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TOWARDS “DISORDER” OR “DICTATORSHIP”? LABOR MARKET REFORM IN GERMANY FROM THE PERSPECTIVE OF NEW COMPARATIVE ECONOMICS

1. Introduction¹

Germany has always been an interesting case study for scientists interested in comparing economic systems. On account of unique institutional features, its system has been categorized as “third way”, “non-liberal capitalism” and “regulated capitalism”. There are two features which justify these epithets. The first is the role of the government. Economic growth on the Rhine has been connected with interventionism, whether it was focused on education in the nineteenth century, or the social order and the *Globalsteuerung* policy in the twentieth. However, this government activity has meant setting a framework for the free market and correcting its imperfections (inequalities, short term orientation, irregularities), rather than replacing it. The second feature is collectivism or, more accurately, the ability for social self-organization. Germans have possessed multilevel social bargaining structures ensuring the stability of the economy and harmony of interest groups, particularly in the labor market. In fact, for a long time the German system has had institutional arrangements aimed at organized, sustainable development. It was very successful in the 1950s and 1960s – a period called the “economic miracle” [Czech-Rogosz, 2005; Gedymin, 2002; Kozłowski 2004; Kowalik, 2000; Siebert, 2005, 43–61; Humpden-Turner and Trompenaars, 2003].

The time of this “miracle” has long passed. For around three decades Germany has been showing relatively poor economic performance, which culmi-

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nated in the decade between 1995 and 2005 (see Fig. 1 and 2). In this period the growth in GDP averaged only 1.5%, which was one of the lowest levels among the OECD countries. An even more anxiety-provoking situation prevailed in the labor market. The unemployment rate rose with every downturn in the economy, with winter 2005 experiencing a record number of over 5.2 million unemployed. This crisis was followed by fiscal problems. For over 5 years Germany constantly broke the rules of the Eurozone stability pact, with its deficit exceeding the allowed mark of 3% of GDP.

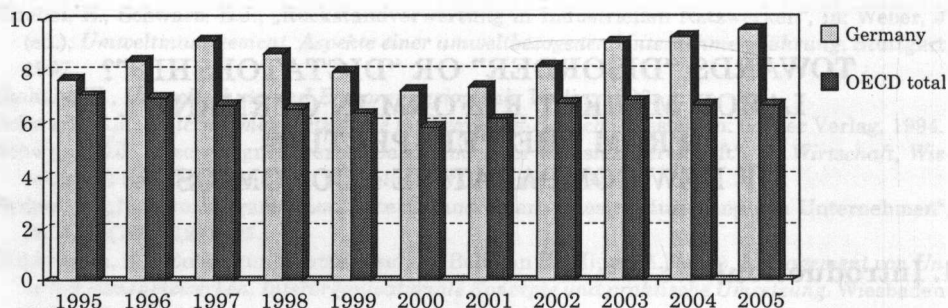


Fig. 1. Rate of unemployment in Germany and OECD-countries 1995–2005

Source: Employment Outlook 2005.

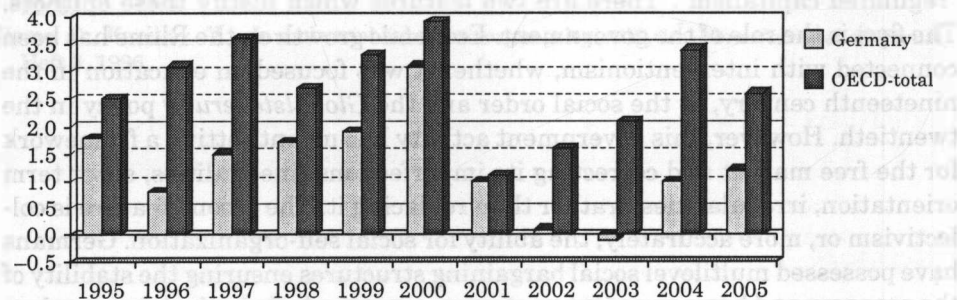


Fig. 2. Economic growth in Germany and OECD-countries 1995–2005

Source: Employment Outlook 2005.

What was the cause of this slump? Some economists have hinted at the disadvantageous set of short-term phenomena which occurred in the 1990s, such as the reunification with the former German Democratic Republic, the costs of introducing the Euro, as well as the slowdown in the world economy that hit the export-oriented German economy [Bofinger, 2005]. Others – and they form a majority – have pointed rather at long-term, structural and institutional problems [Sinn, 2005; Schneider, 2003]. German institutional

arrangements, once a source of economic advantages, seem to have become less and less effective.

The long-term slowdown and fading competitiveness provoked many attempts at reform. But most of them were too superficial to bring an upturn [Abelshauser, 2004, 436; Weimer, 1998, 428]. In 2002, the government led by Gerhard Schroeder, pushed by disastrous news about the highest unemployment in post-war history, decided to undertake fundamental reform (the so called Hartz Reform) of the most troublesome field, the labor market, and in a broader sense, social benefits. In four steps, between 2003 and 2005, these changes embraced the system of unemployment benefits, policy regarding the organization of the labor market and of forms of employment.

There are two questions connected with this difficult, but simultaneously interesting, period for the German economy. First, how can the slump be explained in terms of institutional arrangements? Which features caused the impact and why? Second, have reforms undertaken in recent years changed the institutional arrangements, and if so, what are the features of these changes? These questions are well known in the debate about the evolution of "Rhine capitalism". Some claimed that the labor market reform is a drift from the tradition of the social market economy and a final surrender to the neo-liberal doctrine, openly mistrusted in German society (an example of this was the "locusts debate" in 2005 concerning the role of hedge-funds in Germany). Others maintained more cautiously that the change is just a necessary re-thinking of government regulation due to the changing economic environment [Yamamura, 2003, 136].

In this article I attempt to analyze these questions using tools of the New Comparative Economics (NCE) approach. This concept was presented in 2003 by a group of economists (S. Djankov, E. Glaeser, R. La Porta, F. Lopez-de-Silanes, A. Shleifer), who had worked for the World Bank and focused particularly on institutional arrangements. NCE is an attempt to employ the premises of new institutional economics, more specifically of the economics of property rights, at the level of national economies and governance. The authors assume that clearly defined property rights in a socio-economic system are endangered by private or state expropriation, for example, plunder or monopoly in the first case, taxation or re-nationalization in the latter [Djankov et al., 2003, 9]. There is a trade-off between these two threats. Limiting the costs of privatized "chaos" by governmental activity means increasing the costs of "dictatorship". Every society aims to find an optimal balance, where the marginal costs of both options are equal. A graphic representation of this dilemma is given by the Institutional Possibility Frontier (IPF) curve (Fig. 3). But not just choosing the point on the IPF curve is relevant to economic efficiency – the location and shape of the IPF curve are important too. The closer the IPF curve is located to the origin of the axis, the lower the social costs and thus the higher

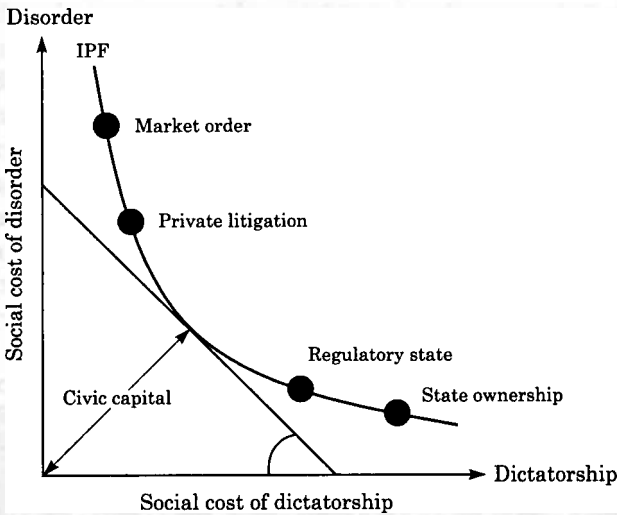


Fig. 3. Institutional Possibility Frontier

Source: Djankov et al. [2003, 599].

the output. This location depends on the amount of “civic capital”, a category which is defined by authors as “wider” social capital including such diverse elements as factor endowment, political stability, willingness to cooperate in society, quality of human capital and others [a critic of this approach is given in: Dallago, 2004; Rosser and Rosser, 2006]. The shape of the IPF curve is in turn dependent on specific features of the market. For example, the market for diamonds needs less regulation than the insurance market because of a lower asymmetry of power and lower frequency of transactions.

Before proceeding, it is important to explain what a crisis means in NCE terms. A crisis is an ineffective institutional arrangement because of: 1) a bad policy, which means a choice of a sub-optimal point on the IPF; 2) “institutional sclerosis” [Olson, 1982], which means insufficient reaction to a change in the shape of the IPF curve or even not achieving the most efficient IPF; 3) a decrease in civic capital, which shifts the IPF further from the origin of the axis.

2. Regulation of the labor market in Germany and its reforms

Siebert [2005, 155] describes the institutional arrangement of the labor market as four interacting fields: social security, labor law, wage setting and market processes. For the NCE approach we can translate them more specifically into four categories: 1) social protection in the case of unemployment;

2) contract freedom; 3) wage setting; 4) information flow in the labor market. The market can be arranged in different ways in each field: from free competition solutions to state monopoly. In the following sections this modus will be used to describe the regulation of the German labor market.

Social protection against unemployment

A high level of social protection against unemployment is in general advantageous to the quality of human capital, because it reduces the risk of investment in specific qualifications. On the other hand social insurance creates an incentive for freeriding – a careless approach to ones present job or deliberate unemployment. If this insurance follows a free market solution ("disorder"), there could be a problem of discrimination against people with higher risks and of asymmetries in information, which could lead to higher insurance costs. In the "dictatorship" of compulsory insurance, the problem of rent seeking and freeriding behavior appears, as well as the ineffectiveness of bureaucracy [Behrends, 2001].

Germany decided on compulsory contributions to unemployment insurance paid both by employers and employees to a state agency, which managed the funds. A few groups were excluded from this duty: freelance occupations, officials and those working in untypical forms of employment [Czech-Rogosz, 2005, 183]. An important feature of the German system was the affordability of benefits. Until the final reform, the unemployed received *Arbeitslosengeld* (ALG) and *Arbeitslosenhilfe* (ALH). The first benefit was paid from contributions for the first two years of unemployment (for older people up to 32 months) and amounted to a maximum of 67% of the last net wage. ALH was paid without any time limit to the long-term unemployed in need from tax income and could not exceed 57% of the last net wage [Datenreport, 2004, 120]. It is important to add that this insurance was subsidized by taxpayers: in 1997 only 67% of the system's expenses were covered by contributions [Datenreport, 2000, 209]. Apart from this, the early retirement age introduced in 1987 fulfilled the function of unemployment protection [Sinn, 2005, 249–251].

In NCE terms the system of unemployment benefits can be described as a mixture of "state ownership" and "regulation". The biggest problem with this system is that it provided incentives to stay out of the labor market for those enjoying both income and free time. Sinn [2005, 200] compares a low monthly wage of 1350 euro (net 947 euro) with the total benefits income of 635 euro. Working 155 hours monthly, this gives an incentive of 2.02 euro/hour – apparently too low to attract people to work. This rent seeking behavior translates into a lower labor supply and could be a source of a "worse" location of the IPF curve – further from the origin – due to changing behavior patterns and recognizing social aid as something guaranteed. It can be supposed that

a long period of unemployment is not advantageous to the quality of human capital.

What did the reform change? It did not abolish the monopoly of unemployment insurance. It is still obligatory for employees and employers to pay contributions.² More changes occurred in the area of benefits. The Hartz IV Reform (2004) replaced the ALH with *Arbeitslosengeld II* (ALG II) – a 345 euro benefit. This is means tested according to the household's income and the readiness of the unemployed person to take a job offered by the labor agency (it can be cut after a refusal). On the other hand, the government created many incentives to work. The unemployed could combine a part-time job with ALG II and take advantage of new proactive instruments of labor market policy (ALMP) like "Ich-AG" (I-Corp.), "Ein-Euro-Job", which made a return to work easier.

The reform generated both disincentives for rent-seeking behavior and incentives for the jobless to be active and integrated into the labor market. In addition to this, the Schroeder government decided to gradually abolish the early retirement age. The "disincentive" part can be understood as deregulation, because the negative impact of governing the labor supply was reduced. On the other hand, the second pillar, the "incentives", constitute regulation, because of the many instruments of labor market policy applied in this case.

The reform of unemployment benefits may be interpreted in the long-term as a move of the IPF curve closer to the origin, so that there is a higher level of civic capital. There are two arguments for this thesis and one against it. First, under the new rules on free time, it becomes relatively more profitable to work, which supports a shift to productive activities – work or training. Hence, the supply of labor and human capital should grow and as a consequence so will civic capital. Second, the reform moderates the exit behavior of taxpayers, who are happier to pay if they know that the risk of rent-seeking in the tax system is lower. It may lead the community to a higher level of cooperation. Third – and this argument questions the "good" change in the IPF curve – opening the labor market to a German version of Mc-jobs could lead to the creation of an "underclass" and the exclusion of some social groups, particularly in the face of increasingly expensive public goods [Rickens, 2006]. Such divisions lower the amount of civic capital.

Contract freedom

If there is full freedom of contract in the labor market, supply and demand could react more quickly to external shocks and the average duration of unem-

² From January 2006, caregivers, self-employed and people working outside the EU may voluntarily insure themselves in the state agency.

ployment would become shorter. A flexible market is, however, not a flawless solution. It discourages companies from investing in teaching their staff new skills and encourages the outsourcing of workers. From an employee's point of view, under a flexible market it is better to disperse risk by possessing "popular" qualifications.

The scope of freedom of contract in the labor market depends on two issues: rules on working hours and contract duration. In the first case Germany emphasized regulation, but with many exceptions. There were strict rules regarding working hours in some branches (like trade) and on holidays, maternity leave and the employment of youths. However, many decisions were left to negotiations between trade unions and employers, which made the regulations much more flexible, particularly in the 1990s. A rapid expansion of the so-called *Zeitarbeit* (delegating workers to other companies) and part-time jobs began even earlier. "630-DM-jobs" ("325-euro-jobs") became a very popular form of employment, since they enjoyed advantageous concessions on tax and insurance contributions. Although many of these concessions were abolished in a 1999 reform, this did not stop their expansion. The share of the part-time job market as a percentage of the total job market grew in West Germany from 10.5% in 1980 to 28.20% in 2003 [Płóciennik, 2005, 17]. The approach to the second issue – contract duration – was dominated by a preference for permanent contracts. Fixed-term contracts were rather an exception and primarily concerned project work. It was not possible to prolong a fixed-term contract more than three times [Bofinger, 2005, 61]. But the most important pillar of this approach was protection against dismissal. Before 2004 *Kuendigungsschutz* made it very difficult for the management of companies with more than 5 employees to freely decide on dismissals. Such decisions required long-term notice, a high redundancy payment and agreement with trade unions [Czech-Rogosz, 2005, 177]. These strict rules had, however, a safety valve in the so-called *Kurzarbeit*: employers could cut working hours and the resulting fall in wages was partially compensated by the state [*Datenreport*, 2004, 111]. The previously mentioned fix-time contracts fulfilled a similar function to some degree.

All in all, we can say that Germany had sophisticated, but at the same time relatively complicated, regulations on the freedom of contract in the labor market (the "regulation" point on the IPF curve). At first sight it looks like a system adapted to the industrial era with a rigid labor market, which is now suffering from "sclerosis" in the hybrid and elastic modern economy. However, it should be stressed that this regulation worked surprisingly well. Arguments about the rigidity of the labor market as an important source of insider effects and unemployment are very popular, but have not been fully shared by labor market experts [*Employment Outlook*, 2004].

What have the reforms of recent years changed? First, there are new, more flexible rules regarding *Zeitarbeit* and the "325-Euro-jobs" were replaced by

minijobs with a maximum wage of 400 euros, no limits on contract duration and a flat rate of tax and insurance contributions. Additionally, the Hartz Reform introduced *midijobs* with wages up to 800 euro and a gradually rising rate of fiscal burdens as wages increased. In 2004 the regulations on dismissal were liberalized by raising the maximum size of companies not subject to these rules to ten employees. All in all, these changes led to deregulation, which means a move up the IPF curve.

Wage setting

Freedom of contract concerning wage setting makes the price of labor close to the market equilibrium, therefore resulting in a higher employment rate. But the process can be influenced by the government using different means essential for maintaining the level of expected wages or minimum wage and for tempering the natural asymmetry of the market, which gives more bargaining power to employers. Such intervention can be advantageous to investment in human capital, stability of global demand, but can lead to higher labor costs and therefore a lower level of employment.

Germany was characterized by a high level of wage control. First, the government tightens the frame for bargaining by its indirect influence on the level of salaries. Though there is no minimum wage (with some exceptions, like the construction sector), fiscal burdens affect wage expectations. Employees had to subtract up to 36.2% (1998) from their gross wage for social contributions and taxes [*Die soziale Situation in Deutschland*, 2005]. On the other hand, employers had to add 0.6% to gross wages for education and training and other costs, 5.8% for health insurance and 13.8% for compulsory social contributions [Destatis, 2006, 37]. These expenditures were not neutral with respect to labor demand. In an open economy, companies could take advantage of exit options to cheaper destinations. The German government tried to curb this habit by increasing labor productivity using large capital investments. This way was much easier than overcoming institutional sclerosis and over-regulation, which were, to a large extent, responsible for the high labor costs.

The actual process of wage bargaining took place in such a fiscal frame and was strictly regulated. Wage setting was dominated by coordinated negotiations between representatives of trade unions and employers' associations (high level of coordination) at the level of branches (semi-centralized). In some cases, ministers of labor (federal and regional) were allowed to consider the effects of negotiations as valid for the whole trade and could impose a set wage level upon companies which did not take part in bargaining. This system is aimed at strengthening the power of trade unions and achieving a lower diversity of wages. It is one of the most distinct features of Rhine capitalism and quite a controversial one. Some authors believe it caused the high unem-

ployment [Sinn, 2005, 143; Kauder, 1999, 242]. On the other hand, employers do not consider it to be a major problem [DIHK, 2004]. According to the NCE approach, the system may be described as a regulation based on a high level of civic capital, more specifically on the willingness of social partners to cooperate.

The reforms undertaken after 2000 have not changed much. Indeed, the government introduced new rules on the pensions system (2004) and the health system (2003) with the ambitious goal of reducing the social burdens on wages [see: Bofinger, 2005, chapter 4]. However, these reforms did not bring an upturn and will be amended in the next few years. The level of interventionism in this area of the labor market remained high. The wage bargaining process remained untouched.

Flow of information

Apart from the forces mentioned above and interactions with other capital and goods markets, the labor market is shaped by problems regarding the flow of information, which is crucial to achieving a balance between labor demand and supply. A way to resolve these problems is using an additional market of agencies liaising between job-seekers and employers. Such a privatized market displays many imperfections, particularly with regard to credibility, negative selection (similar to the "market of lemons" of Akerlof [1970]) and an undersupply of agency services for job-seekers with lower chances of getting a job. If there is a state monopoly, these problems are rather lower innovativeness and lower effectiveness, due to the threat of a rent-seeking bureaucracy.

In the 1960s Germany decided on an almost full state monopoly on the agency market run by the Federal Labor Office (FLO, Bundesanstalt fuer Arbeit). It was complemented with some exceptions allowing private agencies to act. By the 1980s the system was losing its effectiveness. The average duration of agency work became longer and the rates of long-term unemployment rose [Walwei, 1991]. In the mid 1990s under pressure from the EU, private agencies were given more freedom to act, but their role, apart from the temporary work sector, was very unimportant [Kondle-Seid and Walwei, 2002]. It may be supposed that the system became afflicted with institutional sclerosis, being adapted to the patterns of the passing industrial era which was characterized by mass production and large companies. It was relatively easy for a state institution, like the FLO, to manage the flow of information between labor and employers in such a structured market. In the post-industrial era this became more difficult due to a demand for hybrid, service oriented skills [Beck, 2002]. In short, the shape of the IPF curve changed, making regulation more expensive. Apart from this, the FLO became susceptible to opportunistic

behavior. The scandal that erupted in 2002 concerning fake agency statistics was the final proof of this.

The Hartz Reform brought far reaching changes in this area. First, the compromised Federal Labor Office was replaced by a new institution, the Federal Labor Agency (FLA). It has a businesslike management structure, is oriented to be a service provider and has more independence at the lowest level of decision making. In short, it is an office turned into an agency. The second novelty consisted of a wider opening of the job agency market to private companies. However, full deregulation did not arise, because the government imposed strict regulations on the private sector. Job-seekers should be protected against private agents in an asymmetric market. In addition to this, the reform created new instruments for cooperation between the FLA and private sector, which were simultaneously means of supervision. The authors of these changes aimed to combine the credibility of the FLA with the dynamism and innovative approach of private agents. Most of the instruments were based on freelance agreements or common projects like work leasing, e.g. the "Personal Service Agency". Job-seekers could also receive a coupon from the FLA and redeem it in a private agency.

How is one to interpret these reforms? First, replacing the "office" by an "agency" could qualify as a reaction to institutional sclerosis: an attempt to regain the most optimal IPF curve. However, the market was still strongly regulated. The second part – opening the agency market to the private sector – may be interpreted as sound deregulation, a shift of the IPF curve away from a point lying close to the "monopoly point". However, the rather strict regulation of private agencies is costly. This impression is only strengthened by the new fields for cooperation and supervision involving the FLA and the private sector.

3. Conclusions

The crisis in the German labor market was caused in general by institutional sclerosis and the existence of institutions that created incentives for opportunistic behavior (over-regulation). The first factor was particularly apparent in the area of freedom of contract, wage setting and flow of information. The second factor was apparent in the system of unemployment benefits. Considering the longer-term conditions, called civic capital in NCE, it may be said that these two factors had a negative impact, because a clear division into insiders and outsiders in the labor market has its price not only in higher unemployment, but in a decrease in human and social capital.

What did the Hartz reforms change? In the area of unemployment benefits there are now weaker disincentives and a strong package of incentives to

integrate people into the labor market. Freedom of contract has been slightly deregulated, but strong regulations remained. There were no significant reforms of the wage setting process – it is still regulated, along with a high level of taxes and insurance contributions imposed on wages. The last area – the flow of information – was deregulated. However, there is strong and simultaneously refined government supervision. All in all, these reforms should have a positive impact on civic capital, because they open access to the labor market and increase the level of participation of citizens. They have created long-term incentives for investment in education (human capital) and make social cooperation easier. However, there is one danger: the disparity between incomes has become deeper, due to a growing low-wage-sector, which may be the reverse of what was originally intended by the reformers. In conclusion, Germany's reform has focused both on deregulation and the reorientation of regulation. There are some indications that the latter tendency has more influence.

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