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## Labor market policy in the new economy

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Bayerische Julius-Maximilians-Universität Würzburg

Wirtschaftswissenschaftliche Fakultät

# **Labor Market Policy in the New Economy**

**Norbert Berthold  
Rainer Fehn**

Wirtschaftswissenschaftliche Beiträge  
des Lehrstuhls für Volkswirtschaftslehre,  
Wirtschaftsordnung und Sozialpolitik

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# **Labor Market Policy in the New Economy**

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## I. Introduction<sup>1</sup>

When does the new economy arrive in Germany and boost productivity and employment as it has done in the US over the last decade? This has certainly been one of the more frequently asked questions in Germany recently, which is vexing policymakers and economists alike, in particular as Germany is already again at the bottom of growth rates even among Euro-area countries. However, the recent prospect of a downturn of the US economy has put into doubt whether the German labor market will ever benefit on a comparable size as the US labor market from a badly needed positive new economy effect. This skepticism is justified even though the recent slowdown in growth in the US might turn out to be short-lived and mainly of cyclical nature, thus possibly not reflecting deeply rooted structural weaknesses and imbalances.<sup>2</sup> The key problem in Germany and also in the other large continental European countries like France, Italy and Spain appear to be structural rigidities and an institutional framework which is not well suited to cope with the completely new economic environment which is nowadays often dubbed with the buzzword new economy. As long as major structural changes toward a more flexible and employment-oriented institutional setup are not initiated, it seems unlikely that the old world can fully benefit from an invigorating new economy effect thus falling again substantially behind compared to the US. Naturally given the title, this paper deals mainly with the labor market aspects of the new economy and with its consequences for labor market policy.

The dismal situation on labor markets in Germany and several other large continental European countries is by no means a new phenomenon, though. Rather, unemployment has ratcheted upwards since the mid seventies and most of the existing unemployment is of structural nature.<sup>3</sup> Thus, merely expanding aggregate goods demand is not a promising route for improving labor market performance. Much has been written about continental European unemployment and about the enormous political difficulties in implementing the structural reforms which are a prerequisite for achieving lasting progress on the labor market front.<sup>4</sup> Such necessary reforms affect a wide range of policy areas, such as labor, goods and capital markets and the social security as well as the tax system.

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<sup>1</sup> We thank participants of the Paderborn conference and especially Michael Burda as well as Holger Fricke, Michael Neumann, Oliver Stettes and Sascha von Berchem for helpful comments without implicating them.

<sup>2</sup> See Bosworth (2001).

<sup>3</sup> See e.g. Siebert (1997).

<sup>4</sup> See e.g. Saint-Paul (1998) and Berthold and Fehn (1996a).

It is usually argued that entrenched insiders on the labor market lose from such structural reforms and that they therefore exert fierce resistance against actually implementing them. However, while intuitively plausible, this type of reasoning has lost some of its appeal due to recent economic developments. The choice for insiders is not between maintaining the status quo or losing in the short to medium run due to structural reforms. Rather, the 1990s have witnessed drastic changes in the international economic environment, the so called globalization along with the arrival of the new economy, which evidently makes maintaining the status quo an unstable and infeasible policy option. Although it is still a bit early for a definitive judgment, the new economy seems to have spawned something like a new Kondratieff cycle, so that countries will invariably fall behind which are not able to adjust their institutional settings adequately. The dichotomy in economic developments in the 1990s between especially the US and possibly also some European countries such as the UK, Ireland, Switzerland and the Netherlands on the one hand, and the laggard continental European countries Germany, France, Italy and Spain on the other hand justifies such an assessment.

The arrival of the new economy seems to have at least interrupted the long-term process of convergence in per capital income among the highly developed OECD countries. The US spurts ahead again in terms of GNP growth although the US had already at the beginning of the 1990s the highest per capital income of the large OECD countries. Similarly, while employment stagnated or even fell in a country like Germany, the US managed to achieve large scale employment growth in the 1990s mainly in the service sector, in the information-technology (IT) industry, the biotech sector and in knowledge-based industries in general. Much of this employment growth comes about via the creation of new firms. Contrary to a widespread prejudice in continental Europe, many of the newly created jobs are well paid involving people who command over the skills appropriate for being hired in these fledgling economic sectors or in old economy firms which make use of the new technological possibilities.<sup>5</sup> High up on the list of requirements for such people are proficiency with computers, verbal, cognitive and communicative skills along with a great versatility in performing different tasks and in working in teams.<sup>6</sup> To be sure, the US has also created a large number of low-skilled jobs, the so called “hamburger flipping jobs”, which are often hardly sufficient to support a family. Hence, income differentiation has widened considerably

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<sup>5</sup> See Acemoglu (1999).

<sup>6</sup> See OECD (1999a).

although the US tries to keep the working poor problem in check with the “Earned Income Tax Credit System”, which supplements low market incomes via the tax system. The historically almost unique boom in the 1990s has certainly helped to mitigate the working poor problem in the US.

Continental Europe and especially Germany need both, more skilled employment along with more job opportunities for unskilled workers. It is impossible or prohibitively expensive to qualify everybody sufficiently for obtaining employment as a skilled worker who is adequately acquainted with the new technological production possibilities. Nonetheless, labor market policy has to play a key role in raising the number of people with the skills nowadays demanded by firms. In order to discuss what kind of policies are called for on the labor market by the new economy, the paper is organized as follows. Chapter II describes how the new economy affects the labor market. Chapter III lays out which implications the new economy has for labor market policy. Chapter IV provides conclusions.

## **II. How does the new economy affect the labor market?**

There exists no precise definition what the new economy really is and it is also, as of now, unclear whether the new economy measures up to the second industrial revolution of 1860 – 1900 which made possible a golden age of productivity growth and was based on a number of great inventions ranging from electricity, motor and air transport, motion pictures, radio, chemical products, medicine etc.<sup>7</sup> However, technological progress in information and communication technology as well as in data processing, the almost complete computerization of working life and the widespread use of the internet along with the growing importance of human capital appear to constitute integral parts of the new economy. The new economy furthermore seems to be characterized by greater network and economies of scale effects thus potentially raising labor productivity. Economies of scale effects are due to very high fixed costs of developing new products along with extremely low variable costs of producing additional units and positive network externalities. This assessment is especially valid with respect to information products.<sup>8</sup>

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<sup>7</sup> See Gordon (2000), Nordhaus (2001) and Jorgenson and Stiroh (2000).

<sup>8</sup> See Issing (2000), Siebert (2000) and Baily and Lawrence (2001).

The new economy effect has been most pronounced in the US during the 1990s, where the speed limit for growth and the critical threshold for the unemployment rate before inflationary forces are unleashed seem to have changed for the better basically due to a non-negligible positive supply shock which apparently reduced the NAIRU from 6% down to around 4% in the course of the last decade.<sup>9</sup> No clear-cut new economy effect has yet been detected for any European country although they differ widely in adopting new technologies with especially the Southern European countries and as a matter of fact also Germany lagging behind.<sup>10</sup> Hence, most Scandinavian countries along with the UK, the Netherlands, Switzerland and Ireland seem to have a greater potential for a positive new economy effect from this perspective. Considering that IT-technologies which foster the new economy are equally available among OECD countries, there can be little doubt that the stark differences in their widespread adoption must be largely related to institutional differences which facilitate or obstruct the development of a new economy. The new economy in the US has to a great extent come about via the creation of new firms and of innovative products. Hence, entrepreneurial spirit and incentives must be sufficiently developed along with an institutional setting which does not unnecessarily obstruct risky investments in any way, such as via red tape, high firing costs or via underdeveloped venture capital markets.

The economic environment has changed drastically in the course of the last two decades. While the post-war decades were characterized by a period of pretty stable economic and employment growth, things have come under flux and have become much more unstable since the mid seventies to early eighties. Political decisions to tear down trade barriers and to open up capital accounts for international capital flows along with revolutionary technological developments have triggered an unprecedented process of globalization, which has made the world almost like a village by now. With the possible exception of Africa, countries are by now linked via a dense web of trade relations and of capital flows, which makes them mutually interdependent.<sup>11</sup> It seems pretty clear in hindsight that those countries benefited most from the globalization process which were the quickest and the most determined in opening up their borders for trade and, somewhat less clear, for capital flows, such as many South-East Asian countries. However, globalization also has a downside such as creating a

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<sup>9</sup> See Bosworth and Triplett (2000).

<sup>10</sup> See Daveri (2000).

<sup>11</sup> Such an economic mutual interdependence breeds peaceful behavior as could be witnessed during the crisis between the US and China during the recent Hainan incident.

more volatile economic environment with greater and more frequent shocks.<sup>12</sup> Furthermore, contagion effects in the course of financial crises have become more likely as has been demonstrated, e.g., by the Asian crisis. Not all economies are equally well prepared to cope with the resulting diminished stability of labor demand.

Not only the stability of labor demand has fallen, but the structure of labor demand has also changed. Labor demand in the industrial sector is shrinking in the highly developed OECD countries, while it is expanding in the service sector, in the information-technology (IT) sector, in the biotech sector and more generally in knowledge-based industries.<sup>13</sup> Furthermore, the regional concentration of labor demand within countries is growing possibly due to the increasing importance of local technological spillovers and positive agglomeration and network effects. German reunification is a special case of regionally concentrated labor demand due to a political shock. Finally, the development of labor demand with respect to skills differs a lot in the highly developed OECD countries. Whereas labor demand for skilled workers is growing overall, labor demand for unskilled workers is falling thus worsening their income and employment opportunities. The changing nature of the skills which are required by firms makes a high adaptability along with life-long learning of the workforce more important. This requirement of workers is reinforced by shorter product life and production cycles.

While these changes in the structure of labor demand are almost undisputed and are clearly reflected in unemployment statistics across OECD countries, it is still an open question whether globalization or skill-biased technological progress is the main driving force for these developments. Technological progress has certainly become more rapid and is biased in favor of skilled workers but technological progress and globalization are simply too closely interrelated in order to clearly draw the line. Advancements in communication technology and reductions in transportation costs were probably a prerequisite for the globalization of economic transactions, and this globalization in turn enhanced the speed of skill-biased technological progress. In any case, it is usually argued that due to both processes it has become harder for unskilled workers to find decently paid jobs in the highly developed OECD countries. Opening up the EU to the East is likely to further accentuate all of these

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<sup>12</sup> See Bertola and Ichino (1995) and Ljunqvist and Sargent (1998).

<sup>13</sup> See SVR (2000).



developments in Western Europe, in particular the regional concentration of labor demand and the imbalance between labor demand for and labor supply of unskilled workers.

However, it is not as clear as is often assumed that the bottom end of the income distribution will lose due to the new economy which is largely based on innovative IT products. Information becomes more easily available due to IT thus increasing competition among knowledge producers and enlarging their markets. Some of the knowledge producers will win, others will lose, while non-knowledge producers at the bottom end could even gain in the end in absolute terms if they are not substituted easily by IT-based production. This is the case because they are primarily consumers of IT-based knowledge which should become cheaper relative to other goods. Demand for non-IT based services will most likely persist. It does therefore not make sense even from this equity perspective to artificially try to qualify everybody so that he can also become an IT-knowledge producer besides the question concerning the feasibility of such a far-fetched attempt.<sup>14</sup>

It is by no means only formal qualifications which matter more than in the past for being hired and for moving up on the career ladder. So-called soft skills are clearly gaining ground.<sup>15</sup> The IT-revolution and the omnipresence of computers in firms have fundamentally transformed the production process in favor of flexibility, teamwork and multi-tasking. Specialization of employees on certain well-defined tasks as in the Tayloristic or Fordistic mode of production is increasingly obsolete. Rather, employees are now expected to perform multiple tasks and to use their proficiency in one task to increase their productivity in other tasks. There exists considerable empirical evidence that this post-Fordistic or holistic organization of firms with widespread “job rotation” is now becoming predominant thus changing substantially the skill requirements of firms. Physical strength along with the flawless execution of repetitive actions is nowadays much less important to firms compared to creativity, the ability to work with computers, to manage a wide range of different tasks, to solve problems independently, to work in a team along with communicative skills and social competence. Language skills along with international mobility have also become more important due to the globalization process. Persons with the same formal qualifications might differ a lot in these various areas so that they are also valued very differently by firms. Concerning economic policy, the big question is of course, what is the best, i.e., the most

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<sup>14</sup> See Saint-Paul (2001).

<sup>15</sup> For the following, see Lindbeck and Snower (1997), (1998) and (2000) as well as Snower (1997).

cost-efficient way of equipping people with these various skills required by firms so that they will not end up in the low-skill, bad-job trap.

Supervision of workers by firms has become more difficult thus raising motivation and efficiency wage problems. As the importance of investments into human capital and of quasi rents has grown, it is nowadays essential for firms to have workers who are themselves highly motivated to excel and to contribute to the overall success of their firm. Hence, the classical dichotomy between managers or entrepreneurs, who are making the decisions, and workers, who are diligently executing these decisions with as little room for discretionary maneuvering as possible, is increasingly blurred. Any modern firm which wants to benefit from the full potential of its skilled workforce needs to get its employees involved in decentralized decision making with a strong incentive that their team, their profit center and in the end their firm succeeds.<sup>16</sup> This allows the badly needed quicker reactions to the nowadays rapidly changing market conditions and also allows a production which fits better with the more heterogeneous demands of customers. Ensuring homogeneous products of high quality via centralized supervision has become less important due to the almost complete automatization and computerization of nonetheless relatively flexible production lines.<sup>17</sup>

While firms in the past constituted an island of central planning in a wide sea of market forces according to R. Coase, such market forces are nowadays gaining substantial ground even within firms, which are now flatter and less hierarchically structured. Decentralized, relatively small and customer-oriented teams with a changing composition of people form profit centers and these profit centers compete with each other for scarce resources. Hence, the task of top management is more and more restricted to making strategic decisions and to implementing the appropriate organizational structure in their firms while daily decisions are delegated to local profit centers and teams. The big leaps in productivity in the 1990s in the US do at least not seem to be based on people working much harder than before, but rather on technological developments and on new institutional frameworks which enable people to work differently. Market forces are driving firms toward greater sharing of authority, risk and rewards.<sup>18</sup>

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<sup>16</sup> See OECD (1999a) and Bickenbach and Soltwedel (1998).

<sup>17</sup> See Black and Lynch (2000).

<sup>18</sup> See Freeman (2000).

Interestingly, these changes in the organization of production seem to have also altered the comparative advantage of women compared to men between household activities and working on formal jobs. Women are more likely to possess the skills which are now increasingly demanded by firms relative to say physical strength which used to be more important in the past. As early as when they were hunters, men have been more specialized in their professional activities making use of their greater physical strength while household activities of women inevitably involved more multi-tasking. Furthermore, teaching children how to communicate and educating children has accustomed women to solving complex incentive problems and has possibly equipped them on average with greater social competence. Hence, the rapidly increasing integration of women into formal jobs in many OECD countries is not only the result of greater labor supply by women, but probably stems also from greater demand by firms for the specific skills of women. Countries, such as Germany, which lag quite a bit behind in this respect not least due to an institutional framework which makes it difficult to combine having a family with working on a formal job, are therefore likely to forgo substantial growth opportunities.

It has in any case become more important for countries to dispose over a workforce which is skilled in a broad sense, versatile, adaptable and mobile. Much more than in the past, workers themselves need to become small entrepreneurs in order to be successful. The formerly relatively clear-cut distinction between labor and leisure, between office and home is becoming increasingly blurred by the new economy thus transforming society in a quite fundamental way and requiring new institutional arrangements. This increases especially the importance of life-long learning, but also the opportunity set for combining family and work which is particularly beneficial to women.

The changes brought about by the arrival of the new economy concerning in particular the labor market create both, an enlarged opportunity set for countries and a higher adjustment burden. Countries which are characterized by a rigid or ill-designed institutional framework on labor, goods and capital markets, a social security and a tax system which grossly reduce work incentives and stifle entrepreneurial activity not only forgo the potential benefits of the new economy, e.g., for employment and per capital GNP growth, but may actually face a deteriorating employment performance. Hence, the capacity to adjust such an ill-designed institutional framework is crucial for tapping the potential benefits of the new economy. Especially flexible relative prices are becoming crucial such as flexible real wage costs for

firms as well as flexible wage structures with respect to regions, sectors and qualifications. If relative prices are rigid and if workers are furthermore not able to adjust fast enough via being mobile and via enhancing their human capital, growing unemployment is kind of an inevitable result. In particular the large continental European countries seem to have trodden down this path into limbo during the 1990s, while the US appears to have entered into a virtuous circle which has only very recently come to a possibly temporary halt. Given the fact that rising unemployment produces an unsustainable situation sooner or later, the question inevitably arises which kind of policy changes in particular concerning the labor market could help the lackluster continental European countries to escape the current vicious circle in favor of a virtuous circle.

### **III. Implications of the new economy for labor market policy**

Labor market policy must primarily be aimed at two key objectives in the age of the new economy. First, the institutional framework on the labor market must be designed to at least come close to fully exploiting the potential for productivity and employment growth which is created by the new economy. This affects in particular the degree of centralization of wage bargaining, decision making within firms and firing costs. Second, it is sometimes argued that the new economy along with the heralded IT revolution could trigger a digital divide and an apartheid economy between those who are successful in the new economy and are sufficiently proficient at using IT and those who are not up to mastering its challenges.<sup>19</sup> Labor market policy should aim at preventing such a damaging development. However, providing people with the respective skills and qualifications via active labor market policies is at most a second best policy instrument. The foundations are laid much earlier whether or not people are successful in the new economy, namely when attending the education system and when being educated by one's parents. Improving and adapting the different branches of the education system to meet the various challenges created by the new economy must therefore be high up on the political agenda for upgrading the workforce via the buildup of appropriate human capital. The education system is not the focus of this paper though, and we will only briefly touch upon this topic in the concluding remarks.

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<sup>19</sup> See Freeman (2000).

## 1. Risk and reward sharing between workers and firms

The new economy and also more competitive and globalized capital markets induce firms to specialize more on their core competencies.<sup>20</sup> This greater specialization across firms stands in marked contrast to the shrinking degree of specialization of workers within firms. Hence, while it was still common two decades ago that firms diversified and workers specialized, almost the reverse is true nowadays. Multi-tasking and the breakdown of occupational barriers brought about by the new economy along with the accompanying organizational revolution amount to a reversal of a trend in which productivity improvements are achieved via an increased specialization of workers within firms. The beginning of this trend toward greater specialization within firms dates back as far as to the first industrial revolution and was already described extensively by A. Smith in his seminal writings. However, this fundamental change in the organizational structure of firms has far-reaching consequences for the appropriateness of different wage-bargaining systems. In a nutshell, centralized systems of wage bargaining, which cede relatively little room to firms for maneuvering with respect to wages in order to mitigate incentive and efficiency wage problems, are becoming more and more inefficient. They prevent firms from offering their employees adequate incentives to perform the appropriate mix of tasks, thus reducing their profit opportunities and investment incentives. Allowing much greater wage drift is not a solution as this undermines the system and is therefore not acceptable to central wage setters.

Centralized wage bargaining has for a long time been praised by many economists as a system which allows the internalization of various externalities, in particular with respect to inflationary pressures and with respect to unemployment insurance.<sup>21</sup> It is the core principle of any system of centralized wage bargaining that the same wage should be paid for the same job irrespective of the individual economic situation of the firm in which the job is performed. This hallmark of centralized wage bargaining “equal pay for equal work” crucially depends on workers with similar profiles having similar productivities even if they perform different tasks. There even exist two efficiency arguments in its favor. It supposedly helps profitable firms to grow faster and destroys more quickly firms whose efficiency is below average thus possibly promoting structural change in case workers are highly mobile. Furthermore, the

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<sup>20</sup> For the following, see Lindbeck and Snower (1997), (1998) and (2000) as well as Snower (1997).

<sup>21</sup> See Calmfors and Driffill (1988).

possibilities for inefficient rent sharing on the firm level due to insiders holding up firms are reduced by centralized wage bargaining systems.

Several countries decentralized nonetheless their systems of wage bargaining during the 1980s and 1990s.<sup>22</sup> While some might view this institutional evolution across countries toward more decentralized wage bargaining as a coordination or policy failure which lowers social welfare, the new economy with its organizational revolution and the accompanying move from Fordism to post-Fordism provides a powerful economic rationale for this international pattern of institutional change. Central wage setters have little choice but to set wages schematically and to fix one wage or a narrow range of wages for every broadly defined group of tasks. However, the new economy and multi-tasking make this practice inherently inefficient, since the productivity of a particular worker depends even less than in former times only on his formal qualification for this one task but also on the other tasks which he is performing and, in addition, to a great extent on his soft skills. Workers, even if they have similar formal profiles, are unlikely to perform the same set of complementary tasks at different holistic firms. Overall productivity of such seemingly similar workers along with their incentive problems must be expected to differ across firms in a post-Fordist environment.<sup>23</sup> Since people within any particular education, occupation and job tenure group are likely to vary considerably in terms of their social competence, cognitive skills, judgment and ability to perform multiple tasks, wage dispersion even among people with similar formal qualifications needs to increase with the new economy and the accompanying IT and organizational revolution.

To give a simple example, if wages are set on the central level according to the productivity of versatile workers who can make great use of task complementarities, workers who are not able to do so are likely to end up being unemployed. Hence, centralized wage bargaining systems impose a growing efficiency cost on OECD countries by artificially compressing the wage distribution.<sup>24</sup> Allowing greater wage drift is not a sustainable solution because this would slowly undermine the operability of the central wage-bargaining system. The new economy along with skill-biased technological progress improve the outside option of workers with the skills demanded by firms, thus reducing their incentive to stay within a

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<sup>22</sup> See Freeman and Gibbons (1993), Katz (1993) and Berthold and Fehn (1996b).

<sup>23</sup> See Ramaswamy and Rowthorn (1993) and Lindbeck and Snower (1997).

<sup>24</sup> See Davis and Henrekson (2000).

union or to join a union in the first place. The result is the observable decline of union membership across OECD countries, which is the basis for any centralized wage bargaining system, and in the end a greater wage differentiation.<sup>25</sup>

Labor is becoming more heterogeneous with the new economy and is even less than in the past a single-purpose unit which is easily comparable across firms according to formal qualification. The organizational revolution is furthermore likely to trigger a sharp increase in the number of occupational clusters relative to the traditional number of occupational categories. This makes it even more difficult than in the past for centralized wage bargaining parties to establish broad occupational categories within which wage uniformity could be imposed without great efficiency losses. In addition, the dissolution of functional departments in favor of small customer-oriented teams and in favor of profit centers, which produce highly differentiated products, is also increasing the heterogeneity of task clusters across firms, thus further complicating life for central wage bargaining parties.

It is hardly conceivable that the principle of “equal pay for equal work”, which is the foundation of any centralized wage bargaining system, could be amended by redefining work along holistic lines. The dramatic rise in the heterogeneity of workers’ skills which matter, of tasks and of task complementarities even within a particular industry would require that central wage bargaining parties dispose over vast amounts of information which is furthermore very quickly obsolete. This up to date information conglomerate is just as unlikely to be available to central wage bargaining parties as full information about production technologies, customer demands etc. was to traditional communist central planners. Labor markets are becoming more like product markets with respect to heterogeneity, thus raising the efficiency losses associated with centralized wage bargaining toward the level associated with those of centralized price fixing. In short, asymmetric information problems between firms and workers on the one hand and centralized wage bargaining parties on the other hand have risen thereby reducing the optimal degree of centralization of wage bargaining.

It seems to be a reasonable conjecture that the international trend over the last two decades toward more decentralized wage bargaining, e. g., in the US, the UK, Australia, New Zealand,

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<sup>25</sup> See Acemoglu, Aghion and Violante (2001).

the Scandinavian countries or Italy, is at least partly related to this set of reasons, because the described efficiency costs in the end amount to forgone opportunities for GNP and employment growth.<sup>26</sup> This assessment fits with the observation that new economy firms do usually not join centralized wage bargaining arrangements and often even offer remuneration packages to their employees which contain profit sharing components and/or stock options of their firms in order to mitigate the growing incentive and efficiency wage problems. Such remuneration packages have great advantages for new economy firms. First, wage pressure is reduced and payroll costs become more flexible. Second, they foster more decentralized decision making and make it easier to split firms up into profit centers. Hence, from this perspective the new economy promotes the creation of a share economy thus blurring the historic division between capital and labor.<sup>27</sup>

Germany lags behind in the international trend toward more decentralized wage bargaining which boils down to some kind of profit sharing even without explicitly linking wages to profits of their firms. This is the case because wages negotiated at the firm level depend greatly on the profitability of the specific firm. It is well known that a sizable number of firms in the German „Neue Länder“ do not pay according to industry-wide wage agreements even though they belong to the employers' association, but this kind of behavior is clearly illegal. Nonetheless, in the end the gulf between official centralized wage agreements and economic reality in the „Neue Länder“ might help to break up the bargaining cartel which was imposed by the Old Länder on the „Neue Länder“ after reunification.

If unions, employers federations and the government would like to avoid an uncontrolled collapse of the current institutional setting, it is advisable to preemptively make centralized wage agreements more flexible and to cede greater decision-making power to the firm level.<sup>28</sup> Most important, wage negotiations and agreements on the firm level should be legalized without reservation if a qualified majority of the firm's workers agrees to differ from the central wage agreement. In case wage negotiations on the firm level fail, the central wage agreement continues to serve as the fall back position. If this is not feasible, there are some alternatives which are more in line with the current system. First, central wage agreements can only fix a corridor for wage changes within in the industry with the specific number to be

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<sup>26</sup> See Lindbeck and Snower (1997).

<sup>27</sup> See Freeman (2000).

<sup>28</sup> See Berthold and Fehn (1996b).



determined on the firm level. Second, central wage agreements can contain a provision that part of the fixed wage change is allowed to be substituted by a profit sharing component by mutual consent on the firm level. Third, central wage agreements can contain special wage clauses for disadvantaged groups of the labor market like the long-term unemployed or elderly workers. Fourth, the legal possibility for the government to declare a wage agreement as generally binding for all firms of an industry, even those which do not belong to the employers' association, should be abolished. In sum, all institutional arrangements and legal barriers in Germany which obstruct the path toward greater wage flexibility and wage differentiation according to local conditions should be put under very close scrutiny whether they are really economically beneficial under the conditions of the new economy.

## **2. Employee participation in decision making**

It is to be expected that employees who are to share a greater part of the idiosyncratic risk of firms via decentralized wage bargaining and profit sharing want to have a greater voice in their firm's decision making process too. This also makes economic sense as authority, risk and reward sharing should go hand in hand.<sup>29</sup> The question arises, though, whether firms also benefit from greater participation of workers in decision-making processes and whether they are therefore voluntarily willing to involve workers to a greater extent in decision making. From an economic policy point of view, it is worth checking whether some kind of legal intervention is needed, possibly along the lines of the German codetermination law and its planned extensions.<sup>30</sup>

Codetermination by workers is justified from an economic perspective if such a transfer of control, information and decision rights enhances the efficiency of working relations. Labor contracts are a typical case of an incomplete contract which allows in principle ex-post opportunistic behavior by both parties, firms and workers, possibly giving rise to hold-up problems.<sup>31</sup> Codetermination rights can at least potentially foster a cooperative working relationship, thus enhancing the incentive of workers to put maximum effort and creativity into their job. This is especially likely if extended codetermination rights are part of an

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<sup>29</sup> See Freeman and Gibbons (1993) and Freeman (2000).

<sup>30</sup> See Berthold and Stettes (2001).

<sup>31</sup> See Caballero and Hammour (1998).

encompassing bargaining package between firms and their workers. They can furthermore possibly reduce problems of asymmetric information on the part of management if workers are, as is often argued, in an institutional framework with codetermination more likely to share their superior information with management. Such a cooperative behavior produces a quasi-rent which differs across firms. As opportunistic behavior is more easily observable for collective bodies than for individuals, control costs of incomplete contracts can also fall. Hence, codetermination rights can at least theoretically lower transaction and information costs thus enhancing economic efficiency. If these advantages outweigh the possible benefits of ex-post opportunistic behavior, both sides, firms and workers, will then voluntarily enter into such an institutional arrangement. Relatively flexible work contracts with an institutional framework for ex-post bargaining are especially preferable for both parties if continuous investments into the human capital of employees are necessary in order to adjust to quickly changing economic conditions. Workers are then more willing to invest into firm-specific human capital, which could otherwise potentially fall victim to hold-up behavior by firms.

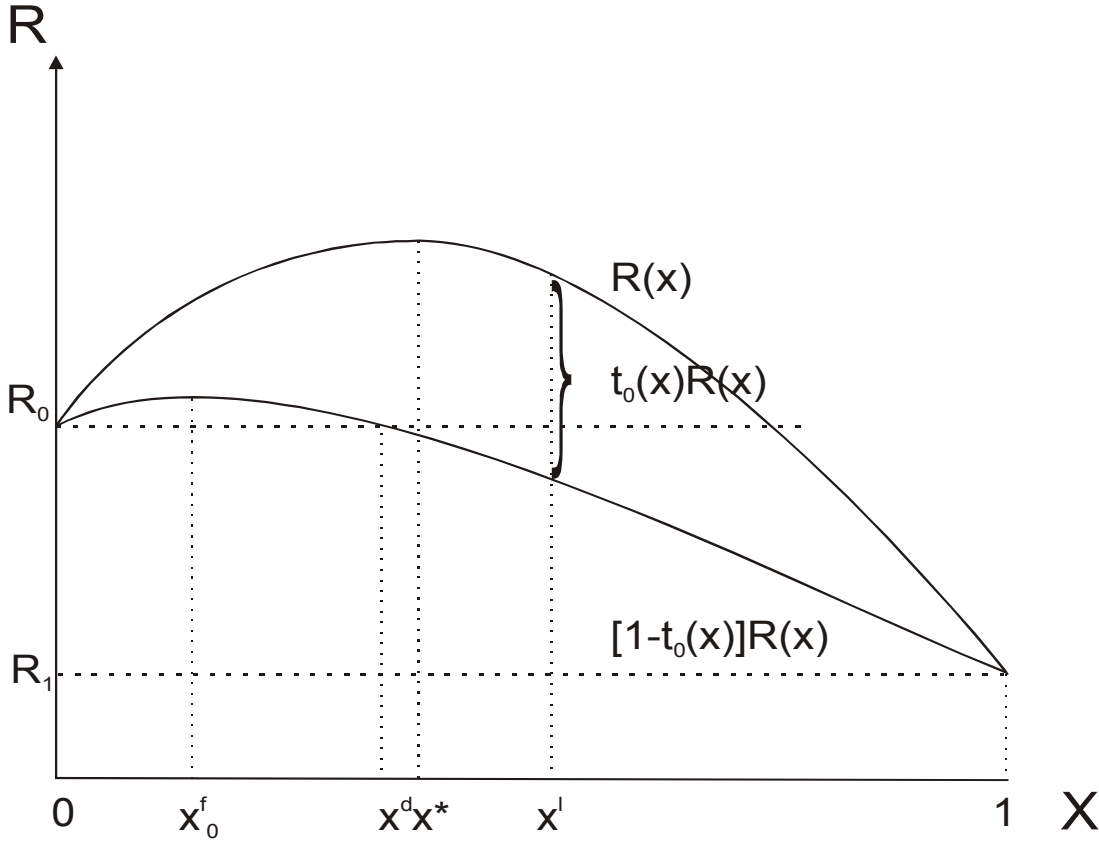
However, extending the participation rights of workers in firm's decision making is likely to have a hump-shape type effect on the profitability of the firm and on general economic efficiency. Figure 1 roughly describes the relevant situation before the onset of the new economy like in the late 1970s and early 1980s. The index of participation rights  $x$  of workers is denoted on the horizontal axis, while the associated revenues are given on the vertical axis. Revenues to the economy as a whole are denoted with  $R(x)$  (upper curve), to firms with  $[1 - t(x)]R(x)$  (lower curve) and to workers with  $t(x)R(x)$  (difference between upper and lower curve). If  $x$  is equal to one, workers completely call the shots in firms without interference by management or providers of capital, reflecting the model of the Yugoslav firm. As is well known, such a setup is highly inefficient, though. If  $x$  is in contrast equal to zero, workers have no say whatsoever in decision making of firms. Such a situation is reminiscent of firms in the 19<sup>th</sup> and early 20<sup>th</sup> century with a highly Tayloristic organization of firms. It is safe to assume that output is larger than in the case of worker-dominated firms, as the latter type of firms does in general not meet the market test anywhere in liberal societies.<sup>32</sup> Yet, such a completely hierarchical top-down organizational structure was also not optimal anymore for firms at least already about two decades ago before the arrival of the new economy, and much less so for workers and for the economy as a whole. According to figure

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<sup>32</sup> A notable exception might be the Kibbutz system in Israel. However, this system was created under very special circumstances after the Holocaust and the foundation of Israel and seems to be in decline nowadays too.

1, already back then firms preferred to involve workers to some extent in decision making with their optimal solution being  $x_0^f$ . However, workers of course wanted to obtain much larger decision-making rights as is reflected in their optimal solution  $x^l$ . For the economy as a whole, the intermediate solution  $x^*$  would have been optimal. Bargaining between workers and firms on the firm level will yield an intermediate solution between the two optima, which could have in principle come close to the aggregate optimum in  $x^*$  depending on relative bargaining power. For any level of participation rights beyond  $x^d$ , firms would prefer to actually go back to the Tayloristic mode of production.

**Figure 1: Employee Participation in Decision Making and Value of Firms**



Source: Berthold and Stettes (2001).

The question arises therefore, why should it be necessary to decree codetermination rights by law if they are indeed advantageous to both, firms and workers. After all, conditions determining which kind of codetermination arrangement is useful will probably vary from firm to firm and it must be assumed that local negotiating partners know those conditions better than a centralized legislative body which cannot make distinctions according to local

conditions. Some kind of market failure is a necessary condition to justify such a legal intervention. Assuming realistically that the political decision-making process also works far from perfectly well, in fact the much stronger assumption is needed to justify legal intervention, i.e., that even an imperfect political solution dominates the less than optimal market solution.

There exist at least three arguments why a legislative solution might be useful. First, each individual worker on the firm level has an incentive to behave as a free rider in firm-level negotiations, i.e., not exercising voice himself but rather counting on his fellow workers to do so. Such a behavior is likely to improve his standing with management and his chances for promotions. Codetermination rights in contrast to wage payments have the character of a collective good for each individual worker. Hence, it is in this respect more difficult for workers to organize on the firm level than it is for management yielding an asymmetry in bargaining power. The free-bargaining solution concerning codetermination rights might therefore systematically deviate downwards from the social optimum leaving in principle some room for improvement via government interference.

Second, ceding codetermination rights to workers voluntarily might give rise to an adverse selection problem for each individual firm doing so. Such codetermination rights usually involve some say when workers are about to be laid off for protecting any quasi rents which have been created, thus increasing de facto firing costs for such firms and the effective degree of employment protection of workers in such firms. Yet, workers are likely to possess superior information concerning their own abilities compared to firms prior to hiring. Hence, workers, who know that they are of relatively poor quality, will systematically prefer to apply for jobs at firms with codetermination rights as this increases somewhat their protection against being dismissed ex post. In contrast, good workers will then prefer to be hired by firms without voluntary codetermination rights as the average productivity of workers in the firm will affect the wage of each individual worker. A general legislative solution can obviously mitigate or possibly even solve this adverse selection problem.

Third, especially small and medium size firms and firms which have only recently been founded tend to have a reputation problem on the labor market. Markets, i.e., not only the labor market but also the product and the capital market, will hardly react if they do not abide by any voluntary agreement with their workers concerning codetermination rights. This

reduces the ex-ante credibility of such an agreement for workers in these firms. Credibility of such voluntary agreements is only high ex ante if ex-post opportunistic behavior of firms is severely punished by markets, possibly in the way that good workers no longer apply or that products of such firms are avoided by customers. Yet, such mechanisms are only likely to be at work with large and well-known firms which receive a great deal of attention from the media. With a legal solution, such reputation problems are not an issue as it is then relatively easy for workers to enforce compliance by firms via suing them in labor courts.

Hence, there exist non-negligible arguments in favor of some kind of a legal solution. To be sure, such legal interference also has substantial drawbacks. Ceding codetermination rights to workers should ideally be part of an encompassing package deal between workers and firms also involving such issues as wages, profit sharing components or work organization. Other typical parts of such a package deal between workers and firms would concern the financing of investments into the human capital of the firm's workforce, streamlining work organization according to efficiency criteria and working time arrangements. Transferring greater codetermination rights to its workers would constitute a possible "quid pro quo" in such a package deal. Obviously, such a "do ut des" approach no longer works if codetermination rights are simply decreed by law. This strengthens asymmetrically the bargaining position of workers and is unlikely to make them more willing to compromise on other issues. It must be feared that workers will abuse such legal codetermination rights to simply extract a greater share of the rents which are created by the activities of the firm without actually increasing the total size of the pie.<sup>33</sup>

There is in fact some empirical evidence for firms listed on the stock market supporting this pessimistic view. Gorton and Schmid (2000) show with an extensive empirical study that the German codetermination law, which transfers control rights from capital owners to workers, not only makes the voting rights attached to shares less valuable, but that it also reduces the return on assets, the market-to-book ratio and the return on equity. According to their empirical results and contrary to general wisdom in Germany, the German system of legally instituted codetermination rights makes employees influence firms' decisions in such a way that the restructuring efforts of shareholders in response to economic shocks are resisted and delayed thus increasing the systematic risk to which firms are exposed. German firms

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<sup>33</sup> See Caballero and Hammour (1997).

apparently reacted to these extended codetermination rights of workers by raising their leverage. Greater debt financing reduces the size of free cash flows in firms and thus also the potential for appropriation activities of workers because this would quickly endanger the existence of the firm and thus also the jobs of its workers. Hence, legislation on codetermination has a similar effect on the optimal capital structure of firms as the threat of impending unionization in the US.

The often propagated efficiency-enhancing effects of German legislation on codetermination must also be doubted due to the fact that this institutional setup has not been adopted by other countries and that in particular Anglo-Saxon firms tend to be reluctant to invest in Germany due to codetermination. If the German approach were really so successful, lawmakers in other countries along with foreign firms should have by now realized its beneficial effects. In conjunction with the aforementioned information problems of any centralized legislative body concerning the particular needs of individual firms with respect to participation of workers in decision making, it appears preferable to set again only a general framework from which workers and firms can deviate on the firm level by mutual consent. This legal institutional framework would just as in the case of wage bargaining only serve as a fallback position if consent by workers and firms cannot be reached voluntarily on the firm level.

The usefulness of the current German legalistic approach must especially be doubted when also taking new economy effects into account. In changing the organization of firms from Fordism to post-Fordism, firms' benefits from involving their workers in the decision-making process increase substantially, thus making the rising section of their return curve in Figure 1 steeper and moving the optimum from the point of view of firms to the right and closer to the aggregate optimum. The incentive of such firms themselves rises to have workers with all their accumulated knowledge participate more and in a cooperative way in actual decision making in firms. Hence, the archaic conflict of interest between capital and labor is reduced and nowadays both sides often have similar or even parallel interests thus reducing the need for legislative interference in order to keep their relationship peaceful and fruitful. This is reflected in the fact that even in the US one-third of workers in firms with more than 50 employees report that they serve on employee involvement committees. These workers make

more suggestions for improvement than other employees and are more committed to their firms thus enhancing productivity.<sup>34</sup>

In sum, legal codetermination rights are neither a blessing nor a curse as such. An assessment rather depends on the specific legislation and the economic environment under which it is passed. It appears, however, that contrary to current efforts by lawmakers in Germany not more but rather less legal interference into the issue of codetermination by workers is called for by the new economy. Participation rights of workers should nowadays as much as possible become part of an encompassing bargaining package on the firm level between management or entrepreneurs and workers concerning the sharing of authority, risk and reward thus also involving a number of other key issues. Several of the planned changes of the German law regulating codetermination rights of workers make little economic sense. This concerns, e.g., the quota for women in works councils or the extended rights for participation in decision making of works councils in qualification measures, team-working, combining family and work as well as safeguarding employment and environmental protection. The same negative assessment holds for the planned possibility that works councils can extend their activities even to those parts of the workforce which do not want to be represented by works councils, for increasing the number of people who are members of the works councils in firms with more than 100 employees and for forcing already firms with 200 instead of 300 employees to have one employee as a full-time member in the works council without normal work obligations.<sup>35</sup>

It is less than obvious that these changes are justified by efficiency arguments. Decision making of firms will often be further slowed down which is the opposite of what is necessary in the age of the new economy. Opportunistic behavior by insiders is encouraged as they obtain a number of soft criteria for interfering with decisions by management which increase their appropriation potential. Arguing, as the German government does, that democracy costs money and that the costs are covered by positive productivity effects, is therefore not at all satisfactory. It neglects in particular that the increase in costs hits mostly relatively small firms, which, however, benefit least from legal codetermination, because they usually entertain a cooperative relationship with their workforce anyway even without any legal codetermination rights for their workers. Competitive pressure on labor and goods market

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<sup>34</sup> See Freeman (2000).

<sup>35</sup> See Schnabel (2001) and Berthold and Stettes (2001).

forces them to do so without any prodding by the government. The envisioned changes in the German law regulating codetermination must therefore be regarded as being mainly part of a gift exchange between unions and the Red-Green government with the government rewarding the unions for complacency in other areas such as the tax reform which was passed in the year 2000 and which was relatively favorable to (big) business.

### **3. Employment protection legislation**

Another important and controversial labor market institution which differs greatly across OECD countries is firing costs or employment protection legislation (EPL). EPL is in general considerably more restrictive in continental European countries than in Anglo-Saxon countries.<sup>36</sup> In particular the US with its “employment at will”-principle is usually ranked very low concerning firing costs. Within continental Europe, firing cost tend to be higher in Southern European countries compared to Northern European countries. Northern European countries usually protect workers against negative shocks rather via relatively generous unemployment insurance and welfare assistance.<sup>37</sup> Firing costs increased substantially in some continental European countries like Germany and France in the late 1960s and early 1970s and have roughly stayed on this higher level since then.<sup>38</sup> However, it was one of the first measures of the new Red-Green government in Germany to extend the scope which firms are affected by EPL, i.e., that such legal restrictions already apply again to small firms with only five or more employees.

It is not obvious how EPL affects labor market performance because there are opposing effects at work. There exist several arguments why some EPL might be superior to the free market solution with no EPL not only for reasons of equity but also on efficiency grounds.<sup>39</sup> First, EPL in the form of severance payments forces firms to internalize some of the costs which they impose on workers who are dismissed and on society at large. Second, EPL smoothes employment over the business cycle because firms will then be more reluctant to fire workers in recessions as this would make them incur firing costs which they might avoid by simply hoarding workers over the downturn. Third, EPL protects workers against arbitrary

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<sup>36</sup> See Blanchard and Wolfers (1999) and OECD (1999b).

<sup>37</sup> See Buti et al. (1998).

<sup>38</sup> See Caballero and Hammour (1997).

<sup>39</sup> See e.g. Bentilola and Bertola (1990).



dismissals by firms thus possibly creating a more trustful working relationship between firms and workers and making workers more willing to invest themselves into firm-specific human capital.

These arguments in favor of some EPL notwithstanding, there are also a number of counterarguments which caution against raising EPL too much. First, EPL increases total labor costs thus reducing labor demand at given wage costs. It is sometimes argued that EPL is viewed as insurance against adverse shocks by workers and that wages will therefore fall in reaction to higher EPL as workers are willing to pay an insurance premium. However, this argument is not convincing in the context of EPL which is imposed by the government and not the result of negotiations between workers and their respective firm. In the latter case, a package deal might be struck between workers and firms involving lower wages in return for higher employment protection ceded by firms, e.g., in the form of severance payments. Workers have no reason to make such wage concessions if the government raises their bargaining power unilaterally via imposing higher EPL on firms. On the contrary, it must be expected that their wage demands will become more aggressive once they are hired and enjoy protection via EPL because their potential to appropriate firms after having been hired is raised.<sup>40</sup> Insiders will not be dismissed by firms as long as wages do not exceed their marginal productivity plus firing costs.<sup>41</sup> The negative effect on labor market performance is the greater, the larger is the long run elasticity of substitution between capital and labor. Recent empirical evidence pointing to a long run elasticity of substitution between capital and labor which exceeds the threshold value of one suggests that the negative effects in the long run of expanding EPL are considerably larger than hitherto assumed.<sup>42</sup>

Second, these considerations also shed some doubt on the assertion that EPL helps to create firm-specific human capital. Due to borrowing restrictions of workers, such firm-specific human capital must be mostly financed by firms as long as the government does not fully step in.<sup>43</sup> However, high EPL then works into the opposite direction because firms have a lower incentive to invest into the firm-specific human capital of their workers. High EPL enables workers to appropriate ex post large part of the quasi rents which are created by investing into

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<sup>40</sup> See Caballero and Hammour (1997).

<sup>41</sup> See Lindbeck and Snower (1988).

<sup>42</sup> See Berthold, Fehn and Thode (2000).

<sup>43</sup> See Acemoglu (1996).

firm-specific human capital thus reducing the incentive of firms to act as financiers in this respect.

Third, EPL makes firms more reluctant to hire workers at given wage costs. Labor market flows in and out of unemployment are unambiguously reduced by EPL.<sup>44</sup> While there is no clear-cut effect on total unemployment from lower labor market flows, the reduced hiring rate due to EPL makes unemployment more persistent and raises long-term unemployment, which is especially problematic not only from an economic but also from a political point of view. Hence, once dismissed it is more difficult for workers in countries with high EPL to obtain a regular job again compared to a laissez-faire country such as the US. EPL therefore increases the segmentation of the labor market into insiders and outsiders.<sup>45</sup>

In addition to these general arguments against EPL, which apply irrespective from economic conditions, the above-described transition to the new economy makes it likely that countries with relatively low EPL fare better nowadays with respect to labor market performance. EPL is especially bad for employment when big structural breaks occur such as is the case with the new economy because firms are then very reluctant to hire new workers while EPL cannot prevent dismissals in firms or sectors which are going down the drain anyway. Furthermore, economic conditions have become more volatile over the last about 15 years due to globalization and the transition to the new economy with shocks occurring more frequently and with shocks also being greater in size. However, such a development toward a less stable economic environment is not innocuous with respect to the effects of EPL on labor market performance. The negative effect of EPL on labor demand is greater in a volatile than in a tranquil economic environment and is especially harmful to firms which are largely financed via debt rather than via equity because labor becomes a quasi-fixed production factor with which firms cannot quickly adjust to changing economic conditions. Thus, quasi-equilibrium unemployment is raised if unions do not exercise sufficient wage restraint in return.<sup>46</sup>

There are two additional arguments why EPL might be especially problematic in the context of the new economy. It can be shown that firms in high-EPL countries are induced to specialize on relatively secure goods at later stages in their product life cycles in order to

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<sup>44</sup> See OECD (1999b).

<sup>45</sup> See Lindbeck and Snower (1988) and Kugler and Saint-Paul (2000).

<sup>46</sup> See Bertola and Ichino (1995) and Fehn (2001).

avoid paying firing costs.<sup>47</sup> New and innovative goods with a high failure risk but which are essential for the transition to the new economy are first developed and produced in low-EPL countries such as the US and only move later on to high-EPL countries, such as Germany, which will then tend to refine their production via process innovations. Furthermore, large-scale creation of new firms has been a hallmark of the new economy in the US. However, newly founded firms often face financial restrictions and a high rate of new firms per period depends on a well-functioning venture capital market in order to circumvent as much as possible such financial restrictions. Venture capitalists in the form of business angels also often help their portfolio firms to survive the especially risky start-up period by counseling and advising them. Empirical studies show, though, that the growth of the venture capital market, which clearly helps a country to be a successful player in the new economy, depends greatly on labor market flexibility, so that countries with a rigid labor market due to high EPL have from this perspective a lower chance of benefiting from a positive new economy effect than countries with low EPL and a more flexible labor market.<sup>48</sup>

Considering though that there are countervailing effects of EPL on labor market performance, the direction and size of the net impact is after all an empirical question. There exist by now numerous cross-country studies concerning the effect of labor market institutions on unemployment.<sup>49</sup> EPL is often found to have an insignificant effect on the unemployment rate, and if the effect is significant, it usually raises the unemployment rate but with a rather small impact coefficient. Most of these studies suffer from three important shortcomings, though. First, the time period which is investigated often only extends up to the early 1990s so that most of the 1990s when the transition to new economy got under way is left out. If the new economy matters, this tends to bias the results in favor of EPL. Second, these empirical studies usually only consider the effect on the standardized unemployment rate and not on employment where the negative effect can be expected to be more pronounced. Third, they either include only institutional variables concerning the labor market or supplement them merely with goods market variables. Capital market variables are as a rule completely left out. This might be an important shortcoming because it is reasonable to assume that a well-functioning capital market, especially concerning venture capital, has become more important for labor market performance with the new economy. If all three of these shortcomings are

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<sup>47</sup> See Saint-Paul (1996).

<sup>48</sup> See Jeng and Wells (2000) and Fehn (2001).

<sup>49</sup> See e.g. Nickell (1997), Blanchard and Wolfers (1999) and Morgan and Mourougane (2000); OECD (1999b) provides an overview of empirical studies.

amended with the time period under consideration extending from 1986 to 1999 and with labor, goods and capital market variables included as explanatory variables, EPL does indeed turn out to have a significant and negative effect on labor market performance across OECD countries, raising the standardized unemployment rate and lowering employment. As expected, the negative effect on employment of EPL is more pronounced than the positive impact on unemployment.<sup>50</sup>

In sum, one can be pretty sure that lowering EPL would help to fight unemployment and to raise employment in the age of the new economy. Conversely, the policy of the current German government with respect to EPL must be regarded as flawed if lowering unemployment is indeed one of the key policy objectives. Extending EPL also to small firms and restricting the possibilities for fixed-term labor contracts does not match with the requirements of the new economy. If outright reductions of EPL are politically not feasible due to resistance by insiders, it should at least be much more clearly stated in the law when dismissals by firms are legal so that labor courts have less discretion in their rulings on disputes between firms and laid-off workers. The current insecure legal situation and the tendency of labor courts to interpret unclear cases in favor of workers does not help to raise hiring rates in Germany. Lower firing costs would also fit well with the above-described desideratum of more decentralized wage bargaining. It would help to prevent locally negotiated wages to be excessively affected by insider-outsider and rent-seeking considerations.

#### **4. Innovative and tailor-made active labor market policies**

It is an important policy question which contribution Active Labor Market Policy (ALMP) can make to fighting persistent unemployment in the age of the new economy. ALMP in combination with institutional reforms of the welfare state must primarily aim at preventing long-term unemployment. The longer one is unemployed the more this person gets out of touch with the real labor market concerning qualification and work routine, and there is a rising risk that this person will never be employed on a regular job again. This assessment holds especially under the conditions of the new economy where qualification requirements of

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<sup>50</sup> See Belke and Fehn (2000); Feld and Santoni (2001) show empirically that EPL also reduced economic growth rates in the EU countries.

firms are rapidly changing and where the continuous ability to apply ever-more sophisticated IT-products in one's job is essential. Hence, a vicious circle of rising (long-term) unemployment and rising taxes and social security contributions to finance this unemployment must be prevented from occurring. Reforms of ALMP and the welfare state must therefore be designed in such a way that they not only help the unemployed and especially the long-term unemployed to find a regular job again but that persons concerned also always have a strong financial incentive to accept regular jobs even if they are only part time or require initially relatively little qualification.

In order to be sustainable, ALMP must pave the way for the unemployed back into regular jobs and not simply hide unemployment. This is in principle possible because ALMP can lower the quasi-equilibrium unemployment rate via a number of channels under the assumption that even laissez-faire labor markets do not work perfectly well and even more so in real-world labor markets, which especially in continental Europe are characterized by numerous rigidities.<sup>51</sup> First, ALMP can improve the efficiency of the matching process by providing information to both sides of the labor market about the other side of the market and via counseling activities. Second, ALMP can serve as a work test device as it is even in welfare states possible and common to cut transfer and insurance payments to those of the unemployed who refuse to participate in ALMP which are offered to them. This is politically much more difficult without such offers even after very long unemployment spells. Third, it can theoretically raise competitive pressure on insiders by keeping effective labor supply high, e.g., if it prevents the unemployed from getting out of touch with the real labor market. Fourth, if it is less attractive to participate in ALMP compared to being unemployed, perhaps because the time advantage and the possibility to work tax free on the black market is lost, then the fall-back position of insiders in wage negotiations falls, thus reducing wage pressure and raising employment. Fifth, ALMP can at least theoretically improve the matching process by qualifying the unemployed according to the needs expressed by firms. This is probably the most important channel in the context of the new economy because the new economy changes and increases the qualifications which firms demand from workers in particular with respect to the aforementioned soft skills. Providing the unemployed with the respective skills via ALMP might therefore constitute a possible route out of mass unemployment as labor supply then matches better with labor demand of firms. However, it is important to keep in mind in

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<sup>51</sup> See Calmfors (1994), Jackman (1994), Katz (1994) and Berthold and Fehn (1997).

this respect that it is not the case that firms simply switch from one set of skill requirements to another, possibly higher but still well-defined set of skill requirements. Rather, firms are today in the new economy very heterogeneous in their expectations and their skill requirements are quickly changing thus demanding great versatility of workers. This reduces immediately the probability that a centralized ALMP which organizes qualification programs off the job can nowadays make a significant positive contribution to equipping adults with the relevant skills and to lowering (long-term) unemployment. It rather suggests that it must be a key objective of ALMP to get the unemployed and especially the long-term unemployed as quickly as possible back into regular working life and to have them continuously acquire the relevant skills on the job.

Due to the increasing importance of ALMP as a policy instrument especially in Germany after reunification, efforts have been stepped up recently to evaluate whether or not ALMP can be judged as successful or not.<sup>52</sup> While there was quite a bit of optimism among economists at the beginning of the 1990s about the efficacy of ALMP in fighting unemployment, the results of these evaluations in Germany and a few years earlier in Sweden, which is the hub of ALMP among OECD countries, can only be called disappointing.<sup>53</sup> This is the case in spite of all the aforementioned theoretically possible positive effects of ALMP on labor market performance. Actual ALMP both in Germany and Sweden largely serves to hide unemployment and helps very little in reintegrating the unemployed and especially the long-term unemployed back into the regular labor market. Actual ALMP has strong wage-raising effects, an expansion of ALMP increases wage pressure by more than an equivalent expansion of regular employment, probably because the government thereby tends to become the “employer of last resort” thus blurring responsibility for employment performance which should rest primarily with unions and employer associations and not with the government. Empirical investigations which use employment growth in the private sector or the sum of official unemployment and people participating in ALMP as target variables, usually find that if ALMP has a significant positive effect at all, it is very small. Providing information to both sides of the labor market and counseling the unemployed appear to be the most efficient components of ALMP. Another useful instrument seems to have been the installation of temp

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<sup>52</sup> See especially Heckman, LaLonde and Smith (1999).

<sup>53</sup> See for Sweden Calmfors (1995), Calmfors and Skedinger (1995), Robinson (1995) and Forslund and Krueger (1997); see for Germany Fitzenberger and Prey (1997), Kraus, Puhani and Steiner (2000), Lechner (1998) and (1999) and Steiner and Hagen (2000); Martin (2000) gives an overview over the effects of ALMP in OECD countries.

agencies which hire workers and lend them to private firms on a temporary basis. A relatively large percentage of the employees working for such temp agencies have thereby found the way back into the regular labor market.<sup>54</sup> In sum, given these empirical results of ALMP at least in the form currently pursued in countries such as Germany and Sweden, it is overall by no means a panacea in fighting unemployment.

These sobering empirical results raise the question about the weaknesses of currently pursued ALMP. Arguing that it is better to finance employment instead of unemployment is from an economic point of view not sufficient for massively expanding expenditures on ALMP as has especially been the case in the „Neue Länder“. ALMP must effectively raise competitive pressure for insiders by outsiders on the labor market. It appears to be one of the key weaknesses of actual ALMP that this objective is not at all achieved and that it often tries to qualify the unemployed off the job, therefore not being successful in qualifying them according to the needs of firms. Substitution and displacement effects of ALMP on regular employment further reduce its efficacy. It is very difficult to design ALMP off the job in such a way that it conveys useful skills to participants without displacing or substituting regular employment. Participants of ALMP in Germany do in addition not only receive their unemployment benefits or welfare assistance payments but are rather paid up to 90% of official wages in regular jobs. As many workers on regular jobs especially in the „Neue Länder“ do not receive these official and centrally negotiated wages, there is in effect close to no difference between the income of participants of ALMP and of many regular workers. Finally, ALMP is as a norm quite a bit more expensive than simply granting benefits to the unemployed so that the wedge between real gross labor costs to firms and real net consumption wages of regular workers is magnified by ALMP. All this inevitably results in rising wage pressure and reduces regular employment.<sup>55</sup>

It must also be taken into account that participants of ALMP often thereby renew their claims on unemployment benefits thus extending de facto actual benefit duration. However, numerous empirical studies have shown that a long benefit duration is very harmful for labor market performance raising in particular the rate of long-term unemployment.<sup>56</sup> The institutional setup is especially counterproductive in Germany where the local municipalities

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<sup>54</sup> See Almus et al. (1998) and Lechner et al. (2000).

<sup>55</sup> See Berthold and Fehn (1997) and Calmfors and Lang (1995).

<sup>56</sup> See e.g. Burda (1997), Scarpetta (1996), Nickell (1997) and Nickell and Layard (1999).

have a strong incentive to place recipients of welfare assistance in some ALMP regardless whether or not this actually increases their chance of being reintegrated into the regular labor market. This is the case because welfare assistance is paid for by local municipalities whereas unemployment benefits and the ensuing unemployment assistance is financed by contributions of firms and workers as well as by the Federal Government. Hence, there is a kind of carousel effect with strong incentives for externalizing burdens instead of trying to find real solutions.

In order to avoid negative side effects of ALMP and to maximize the probability that it actually raises regular employment, it must heed a number of principles. It must concentrate on where it is most efficient, i.e., on providing information and on counseling the unemployed thus raising the efficiency of the matching process. In order to prevent wage pressure on the regular labor market from rising, wages obtained when participating in ALMP should still lie considerably below those wages which are de facto paid for regular employment and ALMP should concentrate on helping disadvantaged groups on the labor market such as the long-term unemployed. Participation in ALMP should not lead to claims on unemployment benefits thus avoiding any carousel effects and there should be strict time limits on participation in ALMP. Those unemployed who refuse to participate in ALMP should not receive insurance and transfer payments anymore. As much as possible, ALMP should help to get the unemployed back into regular firms so that they can acquire the relevant skills on the job. Finally, as qualification requirements differ considerably between firms and regions, ALMP should be organized on the decentralized local level where information about local conditions is best available.

For the German case, the following kind of rough package approach could make sense.<sup>57</sup> The first step for activating the unemployed and for financing work instead of unemployment must be a significant cut in the duration of unemployment benefits, e.g., down to the US duration of six months. After these six months welfare assistance steps in. Unemployment assistance should be abolished. This stick approach is sweetened by a number of carrots, i.e., financial incentives for the unemployed to actively search for jobs. If they find a job, their regular income should no longer lead to an essentially one to one reduction in welfare assistance payments. It would make more sense to only impose an effective tax rate of say

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<sup>57</sup> See Berthold, Fehn and v. Berchem (2001).



50% instead of 100% for a limited period of time and to then slowly increase the cut in welfare assistance payments to 100%. This would abolish the currently existing unemployment trap especially for the less qualified unemployed.

If they have still not found a job after say another six months, the unemployed get in addition monthly vouchers like in the “benefit transfer program”.<sup>58</sup> The value of these vouchers increases with each additional month spent in unemployment with a maximum after about two years in unemployment. The unemployed can offer these vouchers to any firm which is willing to hire them and only the firm can cash in these vouchers at the labor office of the local municipality. Hence, they act as a kind of wage subsidy and should therefore also be granted for a limited time period only and should also be phased out gradually once the unemployed person has obtained a job. Firms should receive more money from the labor office for a given voucher if they can prove that they did not only hire the unemployed but that they trained them and updated their skills. The qualification part of the voucher system is especially important due to the new economy with its rapidly changing skill requirements.

Local municipalities would be in charge of running these systems and should get substantial leeway in deciding the size of welfare benefits in particular of those unemployed who are able to work. Cutting their claims somewhat while leaving those of unemployed persons who are essentially unable to work, e.g., due to disabilities or little children, would further enhance the search activities of those of the unemployed who are able to work and would help to achieve greater wage differentiation and to install a low-wage sector. Local municipalities should also have some room for deciding the details of the financial rewards, e.g., how quickly supplementary welfare assistance and these vouchers are phased out after having obtained a job. Any further activities concerning ALMP like qualification and community work programs should also be organized on the local level so that there is a good chance that the unemployed are really getting qualifications according to local market needs and so that in particular the effect of ALMP as a willingness-to-work-test device is maximized.

However, there should be no illusions. Even the best qualification programs, be they on the job or off the job cannot provide all the unemployed with the kind of encompassing skills which tend to be demanded by firms nowadays. It is therefore essential that a low wage sector

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<sup>58</sup> See Snower (1994) and Orszag and Snower (2000).

is installed so that the number of workers who are currently locked out of the regular labor market is substantially reduced. The above-described package should help in doing so, but of course unions and employer associations must make their contribution by opening up their wage agreements and by granting much greater decision-making power to the firm level.

## **IV. Conclusions**

Only an encompassing set of institutional improvements on labor markets along with a determined reorientation of labor market policy in favor of activation and against alimentionation of the unemployed can help to make continental European labor markets meet successfully the challenges posed by the onset of the new economy. The above-described package should help Germany in particular to abandon its current position as being among the most sclerotic West-European countries thus spurring economic and employment growth. However, complacency and political inertia are very high in Germany making determined institutional reforms, which would hurt large part of the electorate in the short run, not particularly likely. It seems, in fact, that resistance to appropriate supply-side policies on the labor market is so high in Germany that the walls of the labor market fortress will, if at all, only crumble in times of a deep crisis.

However, reforming labor market institutions and labor market policy in the outlined direction is only part of the economic policy package which is actually needed to tap the possible benefits of the new economy. Competitive goods and capital markets, especially a well-developed venture capital market, are also essential components just as well as a tax and social security system which do not stifle but rather spur entrepreneurial incentives.<sup>59</sup> Another key policy area has also just been mentioned briefly so far, this is the education system. It is essential to prepare people for the challenges posed by the new economy when they are young because any repair activities involving adults such as ALMP are bound to exhibit a rather small efficiency. Life-long learning has become more important and can be improved in Germany, but the basic skills, such as reading, writing and versatility to cope with different tasks along with mathematical and communicative skills have to be acquired when people are young. Germans have boasted for a long time that their education system is supposedly one of

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<sup>59</sup> See e.g. Boeri, Nicoletti and Scarpetta (2000), Burda (2000) and Fehn (2001).

the best among OECD countries. However, it is almost uncontroversial by now that there is plenty of room to improve the German university system. More surprisingly, the long-heralded German system of high-school education has also come under fire recently by the results of international tests. Only the apprenticeship system of vocational training still seems to be an asset by international comparison.

Institutional reforms of the education system must therefore be high up on the economic policy agenda for making Germany meet the challenges posed by the new economy. More competition and more decentralized decision making of schools and universities along with at least some form of tuition and an expanded system of scholarships should be integral parts of such a reform package. One of the targets should be to combine an earlier start in working life with an expanded system of life-long learning. It is interesting to note in this respect that the reforms of the German high school system in the 1970s, which favored greater specialization of students, probably went into the wrong direction considering that general skills and not early specialization is called for now by the new economy. The US with a strong emphasis on a broad liberal arts education in good colleges seems to be better prepared for the new economy also from this perspective. Taking furthermore into account what kind of “reforms” have recently been undertaken on the German labor market, a key lesson seems to be that reforms should not be undertaken for their own sake but that they must rather go into the right direction to really constitute an improvement.

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