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Ulrich Walwei\*

# Is Greater Flexibility in the Labour Market the Answer to the Unemployment Crisis?

*In view of high and persistent unemployment in the European industrialised countries there is growing consensus that more flexibility is needed with regard to both the legal and institutional conditions governing the labour market (external flexibility) and the management of human resources within individual firms (internal flexibility). This article examines the interaction between internal and external flexibility with special reference to wages, working time and job security.*

The unemployment crisis has led to increasing support for the view that what the labour market needs is more flexibility. Most recently, at the G7 summit in Lille, the heads of government also called for greater flexibility in employment systems. The consensus is that it is vital for the European industrialised countries to make their economies more adaptable and to increase their innovative capacity. The OECD recently put forward a number of proposals aimed at ensuring that the labour market also takes account of these requirements. The proposals were that a climate more conducive to entrepreneurial initiative should be created, labour costs should be made more elastic, working time schedules should be made more flexible and restrictive rules impeding employment should be reformed.<sup>1</sup>

The European Commission also believes that comprehensive reform of Europe's employment systems is necessary. Although Brussels agrees that flexibility is required in relation to labour costs, working time and employment law, another key object of its recommendations is the question of internal flexibility, i.e. the optimum management of human resources within companies. This includes aspects such as the occupational polyvalence of the workforce, sufficient investment in human capital, performance-related pay incentives and greater control by employees over their own working time.<sup>2</sup> This article will examine the interaction between internal and external flexibility using three examples: wages, working time and job security.

With unemployment as high as it is, the level and structure of labour costs are under the spotlight in the industrialised countries in Europe. The reasons for this are, firstly, that next to the prices of imported goods, wages and non-wage labour costs are regarded as the most important cost factor in macroeconomic terms and, secondly, that new competition has grown up in South East Asia and Eastern Europe where companies are operating on the world markets with much lower labour costs.

International comparisons of labour costs in the manufacturing sector show that year after year western Germany has had the highest costs per man-hour.<sup>3</sup> The reason why western Germany heads the table is that it has the highest absolute level of non-wage labour costs; for example, pension, health and unemployment insurance are virtually exclusively financed by earnings-related employee and employer contributions.

Yet the relationship between wages and employment is an extremely complex one. Liberal theories which attribute unemployment principally to wage levels put forward a relatively simple interpretation. According to this point of view employment can only be increased or unemployment reduced if real wages fall. For full employment to be achieved wage levels would therefore have to be determined as freely as possible in the marketplace. However, if the deter-

<sup>1</sup> Cf. OECD: The OECD Jobs Study, Evidence and Explanations, Paris 1994.

<sup>2</sup> Cf. inter alia European Commission: Growth, Competitiveness, Employment (White Paper), Brussels & Luxembourg 1993.

<sup>3</sup> Cf. e.g. Christoph Schröder: Industrielle Arbeitskosten im internationalen Vergleich 1970-1994 in: iw-trends, No. 2/1994.

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mination of wage levels is subject to restrictions (e.g. the fixing of a minimum wage by government or collective agreement) these are regarded as obstacles to job-creation. Accordingly, the main sufferers of an absence of "outside" competition are the problem groups in the labour market (this is termed "minimum-wage unemployment"). Excessive real wages could also contribute to a low return on investment and as a result to a shortage of job-creating investment (known as "capital-shortage unemployment").

In spite of the apparent plausibility of the liberal approach and its hypotheses there are reasons for doubting its general validity. More recent labour market theories (e.g. search, transaction, contract and efficiency-wage theories) are concerned with economic reasons for wage inelasticity, especially in a downward direction. The arguments can be summarised as follows. In certain circumstances wages which exceed the real "market-clearing level" may even prove to be advantageous to the employer. By offering attractive wages (s)he is able to select suitable candidates from a larger and superior pool of labour and can also minimise staff turnover. Apart from that, in return for higher wages the employer can expect a more positive attitude to work from his/her employees. Empirical research into the labour market has also cast doubt on ill-considered solutions aimed at across-the-board wage cuts. Correlations of employment and wage trends do not fully confirm the inverse relationship which is often assumed. Rising employment can go hand-in-hand with rising real wages; fluctuations in employment are consistent with relatively inelastic wages. This shows that wages should not only be regarded as affecting cost, but also demand.

From the employment-policy viewpoint, the main priority in many European industrialised countries needs to be given to measures aimed at reducing earnings-related non-wage labour costs. If creating more jobs and, in particular, combating the structuralisation of unemployment are to be the key objectives, both an overall reduction in these costs which make the factor labour more expensive and also a specific cut in these charges for the low-paid would have a job-creating impact. Rightly or wrongly, employers expect below-average productivity from

the hard core of the long-term unemployed and from others on the labour market who are disadvantaged. More jobs in the lower-productivity sector would therefore benefit these groups particularly. If cuts in fiscal deductions (e.g. income tax and social insurance) were to be addressed to the lower-paid in particular, lower gross wages should not result in a proportionate loss of net income. Indirect taxation would be the main channel available to compensate for the loss of tax revenue.<sup>4</sup> Economic models developed by the European Commission show a positive outcome for employment if energy consumption is subjected to heavier taxation and non-wage labour costs are reduced at the same time.<sup>5</sup>

A further important aspect of "wage flexibility" is one of variability and differentials in income from employment. The erosion over time of differentials between wage structures based on branch of industry, region and qualification is often criticised for having contributed to the structural rise in unemployment. However, this levelling of wages is not always evident in empirical findings.<sup>6</sup> In this respect the argument as to whether existing wage structures ought not to be made more flexible, e.g. through greater decentralisation of wage negotiations or "leeway clauses" (Öffnungsklauseln) is much more worthy of discussion.

Greater flexibility in wage structures would thus be useful because it would permit a finer adjustment of labour costs when companies are experiencing cyclical and/or structural economic difficulties. However, one drawback of the wage flexibility which has been advocated could be that in an economic boom the upward adjustment of wages would also be more rapid and smoother. At any event, greater elasticity of wage-structure adjustment requires a social consensus. For example, a company incurring losses could suspend pay increases temporarily on condition that these pay increases could be made up when it starts to break even. A further possibility would be to build more success-related elements (e.g. supplementary bonuses over and above collective agreements) into employees' wage.

Another key aspect of wage flexibility is the size of the wage differential. The advantages of greater

<sup>4</sup> Projections by the Institut für Arbeitsmarkt- und Berufsforschung indicate that employment would increase if unemployment insurance were to be funded out of higher value-added tax or mineral oil tax (cf. details in A. Barth: Finanzierung der Arbeitsmarktpolitik, in: IAB Werkstattbericht, No. 8/1994).

<sup>5</sup> Cf. European Commission, op. cit.

<sup>6</sup> Cf. W. Franz: Chancen und Risiken einer Flexibilisierung des Arbeitsrechts aus ökonomischer Sicht, a discussion paper in "International labour market research" (Forschungsschwerpunkt "Internationale Arbeitsmarktforschung"), University of Constance, No. 10/1993.

variation in pay (e.g. following the American model) would be that it would generate greater incentives and that it would make it easier for unemployed "outsiders" to enter the labour market. A major disadvantage would be that it is very likely that jobs could be created which only offer income close to or even below the poverty line (the phenomenon of the "working poor"). One compromise would be to include partial "leeway clauses" in collective-bargaining agreements. In order to make it easier for the long-term unemployed to enter the labour market the unions and management could agree "fresh-starter rates" on a wider scale. Once people previously unemployed had successfully completed an induction period, at least the normal collectively negotiated wage would have to be paid.

## Flexibility of Working Time

There are two aspects to flexibility of working time, one relating to the pattern of hours worked in a business and the other to the length of an individual's working time. More intensive use of productive capacity (e.g. by lengthening machine running times or extending customer-service hours) is the economic motive for measures to create flexible working time. The benefit to companies is that the unit cost of capital required to uphold a given level of capacity falls. A further advantage is that it makes it easier to adjust labour input. Commercial reality naturally involves fluctuations in production and market demand. Using more flexible working time (e.g. by applying annual-working-time models), longer hours can be worked when demand is high and shorter hours when the economy is depressed. In this respect flexible working-time models also help to lower labour costs because they may obviate the need for overtime and associated supplementary pay, either in whole or in part.

More flexible working time would therefore reduce a company's costs in two ways (by reducing unit capital costs and labour costs). The positive supply-side impact for companies could mean that the prices of goods and services would fall. Lower product prices would in turn create additional private and public demand which would have a positive effect on the national product and, therefore, on employment.

However, the combination of flexible working time and a reduction in working time appears to offer the greatest potential in terms of employment policy. There are indications that working-time flexibility also creates significant potential for measures to shorten

working time overall. Such potential is available in shift models to determine weekly working patterns (e.g. four shifts of nine hours instead of five shifts of eight hours), in the use of annual working-time models to reduce or even eliminate overtime, and in the extension of plant operating times by creating new part-time jobs. In general, the effects of a shortening of individual working time on employment and unemployment would be greater,

- ☐ the larger the reduction in working time (e.g. where there is job-sharing);
- ☐ the smaller the resulting rise in unit labour costs (e.g. where part-time employment is increased or weekly working time is reduced for proportionately less pay);
- ☐ the smaller the resulting effect on productivity (e.g. due to intensified work processes or rationalisation investment);
- ☐ the more the qualifications of the new employees meet the company's requirements (e.g. also supported by training measures);
- ☐ the less the reduction in working time increases the supply of labour (the "hidden reserve" tends to be tapped particularly when there are more half-day jobs).

One policy option which has been right at the top of the charts in the European discussion on working time for quite a while is the promotion of part-time work.<sup>7</sup> Expansion in this area, so it is argued, would create employment for a greater number of people, and the unemployed would also ultimately benefit from the increased employment opportunities. The Netherlands is often cited as an example, as this is the country with the highest proportion of part-time employment in the Western world. In the 1980s a large part of what by European standards was a substantial increase in employment in the Netherlands was due to a sudden surge in part-time employment. However, the apparently inexorable growth in this form of employment is a reason not only for optimism, but also concern.

Increased part-time employment may firstly be a reflection of a change in employment patterns. Part-timers can more easily combine their work with other activities such as family life, education, voluntary work

<sup>7</sup> On the following, cf. Ulrich Walwei and Heinz Werner: Weniger Arbeitslosigkeit durch mehr Teilzeitarbeit?, in: Wirtschaftsdienst, No. 3/1996, pp.131-138.

and hobbies. It can also be regarded as a transitional phase between two stages in a working person's life. It makes it easier for job seekers and those returning to work to enter the labour market. Part-time employment also enables a gradual transition to be made into retirement at the end of a person's career. However, more part-time employment can also be a sign of a lack of alternatives, in particular a shortage of full-time jobs.

Growth in part-time employment may also reflect a change in employers' policies towards human resources. Part-time work enables manpower to be adjusted more flexibly to production requirements or, in the case of service companies, to those of the customer. The flexible employment of part-time workers can also reduce the need for expensive overtime. Furthermore the use of part-time employment relationships also enables companies to pursue other objectives within a human resources policy. For example, by granting "part-time parental leave" companies can secure the services of skilled staff on a long-term basis. A temporary increase in part-time employment may also enable companies to cope with periods of crisis due to drops in orders. Finally there is constant reference to the higher productivity achieved by part-time relative to full-time staff. The beneficial effects of part-time employment on productivity are attributed in particular to the higher

incidence of fatigue and sick-leave among full-time employees. Equally there are reasons why companies do not employ part-time workers or do so only to a small extent, e.g. the difficulties of splitting jobs and the higher cost of coordinating and managing a larger number of employees.

The macroeconomic aspects of promoting part-time work are also controversial. When there is a shortage of labour, part-time employment is regarded as one way of increasing its supply (e.g. by employing returning parents or pensioners). In a recession job-sharing can be used to protect jobs and prevent unemployment. Growth in part-time employment may, however, also be accompanied by adverse side-effects. If there is a shortage of full-time jobs "part-time unemployment" may result. This may lead to phenomena such as people holding second or even third jobs. "Enforced" part-time working may also lead to increased activity in the black economy because of the greater amount of free time associated with it.

Initiatives to promote part-time employment require a great deal of staying power because a change in the behaviour of those involved plays a key role in the dynamics of part-time working.<sup>8</sup> The problem which always accompanies the distribution of work among a

<sup>8</sup> For detail, see *ibid.*

Club von Florenz (Hrsg.)

## Europa: Der unmögliche Status quo

Vorwort von Jacques Delors

The Club of Florence – a discussion forum of well known Europeanists headed by Max Kohnstamm – presents its proposals for the further direction of European integration. Central to their thesis is that the EU has to adopt to Europe's transformation without losing its spirit of integration. In a further enlarged Europe efficiency and legitimacy are of crucial importance. And the Club of Florence proposes – just in time for Maastricht II – a number of measures how this could be achieved. One thing, however, remains clear to the authors: the status quo is not an option to achieve these goals. If the EU does not find the courage to carry out the necessary reforms its stability will inevitably suffer.

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greater number of people, that of matching the skills demanded and supplied, indicates that growth in part-time employment will be relatively slow. Even if jobs are commercially divisible, the skills of the two or even more job-sharers must first match.

The promotion of part-time work cannot be regarded as a panacea for achieving a sustainable reduction in unemployment, and not only because of what is anticipated to be its rather slow growth. An expansion of part-time employment would also always, as shown by employers' motives to make use of it, imply higher productivity per employee. If the newly created part-time employment relationships only differ slightly from full-time employment relationships in terms of the average working week, as many employees wish to be the case, then taking into account the productivity effect, the macroeconomic employment effect (and hence the fall in unemployment) is likely to be rather slight. If, on the other hand, the additional part-time employment relationships created differ from full-time work to a greater extent, then this would indeed result in increased employment but, as shown by the example of the Netherlands, the "part-time world champion", only in part through a reduction in unemployment, and rather more by tapping into the "hidden reserve".

This is not in any way intended to deny the value of initiatives and campaigns to promote part-time employment, but their benefit lies primarily in protecting existing jobs, in giving employees greater freedom of choice, in increasing the productivity of the overall economy and of individual economic units and also in reducing the "hidden reserve", which is also desirable in itself for social-policy reasons. To a certain extent an increased supply of part-time jobs may therefore counteract the development of a rift in society between people with work and those without.

## More Jobs via Less Job Security?

In principle legal protection is not necessarily a prerequisite for job security. It is significant that in spite of a lack of contractual protection employees (e.g. of certain small businesses) are able to enjoy a high degree of real job security. Equally, legal protection from dismissal ought not to be treated as tantamount to absolute job security. Protection from dismissal should only prevent arbitrary firings and should be based on sound economic principles. For this reason employers are required to justify dismissals on objective grounds and to adhere to certain procedures (e.g. notice periods).<sup>9</sup>

Employment relationships are composed of a whole series of elements, e.g. remuneration, working time and job security. However, all the elements do not have to be and cannot be flexible at the same time. Flexibility in one element can compensate for rigidity elsewhere. For example, a high degree of job security may, at least in part, be compensated for by increased scope for flexible working time (including overtime and short-time working). In this respect totally rigid employment relationships would be detrimental. Furthermore certain forms of flexibility are only possible within a stable framework. Protection from dismissal does limit "numerical" flexibility in the deployment of personnel but, via an undefined prospect of future continuation, creates the framework for labour to be able to react to new challenges in a way which is "functionally flexible" (e.g. in relation to employees' willingness to move within a company or to accept technical progress) and for productive investment to be made in human capital.

If, however, protection against dismissal is too extensive it can be a counter-productive arrangement in that a highly beneficial provision for those involved has an adverse effect on third parties. High levels of job security and low turnover in a situation of general under-employment can make it difficult for the unemployed to integrate into the labour market. The right to a high degree of employment protection once in a job (e.g. in the case of those who qualify for special protection against dismissal, such as severely disabled people in Germany) may contribute to an increase in the risk of people in this category remaining unemployed. Finally protection from dismissal may also fail to achieve its objectives if there are ways of avoiding it. Too extensive a protection would give companies an incentive to choose principally those forms of employment which do not have built-in protection from dismissal or have it only to a small extent (e.g. limited-term employment, the use of temporary agency staff or contracting out to the self-employed).

However, the existence of such atypical forms of employment is still the source of intense controversy.<sup>10</sup> The fact that forms of employment which deviate from "normal employment relationships" are reasonably

<sup>9</sup> On the following, cf. Christoph Büchtemann and Ulrich Walwei: *Employment Dismissal Protection* (forthcoming, Handbook of Labour Market Policy Evaluation).

<sup>10</sup> Cf. on this subject Ulrich Walwei: *Atypische Beschäftigungsformen. Kongruenz und Divergenz der Interessen*, in: Bernd Keller and Hartmut Seifert (eds.): *Atypische Beschäftigung. Verboten oder gestalten?*, Cologne 1995, p. 9 ff.

widespread has added further fuel to the debate. When empirical results prove that more and more women are employed in part-time work, that many new jobs are for a limited term or that companies are increasingly "laying off" employment risks by engaging temporary agency staff or contracting out to the self-employed, this gives rise to hopes or fears, depending on one's point of view.

Most previous discussions were dominated by one-sided arguments. In these discussions the commercial advantages of greater use of atypical forms of employment made possible by deregulation were compared with the disadvantages for employees. One side argued that the lack of flexibility and the fact that this would result in even higher costs would have a negative effect on employers' willingness to take on new staff. The other side argued that it was employees who would have to pay the price for more flexibility because pay and working conditions as well as social protection would deteriorate as a result of atypical forms of employment.

However, on a closer look at the changes in gainful employment which are taking place throughout the world, these discussions lack subtlety. Most companies are still not fully utilising the available potential for staff flexibility. Companies are using the various forms of atypical employment primarily to reduce the costs of structural adjustment with the aid of greater personnel flexibility. Alternatively or in addition to this, temporary forms of employment in particular (agency staff, limited-term contracts) are important in that they allow employers to take people on an uncommitted trial basis, and hence to be able to select better personnel.

The interests of employees are also anything but homogeneous and are not predetermined to always prefer one particular form of employment. As values in general continue to change, motives increasingly arise on employees' part which would suggest quite a considerable supply of labour for atypical forms of employment. So even for employees as an overall group, blanket attempts to hold back the growth of atypical forms of employment are hardly now likely to constitute an optimum approach. At the same time a distinction should be drawn from the employee's perspective between atypical employment as the main or as a supplementary source of income. Atypical employment only seems to be of interest as the main source of income if it can act as a springboard to a subsequent career or as a way out of recent or long-term unemployment. Moreover, the main types of people for whom the various forms of

atypical employment can be attractive are those interested in a discontinuous or less extensive earning occupation, possibly only as a sideline.

As atypical employment would probably not be the first choice of either employers or employees as a rule, both congruence and divergence of interests between the parties involved are conceivable situations. To what extent atypical forms of employment are ultimately created in the case of diverging interests depends essentially on the willingness of both parties to make concessions. The evaluation of atypical forms of employment therefore is and will continue to be ambivalent. Atypical employment may (but does not have to) be precarious in nature. In view of this, prohibition would be economically senseless and would fail to heed today's realities.

The law applying to atypical employment therefore has a multi-faceted role to play in shaping employment patterns at the current time. Firstly the institutional framework should promote or at least not hinder the creation of the hoped-for voluntary agreements to establish atypical forms of employment. An important prerequisite is that those employed atypically should as far as possible be treated on an equivalent basis to those employed "normally". The principle is not therefore one of exclusion, but integration. The abolition of widespread existing discrimination against the employees concerned, particularly with forms of employment which offer future potential and which can be integrated into the existing employment system relatively easily (such as part-time or temporary employment), would contribute to the "normalisation" of the "atypical". Voluntary agreements would also be facilitated by regulations which are practical and, therefore, easy to apply (fulfilling the principle of legal clarity). Voluntary agreements would also benefit if, where possible and necessary, the law were to allow flexible scope for collective and individual agreements (particularly in relation to part-time employment). A second important task of socially protective legislation consists in always seeking to avoid agreements which are partly entered into on an involuntary basis (because of a lack of suitable alternatives), or at least to confine them to a few worthwhile exceptional cases.

Thirdly, atypical forms of employment could also be put to good use with the objective of reintegrating people who are difficult to place, in particular the long-term unemployed. A number of variants of atypical employment can offer ways of helping the

longer-term unemployed not to lose, or to restore, contact with the primary labour market. First of all there is what is referred to as the "Start Model", which would follow the example set in the Netherlands, and could allow people who are difficult to place to be hired out temporarily to companies through a non-profit-making employee agency, on a trial basis. In addition, especially when it comes to filling more part-time posts with people previously unemployed, consideration must be given to raising the additional earnings permitted for those receiving social benefits, thus reducing their dependence on such benefits. Finally specific assistance to encourage self-employment (e.g. in the form of advice and support services) also offers a possible route out of unemployment. However, the potential number of unemployed who could be candidates for such support should not be overestimated. Studies which have been carried out show that only a small number (under 5%) of the unemployed would be eligible.<sup>11</sup>

In contrast to the increasingly difficult jump from long-term unemployment to normal employment relationships, the hurdles on the way to a sustained reintegration into the labour market would be gradually lowered by these proposals. How ought the continuing advance of atypical forms of employment, evidently necessary for the functioning of modern labour markets, to be judged in policy terms?<sup>12</sup> An analysis of the potential employment effects of greater use of limited-term contracts and increased employment of temporary staff does not show any dramatic results. Greater use of temporary forms of employment would, it is true, partially counteract the cautious recruitment stances now adopted by companies during economic upturns. Conversely it would make it easier to terminate employment (especially when temporary contracts expire) during economic downturns. The net result would be that average employment would not be much higher over time. Only turnover of labour would be expected to rise, which would at least improve the chances of integrating "outsiders", i.e. the unemployed and others who are currently not in the labour market.

## Flexibility of Employment at Any Price?

In principle flexibility of employment is necessary for companies and labour to be able to adapt to new internal and external challenges, so that existing employment relationships can be reshaped or

dissolved and new ones established. This article has shown that flexibility occurs in various forms in different elements of the employment relationship and can be divided between the parties in various ways.

However, all elements within the employment relationship do not have to be flexible at the same time. The possibility of flexibility in one element or on one side of the market may compensate for flexibility deficiencies elsewhere. It is also the case, particularly in international competition, that the more rigid the regulations are or ought to be for social-policy reasons in one element of the employment relationship, the greater the flexibility of adjustment required in other elements to aid the proper functioning of the labour market. For example, high employment termination costs resulting from legal requirements can be offset either in total or at least in part if there is greater scope for flexibility in relation to wages or working time.

Furthermore all elements of the employment relationship cannot be flexible at the same time. Indeed, flexibility in certain elements even necessitates stability in other areas. For example, protection from dismissal has the effect of stabilising the employment relationship. An employment relationship which can be terminated in principle but is not finite in time therefore becomes the rule. Protection from dismissal creates the conditions necessary for labour to react to new challenges in a "functionally" flexible way.

What is needed is not maximum labour-market flexibility across the board, but the well-considered modernisation of the institutions and regulations affecting the labour market. However, when reforming the employment system there is always a trade-off involved, and the economic and social consequences need to be meticulously evaluated. The measures which would seem to be most urgent from the employment-policy perspective while also acceptable in socio-political terms are greater elasticity of wages, approved by management and the unions, as small as possible a burden on labour costs imposed by earnings-related social contributions, a greater link between flexibility of working time and reduction in individual working time, and more effective integration of what are referred to as "atypical forms of employment" into the employment system as a stepping stone to "normal employment relationships".

<sup>11</sup> Cf. OECD, op. cit.

<sup>12</sup> Cf. the potential employment effects of promoting part-time employment cited in the section "Flexibility of Working Time" above.