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National institutional systems in global competition and the inertia of German labour market institutions

Wolfgang Ochel*

Introduction

In the German Federal Republic a system of labour market institutions has been created that has strongly regulated the labour market. Powerful collective bargaining parties determine wage developments via area-wide collective wage agreements. By means of generally binding declarations, the contents of collective wage agreements are extended to non-union members. 70–80 percent of wages and salaries are thus subject to collective wage agreements. Protection against dismissal is comparably strong. Until recently temporary jobs and temporary agency work were thoroughly regulated. The systems of social protection ensure that wide segments of the population are protected against diverse risks at a high level. They form an important component of redistribution policies.

The system of labour market institutions has contributed to correcting failures of the labour market and producing more social justice than the market provides. On the other hand, it has led to losses in economic efficiency and increased unemployment in Germany. It is made responsible for problems Germany has as an investment location. The negative effects have become especially perceptible in recent years. This has led to demands for thorough reform of labour market institutions. Such reforms have been largely delayed, even though Germany is exposed to intensive global competition that also affects institutional regulations.

Why has global competition (also referred to as systems competition) not led to fundamental labour market reforms? Have the forces of systems competition been too weak? Or has the reform willingness been weakened by effective counter forces?

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Reasons for the introduction of labour market institutions

Labour market institutions are created for different reasons. On the one hand they are meant to reduce inefficiencies as a result of market failure. Market failure can result from monopoly power, external effects as well as asymmetric information. If monopoly power is on the side of the employees, efficiency gains can be achieved, depending on circumstances, by means of opt-out clauses in the collective wage agreements or a modification of the so-called principle of advantage. In the case of external effects false incentives can be avoided by an internalisation of regulations. When, for example, enterprises neglect education and further training because skilled workers can be hired from other enterprises, this can be countered by levying a training tax on companies that do not train for the benefit of those that do. If a company does not offer maternity leave because of the danger of adverse selection, the legislator can encounter this by making it obligatory for all enterprises to offer maternity leave (Blau and Kahn 1999, p. 1405).

In addition to regulations that pursue an increase in efficiency, institutions are also created to correct the distribution results of the market and to increase earnings stability. The introduction of central wage bargaining systems is frequently carried out with the aim of reducing the wage gap. Social security systems also aim at guaranteeing secure earnings when serious social difficulties occur.

Finally, institutional arrangements can be the result of the influence of pressure groups. The protection against dismissal can be seen as an example of interest-oriented regulations that those who have jobs (insiders) achieve at the expense of the unemployed (outsiders). The protection against dismissal increases job security for the insiders and enables them to negotiate higher wages without jeopardising their jobs.

For improved efficiency, income redistribution and under the influence of powerful pressure groups, a highly developed system of labour market regulations has been created in Germany. Its most important components are freedom of collective bargaining with industry-wide wage agreements, protection against dismissal and a generous system of social protection.

The German labour market institutions: Maintaining an internationally high level

The German collective bargaining system has been very stable. Since the 1960s, the collective bargaining coverage has for a long time been about 90 percent. This exceeds that of most OECD countries, and in some countries (Great Britain, USA and New Zealand) this coverage has declined considerably. Wage negotiations are strongly co-ordinated in Germany (Ochel 2003). In this point as well, no change can be seen since the 1960s, in contrast to other countries (Nickell et al. 2001, pp. 28–30). West German labour costs per hour in manufacturing have held top rankings in an international comparison since the early 1980s. Important rivals such as France or Great Britain have labour costs that are under Germany's by more than a quarter (Schröder 2002).

The protection against dismissal in Germany is strong in an international comparison. The OECD carried out the most comprehensive evaluation of the strictness of employment protection for their member states, according to which Germany ranked 14 among 19 countries at the end of the 1980s (rankings increase with the strictness of protection). Employees in the Anglo-Saxon countries enjoyed the lowest protection against dismissal; the highest protection was in Southern European countries. During the 1990s it became somewhat easier to dismiss workers in Germany, but still Germany was ranked 13 among 19 countries for this decade (OECD 1999, p. 66).

The social security systems have been expanded in Germany on a relatively large scale. They burden employee earnings with high social insurance contributions. In the case of a single employee, social insurance contributions as a percentage of average gross wages increased to 30.8 percent in 2002 from 24.8 percent in 1979 (OECD 2003, pp. 396ff.). The marginal tax rate on additional income of the average German employee was 66 percent in 2001. This placed Germany in the top group of OECD countries. Even welfare states such as Sweden or the Netherlands impose a lower burden on the average employee (Sinn 2003a, p. 18).[1]

Unemployment assistance and social welfare are granted without time limits in Germany. They provide the recipient with an above-average net income in an international comparison. The net replacement rates of a married couple with two children with reference to average earnings was 65 percent in Germany in 1999 (OECD 2002, pp. 15, 23–24 & 36). The tax financed unemployment assistance and social welfare are important instruments of redistribution in Germany.

Labour market institutions in systems competition

In an open economy, labour market institutions are exposed to systems competition. Governments must bear in mind that many actors have the choice of cross-border movement. Internationally mobile enterprises and production factors can, with their locational decisions, show how they rate the institutional attractiveness of national sites. To some extent only the announcement of locational changes or the mere reference to more beneficial foreign institutions suffices to influence their own governments.

The functioning of systems competition differs according to whether the labour market institutions influence the position of enterprises in international competition or whether they contain a redistribution between rich and poor within a country. If the locational conditions of a country deteriorate relative to other countries, site-independent enterprises may change sites. Such locational shifts can be triggered by high wages resulting from a high unionisation of employees, the dominance of area-wide collective wage agreements and the extension of wage agreements to non-unionised workers. They can also be the result of strong protection against dismissal that limits the reversibility of hiring decisions and thus reduces, according to new investment theory, the attractiveness of a location for risky investment projects (Pull 2001). If such reactions of the mobile factors occur to a large extent, this can encourage governments to take this into account and to change their institutional regulations.

With regard to redistribution, systems competition works in another way. Take the example of a country with a generous social insurance system. In an open economy, with the right to change the country of residence, people with good risks tend to leave this state, whereas people with bad risks are attracted to it. To reduce factor migration, net con-

[1] The marginal tax rate on additional income consists of the social insurance contributions of the employee and the employer, income taxes of the employee and the value-added tax.

tributors are placed in a better position and net recipients in a worse position by means of benefit cuts. As other countries react the same way, the social insurance systems are eroded. A desirable re-distribution policy from the national point of view, which is the reason for establishing a social insurance system, suffers from this competition (Sinn 2003b).

Such a race to the bottom can occur both with regard to national redistribution systems and also with the labour market institutions related to location competition. An erosion of labour market institutions has not yet occurred in Germany. The question is: "Why not?".

Low intensity of systems competition

The limited effect of systems competition on German labour market institutions might be a result of its low intensity, for which there are different causes.

The agents of production have differing roles in systems competition. They are not all mobile to the same extent. Cross-border portfolio investments and loans are subject to few constraints today. Direct investment to and from Germany has increased strongly, particularly since the mid-1980s. On the other hand, labour mobility – with the exception of the small group of management elite – is quite restricted. Despite a virtually unlimited freedom of movement in the European Union, no appreciable migration of workers has occurred. Movement is restricted by transaction and mobility costs. Also the immigration of non-EU aliens is relatively small. It is administratively restricted. The factor labour has thus made only a small contribution to systems competition.

But also capital has only made a limited contribution to institutional competition despite its high mobility. This is because site decisions are not only based on labour market institutions but depend on many other determinants. For example, proximity to the consumer is the determining investment motive for sales-oriented direct investment. Procurement-oriented direct investment, on the other hand, is motivated by the presence of complementary factors of production, the existence of supplier industries, the strength of the domestic competition, the government's economic policy, etc. (Porter 1990). The migration of capital, as a rule, does not take place selectively with regard to individual institutional regulations (for example, a relatively strong protection against dismissal), but with regard to a whole complex of institutional regulations, tax laws as well as other determinants. Labour market institutions play only a subordinate role in a company's site decisions. In addition, migration of capital presupposes that the migrating enterprises have (company-related) competitive advantages that enable them to displace foreign enterprises in their own countries.[2]

Systems competition – political competition

For systems competition to have its effect, the reactions of the mobile factors of production must be relevant for politicians who shape national institutional systems. Politicians also compete, and their utmost goal is re-election. This means that they must take the interests of all voters into consideration and not only those of the mobile factors. The extent to which the interests of the mobile factors of production are respected depends on a number of factors.

The influence of systems competition is higher in a small country with great external economic ties than in a large country. The same applies to an economy in which tradable goods and locationally unbounded firms have a comparably high share in economic output. The share of employees and thus the voters that are exposed to international institutional competition is correspondingly high.

In addition to these objective factors, considering the reactions of the mobile factors of production depends on the ability of the government to identify those institutions in the country that have led to business relocations. This presupposes that the politicians who are exposed to diverse factors in their decision-making are aware of the needs of mobile enterprises and workers. Their interests and the interests of the indirectly affected immobile factors of production must be organised in order to underscore the necessity of reform in the identified institutional areas. The interests are especially regarded when the government is threatened by sanctions in political competition (Streit and Kiwit 1999).

[2] If this is not the case, they are exposed to the import competition from foreign enterprises (unless the domestic institutions that hinder competitiveness are reformed in time; Dunning 1981).

Such sanctions presuppose that a majority of the voters approve of the reform of labour market institutions, i.e., that they favour a decentralisation of collective bargaining, a weakening of the protection against dismissal and/or a reform of the social insurance systems. But it is questionable whether this approval can be found. Empirical studies have shown that as an economy becomes more open (and with it a potentially greater influence of systems competition on political competition) the security interests of the population increase (Rodrik 1997; Agell 1999). The state is expected to take safeguarding measures to counter the heightened insecurity as a result of globalisation.

Such a voter attitude can be influenced, however, by pointing out the negative economic results of a refusal to reform. Surprisingly, social-democratic governments are better at this than conservative governments, since people tend to believe that they are lowering social benefits out of objective necessity than for ideological motives (Cukierman and Tommasi 1998). This might partially explain the reform backlog that occurred during the Kohl era.

Path dependency and institutional inflexibility

With systems competition that has accompanied globalisation, the pressure has increased to reform the systems of institutional rules with a view to the reactions of the mobile factors of production. But to what extent are national institutional systems changeable? According to the thesis of the path dependency of institutional development, path deviations lead to disruptions of institutional compatibility and are accompanied by considerable costs. The result is a broad-scale institutional inflexibility.

Positive-feedback effects are responsible for the path inflexibility of institutional development. Following David (1994), Ackermann (2001) distinguishes three causes of positive feedback with respect to institutions. They refer to levels at which individuals interact with each other, to the regulation level that structures these interactions and to how the interaction and regulations levels affect each other. On the interaction level co-ordination effects arise from the advantages of the compatibility of standardised behaviour. These can lead to stable regulations. On the regulation level, complementary effects can arise if the interdependent relationships between institutions are complementary, that is, if compliance with a regulation becomes more attractive through the interdependence with other regulations. Finally, positive-feedback effects from the interaction between the level of social regulations and that of individual behaviour result from the fact that, by means of social communication in a society, the mental models of individuals in the society converge.

According to the concept of path dependency, the feedback effects result in the path of the institutional development strongly limiting the scope for institutional change. For this reason suboptimal institutions are also preserved. A deviation from the path of institutional development does not occur until the actors assess their efficiency losses as higher than the costs for creating new, efficient institutions (North 1992).

A more detailed explanation for the effectiveness of feedback effects is provided by the "theory of comparative institutional advantages", which looks at the labour market institutions that are relevant to competitiveness. According to this theory, a specialisation of countries with regard to specific products is linked with a specialisation in particular institutional structures. The United States, for example, with its deregulated labour markets and dynamic venture capital markets would provide advantages to those businesses that emphasise "radical innovations" (development of completely new products, implementation of new production methods). In order to implement such innovations, they must be able to employ and dismiss workers quickly, to start up companies easily, etc. Under such general conditions, firms thrive particularly well in the fields of biotechnology, software development, microelectronics, entertainment, etc. In Germany, on the other hand, the theory points out that a system of industrial law has developed providing job security, in-company training, worker participation possibilities, etc. In addition, the German system of corporate governance offers businesses a long-term planning horizon. This and other elements favour incremental innovations (continuous, small improvements of products and processes). Such innovations provide competitive advantages in the production of machines, vehicles, consumer durable goods, etc. (Hall and Soskice 2001). A reform of the labour market institutions is not necessary as long as they allow Germany to specialise on value-added intensive production. On the other hand, the feedback effects also prevent the necessary structural adapta-

tion processes and lead to a conflict between the forces of the status quo and the reactions of the mobile factors of production.

The politics of institutional transfers

In addition to the spontaneous (power-free) institutional development processes that the concept of the path dependency is based on, government power, constraints on political decision-making processes and the influence of pressure groups can be the cause of institutional inflexibility. They can also hinder an international institution transfer initiated by systems competition. Power and interests play a role in the perception and selection of advantageous institutional arrangements and in convincing socially relevant groups of the benefits of these institutions. They are of even greater importance with regard to decisions on the actual introduction and application of the regulations. Political decision-making processes are determined by the monopoly power of the state to determine the design and the sequence of the reform steps as well as by the necessity to attain voter approval for the reforms. If the potential results of the institutional reforms are highly insecure, a revision of the reforms can be very costly, and if many voters feel they are losers of the reforms, their resistance is likely (Roland 2002). If the losers are members of powerful pressure groups, the reforms will be prevented.

Resistances to the adoption of foreign labour market regulations in the wake of systems competition can have different causes:

- The number of losers is greater than the number of winners. For example, with a liberalisation of the dismissal protection laws, the risk of job loss can increase for many insiders, and the chance to find jobs may increase only for relatively few unemployed persons.
- Although the number of losers resulting from a labour market reform is small, the great number of winners consists of heterogeneous groups that pursue different interests apart from the labour market reform and therefore cannot agree on a common reform strategy. In this case the resistance of the losers could be successful.
- Uncertainty regarding the effects of reform is widespread. Many (risk-averse) people affected by the reform cannot foresee whether they will be among the losers or not, and thus favour a retention of the quo status.
- If the reform is associated with efficiency increases, the losers could be made into winners by way of compensation payments. However, the losers fear that the compensation payments may not be high enough or may be cancelled in future and therefore refuse to approve the reform (Dewatripont and Roland 1995; Saint-Paul 2000).

Outlook for a reform of labour market institutions

Several factors have been mentioned to explain the inertia of German labour market institutions with regard to the forces of systems competition. The extent to which these have contributed to the reform backlog and have prevented the reduction of social benefits could not be examined in this article. It has been demonstrated, however, that the strength of systems competition with regard to German labour market institutions may have been relatively small. This might change in the course of the eastern EU enlargement, however.

With the eastern enlargement the EU will unite about 25 countries in a homogeneous market in which the four basic freedoms of the Rome treaties will apply to a large extent. The number of EU inhabitants will increase by around 106 million or by 28 percent. Joining the EU will be countries whose wages are a tenth to a fifth of western German wages, at least at present exchange rates (on the basis of purchasing power parities the wage gap is smaller). After eastern enlargement German enterprises will examine sites in Eastern Europe even more carefully than now and will contract for new locations. The high wages and the strong dismissal protection in Germany as well as the tax burden and other locational factors will come under close scrutiny.

Eastern EU enlargement will trigger a strong migration to the west. Living conditions in the east will not approximate those in the west for some time. According to estimates of the Ifo Institute, approximately 4 to 5 percent of the inhabitants of the Eastern European accession countries will migrate to Germany (net), resulting in a net migration of about 4 to 5 million persons (Sinn et al. 2001).

Migration will produce wage pressure, especially for the less qualified in the labour market, despite the possible earnings boost for the majority of German residents. If displacement effects in competition for jobs are to be avoided, the adaptability of the German labour markets must be improved.

In addition migration will also place pressure on western European social systems. In the choice of their target country, eastern European migrants will be guided among other things by the generosity of the social welfare systems.[3] In this situation western European countries will endeavour to reform their social services so as not to exert any unnecessary migration incentives. On the other hand, a number of high earners in Germany, who are strongly burdened by migration in a redistributing social welfare state, will seek out a country with a lower tax burden. The German (and European) welfare state will thus be exposed to erosive forces (Sinn and Ochel 2003).

Conclusion

National institutional systems are frequently characterised by strong inertia. This is also the case for the German system of labour market institutions. Although exposed to systems competition, this seems to have been relatively weak thus far. In addition governments, who are responsible for the reform of labour market institutions, are not only influenced by the needs of the mobile agents of production. They are engaged in political competition and attempt (in democratic societies) to take into account the possibly contrary wishes of the voters. They must also consider that path-based feedback effects can bring about costs of institutional change. Finally it is difficult for them to ignore the interests of powerful groups.

The resistance to reform of labour market institutions, however, is not likely to continue in the previous form. The eastern enlargement of the EU will intensify systems competition which will considerably increase the pressure for reform.

[3] Typically immigrants work, at least temporarily, in low-skilled jobs and profit from the redistribution from the rich to the poor in western European welfare states. They earn low incomes and pay comparably low taxes and social insurance contributions while at the same time benefiting from the tax financed spending of the state.

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