

## Current reports

# Curing the Sick Man: The German Labour Market on the Way to Good Health? <sup>1</sup>

## What to expect

In 1999, "The Economist" referred to Germany with the meaningful headline "The sick man of the euro". 15 years later, the world is talking about the "German Labour Market Miracle". In the first part, this paper describes the characteristics of the traditional German labour market, the resulting situation, and the problems which had to be tackled. In the process of curing Germany's problems, the fundamental reforms of the Schröder-administration played a significant role by bringing more flexibility to the labour market. In a second part, the report outlines current difficulties of the German labour market such as persistent long term unemployment. It also tries to find answers to the question whether the German labour market is in a healthy state now. Furthermore, the author presents an outlook on challenges the country may face in the near future.

<sup>1</sup> Presentation at the Closing Ceremony of the 5th International Diplomats Programme, Headquarters of the BMW Stiftung Herbert Quandt, Berlin, 11/28/2013

In 1999, "The Economist" published an article referring to the German situation with a meaningful headline: "The sick man of the euro". The following quotation makes rather clear how the situation in Germany was seen at that time:

*"The biggest economy in the Euro area, Germany, is in a bad way. And its ills are a main cause of the euro's own weakness. The social-market economy devised in Germany after the Second World War .... served the country well for several decades. But it is now coming under pressure as never before. As economic growth stalls yet again, the country is being branded the sick man (...) of Europe. This is inevitably casting a cloud over Europe's single currency, the euro, for Germany accounts for a full third of the euro countries' output. When Germany sneezes, its neighbours feel a chill – and nervous markets are likely to sell the euro. Thus the biggest problem for Europe today is how to revive the German economy".<sup>2</sup>*

After the millennium the situation in Germany even got worse. The economic slack went on until 2005 and unemployment reached new top levels. However, since then the picture has changed significantly. Today, the world is talking about the „German Labour Market Miracle“. The development in Germany in recent years is of great interest to many countries, particularly for those currently in trouble and experiencing mass unemployment. And also international organizations such as the OECD, the ILO or the European Union carefully study developments in Germany.

The questions are: What has happened to the sick man? How did Germany become healthier? Is the German labour market now on its way to good health? Are there any dangers of getting sick again or of being affected by new diseases? This report will give at least tentative answers to these questions.

## The German model

In order to understand the changes in labour market performance over time we first of all need to describe the characteristics of the traditional German labour market model. They are as follows:

- a dual apprenticeship system covering large parts of the economy,
- a relatively strict job protection, particularly with respect to individual dismissals,
- a high coverage of collective bargaining, especially in the western part of Germany,
- a strong role of social partnership and unionization as well as a considerable level of co-determination and workers' participation,
- a strong social security net, particularly in case of pensions and health,
- quite generous social benefits, especially for long-term unemployed people (i.e. comparatively high replacement ratios as well as a rather long entitlement period for unemployment benefits),
- and, finally, the dominance of the "Male Bread-Winner Model" with elements such as the married couples tax splitting (i.e. a tax system in which husband and wife each pays income tax on half the total of their combined incomes).

<sup>2</sup> The sick man of the euro, in: The Economist, 06/03/1999.

The traditional German Labour Market Model has not surprisingly led to a certain outcome which can be described as follows:

- a great importance of firm-specific human capital (with elements such as vocational training within the firm),
- a strong role of manufacturing within the German economy facilitated by the dual system of apprenticeships,
- a high level of social peace (only few severe strikes take place),
- high social security contributions which increased labour costs on the side of employers and reduced net earnings of workers,
- a rather low external flexibility (i.e. low speed of workforce adjustment in times of crisis and a rather long tenure of workers within companies),
- a comparatively high internal (within-firm) flexibility, particularly by adjusting working hours,
- and a relatively low wage dispersion compared with other countries.

Of course, these outcomes were not at all the triggers for the article in "The Economist" at that time. There were other issues questioning the traditional German model. We observed

- a low trend in economic growth
- combined with low rates of job creation,
- a high and increasing unemployment since the mid-1970s (implying hysteresis effects; i.e. each recession leading to a higher level of unemployment: a continuous increase of the so-called structural unemployment),
- a high financial burden due to German re-unification,
- Germany was blamed as a laggard in structural change with an under-developed service sector,
- and last but not least Germany was seen as an example of Eurosclerosis, i.e. a regime with a considerable lack of flexibility.

## Labour Market Reforms

As one of the main responses to the difficulties, former Chancellor Schröder began a fundamental reform of the German labour market; the so-called Hartz reforms. In March 2003, Schröder said something very interesting: "If Germany refrains from modernizing its labour market institutions then it would be modernized through the brute forces of the global market leaving barely room for a social protection net."<sup>3</sup>

The already mentioned reforms were enforced in several steps between 2003 and 2005. Their central idea was to increase the flexibility of employment and to activate the unemployed by both sticks as well as carrots. The elements of the reform package included in particular:

<sup>3</sup> Policy Statement by Federal Chancellor Gerhard Schröder in the German Bundestag "Courage for peace and courage for change", 03/14/2003

- a lower level of job protection, especially with respect to more freedom of dismissal for small and medium-sized firms,
- a far-reaching deregulation in the case of temporary work agencies,
- a reduction of the maximum period for unemployment benefits, particularly concerning older workers,
- a tightening of job acceptance rules for the unemployed,
- a merger of the former unemployment assistance and welfare to a uniform benefit; the so-called "Hartz IV",
- and last but not least, a huge reform of the Federal Employment Agency.

The main result of the labour market reform was the so-called "Teutonic or German Turnaround". Since then we have seen a remarkable employment growth and a significant reduction of unemployment. OECD figures show that during the rather short period between 2005 and 2012 the unemployment rate was cut by more than half: it went down from 11.3% to 5.5%. Research findings show that the comprehensive labour market reform had impacts in two respects. On the one hand, the reform has increased the absorbability of the labour market (Klinger & Rothe 2010). More flexible employment has facilitated the entrance to the labour market. On the other hand, the reform – particularly less generous benefits – can be seen as a signal for individuals, which caused a change in their behaviour. The reform has significantly strengthened search intensity. Unemployed persons as well as workers (who are in fear of losing their jobs) are now much more willing to accept less attractive jobs which often imply low wages, less job stability or other unpleasant working conditions (Kettner & Rebien 2009).

However, one should neither underestimate nor overestimate the impacts of the labour market reform (Dustman et al. 2014). We can obviously identify a significant contribution of the reform concerning the overall improvement. If we compare the period after the reform to the period prior to the reform we realize that recently a given economic growth is accompanied by more employment and less unemployment. To put it differently: since the reforms, economic growth has been more employment intensive. Although the reforms were of great importance for the improved labour market performance, they were not the only determinant. There were other factors which accompanied them:

- in contrast to developments in the past, labour supply no longer increased „ especially because migrant worker groups were smaller,
- German companies already improved their competitiveness at the beginning of the last decade and generated a specific demand for their products. The German industry has been revived offering an interesting product range being particularly attractive for economically developing areas of the world,
- We also realize something which we never before saw to the same extent. Even in a period of economic boom (2005 to 2008) wages increased only moderately. This means, social partners have made their job and contributed to the improvement.
- And finally, Germany managed the Lehman crash in a proper manner by using its traditional strengths.

Therefore, there is no mystery about German policies; there is a quite simple answer to how Germany actually tackles the crisis. The answer lies in an amazing increase of internal business flexibility which was implemented by a temporary adjustment of working hours and wages. This policy was partly fostered by labour market policies, particularly short-time work. This was only possible because of the comparatively high competitiveness of German companies at that time and positive expectations concerning future demand of products. Otherwise, internal inflexibility would have led to severe structural problems caused by the survival of firms which would otherwise never have such a chance in the long run.

An interesting question for many countries, of course, is to what extent can the German way be transferred. One has to be quite cautious in this respect. First of all, it would be necessary to understand what has happened in Germany. The next step would then be to analyse the problems in a different country (which is another ambitious study). And after this exercise we may then identify some lessons from the German case which are of relevance. However, what we did learn is that in particular the timing of reforms is of great importance. Especially in a period of economic downturn it is rather difficult for a society to accept contraction in terms of labour market flexibility or benefits.

## Three new challenges

Let us now move to the second part. Is the German labour market already in good health or are there risks that Germany will sneeze more or less heavily again? There are at least three areas which may be a cause for concern (Dietz et al. 2013).

The first risk is that Germany may not succeed in tackling the hard core of unemployment. As already mentioned, unemployment continuously decreased since 2005. However, it has been more or less stagnating since 2012. Employment growth continued and has recently been facilitated by two sources: increased migration and higher employment rates of mothers as well as of the older workforce. If further reductions of unemployment are intended – which is, of course, the case – Germany needs to address difficult-to-place workers to a greater extent than it did in the past. In this context we are talking about the so-called “hard core” of the unemployed. It particularly contains long-term unemployed people for whom the lack of jobs is only one problem. Other problems may be bad health conditions, housing difficulties or care activities. OECD figures show that in 2012 almost one half of the German unemployed were out of work for more than one year (OECD Employment Outlook 2013). Another figure clearly points out the problem: the probability for a short-term unemployed person (who is out of work for less than one year) to find a job was seven times higher than for a long-term unemployed person in 2012 (BA-Statistik).

What can we do in order to reduce long-term unemployment significantly? This might be the one million dollar question of the labour market. But it does not mean that we do not know anything. Research in general indicates that it is important to ensure a minimum level of education and qualification. No other determinant is influencing risks as well as opportunities of individuals to a greater extent. A lack of skills goes along with a significantly higher level of unemployment, a lower level of employment, a higher appearance of non-standard jobs for

individuals, a much lower level of life-term income, lower pensions and a higher risk of poverty. The problem in the German case is that the share of low-skilled workers is still too high and unfortunately is currently not decreasing as it should. Therefore, one answer is to avoid low standards of education and low skills as far as possible.

However, prevention is only one solution and will unfortunately not immediately generate impacts. This means: the existing hard core needs intensive care today. In this respect employment agencies have the difficult task of making problematic groups of the labour market ready for work. A range of measures needs to be taken into account for this. These measures do not only cover traditional instruments such as publicly sponsored jobs in order to bring unemployed persons closer to the regular labour market. Also, one way would be to make the dual system of apprenticeships more flexible. This means that certain modules should make it easier for less educated workers (particularly those aged between 25 and 35 years) to receive a certificate which in the German case would help to sustain labour market success. In addition, we also have to look for new approaches. One may be an increased use of specific sponsorships. Because the capacities of employment agencies are limited one additional option would be to get more impulses from the civil society. Especially with respect to less educated pupils such sponsorships have already been successful. The idea is that well educated people may give orientation to disadvantaged youngsters and might offer them access to relevant information and even to jobs which are appropriate for them. The same might be an option for the long-term unemployed.

The second risk which might endanger the health of the German labour market concerns the eroding quality of employment: research findings show that employment today is much more heterogeneous than in the past. We observe an increasing level of non-standard work arrangements and more wage dispersion. This development already started in the 1990s and went on until the recent past.

However, non-standard work or low wage jobs are often, but not necessarily, a problem. For example, part-time employment can offer the option to combine work with other activities such as family work or education. A low wage job may not be a problem if further income sources are available for the respective individual, e.g. income generated by a spouse. In addition, less attractive jobs may be seen as an opportunity to enter the labour market at a low level. This leads us to the conclusion that the main problem is a situation in which the whole biography looks like a trap and is therefore getting precarious. Such a situation may be characterized by revolving doors between employment and unemployment or a permanently low income for the complete household.

Again, there are no easy solutions for this problem. The challenge here is to improve the quality of work over time for an individual without considerably limiting access to the labour market. The ongoing discussion about the minimum wage is a good example for this conflict of goals. A minimum wage might help low wage earners to a certain extent especially because in Germany collective bargaining has lost importance. However, with respect to possible employment effects the level of minimum wages is decisive. If minimum wages are set too high they can hurt even the people who should benefit from them.

Nevertheless there is a superior way to a far-reaching re-regulation of labour: it aims at increasing upward mobility of individuals. A starting point in this respect is the question, what

may drive transitions from less attractive to more stable and better paid jobs. One option would therefore be to address labour market policy to employed persons to a greater extent. On-the-job training definitely needs to get more attention and could be fostered by targeted programmes. There is also evidence that transitions from one employer to another may improve the situation for individuals (Stephani 2013). Therefore, the so-called "after care" policies of job agencies might be an additional option. This would imply that workers who had been placed in non-standard jobs should still get job offers by employment agencies (because there might otherwise be a risk of them being unemployed again in due course).

The third risk addresses the massive consequences of demographic change. Here the main problem or challenge is that in future the overall labour force will definitely decline and will get older. The main dangers of this development are a slowing down of economic growth and problems of a sustainable financing of the social security system.

Several options are available in this respect, but their possible impact should not be overestimated: they may relieve possible pains but not turn around the trend. In this context the increase of employment rates of young mothers as well as of older persons is important. In the case of young mothers, or even families as a whole, care facilities are of key importance. They must meet the demands of employed persons, meaning that e.g. flexible opening hours are crucial. Concerning the older workers, it is up to the employers to prevent workers from skill devaluation and health problems. In addition, they can make use of the broad experience of older workers. Several surveys show that companies appreciate characteristics of older workers such as their loyalty, their discipline and their awareness of quality (Bellmann et al. 2003). Considering that the older workers are one of the major human resources in the future their ability to work is of great importance.

However, the strongest contribution to deal with the demographic challenge stems from migration. In this respect, Germany is still at the very beginning of a process of change. The country is still very cautious, maybe too cautious in this case. Research shows that qualified migrants will push economic growth and may even create additional employment (Brücker et al. 2013; Brücker 2013). In consequence, Germany needs to compete to a much greater extent with other countries for qualified migrants. Unfortunately, till the present time the relevant regulations (e.g. concerning entry wages) do not meet urgent requirements. We all know that the impacts of migration are complex. It is not as simple as it looks. There are not winners with brain gain on the one side and losers with brain drain on the other side. New studies show that home countries may also benefit by getting remittances and by strengthening incentives for individuals to invest in their education and qualifications (Brücker et al. 2013; Brücker 2013). And what we also realize is that migration might be less permanent than it was in the past. This is due to the fact that universities and companies are becoming more global and even workers (depending on qualification) appreciate more and more variety and change. Therefore, Germany, as well as other countries, needs to take into account that circular migration is getting more relevant. This implies that institutions like the welfare state need to be prepared for these new developments in a proper way.

## Conclusions

There is no doubt: we have observed a magnificent improvement of the German labour market performance since 2005. Therefore, we can argue that the labour market is healthier than at the beginning of the last decade. However, further improvement is not guaranteed at all. Sickness has not yet been completely cured. There are even risks of infection which have to do with the debt crisis in Europe. Here, an interaction between countries in Europe – particularly those within the currency union – can be observed. Without doubt, Germany is a main player in this respect (as reported by "The Economist"). Due to this, Germany has certain responsibilities which have to be met. The country is not an island. In the long run a sick Europe will also affect Germany. Germany may be justified in demanding much from other countries in Europe but should not ask too much from them. In addition, we have learned that the German immune system, in particular, has to be further strengthened. In this country we need to focus more on difficult-to-place workers, on upward mobility of workers with less attractive jobs and to address the demographic challenge, particularly by increasing employment rates of young mothers and the older workforce as well as by strengthening the competitiveness of Germany with respect to qualified migrants.

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