

NUMBER PB14-1

JANUARY 2014

# Making Labor Market Reforms Work for Everyone: Lessons from Germany

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## I INTRODUCTION

Mark Twain once wrote an essay about the difficulties of learning what he called “The Awful German Language.”<sup>1</sup> Similar barriers to comprehension seem to plague those trying to explain recent German economic performance. By most measures, Germany has the best functioning labor market among large economies in the West, with levels of employment reaching those in the United States at the end of the turbo-charged 1990s. A debate has stirred, however, about whether this success has come with a price—specifically, whether Germany's domestic structural reforms have lowered living standards for Germany's low-income workers and worsened income inequality and whether Germany is fortuitously and perhaps selfishly riding a wave of strong foreign demand for German exports.

This Policy Brief aims to show how Germany's recent labor market success—its low unemployment rate, high labor participation rate, and increased productivity—has indeed

1. Twain (1880, appendix D, 299–312).

resulted from the country's comprehensive structural reform of its labor market in the early 2000s. Moreover, Germany's successful record suggests that other euro area economies can yield large economic and social benefits from such adjustments without worsening the trend toward income inequality that many Europeans deplore and fear. There has been German wage restraint, but the evidence shows that such restraint has played a lesser role than widely assumed, while the expansion of low-wage “mini-jobs”—much criticized for allegedly squeezing the low-wage workforce—can largely be explained by evidence that they are used increasingly as second jobs. Germany thus proves that higher employment, increased labor force participation, and improved productivity can be achieved at no additional rise in inequality.

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I lay out my argument in four sections. Section II presents the evidence of Germany's labor market performance relative to its large industrialized peers. Section III surveys the nature of Germany's labor market reforms. Section IV focuses specifically on the changes made to the low-wage part of the German labor market and highlights that so-called mini-jobs in Germany have expanded primarily because German workers have increasingly held them as second jobs (*neben-jobs*). Section V concludes that despite this record of success, Germany can and should do more to improve the options for German women to work full time and avoid a two-tiered labor market that favors people with secure jobs over those outside the productive labor force. Achieving that goal will involve additional expenditures of public resources to help workers upgrade their skills.

## II THE HIGH-PRESSURE GERMAN LABOR MARKET OF THE 2000s<sup>2</sup>

Germany's labor market performance and job levels since 2005 rival those of the United States in the dot-com expansion of the late 1990s, a feat all the more impressive considering that Germany has not had the economic steroids of real estate or asset bubbles. For example, Germany has enjoyed record employment-population ratios of over 73 percent since 2005, eclipsing the traditionally more flexible labor markets in the United States and United Kingdom (figure 1).<sup>3</sup> The contrast with the United States is striking, because US employment rates were 10 percentage points higher than in Germany during the 1990s but are now lower by 5 to 6 percentage points. In the euro area, German job creation contrasts with the stagnation in France and recent recessionary declines in Italy and Spain. In terms of labor force participation (figure 2), Germany has outperformed comparable large industrialized countries since 2005.

Such large-scale changes in the employment and labor force participation ratios rarely get discussed when the more publicized unemployment data are released. They matter greatly, however. Germany's working age labor force participation ratio has increased by 4 percentage points since 2005, while its unemployment rate today is around 6 percent. In other words, all other things being equal, without these increases in labor force participation rates, Germany's unemployment rate today would hypothetically be around 2 percent, well below normal full employment levels. The situation in the United States is the reverse. With a working age employed population of about 137 million,<sup>4</sup> the estimated 4 percentage points decline in the working age employment ratio since 2005 translates<sup>5</sup> into more than 5 million "missing jobs" today, had the US employment ratio stayed constant since 2005. Adding this number to the recorded number of US unemployed yields around 17 million missing jobs, well above the peak levels in early 2010.

German employment growth after 2005 has also been remarkably broad-based across gender and age groups, as illus-

trated in figure 3. Only teenaged men in Germany are today marginally less likely to be employed than in 2005, while employment among older Germans has dramatically increased in recent years. A fifth of all 60-to-64-year-olds (more than 20 percent in figure 3) have become employed since 2005. As I discuss later, this distribution of German employment gains results from Germany's labor market overhaul of the mid-2000s, and it alleviates the problems of its aging population.

The overall ability of the German labor market to match the unemployed with firms looking for new workers (matching efficiency) has also improved since 2005, as illustrated in the Beveridge curve (figure 4), which combines data on the number of unemployed with the number of firms looking for workers. An improving Beveridge curve moves in the lower left direction over the course of the business cycle to lower unemployment levels and fewer firms looking for workers.

Figure 4 shows how the German Beveridge curve has developed dramatically since 1995. In the pre-euro era until 1999, the German labor market changed little in matching efficiency, while from the introduction of the euro in 1999 to 2005 the German labor market deteriorated as the Beveridge curve moved to the lower right. Since 2005, however, the change in labor market matching efficiency over the business cycles has been positive and toward the left, as German unemployment fell, while fewer firms looked for workers. Something evidently changed in the functioning of the German labor market after 2005.

Moreover, the increase in German labor utilization since 2005 has taken place without sacrificing aggregate Germany productivity levels, as presumably less productive workers entered the economy. Figure 5 shows how broad German labor force utilization (hours worked per capita) fell from reunification in 1991 during the deutsche mark years until 1999 and in the early euro era to 2005. In this period, productivity rose (real GDP per hour worked). From 2005 to 2012 both German labor force utilization and productivity rose, however, in contrast with the time trends in other large European economies and the United States.<sup>6</sup>

## III ANALYZING THE LABOR MARKET REFORMS OF GERHARD SCHRÖDER

One of the ironies of recent German political history is the fact that the all-embracing scope of German labor market reforms, which have yielded considerable successes in recent years, were undertaken by the government of Gerhard Schröder, who led Germany as chancellor from 1998 to 2005, when

2. In 1999, Lawrence Katz and Alan Krueger wrote a paper titled *The High-Pressure U.S. Labor Market of the 1990s* describing the extraordinary performance of the US labor market in the 1990s.

3. All tables and figures appear at the end of the Policy Brief.

4. Based on Bureau of Labor Statistics, Current Population Survey household data.

5. Employment ratios are estimated with the total working age population in the denominator, whereas unemployment rates are calculated as percentages of the (smaller denominator) labor force. As such, the percentage point changes cannot be directly compared but relatively understate the implied increase in the current recorded US unemployment rate at an assumed constant 2005 employment ratio.

6. Low German annual hours worked and—as will be elaborated below—increasing part-time work keep German hours per capita below US and UK levels, despite a higher employment rate.

his Social Democratic Party was defeated in national elections by the Christian Democrats of Angela Merkel. His record is often underappreciated, or remembered principally by the politically contentious Hartz IV reforms—named after Peter Hartz,<sup>7</sup> who headed a reform commission in that period—which reduced long-term unemployment benefits. Germany's reforms were in fact far more comprehensive and complicated, though many analysts single out those they most support or oppose.

Table 1 illustrates their sweeping nature and focus on both supply and demand for labor, including scaling back early retirement options, improved active labor market policies to help the jobless find work, and reorganizations of national employment agencies. Their comprehensive nature contrasts with many piecemeal crisis-induced labor market reforms in recent years in other euro area countries.

Table 1 highlights how the higher employment rates for older workers seen in figure 3 flow from the labor market and retirement options newly available for this group. Unemployment benefits were cut for German workers over 55 and 58 years, while the minimum age for early retirement was raised from 60 to 63 years in 2006–08. Without the opportunity to retire at 60, German workers remained employed. Many analysts have argued that the fact that German wages rose more slowly than wages in many euro area countries after 1999 explains Germany's recent economic resurgence.<sup>8</sup> Domestic wage restraint is cited as the reason for Germany's regained competitiveness in the euro area, enabling it to take advantage of unit labor cost differentials with other euro area countries and enjoy an export boom that has run up large current account surpluses. No doubt the German economy benefited greatly from the boom in the rest of the euro area following the euro introduction, as many others have argued, and from the very high global growth rates in the years before the recent global financial crisis. In the early euro era the country's increasing external surplus indeed contributed to the majority of German GDP growth.

But the euro area unit labor cost divergences can result from many different developments in both Germany and other countries. Figure 6, for example, shows how wage developments relative to Germany in the tradables sector vary widely between different euro area members. Only in Ireland and Spain, two housing-bubble countries with manufacturing

sector wage growth higher than in other euro area members, do wage differentials to Germany exceed about 10 percentage points. Meanwhile, Portuguese manufacturing wages have actually fallen dramatically relative to Germany since 1999, despite Portuguese real unit labor costs deteriorating by as much as 20 percent versus Germany by 2007.<sup>9</sup> Limited German wage growth is thus far from the whole explanation for the euro area periphery's uniformly higher labor costs.

The national hourly manufacturing wage data in figure 6 for 1999–2012 may have lost some validity, as German firms acquired the legal option to opt out of nationally negotiated sectoral collective bargaining agreements during the 1990s. Consequently, actual German manufacturing wage moderation during the euro years might be higher than reflected in the reported national data in figure 6. This arises from individual companies accepting more procyclical wages (i.e., lower wage growth in crisis times and higher wage growth in boom times) at the local level, ignoring national collective bargaining agreements. Assuming firm-level wage flexibility has actually increased in Germany since the early 2000s, a similar development should be expected in other euro area peripheral countries. These peripheral countries have also recently allowed firms to opt out of binding national collective bargaining agreements. Having experienced deep recent recessions, companies in Spain and Italy should consequently be expected to use their new-found—but unreported—wage flexibility and secure lower wage growth than what was called for by Spanish or Italian collective bargaining agreements. Any unreported actual German relative wage restraint in the early 2000s beyond what is shown in figure 6 should therefore be a temporary phenomenon, as peripheral firms make full use of their new freedom to negotiate wages down during economic crises.

Wage costs, moreover, are only one component of total gross labor costs to which employer social contributions and other employer taxes must also be added. Even if wage levels are stagnant, such social contributions might go up. Social contributions and payroll taxes are typically paid as a percentage of wages, so the same nominal wage increase will increase total labor costs more in countries with higher levels of social contributions. Level differences in overall labor cost will often also be of such a magnitude that a relatively short period of time of lower wage growth in one country—like in Germany after 1999—will not affect the overall total labor cost differentials between it and its trading partners. Figure 7 illustrates this outcome for Germany, France, Italy, Spain,

7. Peter Hartz was a human resources director at Volkswagen (20 percent owned by the German state of Lower Saxony) and close personal advisor to Schröder during the eight years from 1990 to 1998 when he was the Lower Saxony state premier. Hartz resigned from Volkswagen in 2005 following a corporate scandal at the company. See "VW Executive Resigns as Scandal Spreads," *New York Times*, July 9, 2005.

8. See, for instance, Whyte (2010).

9. Data are from the European Commission's annual macroeconomic (AMECO) database.

Greece, Ireland, Portugal, and the United States in 2000 and 2012.

Figure 7 thus makes it clear that Germany's reputation as a "low wage country" is without foundation. Germany had the highest total gross labor costs at the beginning of the euro era<sup>10</sup> among the included countries, and it still has the highest total gross labor costs by a significant margin. In fact figure 7 shows

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that German total gross wage costs grew *faster* than in most of the other countries between 2000 and 2012.<sup>11</sup> As a share of total German gross labor costs, French, Italian, Spanish, Greek, and American costs have all fallen since the introduction of the euro.

Accordingly, while the German labor market has benefited from fortuitous external circumstances, the comprehensive reforms implemented by Schröder are the major reason for its post-2005 resurgence.

#### IV GERMAN JOB GROWTH HAS BEEN WIDESPREAD AND NOT JUST IN THE LOW-WAGE SECTOR

Figures 1 and 2 showed how national German labor force participation and employment ratios increased since 2005, a trend that continued throughout the global economic crisis, despite a drop in GDP that was bigger in Germany than in the United States. Some attribute the rise in the ratios to an expansion of low-wage jobs and a lack of traditional social protections.<sup>12</sup> I argue that this analysis is based on flawed readings of German employment data. True, Germany does not (yet) have a statutory minimum wage, for historical reasons, partly

because of the tradition of social partners' self-regulation and the postwar desire to decentralize the German economy. True also, low-wage jobs have expanded in Germany since 2005. But this trend represents a minor part of the German jobs miracle since 2005.

Figure 8 shows that Germany has created more than 3 million jobs with full social protections and contributions since 2005, a number exceeding the 2 million decline in the number of recorded German unemployed in the same period.

In other words, since 2005, more than a million Germans have taken jobs after being previously inactive. Germany has thus not only brought down unemployment but also materially reduced inactivity levels through an expansion of fully socially insured jobs.

Some might note that this record came at the expense of German workers and occurred in the newly liberalized low end of the wage distribution (Hartz II in table 1). Some metrics do show that income inequality in Germany has increased in recent years and that the 22 percent share of Germans earning two-thirds or less of the national median gross hourly earnings is higher than in any other Western European euro member.

But the same data<sup>13</sup> show that in 2006 Germany had over 20 percent of workers in the same group and with a median wage of more than €15 per hour—above the euro area median wage level. The recent German labor market reforms have thus not led to an explosion in German inequality but rather a modest increase also witnessed in many other EU countries.

Figures 1 and 3 also make it clear that the recent positive German labor market developments and the modest increase in inequality have taken place amid a massive expansion of the total German employed labor force. That trend is dramatically different from what occurred in the United States, for example. Many analysts might note that a large increase in job creation in return for only a very modest increase in inequality is a positive tradeoff that other countries would happily embrace. To understand how the deregulation of Germany's low-wage sector worked after 2003, one must look at the Hartz II round of labor market reforms (see table 1 for details). The following major changes were introduced into the German labor code concerning the low-wage or mini-jobs:<sup>14</sup>

1. The monthly minimum income limit for mini-jobs was raised from €325 to €400,<sup>15</sup> thereby increasing the income threshold for this type of job contract in Germany.

13. Eurostat Structure of Earnings Survey, [http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php/Earnings\\_statistics](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Earnings_statistics).

14. See Bundesagentur für Arbeit (2007) for details.

15. Raised to €450 per month in 2013. See Yasmin El-Shaif, "Geringfügig Beschäftigte: Minijobber Dürfen Künftig Mehr Verdienen" ["Low-wage Workers May Earn More in the Future"], *Der Spiegel*, June 7, 2012.

10. OECD Taxing Wages statistics are only available on a comparable methodology from 2000 onwards.

11. The seemingly counterintuitive result that Portuguese gross labor costs grew faster than in Germany—rising to 47 percent of Germany's in 2012—over this period, while figure 6 showed manufacturing hourly rates declining relative to German wages, most likely originates in the very large wage increases in the Portuguese nontradables sector. These are included in the aggregate data in figure 7 but not in the manufacturing sector data in figure 6.

12. See, for instance, Adam Posen, "Germany is Being Crushed by Its Export Obsession," *Financial Times*, September 3, 2013.

2. The employer is obligated to pay a 25 percent “flat tax” on top of gross wages (12 percent for pensions, 11 percent for healthcare, and 2 percent taxes) for a mini-job.
3. For mini-jobs in private households, social contributions are only 12 percent (5 percent each in pensions and healthcare and 2 percent taxes).
4. The ability to have a mini-job as a second job alongside a primary job with full social contributions was introduced.
5. So-called midi-jobs with a monthly income limit between €400 and €800 were introduced.<sup>16</sup>

These changes have several important implications for understanding mini-job (e.g., German low-wage job) data. First, a mini-job entails a contract with a monthly income limit. But this type of job does not require clocking a certain number of hours to earn the statutory (now) €450 minimum. A worker might reach the minimum income threshold by working just a very few hours at a relatively high hourly wage. Second, only the employee is exempt from social security contributions, whereas the employer is not. Some social contributions are therefore made for mini-jobs, though a worker can increase his/her income through a mini-job without having to pay any social charges. This means that a worker faces a low marginal tax rate on mini-job income, giving the worker an incentive to increase working hours and add to take-home pay by taking a mini-job. Third and crucially, German workers can now hold both a regular job and a mini-job without having to pay social contributions on the combined income. This means that a large increase in recorded mini-jobs does not necessarily imply an increase in “low income workers” in Germany. The increase could in fact stem from an increase in the number of Germans with more than one job, of which one is a low-wage mini-job.

Figure 9 breaks the 7.5 million reported German low-wage “mini-jobs” into their two constituent parts: “low wage only mini-jobs” and “mini-jobs as side jobs,” as this jobs category was created in 2003. Figure 9 also shows the development in the main category of jobs with full social insurance. (Social contributions are paid by both the employer and the employee.)

Most of the increase in the number of mini-jobs—from a little over 4 million in 2003 to 7.5 million today—is accounted for by the new category of mini-jobs as “side jobs,” or second jobs. More than 2.5 million such side jobs have been created in Germany since 2003, whereas the increase in stand-alone mini-jobs was only about 600,000 in the first 15

to 18 months after Hartz II was implemented in 2003. Thus the apparent large headline increase in low-wage mini-jobs in Germany since 2003 is misleading, a “statistical mirage” attributed to the expansion in flexibility legislated with the Hartz II reforms.

Since the beginning of 2005, when more than 3 million jobs with full social insurance contributions were added in Germany, the number of stand-alone mini-jobs has been flat at under 5 million. Except for the early period of Hartz II’s operation, there is no evidence that liberalizing low-wage mini-jobs in Germany has come at the expense of job creation at higher wage and social security contribution levels. Indeed, the opposite is the case. Figure 9 is a strong reminder that in Germany all types of jobs have increased in recent years.

At the same time, the distribution of mini-jobs between stand-alone and side jobs is uneven across age groups. Figure

### **The apparent large headline increase in low-wage mini-jobs in Germany since 2003 is misleading...all types of jobs have increased in recent years.**

10 shows that in 2013 half the mini-jobs among prime-age workers—the 25-to-54-year age group—are side jobs. Stand-alone mini-jobs account for the majority of mini-jobs for both young and older workers.

The young and the old in Germany are thus disproportionately prone to having a mini-job as their only source of wage income. But figure 10 shows the number of prime-age Germans with a mini-job as their only job has actually declined slightly from 2003 to 2013.<sup>17</sup> Strong growth in fully insured jobs has enabled prime-age workers to transition from stand-alone mini-jobs to fully insured jobs; at the same time, these workers have also increasingly taken up mini-jobs as side jobs.

The strong growth in mini-jobs as side jobs in Germany since 2003 is also probably related to German women increasingly taking up part-time jobs with full social insurance. Figure 11 breaks down German jobs with full social insurance by working time and gender from 2005 to 2011Q2.

Figure 11 shows that more German men than women work full time. Job growth in this category from 2005Q2 to 2011Q2 was somewhat evenly distributed among men (1.06

16. Raised to €450 to €850 per month in 2013. See El-Shaif, “Geringfügig Beschäftigte.”

17. The overall decline in stand-alone mini-jobs for the 25-to-54-year age group from 2003Q2 to 2013Q1 is very small from 2.195 million to 2.187 million.

million) and women (1.24 million). But whereas German men largely entered into additional full-time jobs (728,000), almost all German women started a new part-time job (972,000). Many German women employed part-time with full social insurance probably also hold a mini-job as side job.

When data in figure 9 are broken down by gender in figure 12, they reveal a gender differentiated impact of the 2003 mini-jobs reform. Almost all the newly created mini-jobs for German women are in the mini-job as side job category (which more than doubled from 660,000 to 1.5 million), while the number of stand-alone female mini-jobbers has been basically stagnant since 2003. Meanwhile, among male German mini-jobbers, the increase is more evenly distributed, with two-thirds (~600,000) of new jobs in the mini-job as side job category and one-third (~300,000) in the stand-alone mini-job category. The liberalization of the mini-jobs category in 2003 thus seems to have helped Germans combine two jobs—one part-time (with full social insurance) and one mini-job.

Comparing the sectoral distribution of mini-jobs and regular full social insurance jobs in Germany (figure 13) reveals that mini-jobs are disproportionately concentrated in traditional seasonal and high-labor-turnover sectors like agriculture, construction, wholesale and retail trade, hotels and restaurants, and household activities.<sup>18</sup> Meanwhile, mini-jobs are less prevalent in traditionally higher-skilled and unionized sectors like manufacturing and healthcare.

Figure 13 further illustrates that mini-jobs have been modestly used in manufacturing, indicating a limited impact of mini-jobs on wage and unit labor costs in this important tradables sector.

Hartz II and the mini-jobs reform liberalized Germany's low-wage workforce and spurred the growth of regular part-time jobs in Germany. The German labor market reforms are in some ways similar to other partial labor market reforms in the euro area, which liberalized conditions for women and young people. The German labor reforms (table 1) did tighten conditions for older workers, while doing relatively little to increase flexibility among prime-age “insider workers” holding full-time jobs with full social contributions. The risk therefore is that Germany's labor market reforms have aggravated the “insider-outsider” labor market (those with secure jobs and those outside the labor force). Women, youth, and older workers (e.g., outsiders) in Germany now have better incentives to take up jobs, but many of those jobs lack the employment protections enjoyed by prime-age men (insiders). The increase in overall German labor market flexibility is therefore

18. The mini-job sectoral classification is based only on jobs for which sectoral specification is available. As a result, these data likely substantially underestimate the prevalence of mini-jobs in private households in Germany.

concentrated only among some groups of workers. See box 1 for the potential impact of the new federal minimum wage in Germany.

The risk of aggravating the “insider-outsider” labor market is lessened because of the actual flexibility among German “insider” workers and short-time workers, or *kurzarbeit*.<sup>19</sup> *Kurzarbeit* is a German labor market tradition that encourages traditionally protected workers to work fewer hours during a crisis, while receiving temporary income support from the government. The system enabled German aggregate labor utilization in 2009 to adjust to a 5 percentage point decline in German GDP without increasing unemployment. These wage supplements went to workers forced to accept fewer hours during the Great Recession, which did not last as long as feared. German exporters quickly returned to growth and the need for wage subsidies subsided. Many analysts regarded the system as a “one time wonder,” but *kurzarbeit* in 2009–10 was not without precedent. It was the latest historical example of the German economy's insider workers adjusting to adverse shocks by absorbing the downturn across a large number of workers, avoiding mass layoffs. Figure 14 shows the historical spikes in *kurzarbeit* benefit recipients in Germany since 1950 and highlights the strong historical procyclicality of *kurzarbeit*.<sup>20</sup>

Since the early period of the *Wirtschaftswunder* of German postwar reconstruction, the German economy has repeatedly experienced large temporary increases in *kurzarbeit* benefit recipients. This happened in 1967, after the oil price shocks of 1973 and 1979,<sup>21</sup> after reunification in 1990 in East Germany, and then again in 2009, when large layoffs were averted.<sup>22</sup> Actual aggregate flexibility among German “insider workers” in a crisis is higher than what metrics focusing on individual job protection clauses suggest.<sup>23</sup> This is particularly the case in

19. “*Kurzarbeit* workers” are defined as employees who due to a temporary work outage of more than 10 percent of the employer's total usual hours are placed on reduced individual hours, entitling them to receive partial unemployment benefits (*kurzarbeitergeld*).

20. See Will (2010) for a detailed analysis showing the legal origin of *kurzarbeit* in Germany going back to 1909.

21. The annual average gross *kurzarbeit* recipient data shown in figure 14 underestimate the relative importance of *kurzarbeit* in earlier German recessions, when total West German employment was substantially lower than today.

22. The relatively limited increase in *kurzarbeit* in the crisis/stagnation years of 2002–03 is noteworthy and highlights that during this period, the slowdown in the German economy was not short-term and cyclical but rather structural in nature. This consensus in Germany ultimately provided the foundation for Schröder's Agenda 2010 reforms highlighted in table 1.

23. The Organization for Economic Cooperation and Development (OECD 2013, chapter 2) lists Germany as having the most rigid employment protection legislation to protect permanent workers against individual and collective dismissals in the OECD today.

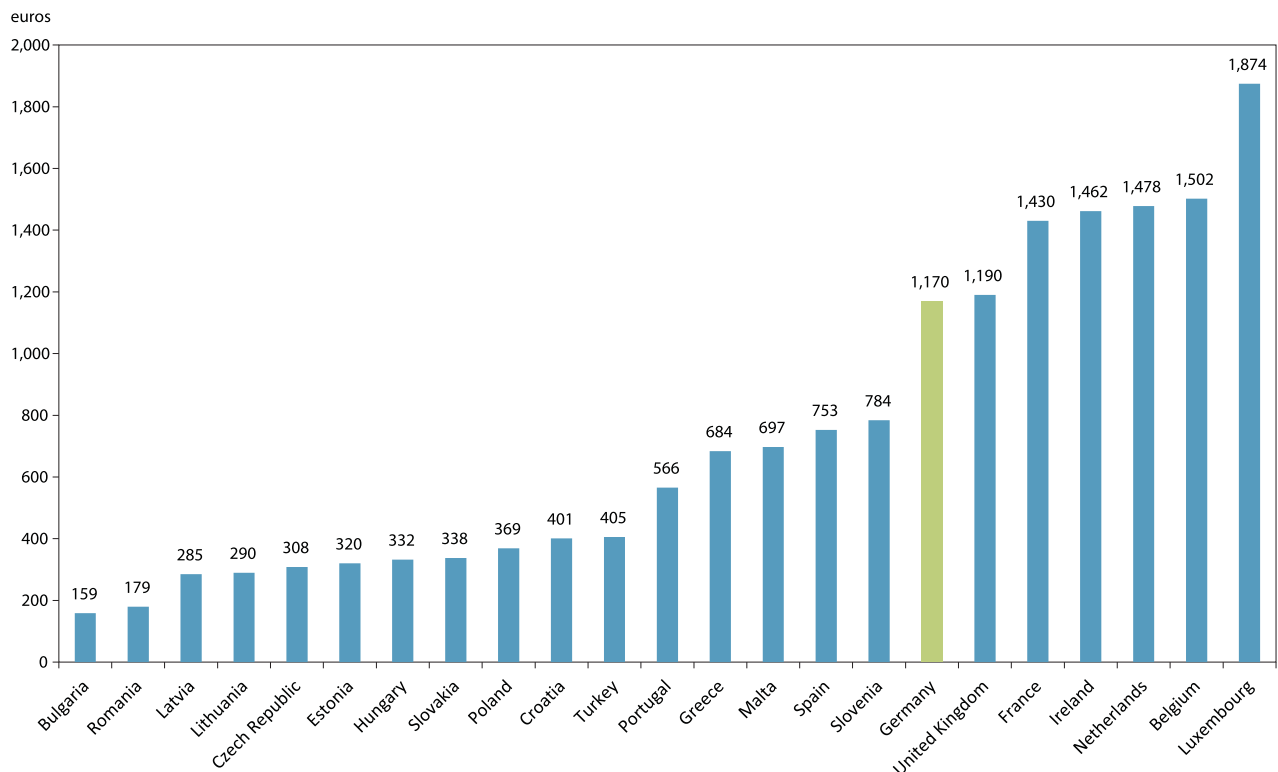
**Box 1 Potential impact of the new federal minimum wage in Germany**

Germany has traditionally left wage-setting to social partners and therefore has no statutory minimum wage. As part of the recent grand coalition, the Angela Merkel’s Christian Democratic Union (CDU) accepted the proposal of the Social Democratic Party (SPD) for a new German federal minimum wage of €8.50 a hour.<sup>1</sup>

The impact of a new minimum wage will depend on how it is implemented. The SPD estimates that its proposal would affect about 6.8 million German workers earning less than €8.50 per hour, while the German wage distribution data from 2010 show that 21 percent of all employees earn less than the low-wage threshold of €10.26 per hour.<sup>2</sup>

Figure B.1 uses the average weekly hours of German employees to estimate the monthly wage level of the SPD’s proposal. At 34.4 hours per week for four weeks a month, the SPD’s new minimum wage would be at the upper end of EU statutory minimum wages at around €1,170/month. That is about the level in the United Kingdom but below those in other continental economies like France, the Netherlands, and Belgium.<sup>3</sup>

**Figure B.1 Statutory minimum wages in the European Union, 2013Q2, and estimated new German minimum wage**



Source: Eurostat and author’s calculations.

The grand coalition agreement<sup>4</sup> is vague on the precise rules that will govern Germany’s new minimum wage. According to the agreement, it would come into effect in 2015, though sectors covered by agreements among the social partners may be exempted until 2017. Moreover, the 12 sectors already covered by the Posted Workers Act (Arbeitnehmer-Entsendegesetz

*(continues on next page)*

1. See the SPD website at [www.spd.de/themen/102812/arbeit.html](http://www.spd.de/themen/102812/arbeit.html).  
 2. See DESTATIS (2012).  
 3. Like Germany, Denmark, Italy, Cyprus, Austria, Finland, and Sweden also do not have statutory minimum wages.  
 4. The agreement is available at [www.cdu.de/sites/default/files/media/dokumente/koalitionsvertrag.pdf](http://www.cdu.de/sites/default/files/media/dokumente/koalitionsvertrag.pdf).

**Box 1 Potential impact of the new federal minimum wage in Germany (continued)**

[AEntG]) in federal German law will be permanently exempted. Several of these regulated sectors already have minimum wages of around €7.50 an hour in the former East Germany,<sup>5</sup> making it likely that they will remain below the new €8.50 minimum after 2017. In fact, the coalition agreement calls for an expansion of the coverage of the Workers Act to still other sectors of the economy.

A German sector falls under the AEntG's jurisdiction if the social partners in the sector request that the federal Ministry of Labor and Social Services elevate their agreed wage and working conditions as "generally binding in their sector." This is typically requested if a sector is subject to competition from foreign-owned firms not bound by the German collective bargaining agreements. Some sectors have also had a minimum wage dictated by the AEntG rescinded again.<sup>6</sup> The federally mandated minimum wage under the AEntG amounts to a voluntary option for the social partners in a sector. Many more sectors will likely seek to come under its coverage if the partners feel that such a step is in their best interest. The €8.50 minimum is thus an optional minimum.

The new minimum wage will also be subject to regular review by a new commission of the social partners—who for decades have opposed a federal statutory minimum wage in Germany—with the power to adjust it "as required." If the new minimum is found to damage job creation, it could be lowered again, notably in East Germany. The new German minimum wage therefore may not last very long at the agreed (by the politicians) €8.50 an hour level.

The German minimum wage would also have different effects in different sectors. It may not affect manufacturing at all because minimum wages agreed by the social partners in that sector already exceed €8.50 an hour. The new minimum wage therefore would likely have a negligible effect on German tradables unit labor cost. Instead the impact will be felt more strongly in traditionally high-labor-turnover sectors like hotels and restaurants and construction. At around €1,170 per month, the new minimum wage would seemingly outlaw the lower-wage mini-jobs at only €450 a month. Hence, it could potentially affect many hard-to-employ Germans working in mini-jobs. The new minimum wage is binding at the hourly wage level, however, and would not necessarily affect mini-jobs with few monthly hours. Nor is it clear how an hourly minimum wage would affect mini-jobs as side jobs.

The overall economic effect of a carefully calibrated and gradually phased in minimum wage in Germany may therefore be relatively muted.

5. For instance, security services (Sicherheitsdienstleistungen) and indoor maintenance cleaning (Innen- und Unterhaltungsreinigungsarbeiten).

6. For instance, this is the case in mail delivery services and some mining and laundry services.

manufacturing, where *kurzarbeit* programs were prevalent in 2008–09.

By avoiding layoffs in crises, employers also benefit by retaining their high-skilled workers, softening the adverse effects of the country's demographic decline and future worker scarcity. The system also helps employers scale up production again when a recovery begins. *Kurzarbeit* institutions are thus beneficial to a high-skilled manufacturing economy like Germany, which faces volatile external demand for its products.

*Kurzarbeit* labor market institutions have evident redistributive and inequality implications. They reduce cyclical layoffs among insiders and work as an additional de facto "automatic stabilizer" providing direct and immediate income support for workers who remain on the job in a crisis. Moreover, the prac-

tice encourages German firms to train their workers, as they face fewer risks of having to fire them in times of economic volatility.

But there is a downside to the benefits of this system. The highly prized flexibility it provides may inhibit creative destruction forces and the innovation that it encourages, freezing sectoral economic shares at their historic levels when change might be in order. *Kurzarbeit's* subsidizing of insider employment enables too many companies (especially in manufacturing) to avoid necessary changes, impeding productivity growth and discouraging reallocation of resources to promote innovation and entry into faster growing sectors of the economy. Thus the increased flexibility and advantageous human crisis impact of *kurzarbeit* institutions pose the adverse risk bias favoring high-skilled and successful incumbent firms at the expense of new, fast growing, and entrepreneurial firms.



The degree to which this is a desirable outcome involves broader societal choices outside the scope of this Policy Brief. But at the time of this writing—and paraphrasing only slightly—Germany’s practice of making BMWs as opposed to moving into high-speed financial derivatives trading hardly seems an outlandish public policy choice to make.

## V CHALLENGES FOR THE NEXT GRAND COALITION IN GERMANY

This Policy Brief illustrated six basic points about recent German economic performance and showed how comprehensive structural reform can yield large economic and social benefits. First, Germany has the best functioning labor market among large economies in Europe and the United States. Second, German wage restraint is of a relatively limited magnitude compared with most euro area countries and hence fails to explain the uniformly large intra-euro area unit labor cost divergences between Germany and other members after 1999. Third, total German labor costs per worker continue to exceed costs in other major EU countries and the United States. Fourth, Germany’s recent labor market revival has not come about through the expansion of predominantly low-wage jobs. Fifth, the expansion of mini-jobs in Germany since 2003 has overwhelmingly taken place as second jobs. And sixth, the successful reliance on *kurzarbeit* programs in 2009 was not an innovation but rather another instance of labor input adjustment in favor of “insider workers” in Germany.

Germany thus shows that countries can reform labor markets comprehensively and enjoy higher employment, higher labor force participation, higher productivity, and no increase in inequality beyond what other countries have experienced. This is a powerful message to other European countries and even the United States, which languishes with an increasingly European looking labor market despite historically superior labor market performance than Europe. Other euro area countries should learn from the comprehensive nature of Germany’s reforms and their generally liberalizing direction, while Washington should take in how successful public policy supports active labor market programs and provides for worker retraining options.

Germany’s experience also provides an example of why short-term growth concerns need not justify delays in implementing required reforms. The outgoing German coalition of Chancellor Merkel’s Christian Democrats and Christian Social Union (CDU/CSU) and the Free Democrats (FDP) evidently reaped the economic benefits of Schröder’s earlier successful labor market reforms and was lucky that its overhaul of labor markets was carried out before the global financial crisis hit.

But that does not mean that Germany’s recent labor market outperformance is a coincidence. Rather it highlights why the debate over the optimal business cycle timing of structural reforms is misguided and just how important it is for all countries—especially those in the euro area without short-run exchange rate flexibility—never to wait to implement necessary structural reforms until the economy is improving or close to full employment.

Schröder had no idea in early 2003, when he launched his Agenda 2010 domestic reforms,<sup>24</sup> that they would shield Germany during a future economic slump or that such a severe slump would hit Germany in 2008–09. But his politically courageous decisions—his SPD party has not regained power in Germany since—provided Germany with economic resilience to withstand the recent very large economic shocks better than other large economies and better than Germany had in the past. Since no one can predict the future, it is always better to carry out required structural reforms without delay.

Lastly, there is much room for improvement in German domestic economic policy. At least two domestic labor market challenges are evident from the analysis:

- 1) *Continue to raise female labor input.* The successful Schröder labor market reforms leave room for further changes in German legislation to seek to increase the share of German women working full-time, as opposed to part-time and/or in a mini-job. The fact that full social contributions are payable once mini-job wages exceed €450 a month discourages expansion of working hours.<sup>25</sup> Another disincentive for many German women to shift to full-time work flows from the increase in the marginal tax rate for two-earner households, as the German tax schedule’s application to the average income of both spouses makes it less advantageous for many German women to shift to full-time work. Germany should make changes to its labor and tax laws to overcome these issues and give higher priority to child and elderly care to allow German women to increase their salaried working time outside the home.
- 2) *Avoid a dual labor market.* The Schröder reforms raised labor utilization by lowering the wages at which workers are willing to take up employment (reservation wages) and increased the availability of mini-jobs in the economy. Germany should now focus on helping workers trapped

24. Deutscher Bundestag, Stenografischer Bericht, 32. Sitzung, Berlin, Freitag, den 14. März 2003. [German Bundestag Stenographic Report, 32nd Plenary, Berlin, Friday, March 14, 2003], <http://dip21.bundestag.de/dip21/btp/15/15032.pdf>.

25. This is especially the case as healthcare is freely provided to mini-job holders in Germany, despite these jobs not being subject to employee healthcare contributions.

in quick-turnover, part-time, and low-wage employment by providing them with skill upgrading options so they can take permanent and higher-paid jobs. At the same time, the country should reduce the gap between well-protected regular jobs subject to full social security contributions and other types of employment by introducing more flexibility for “insiders” in higher-end work.

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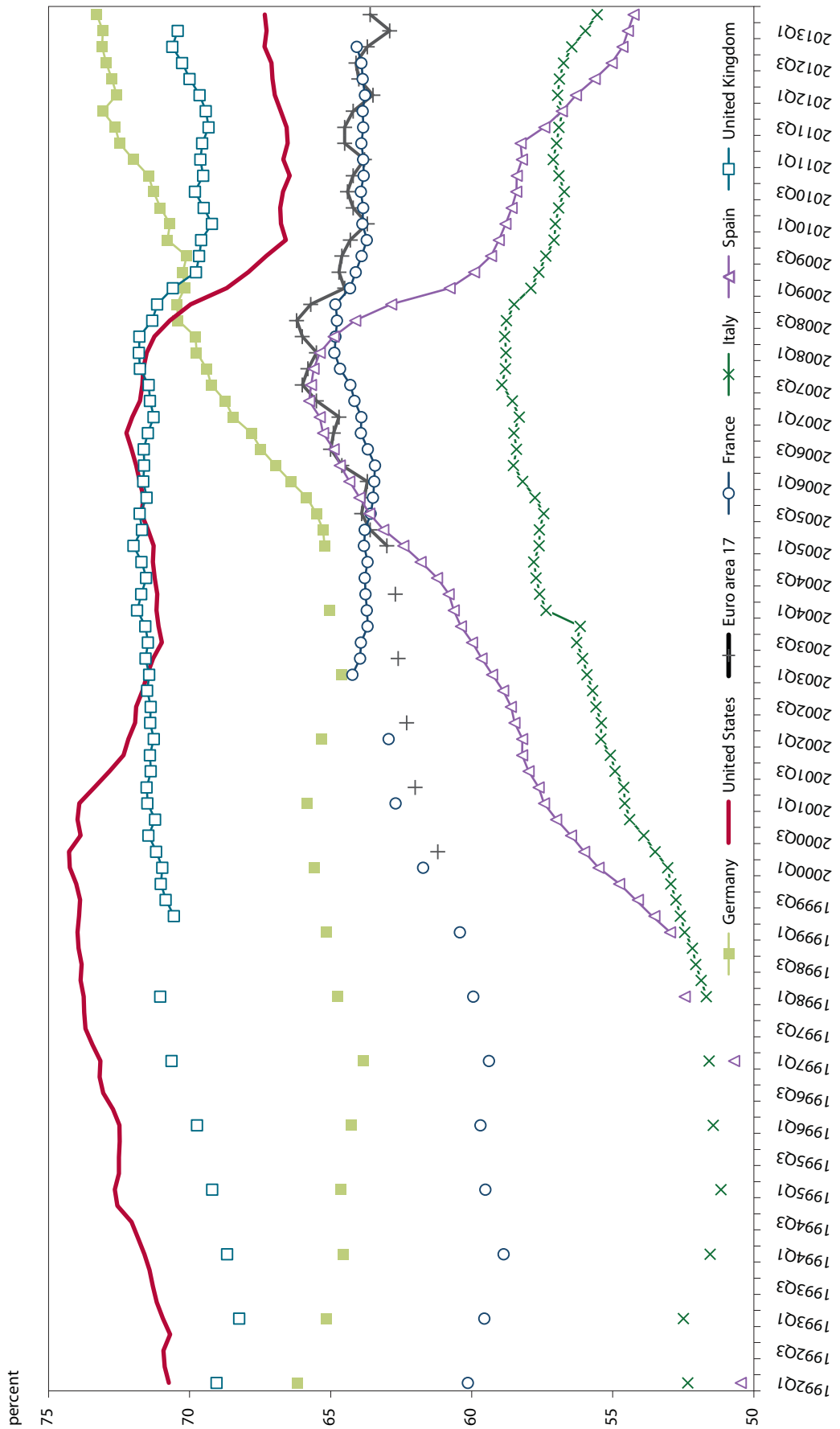
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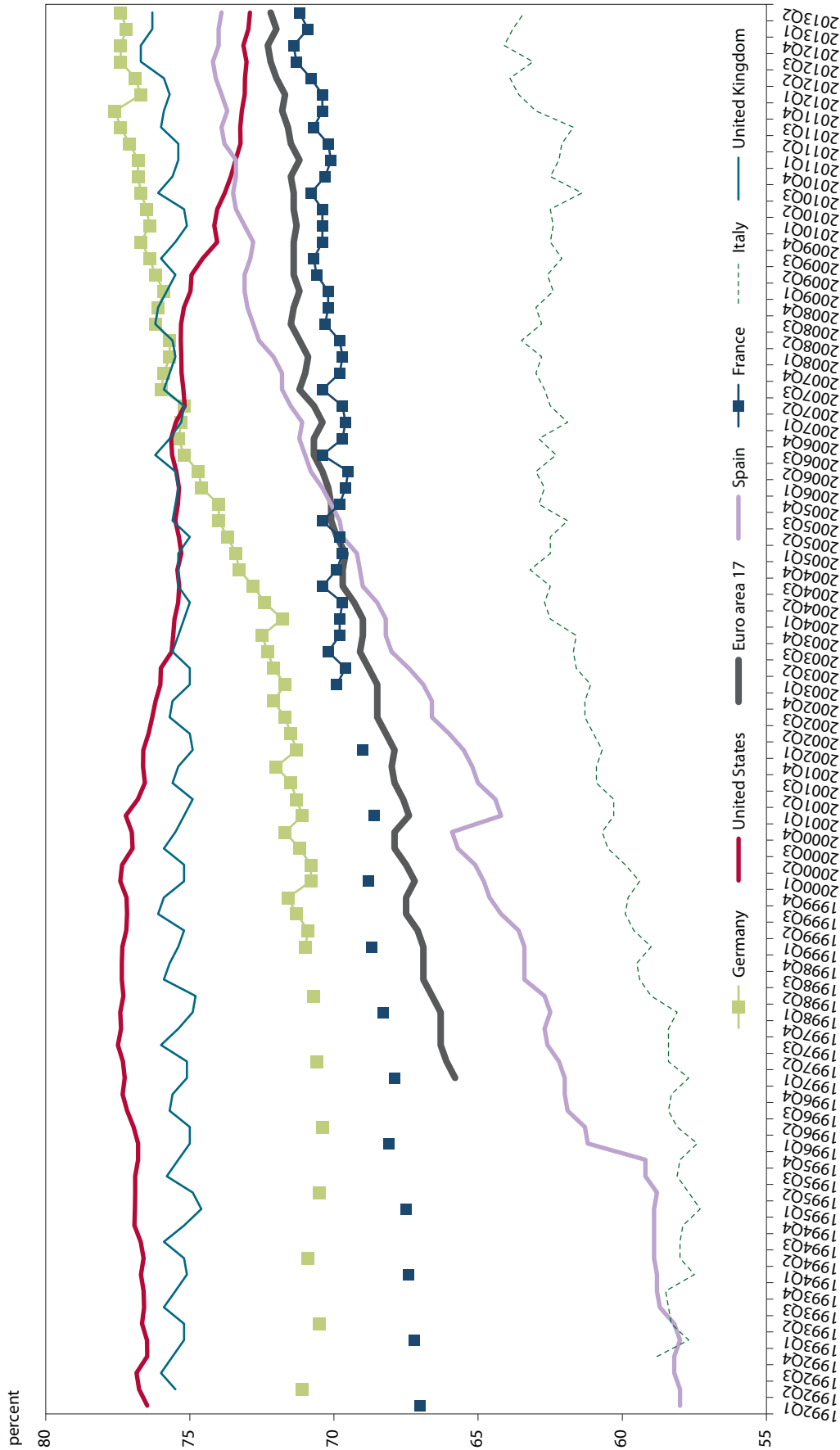
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Figure 1 Employment-population ratios, 15-64 years, 1992Q1-2013Q2



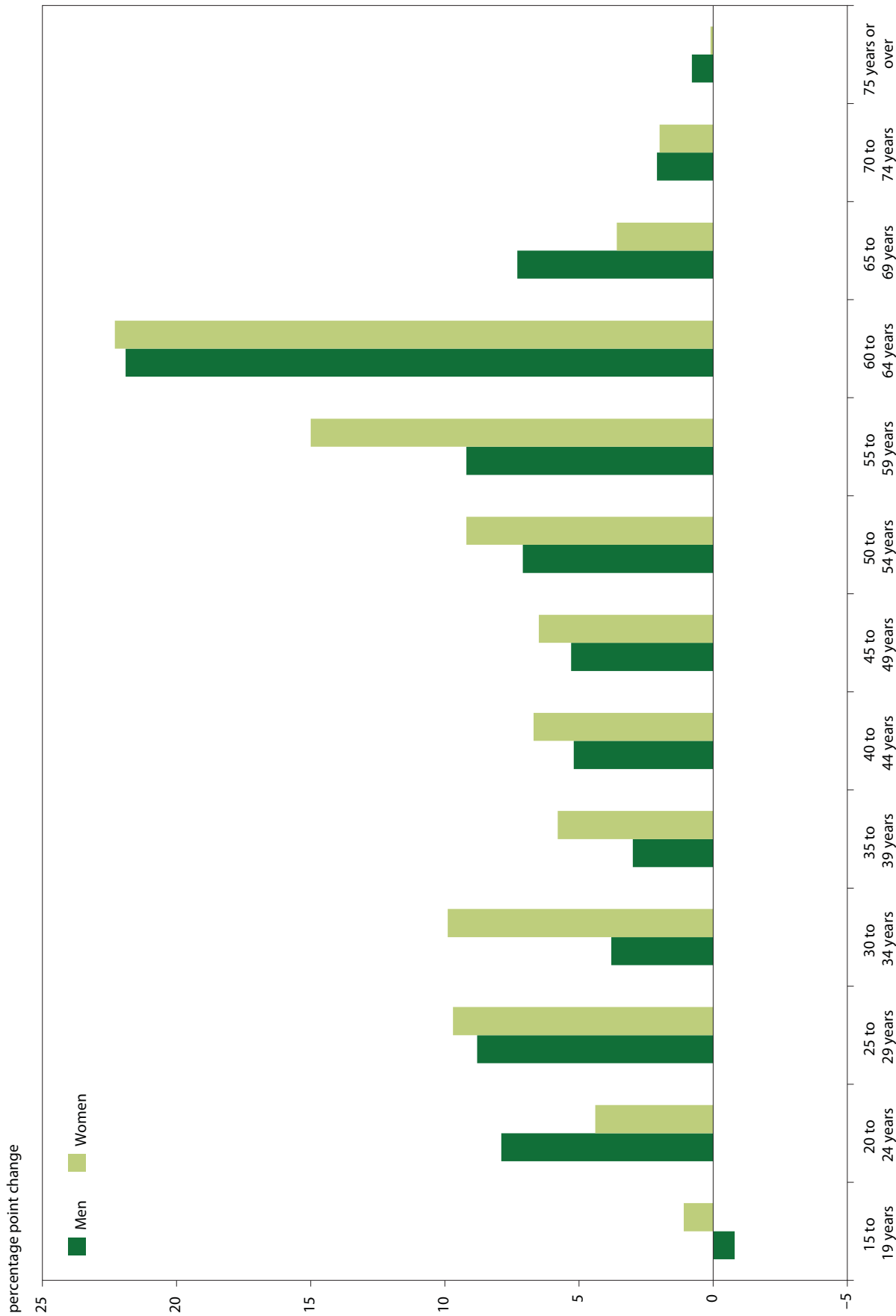
Source: OECD Labor Force Statistics.

**Figure 2 Labor force participation, 15–64 years, total population, 1992Q1–2013Q2**



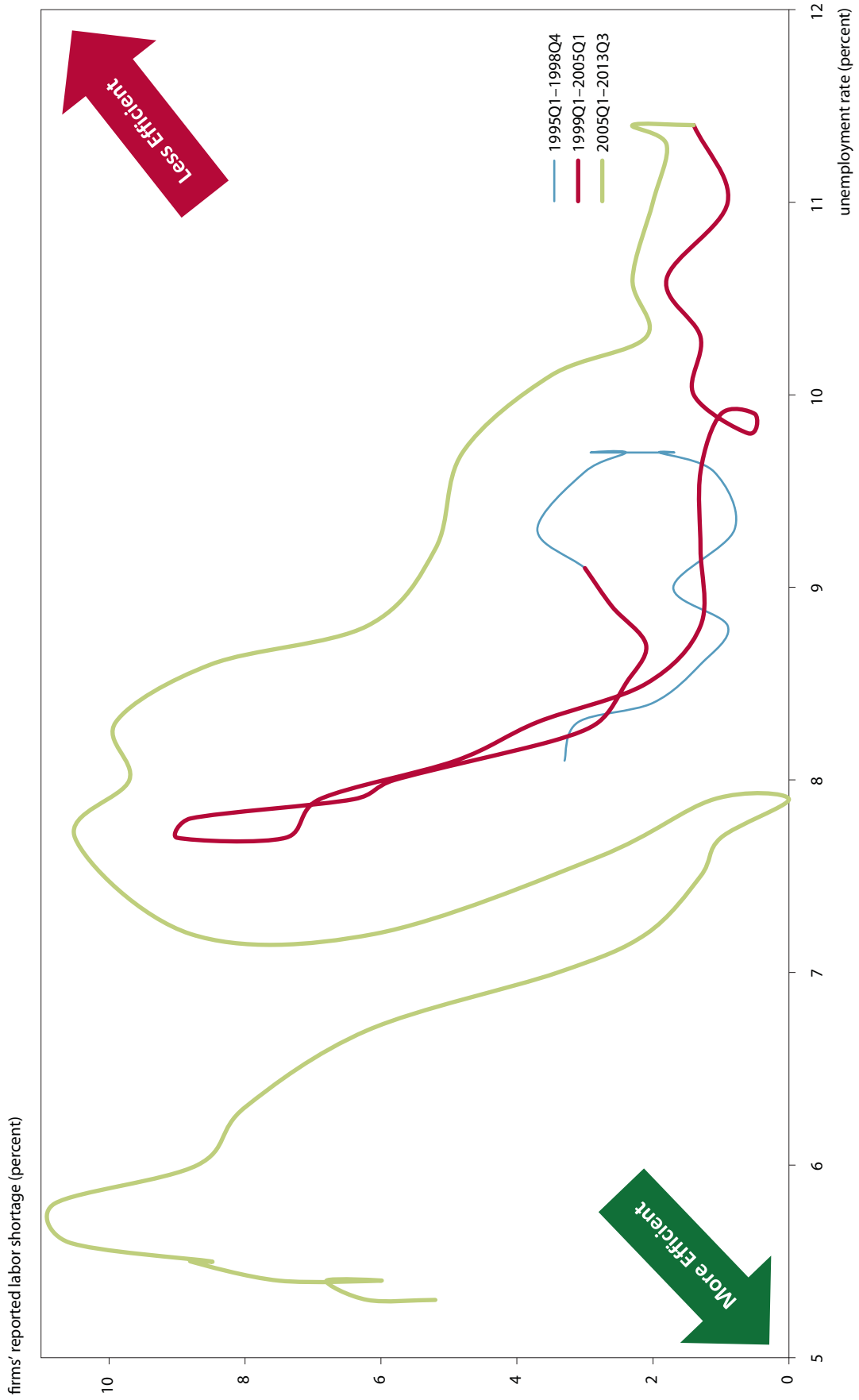
Sources: OECD Labor Force Statistics; Eurostat Employment and Labor Force Statistics.

**Figure 3 Change in employment rates, by age group and gender, 2005Q1-2013Q2**



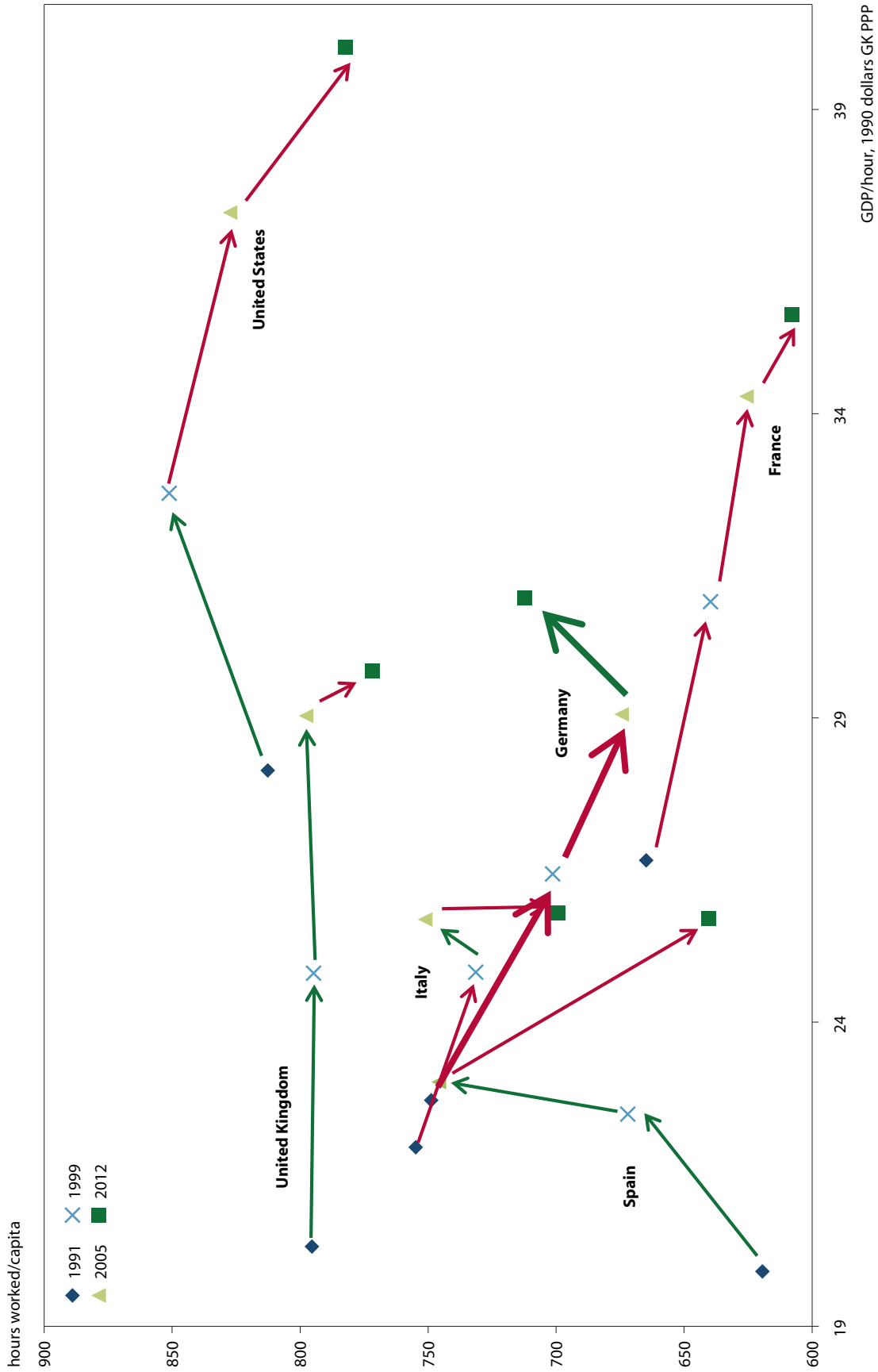
Source: Eurostat Employment and Labor Force Statistics.

Figure 4 German Beveridge curve, 1995 to present



Sources: European Commission; Eurostat.

**Figure 5 Hours worked per capita and GDP per hour, 1991, 1999, 2005, and 2012**



GK PPP = Geary-Khamis purchasing power parity

Source: The Conference Board Total Economy Database, January 2013.

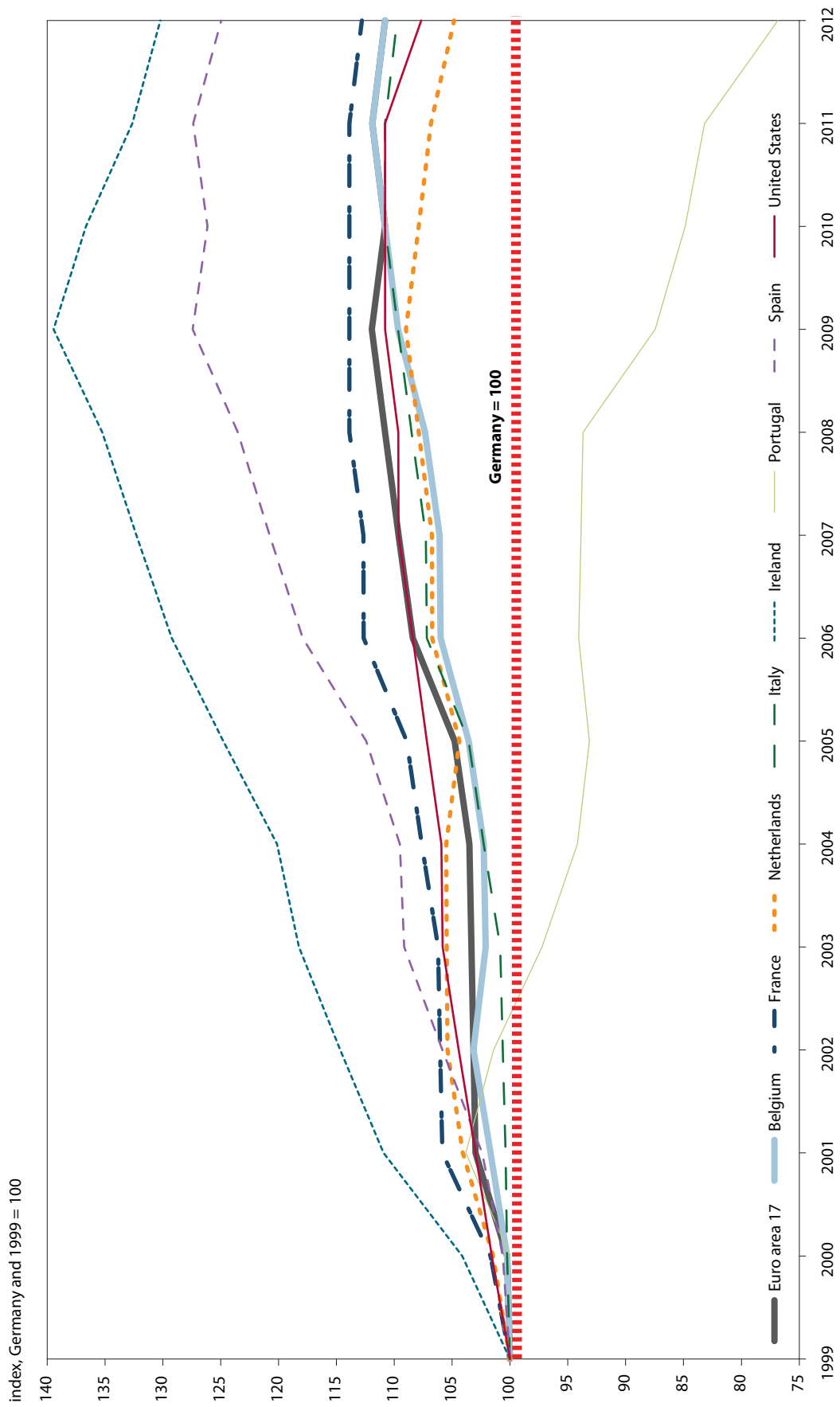
**Table 1 Main features of Germany's labor market overhaul, 2002–10**

<b>Reform</b>	<b>Implementation date</b>	<b>Main features</b>	<b>Likely jobs market effect</b>
Job-AQTIV	2002	Introduce individual quantitative profiling of jobseekers. More efficient use of active labor market policies.	Improved job search efficiency.
Hartz I	January 2003	Enlist private firms to help jobless find work. Tighten conditions for acceptability of jobs and introduce sanctions for jobless person's refusal of job offer. Liberalize temporary agency work.	Improved job search efficiency and enhanced incentives to take up employment.
Hartz II	January 2003	Reform mini- and midi-jobs with limited social contributions. New subsidy for unemployed who become self-employed (Ich AG).	Raising incentives to take up employment.
Hartz III	January 2004	Reorganize Federal Employment Agency towards more efficient servicing of jobless people. Simplify active and passive labor market policies.	Improved job search efficiency.
Hartz IV	January 2005	Merge long-term unemployment assistance and social assistance into a (lower) means-tested unemployment benefit II.	Raising work incentives to welfare recipients by lowering reservation wages.
Cut in unemployment benefit duration	February 2006	Maximum benefit duration cut to 12 months (from 26 months) for recipients up to 54 years and 18 months (from 32 months) for recipients 55 and over.	
Phasing out early retirement options	2006–10	Increase age threshold for early pension for unemployed (Altersrente wegen Arbeitslosigkeit) from age 60 to 63 in 2006–08. Eliminate the option for unemployed over age 58 to receive unemployment benefits without actively searching for work (58er Regelung). Eliminate subsidies for part-time employment for older worker new entrants (Altersteilzeit) after January 2010.	Increased work incentives for older workers.

Source: OECD (2012, 43).

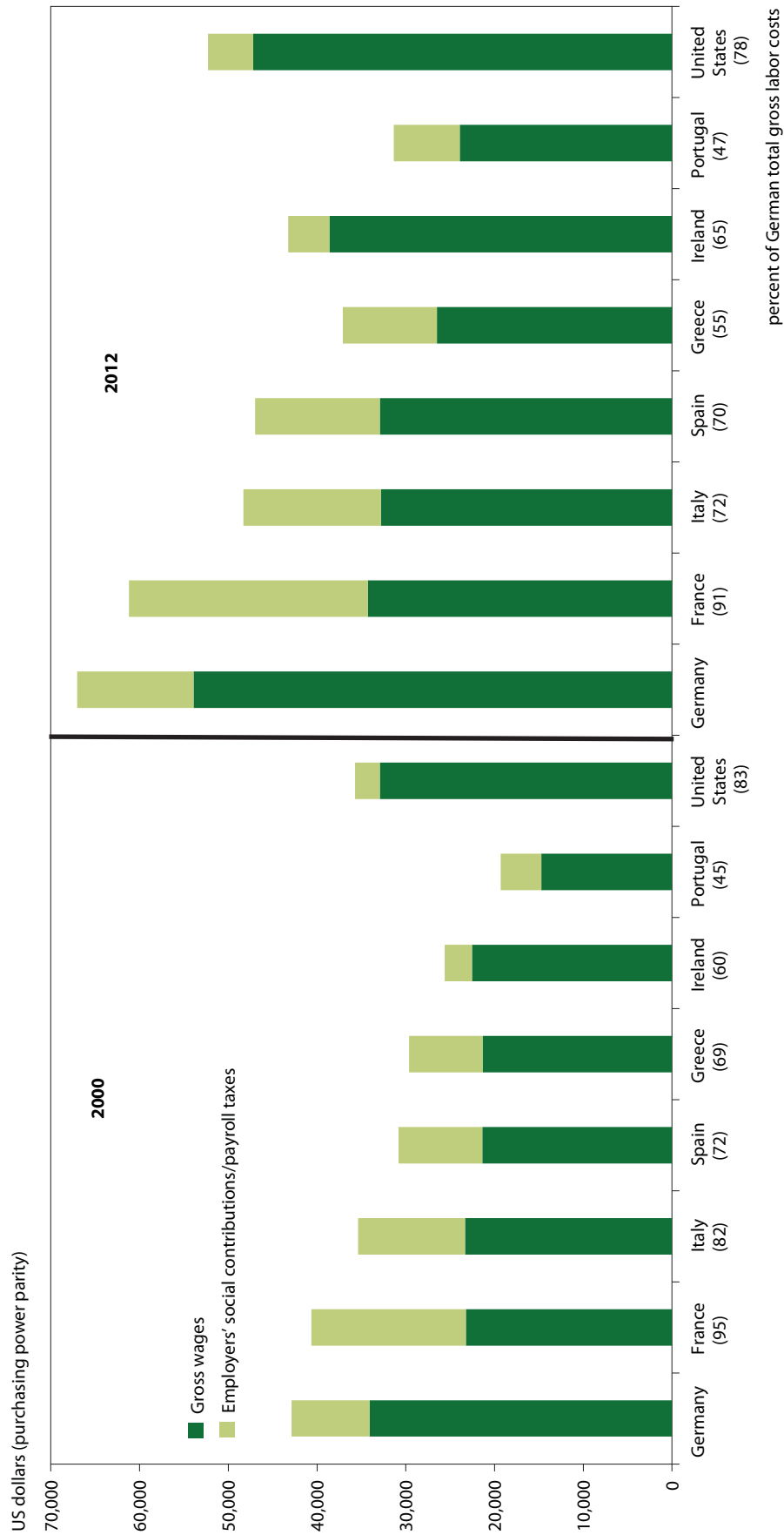


Figure 6 Hourly manufacturing wages, 1999-2012



Source: OECD Main Economic Indicators Database.

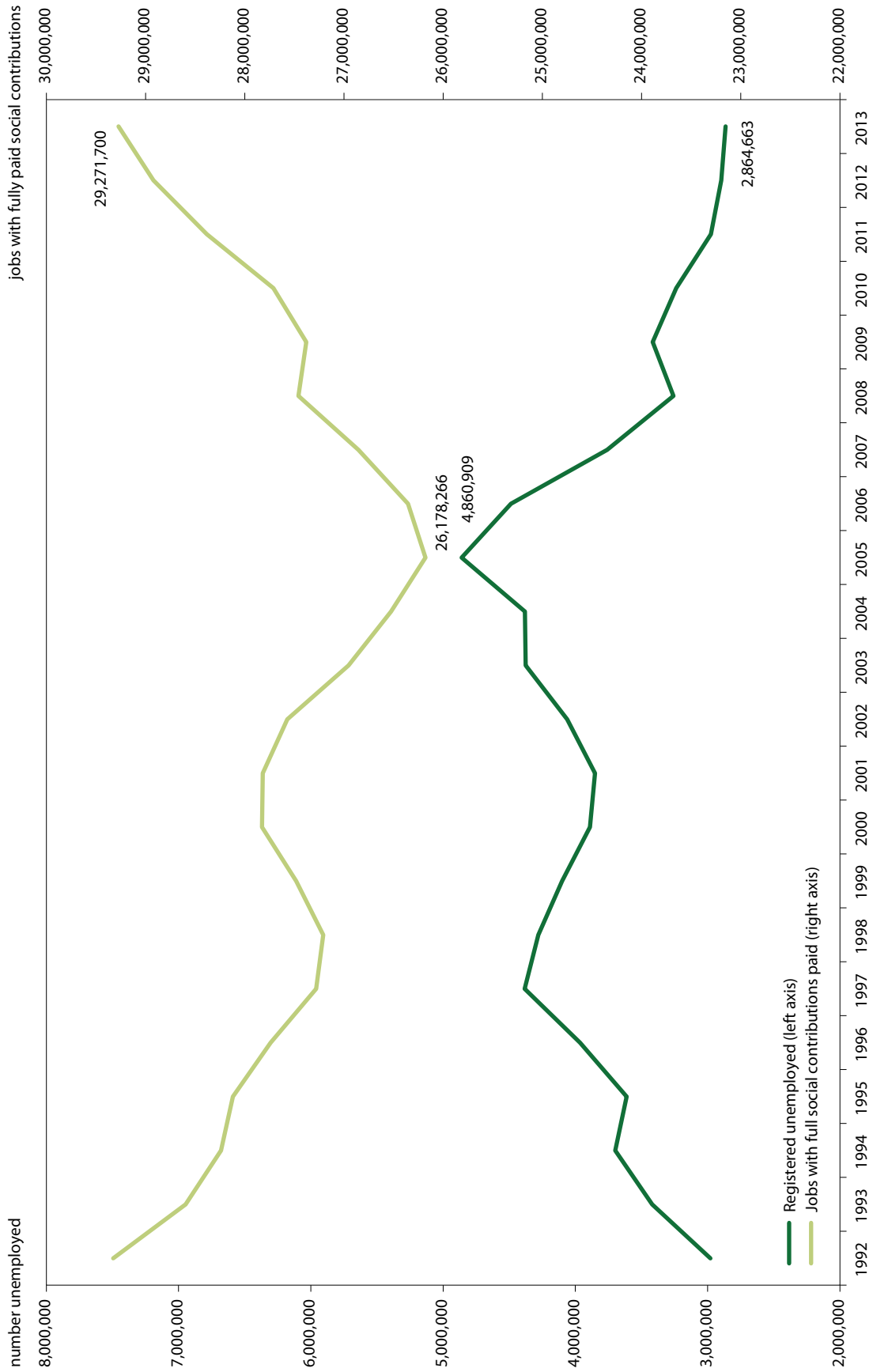
**Figure 7 Total gross labor costs before taxes, 2000 and 2012**



Note: Data for single worker earning 100 percent of average earnings with no children.

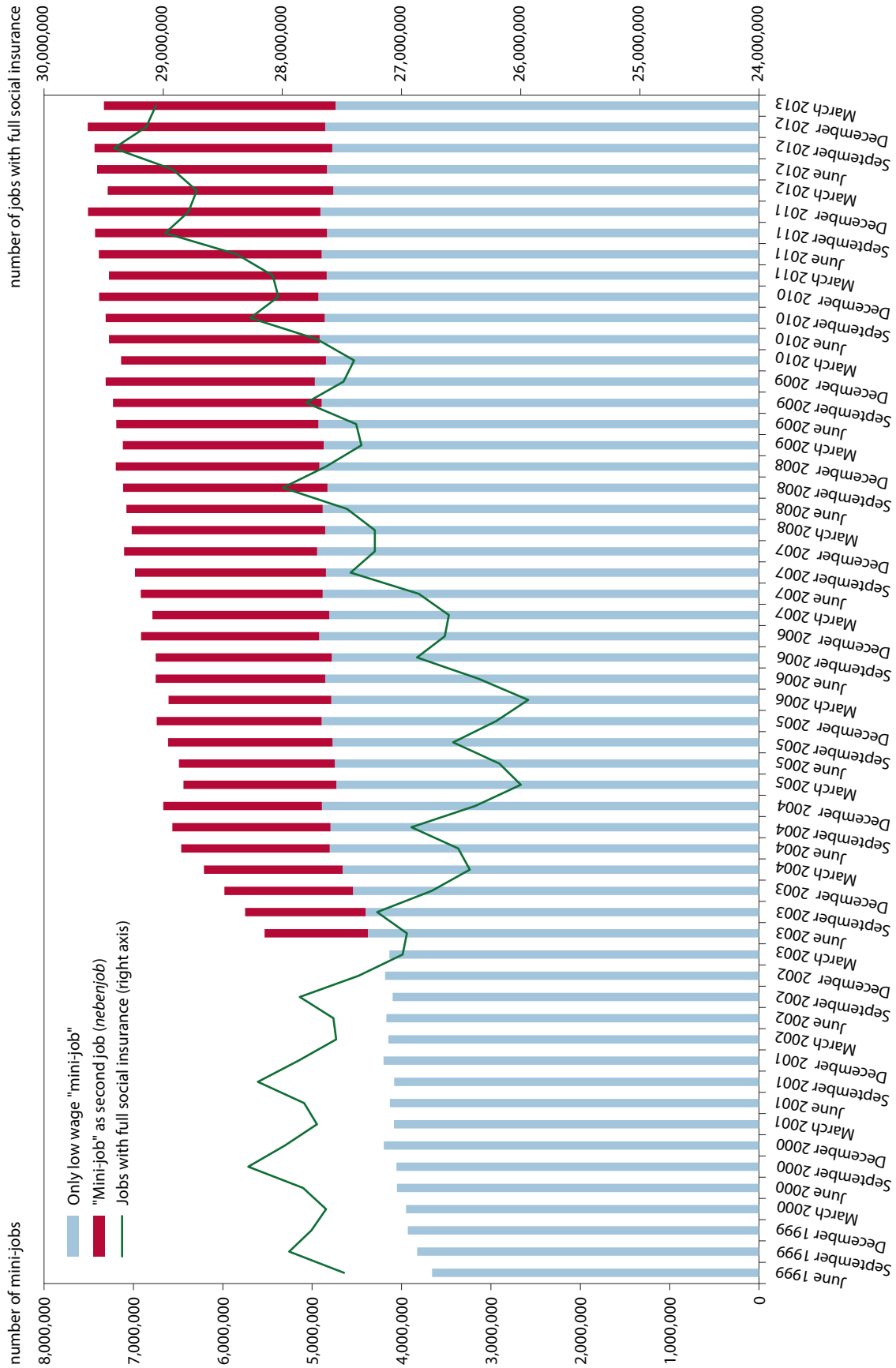
Source: OECD Taxing Wages Database.

**Figure 8 German employment and unemployment, 1992–2013**



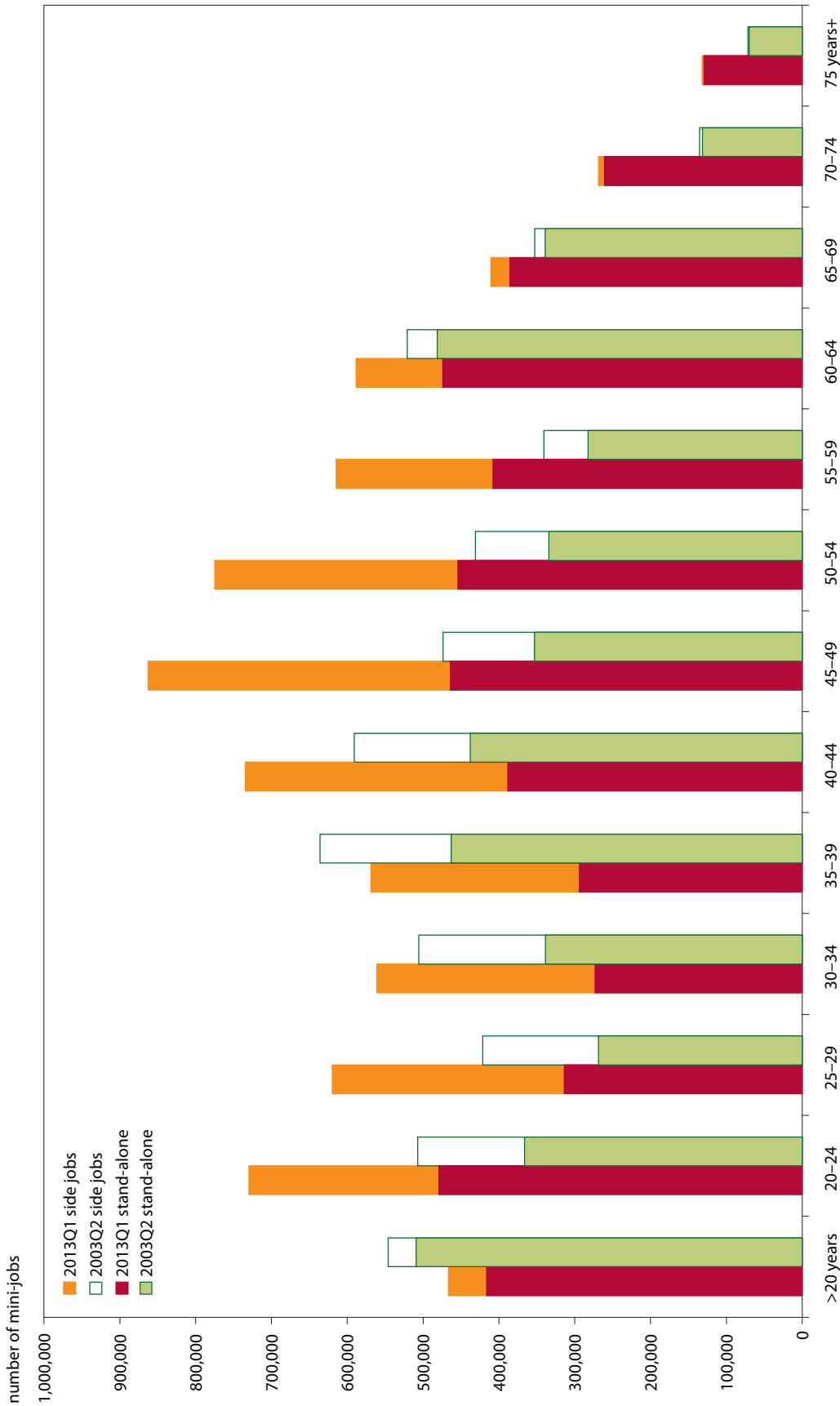
Note: Employment data refer to Q2 data after 1999.  
 Source: Bundesagentur für Arbeit Online Employment Database.

**Figure 9 German "mini-jobs" by category and jobs with full social insurance, 1999–2013**



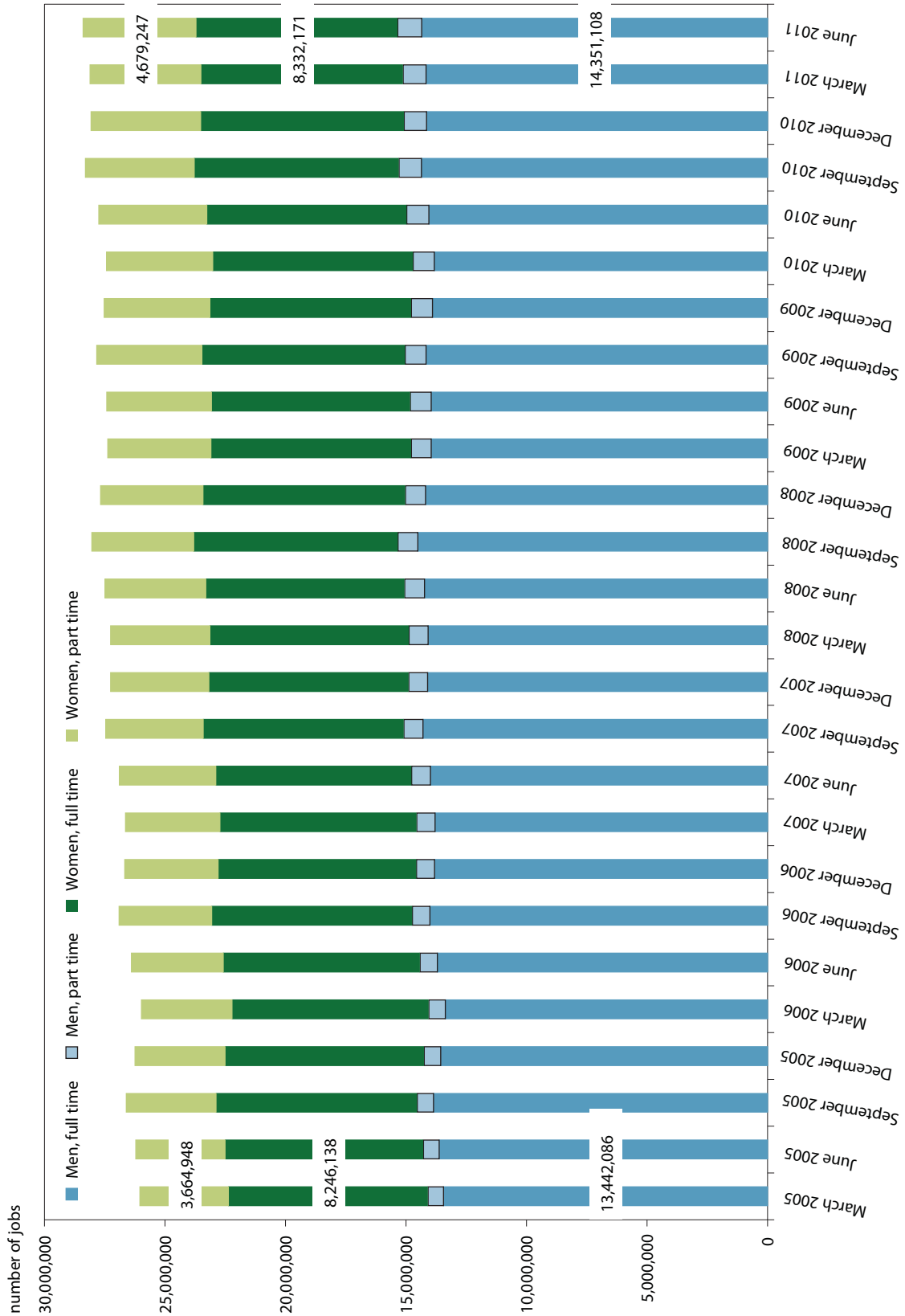
Source: Bundesagentur für Arbeit Online Employment Database.

**Figure 10 Mini-jobs, by age and job category (stand-alone and side jobs), 2003Q2 and 2013Q1**



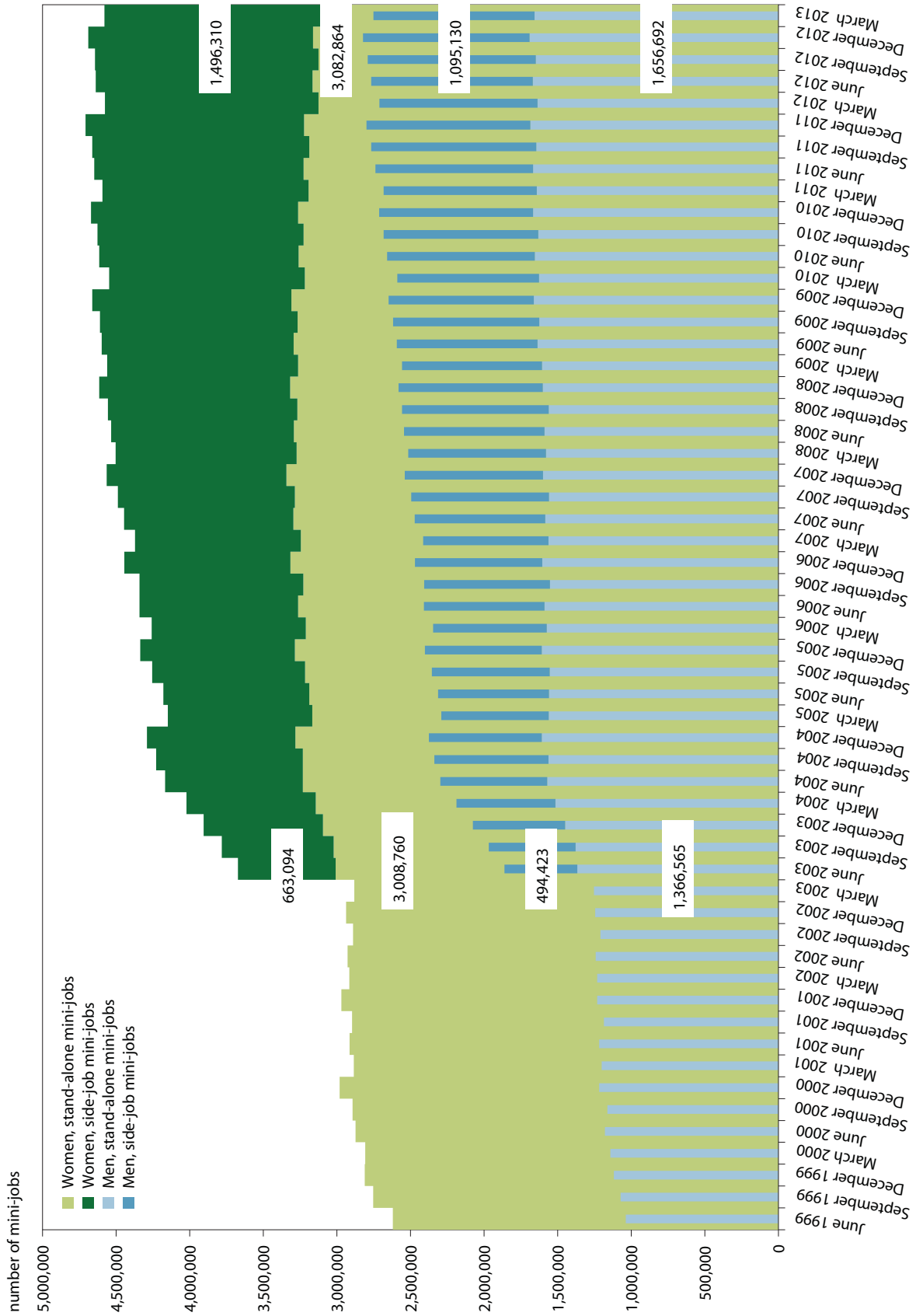
Source: Bundesagentur für Arbeit Online Employment Database.

**Figure 11 German jobs with full social insurance, by working time and gender, 2005Q2–2011Q2**



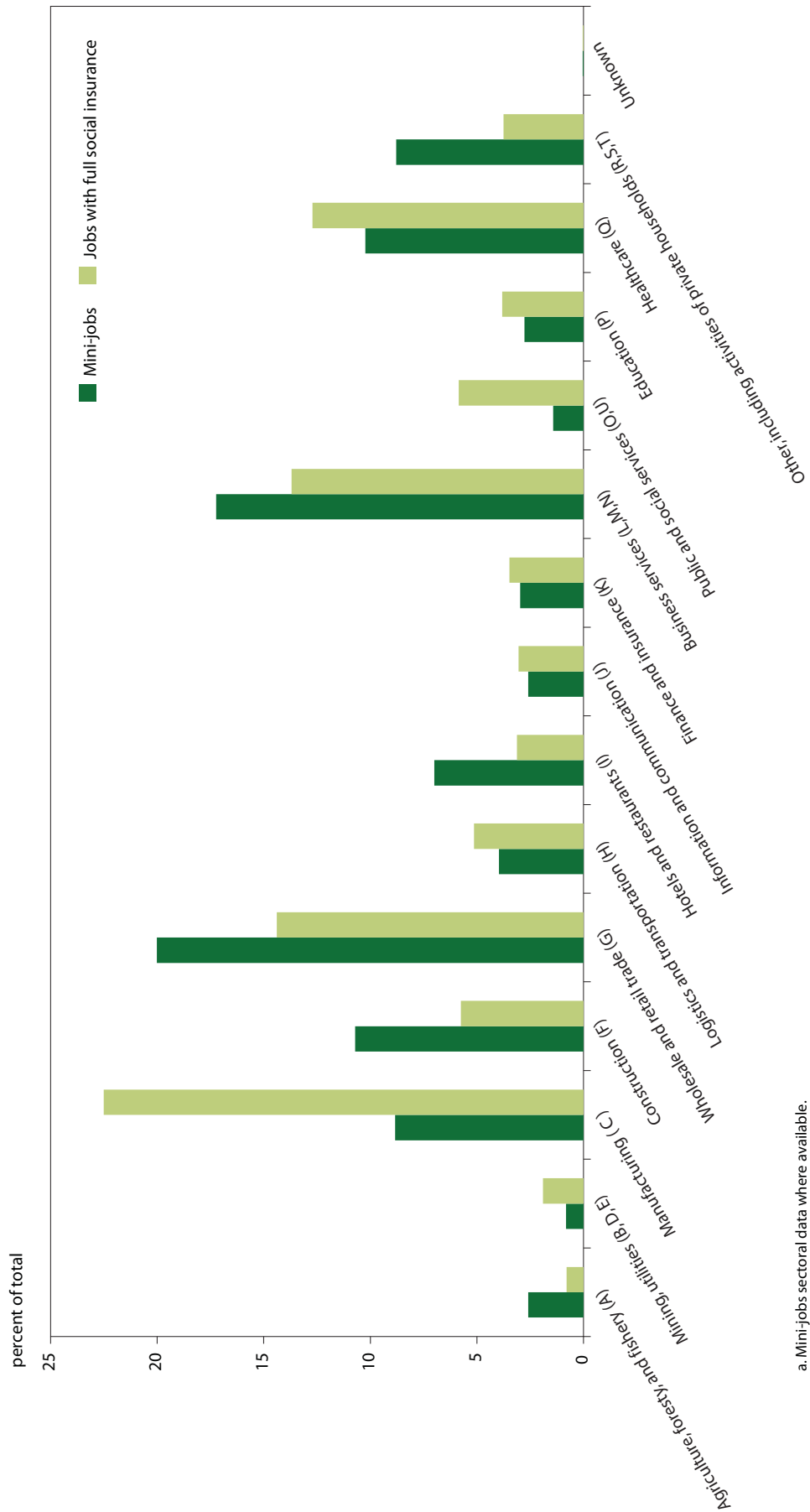
Source: Bundesagentur für Arbeit Online Employment Database.

**Figure 12 Mini-job creation, by category of mini-job and gender, 1999–2013**



Source: Bundesagentur für Arbeit Online Employment Database.

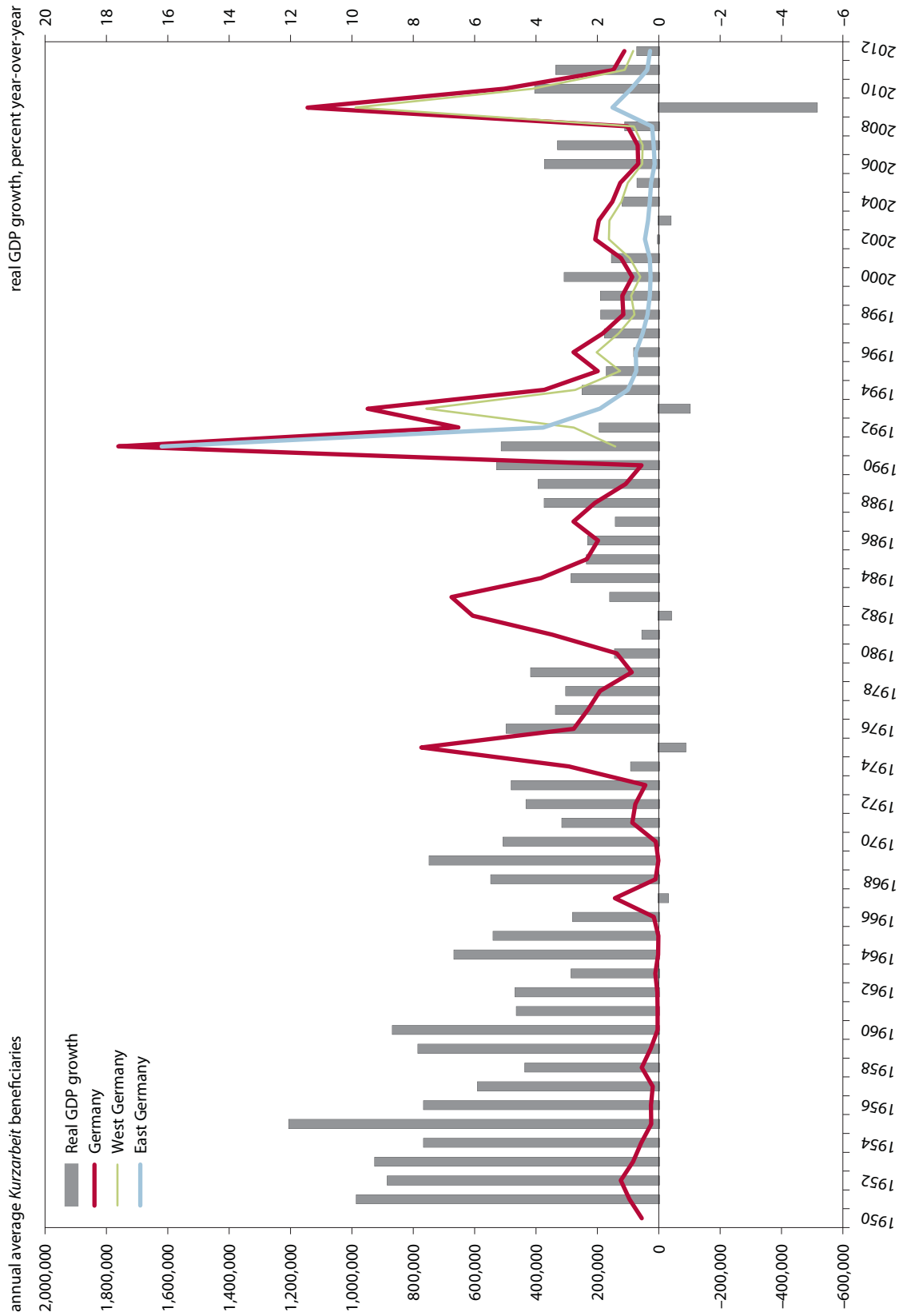
**Figure 13 Sectoral distribution of employment in Germany, September 2013, by job category<sup>a</sup>**



a. Mini-jobs sectoral data where available.  
Source: Bundesagentur für Arbeit Online Employment Database.



**Figure 14 Kurzarbeit beneficiaries in East, West, and unified Germany and real GDP growth, 1950–2012**



Sources: Bundesbank Online Database; Bundesagentur für Arbeit (2013).