stable). It is unclear to us why it may be desirable to link the birth of children to reduced pension risks and returns.

3.1.3 *Tax and Transfer Policy*

To reduce tax-induced disincentives to work and save, Sinn proposes a dual income tax, i.e., a different taxation of capital income (which is mobile across countries) and labor income (which is more immobile). He proposes that capital income be taxed at a lower rate than labor income, and that labor income be taxed in four tax brackets: 0 percent, 15 percent, 25 percent and 35 percent (p. 207).

As generous welfare states tend to attract foreign migrants that make relatively high use

⁴⁰ Conversely, it raises the remuneration of capital, which does not contribute to the German social security system, and the remuneration for high skilled workers who are also partially exempt from the social security system.

⁴¹ See also, p. 305.

of them, Sinn recommends that immigrants to Germany should not be given immediate access to German welfare benefits.⁴² Instead, he suggests instituting a transition phase in which the tax-financed social benefits for immigrants are limited so as to be fiscally neutral, and inactive immigrants direct their claims to their home countries. With these provisions in place, he proposes that current European constraints on immigration be lifted.

3.1.4 *Institutional Reform*

Sinn recommends institutional reforms to weaken trade unions (p. 295 and ch. 3). Specifically, he suggests allowing firms to deviate from pattern bargaining contracts and abolishing all statutory job protection legislation. He suggests that further wage reductions could be negotiated in return for shares in the firm. These policies, too, follow from the specialization approach to globalization. By raising wages, Sinn argues, unions interfere with the mechanism of comparative advantage. Thus, Germany's production and exports become more capital-intensive and its imports become more labor intensive than they otherwise would be. Sinn maintains that this development is particularly undesirable in view of Germany's relatively high unemployment rates.

Sinn also recommends an increase in weekly working hours (legislated full-time working hours per week), without a change in weekly pay (p. 294). This policy is meant to counteract union's downward pressure on working time. Since it would effectively reduce hourly wages, it would increase the labor intensiveness of production and exports, thereby contributing to the reduction in

unemployment. Since this policy would make the incumbent workers worse off, however, it has not received much mainstream political support in Germany.⁴³

Furthermore, Sinn favors better German pre-school education, improvements in all-day child care and the broad-based introduction of full-day schooling. These measures could reduce skills inequality. They would also reduce women's disincentives to bear children, since women would then find it easier to combine work and child care.

In sum, all of Sinn's policy proposals recognizably mitigate problems associated with the specialization view of globalization.

3.2 *Our View*

The Great Reorganization view of globalization has quite different implications for the welfare state.

The three new features of globalization that we identified above—the geographic decomposition of value chains, the rising importance of personal relationships, and the increasing flexibility and versatility of work—have one far-reaching implication: work is becoming more heterogeneous. Workers used to be easily classifiable into well-defined occupations, each of which consisted of a well-defined bundle of tasks. These occupational categories were similar from country to country and were also reasonably stable through time. In the new stage of globalization, occupational barriers are breaking down, for a variety of reasons. First, as value chains are decomposed geographically, the tasks that were grouped into an occupation can become unbundled. For example, routine white-collar jobs—such as standardized book-keeping procedures and

⁴² See chapter 8—"EU Enlargement, Migration, and the New EU Constitution," especially p. 277.

⁴³ It is also worth noting that, in the presence of sticky wages and prices, an increase in working hours may be expected to reduce employment in the short run, since firms' transactions costs per hour of work would fall and

thus, the increase in working time would be analogous to a positive productivity shock. The relevant theoretical and empirical literature (e.g., Jordi Gali 1999) indicates that productivity shocks under nominal rigidities reduce employment in the short run.

routine phone calls—can be outsourced, leaving white collar workers to restructure their job descriptions along more creative, imaginative, non-systematizable ways. The resulting jobs tend to be very heterogeneous. Second, as personal relationships become an increasingly important characteristic of non-offshorable jobs, workers combine their primary work competences with a wide variety of social, communication and interaction skills. These combinations are also highly heterogeneous. Third, the new information and telecommunications technologies not only permit firms to unbundle their value chains, but they also allow workers greater latitude in choosing their idiosyncratic constellations of tasks. Due to the resulting flexibility and versatility of work, workers are increasingly choosing portfolios of skills that are appropriate to their individual abilities and their customers' preferences. Since these abilities and preferences are heterogeneous, the nature of work is becoming increasingly heterogeneous as well.⁴⁴ Fourth, the new technologies permit firms to identify increasingly differentiated customer needs and to bundle these needs in idiosyncratic ways in order to reap differentiated economies of scope. Consequently workers must be willing and able to keep finding new market niches in which they—with their particular human capital, working with their particular physical capital and resource endowments—have a comparative advantage.

The new challenge facing the welfare state is to deal with this ever-changing heterogeneity of work. To address this challenge, it is increasingly inappropriate to rely primarily on policies that support low-wage, low-skill workers. The reason, first,

is that these policies—such as Sinn's low-wage subsidies—tend to penalize training, since training raises productivity and wages and thereby reduces workers' access to the support.⁴⁵ Second, although the low-wage workers clearly do need support, these policies are not enough to promote efficient social insurance. After all, as the nature of the jobs keeps changing, the new danger is that the skills, activities and interests of the workers do not adjust in tandem. If this adjustment does not take place, the new stage of globalization may send a highly heterogeneous group of workers into the arms of the welfare state—any workers, not just the unskilled, whose jobs heretofore can be performed more cheaply or productively by workers elsewhere, and who are not inclined to find new tasks that they are now relatively good at.

Furthermore, it is increasingly inappropriate to rely on education and training policies that aim to move workers from identifiably insecure jobs in declining sectors to identifiable secure jobs in expanding sectors—as suggested, prominently, in the EU's Lisbon Strategy. The reason, as noted, is that the new stage of globalization is progressively breaking the link between the economic prospects of a sector and the economic prospects of the local employees in that sector.

As competition increases among disparate groups of workers in disparate parts of the world, the welfare state must give workers an incentive to keep finding new market niches in which they—with their particular human capital, working with their particular physical capital and resource endowments—have a comparative advantage. In short, the new

⁴⁴ The implications of this heterogeneity for centralized bargaining are analyzed in Lindbeck and Snower (2001).

⁴⁵ Frank Oskamp and Snower (2006) show that low-wage subsidies have little effect on unemployment because although they stimulate low-skilled employment, they discourage human capital acquisition and thereby increase the number of low-skilled workers, who are associated with higher unemployment rates.

challenge of the welfare state is to *promote adaptability* of workers.⁴⁶ As workers' job security becomes decoupled from their skills and sectors, the welfare state needs to provide more flexible forms of social insurance, which help people adjust to changing market conditions, rather than ones targeted at particular skill groups or sectors. What is needed are policies that empower workers whose jobs become at risk to adjust their idiosyncratic portfolios of tasks and their idiosyncratic skills to variable, differentiated customer needs.

As globalization creates changing, often unpredictable, constellations of winners and losers within a country, the welfare state increasingly needs to give workers the tools to turn themselves into winners whenever they happen to find themselves among the losers. This implies a new way of thinking about social insurance. In the old policy paradigm, people's skills and job definitions are taken as given (or adjustable only very gradually) and it is the welfare state's job to provide automatic stabilizers that support them in the event of adverse shocks. In the new paradigm, the aim is to make people more adaptable and versatile, so that they themselves—through their choices of jobs and skills—become part of the automatic stabilization process.

In what follows, we argue that there are two potentially effective ways of achieving this goal: "welfare accounts" and "benefit transfers."

As discussed below, welfare accounts promote adaptability by giving people property rights in welfare services. These property rights enable people to internalize more of the costs and benefits of the welfare services and thereby they induce people to use these

services more efficiently and adjust them automatically to their changing employment, skill acquisition and pension needs.

Benefit transfers involve redistributing economic incentives—particularly incentives to work and train—to the disadvantaged. This differs from the traditional approach of redistributing purchasing power to the disadvantaged. Whereas the latter generally discourages people from engaging in productive activities and adapting to new conditions of work, the former encourages them to do so.

3.2.1 *Welfare Accounts*

Adopting welfare accounts involves moving to a welfare system based on individual accounts, financed through compulsory saving. In particular, consider the following welfare accounts: an unemployment account (covering unemployment support), a skill account (covering post-school education and training), and a retirement account (covering pensions).⁴⁷ When people become unemployed, they would make withdrawals from their unemployment accounts instead of receiving unemployment benefits; when they acquire skills, their withdrawals from their skill account would substitute for the current government expenditures on post-school education and training; when they retire, their withdrawals from their retirement account would substitute for their current state pensions.

To understand welfare accounts, it is useful to view them from two perspectives: the rules that define how they work and the incentives that they create. To fix ideas, we begin by focusing on unemployment accounts.

⁴⁶ Of course, the adaptability of firms must be promoted as well, for example, through policies that promote competition and stimulate infrastructure investment. These policies however lie beyond the purview of the welfare state.

⁴⁷ For a general description of this system, see J. Michael Orszag and Snower (1997) and Stefan Folster et al. (2003). A detailed analysis of unemployment accounts is presented in Alessio J. G. Brown, Orszag, and Snower (2008). See Alfred Boss, Brown, and Snower (2008) for a detailed account of how such a system can be designed and implemented in Germany.

Unemployment Accounts: Rules

Starting with the first perspective, the simplest rules to implement unemployment accounts are ones that reproduce the provisions of the unemployment benefit system that is currently in place.⁴⁸ To begin with, let us simply reinterpret an existing unemployment benefit system in terms of unemployment accounts:⁴⁹ Each individual's contributions to the existing unemployment benefit system (e.g., through taxes that finance the unemployment benefits) can be interpreted as the individual's "contributions" to his or her unemployment account; each individual's unemployment benefit receipts can be interpreted as that individual's "withdrawals" from the unemployment account. Under the rules of existing unemployment benefit systems, the "balances" remaining in each account at the end of an individual's working life (i.e., the difference between the discounted sum of "contributions" and the discounted sum of the "withdrawals" for each individual) are fully expropriated.⁵⁰

In its simplest form, the proposed unemployment accounts differ from this interpretation in only one respect: positive balances at the end of one's working life are not fully expropriated. In particular, people whose present value of contributions is greater than their present value of withdrawals on retirement receive a partial refund in the form of a pension top-up. Those who have negative account balances on retirement receive no refund and pay no penalty when they retire.

⁴⁸ Of course the adoption of welfare accounts can be used as an opportunity to introduce various other reforms in the financing and provision of welfare services. We expect that since welfare accounts make interpersonal transfers more transparent, they are likely to induce citizens to vote for welfare reforms.

⁴⁹ The welfare accounts need not necessarily be fully

Comparing the proposed unemployment accounts with existing unemployment benefit systems, we find:

(1) Under unemployment accounts, the government makes a transfer—in the form of the pension top-up—that it does not make under the existing unemployment benefit system.

(2) The pension top-up creates employment incentives, for the longer a person works, the greater the unemployment account balances at retirement and thus the greater the pension top-up.

The proposed unemployment accounts are self-financing if the employment incentives are sufficiently strong to generate enough tax revenue in order to finance the pension top-up. Brown, Orszag, and Snower (forthcoming) show that this condition is easily fulfilled in the context of a simple calibrated model and that the resulting incentive effects of a shift to unemployment accounts can lead to substantial increases in employment rates, without making the unemployed worse off than they were under the unemployment benefits system and allowing all others who cannot finance their welfare needs out of their own accounts to receive support on the same terms and conditions as under the current system.

Unemployment Accounts: Incentives

Let us now view unemployment accounts from the second perspective, namely, in terms of the incentives they create. Current unemployment benefit systems—that the unemployment accounts are meant to replace—have two main purposes: they are meant to provide insurance against

funded; if the current welfare services (such as unemployment benefits) are financed on a PAYG basis, the corresponding welfare accounts can be run on these lines as well.

⁵⁰ For example, people who are employed for their entire working lives, and thus make contributions but no withdrawals, receive no refund.

unemployment and to redistribute income. Regarding insurance, the employed people's contributions to the unemployment benefit system⁵¹ can be interpreted as insurance premia and the unemployment benefits can be interpreted as payouts. In the presence of adverse selection or moral hazard, the optimal insurance contract involves rewarding "good risks" and punishing "bad risks," through such incentive instruments as payout-dependent insurance premia and deductibles. But the second purpose of the unemployment benefit systems—redistribution—prevents these incentive instruments from being used. (In other words, people with high risks of unemployment do not pay higher contributions, workers do not have the option of self-financing an initial period of unemployment in return for lower contributions.) The absence of such incentive instruments generates adverse work incentives.⁵²

In this context, the proposed unemployment accounts system differs from current unemployment benefit systems in two important respects: (1) It allows policymakers to introduce an incentive instrument for rewarding good risks. This instrument, as noted, takes the form of the pension top-up, which amounts to a fraction of the positive unemployment account balances on retirement.⁵³ The pension top-up effectively gives people some property

rights on the unemployment benefit system. (2) The government's redistributive goals are met by taxing the contributions of the rich and subsidizing the contributions of the poor. This is a more efficient redistributive scheme than that implicit in current unemployment benefit systems, since there is less disincentive to work when the transfers depend on income rather than employment status.

The employment incentives created through the adoption of unemployment accounts can also be understood in another way. Specifically, the unemployment accounts permit the account holders to internalize an important externality. The traditional unemployment benefit system involves both interpersonal redistribution (the contributions of the employed help finance the benefits of the unemployed) and intrapersonal redistribution (my contributions during my periods of employment help finance my benefits during my periods of unemployment). Whereas under the traditional unemployment benefit system both types of redistribution are associated with negative externalities, under the proposed unemployment accounts the externalities from intrapersonal redistribution are internalized (since people use their account balances to support themselves during periods of unemployment).⁵⁴

⁵¹ These contributions may for example take the form of hypothecated payments or taxes.

⁵² The unemployed have deficient incentives to seek work and the employed have deficient effort incentives to remain employed. In addition, firms may have excessive incentives to lay off and rehire workers in response to demand fluctuations, relying on the unemployment benefit system to pay the bill. This latter inefficiency can be addressed through experience rating, which is particularly appropriate for the United States (where layoffs are common) rather than for the high-unemployment countries in Europe (where layoffs are rare). Unemployment accounts affect workers' incentives to work, but have no direct effect on firms' layoff activities.

⁵³ The pension top-up comprises only a fraction—but not all—of the account balances for two reasons: (i) Some of the balances are redistributed from the rich to the poor, so that the unemployment account system can ensure that

people do not receive less than the unemployment benefits they received in the traditional system. (ii) Unemployment accounts are meant to provide insurance against unemployment, and this involves relating the insurance premia positively to the observed, underlying risks. In car insurance, for example, insurance premia may fall with the length of time spent driving accident-free. This is clearly equivalent to paying time-invariant premia and receiving a refund for good performance but, equally clearly, no insurance will refund *all* the premia paid on termination of the insurance contract. For the same reason, unemployment accounts provide a pension top-up that is positively related to the positive balances remaining on retirement, but they do not refund all these balances retirement.

⁵⁴ It is on account of the interpersonal redistribution that people are refunded only a *fraction* of their final-period account balances; the rest is redistributed to others.

It is important to note that unemployment accounts aim not only to improve employment incentives by reducing negative externalities, but also to promote adaptability in the labor market. Unemployment accounts reward the accumulation of positive account balances and, in the current stage of globalization, this accumulation would increasingly require workers to adapt their skills to the rapidly changing patterns of comparative advantage.

Skill Accounts and Retirement Accounts

Analogous incentives are generated through skill accounts. In many post-school state education and training systems, people are offered free education or training immediately upon graduating from high school. These education and training services are analogous to withdrawals from skill accounts, and the taxes that finance these services are analogous to contributions to the skill accounts. In the traditional systems, people who do not make use of these services upon leaving school are generally expropriated. Under skill accounts, they would retain access to their account balances throughout their working lifetimes. This provides an incentive to use public funds for education and training more efficiently than under the current systems: people will make withdrawals from their skill accounts whenever they believe that doing so will raise the present value of their utility above the present value from leaving these funds in their skill accounts and transferring a fraction of them to their retirement accounts upon retirement. On account of the geographic decomposition of value chains combined with the increasing flexibility, heterogeneity and versatility of work, such skilling opportunities need not just arise at the beginning of one's working life, but increasingly require lifelong learning.

⁵⁵ See Snower (1994, 1997) and, for more recent assessments, Orszag and Snower (2003) and Brown, Merkl, and Snower (2007).

Many OECD countries already have some form of retirement accounts. Whereas Sinn's pension proposal is primarily concerned with ensuring the financial health of the pension system without significant reductions in pension benefits, our proposal is primarily concerned with giving people the opportunity to respond flexibly to the idiosyncratic shifts in labor demands induced by globalization, cutting across the skilled/unskilled divide. Accordingly we suggest that for countries that have a legally defined retirement age (like Germany), people be given the opportunity to work voluntarily beyond this retirement age, provided that they relinquish their job security privileges. This would ensure that people would continue working only if this option is preferred by both employees and employers. The longer a person works, the greater her eventual pension benefits. The present value of a person's lifetime contributions should be equal to the present value of the pension payouts, minus the requisite redistribution. In this context, retirement accounts also promote adaptability of the labor force.

3.2.2 *Benefit Transfers*

Our proposed benefit transfers redirect funds from passive welfare support towards vouchers that give workers and firms an incentive to engage in productive activities.⁵⁶ For example, *unemployment benefit transfers* enable unemployed people to transfer a fraction of their unemployment benefits into hiring vouchers (that reduce employers' employment costs) or training vouchers (that reduced employers' training costs).⁵⁶ This

⁵⁶ In other words, the size of the voucher received over a given time period (e.g., a month) is a fraction of the unemployment benefit that would have otherwise been paid. The fraction is less than one because the voucher is meant to be self-financing and it generates deadweight and displacement effects. (See, for example, Brown, Merkl, and Snower 2007).

means that when an unemployed person finds a job, she receives a hiring or training voucher. Similarly, *disability benefit transfers* allow people to use a portion of their disability benefits to provide hiring or training vouchers in order to encourage partially or temporarily incapacitated people of working age to work. Finally, *pension transfers* enable people who have reached at least early retirement age to transfer some of their pensions into hiring or training vouchers.

Benefit transfers are voluntary (only those workers and firms who wish to take advantage of them do so). They are approximately self-financing, in the sense that the expected present value of the vouchers is approximately equal to the expected present value of the unemployment benefits that would otherwise have been paid.

Benefit transfers aim to alleviate labor market inefficiencies that generate excessive wages and excessive unemployment (e.g., externalities arising from efficiency wages, insider power in wage bargaining) or deficient skill acquisition (e.g., poaching externalities). These inefficiencies are often aggravated when the losers from globalization receive passive welfare support. For example, workers who lose their jobs due to global competition often claim unemployment benefits that are financed through taxes. Since both the benefits and costs are uncompensated, they generate externalities. In this context, benefit transfers reduce inefficiencies by reducing firms' labor costs while raising workers' earnings (since employers can afford to pay more for workers who are subsidized). The difference between what workers receive and what firms pay is financed by the welfare benefits that would otherwise have been paid. This free lunch is possible because the benefit transfers reduce existing inefficiencies. As previously unemployed or inactive people become productive, they produce more output, and benefit transfers divide the proceeds from the sale of this output among

the workers and firms. And they do so in a way that equalizes people's employment opportunities.

The crucial difference between benefit transfers and Sinn's activating social assistance lies in policy targeting. While Sinn's policy is targeted at low-wage workers, our policy is aimed primarily at helping people who have become unproductive—for whatever reason—to become productive by adapting to their changed circumstances. We argue that since globalization is now affecting a more heterogeneous group of workers, it is important to establish an automatic stabilizer that gives people who have been displaced from their jobs the automatic incentive to seek alternative employment and adapt their skills accordingly. Targeting unemployed and inactive people is useful for this purpose, since those who are displaced from their jobs frequently become either unemployed or inactive (e.g., by taking early retirement or becoming disabled through stress-related problems).

For unemployment benefit transfers, the magnitude of an unemployed person's hiring or training voucher rises with the duration of unemployment and falls with the duration of subsequent employment. Unskilled workers receive higher vouchers than skilled workers, because the present value of the vouchers is tied to the present value of the expected unemployment benefits that would have been received and unskilled workers have higher unemployment rates than skilled workers do.⁵⁷ For a model calibrated on German data, Brown, Merkl, and Snower (2007) show that hiring vouchers are "approximately welfare efficient," i.e., they improve aggregate employment and welfare, they do not increase earnings inequality (measured by the Gini coefficient) and they are approximately self-financing (requiring

⁵⁷ See Brown, Merkl, and Snower (2007) for a detailed analysis of the effectiveness of hiring vouchers. See Boss et al. (2007) for a description of how hiring vouchers could be implemented in Germany.

little or no additional government expenditure).⁵⁸ Training vouchers,⁵⁹ by contrast, are meant to help workers adapt their skills to market-driven labor reallocations such as those induced by globalization. Firms receiving these vouchers have the incentive to make the training maximally appropriate to the available jobs. Moreover, regions of high unemployment, like East Germany, would become ones containing many workers with training subsidies, providing an incentive for firms to move there and retrain the local workforce.

Disability benefit transfers (devoted to either hiring or training vouchers) is aimed at working-age incapacitated people who are able and willing to do some productive work but whose disability prevents them from finding employment at the prevailing wages, and those who are able to find employment at the prevailing wages but who choose to be classified as incapacitated since they prefer receiving disability benefits to accepting the available jobs.⁶⁰ Current disability benefits are commonly granted on the condition that no work is done, and thereby these benefits push partially incapacitated people out of the labor force and lengthen the inactivity periods of temporarily incapacitated people. (The partially and temporarily incapacitated

people constitute the vast majority of all the working-age incapacitated.) As above, disability benefit transfers are voluntary, so that they do not push people into work they are unable to do.

Pension transfers aim to address negative externalities arising from PAYG state pensions (e.g., excessive incentives for early retirement, financed by current employers and employees; intergenerational externalities) and to help people adapt their retirement decisions to the labor reallocations generated through globalization. This policy involves taking some of the funds that would have financed public pensions and using them instead to provide hiring or training vouchers.⁶¹ People who take advantage of this option lose their corresponding pension rights and gain improved employment opportunities instead.⁶²

It is straightforward to combine welfare accounts with benefit transfers. People could use their welfare account balances to purchase vouchers. In addition, the government could provide subsidies for the long-term unemployed to use their unemployment or retirement account withdrawals to purchase hiring vouchers or to use their education accounts to purchase training vouchers.

⁵⁸ Hiring vouchers strongly outperform Sinn's low wage subsidy (which he wants to combine with a cut in unemployment benefits). The reason is that, compared with hiring vouchers targeted at the unskilled long-term unemployed, wage subsidies for the unskilled have relatively high deadweight effects (since the subsidy is given to all the low-wage workers, many of whom would have found employment even without the subsidy) and wage effects (the subsidy improves the position of the unskilled workers in the wage bargaining process and thereby leads to higher producer wages). Furthermore, as shown in Oskamp and Snower (2006), hiring vouchers would not create as large disincentive effects in skill acquisition as low-wage subsidies. When a worker acquires more skills, his productivity rises and this raises his wage, but it thereby reduces his entitlement to the low-wage subsidies.

⁵⁹ The training vouchers are to be paid to employers who can prove that they are devoting these funds to train

ing their new recruits at nationally accredited training schemes.

⁶⁰ See Orszag and Snower (2002a). Since the deadweight effects associated with incapacity benefit transfers are relatively low, the hiring and training vouchers can be large relative to those associated with unemployment benefit transfers.

⁶¹ Again, this policy is entirely voluntary. Older workers would avail themselves of the pension transfers only if the remuneration they receive from employers is sufficiently high to warrant giving up their public pension rights over a given period. Similarly, employers participate only if the resulting labor cost is sufficiently low to make the older workers profitable.

⁶² See Orszag and Snower (2002b). This policy is particularly effective when combined with a raising or abolition of the legal maximum retirement age. If this retirement age remains unchanged, however, then pension transfers may be expected to discourage early retirement.

4. Concluding Thoughts

Hans Werner Sinn's book is an important contribution to the question how welfare states should be reformed to reap the benefits of globalization, while helping the poor. Sinn analyzes this question in light of the specialization view of globalization. In this context, globalization reduces the demand for unskilled workers and the German welfare state, with the help of the unions, sends these workers into unemployment. He therefore recommends "activating social assistance," which improves the job prospects of these workers. In addition, he proposes reforms to weaken the unions, increase working hours, improve child care, simplify the tax system, reduce welfare support for immigrants and strengthen pension finance through a child-funded pension. These are all measures aimed at promoting employment and encouraging competitiveness in a globalized world.

We have argued, however, that many of these policies were relevant primarily to the previous stage of globalization, when new technologies and global trade networks were used to perform the old jobs. Now, we suggest, globalization has entered a new stage, with fresh and changing patterns of winners and losers. Here the problem is not just excessive wages, falling demand for unskilled workers and deficient labor force participation. Rather, the difficulty is a lack of adaptability and versatility in the presence of the reorganization of production and work in response to technology-driven globalization processes. Consequently, we recommend welfare state reforms that encourage people who have been hurt through globalization—regardless of their skills or sectors—to turn themselves into winners through their own efforts. We have indicated that this could be achieved by giving people property rights in their welfare services (through welfare accounts) and redistributing economic incentives to the disadvantaged (through benefit transfers).

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