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Labor Market Reforms and the Great Recession

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ABSTRACT

Labor Market Reforms and the Great Recession^{*}

Germany can be regarded as a showcase for labor market reforms. Moreover, its labor market responded only mildly to the Great Recession. This paper assesses the role of the labor market reforms for the latter development. Against this background, general lessons are drawn from the German experience that include, for example, placing a greater emphasis on work incentives, individual responsibility and flexibility in combination with a solid level of social cohesion. Although it is clear that there is no one-size-fits-all solution, models and approaches that are developed for a specific country context can draw upon a number of features of the German model.

JEL Codes: J21, J68, P52, O57

Keywords: economic crisis, Germany, short-time work, unemployment, labor market institutions, internal flexibility

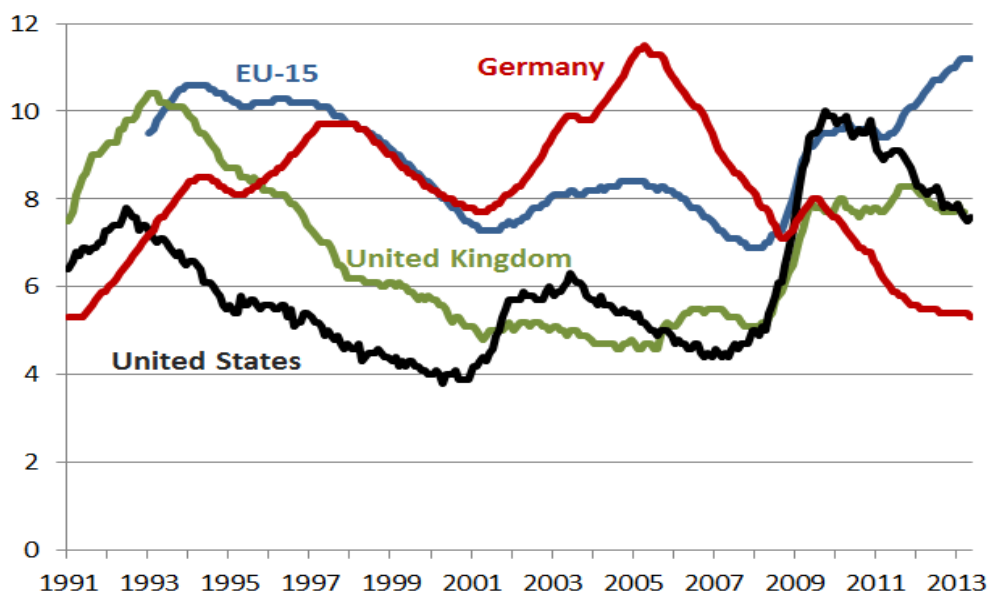
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Germany's economy has proven to be quite resilient with regard to weathering the effects of the global financial crisis (see, e.g., Rinne and Zimmermann, 2012). Alone among Europe's largest economies, Germany's unemployment rate was hardly affected by the Great Recession. And it even continued to decline soon afterwards. Given that unemployment levels had been chronically high for several decades and escalated around 2005 that came as quite a surprise. **Figure 1** exhibits this German success in comparison with the EU-15, the United States and the United Kingdom.

Figure 1: Selected Unemployment Rates (1991-2012).



Source: Eurostat.

Notes: In percent. Seasonally adjusted rates based on ILO guidelines. EU-15: "old" 15 EU member states.

Some analysts have explained this performance as a result of Germany's export focus and/or the benefits of the euro. As tempting as it may be to embrace this explanation, it falls way short of capturing the range and depth of the real reform process that came to bear in Germany.

For the sake of a prosperous economic future for Europe, and for the benefit of the countries that have not managed to achieve the same success—principally Italy, France and Spain—it is of pivotal importance to understand precisely what brought about success in Germany.

First and foremost, it was a *national willingness to embrace the real problem factors* head on. After all, any country can go on only for so long putting its collective head into the sand. Germany had done plenty of that in the 1970s and 1980s when the cumulative effects of high-wage and high-benefit policies that were no longer supported by productivity trends became apparent.

But at some point, a strong sense of realism prevailed. In Germany's case, it came from an unexpected quarter. A center-left chancellor, Gerhard Schroeder, determined that, in order to serve the country's long-term interests, he had to address the overall situation. In particular, *tax and benefit levels needed to be adjusted* if the country's economy—and, in the ultimate analysis, all its employees—were going to have a promising future in the global economy.

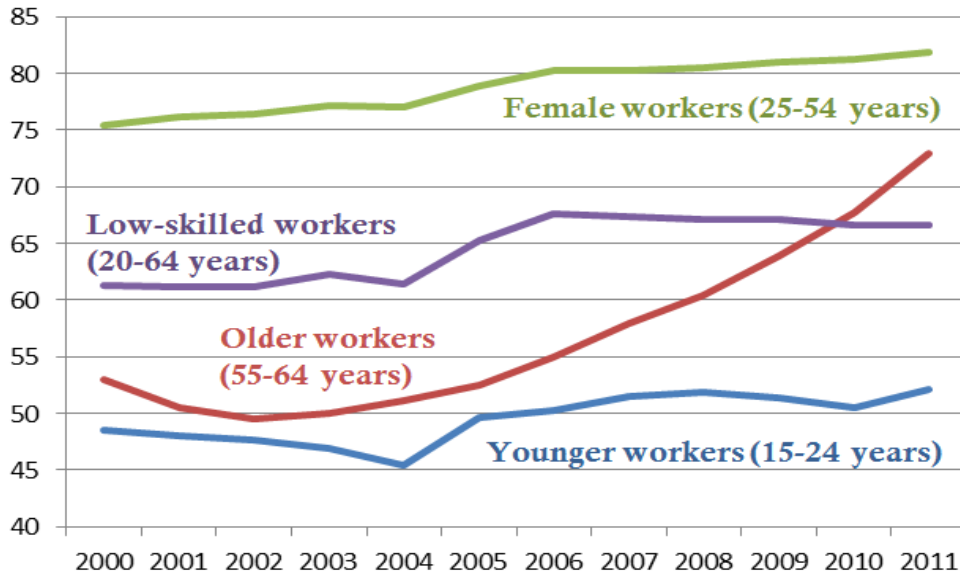
The so-called Agenda 2010 was implemented 2003 to 2005 at great political cost to the chancellor and his party, but the country as a whole benefited tremendously. Unemployment benefits were significantly curtailed, mainly to give people a true *incentive to look for a job*, even if it meant traveling a longer distance. This straightforward reform caused the intended behavioral effects. Faced with low support payments, the inclination to go to work again in order to exit from unemployment rises significantly.

Figure 2 shows that population groups that had previously been characterized by comparatively low participation rates experienced substantial improvements in this regard. Next to female workers', low-skilled workers' and younger workers', in particular older workers' participation in the labor market increased massively, from around 50 percent in the early 2000s to more than 70 percent in 2011. This increase is huge, but in line with several empirical studies documenting the substantial responsiveness of older workers to early retirement options, which were phased out in Germany as part of the reforms.

In many ways, there is no particular magic to the German policy approach. It could be summed up with the old dictum: When you find yourself in a hole, stop digging. Quite often, effective labor policy and labor market reforms can be boiled down to such commonsensical, almost trivial

statements. The key is to bring a sense of pragmatism and realism back to the political world. It seems to excel mainly in the mono-directional piling up of promises that become increasingly unsustainable financially.

Figure 2: Labor Force Participation Rates (2000-2011).



Source: OECD Statistical Database (older/younger/female workers); Eurostat (low-skilled workers).
Notes: Annual figures. In percent of the respective age group. Low-skilled workers include pre-primary, primary and lower secondary education (ISCED levels 0-2).

In the German case, an unexpected force in the transformation equation was the aftermath of the country's unification, which actually served as a crucial reminder for Germans to come back to their senses. The sudden need that arose after 1990 to finance the special burden of updating the eastern part of the now unified country and bringing it into modernity economically was clear for all to see. The additional fact that Germany entered the euro with a burdensome exchange rate further exposed the weaknesses of the German policy formula of the era.

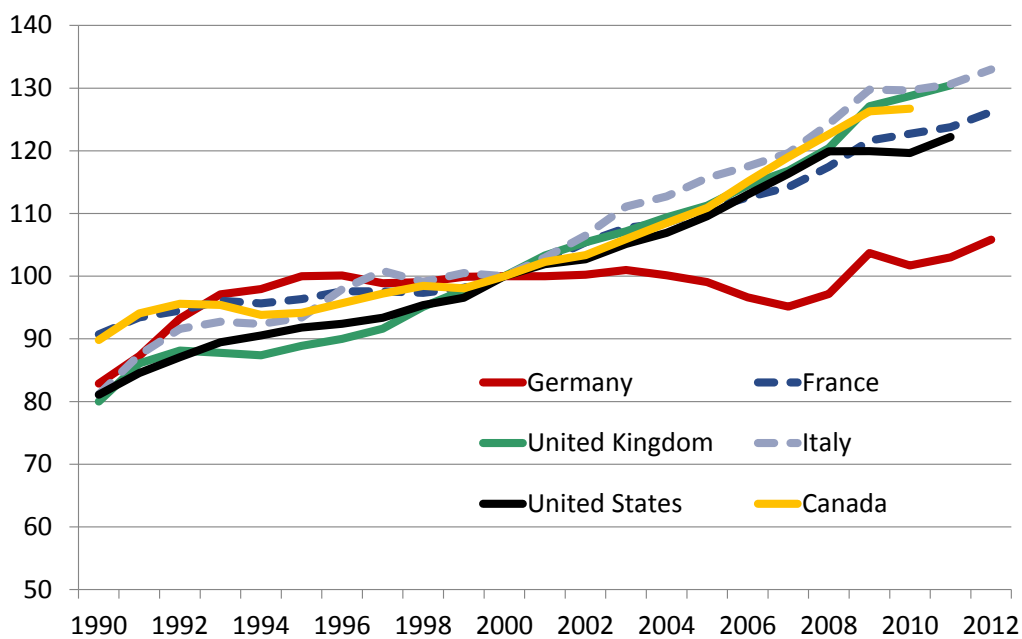
The lesson in this for Germany's European partners today is simple: Use adversity in your favor. Turn unexpected burdens and negative outcomes into catalysts to launch long overdue reform measures. In other words, *economic difficulties are the friend of economic reforms, not their enemy.*

After all, in the real world, the politicians and populace that trigger reforms when everything looks dandy are very rare, if existent. Such foresight no longer seems an integral part of the canon of democracy. By the same

token, that means that reforms must be triggered when the pressures are high.

When considering the development of unit labor costs in **Figure 3**, the reforms contributed to Germany regaining international competitiveness. Unit labor costs in Germany were persistently high for many years, but decreased after implementation of the reforms began in 2003. In contrast, unit labor costs increased continuously during the 2000s in, for example, the United States and the United Kingdom.

Figure 3: Unit Labor Costs in International Comparison (1990-2012).



Source: OECD.

Notes: OECD Index, base year 2000=100. Seasonal adjusted values (national currency).

Reforms must be triggered when the pressures are high—that is the lesson, for example, of the problems which today’s Greece and Spain now have to cope with. These countries allowed wage increases that were largely aspirational, but not based on achievements in the real economy. Countries that grant themselves wage increases in the order of 30% over a short period of time, largely because they feel they now belong to the “European club,” are doing themselves no favor. They drive up their labor unit costs to a level that makes them uncompetitive in international markets. For example, Spain’s pay excesses became Turkish sub-contractors’ big opportunity.

Countries that engage in such strategies also accomplish something far more difficult to change in the future. They create a sense of expectation in their workforce and entire population that is bound to lead to great frustration and pain, given that the prevailing wage level is based on wishful economic thinking or unsustainable economic strategies.

Italy's case is different. Italian industry, especially the medium-sized businesses in the country's north, shares many attributes with Germany's export-oriented SMEs. But Italy did not have to sustain shock therapy in economic terms like Germany's unification. And Italian politics, by comparison to Germany's, is unfortunately frozen in time. Nobody seems capable or willing to transcend their own political camp's familiar positions. No political leader so far has really tried to transform the country's politics. Italy pays with a substantial rise in unemployment.

It is only logical under such circumstances that politics remains a zero-sum game. In economic terms, this results in an excruciatingly painful and saddening process of delaying reforms, whether by living off the proverbial "family silver," accounting gimmicks or other activities to massage corporate balance sheets.

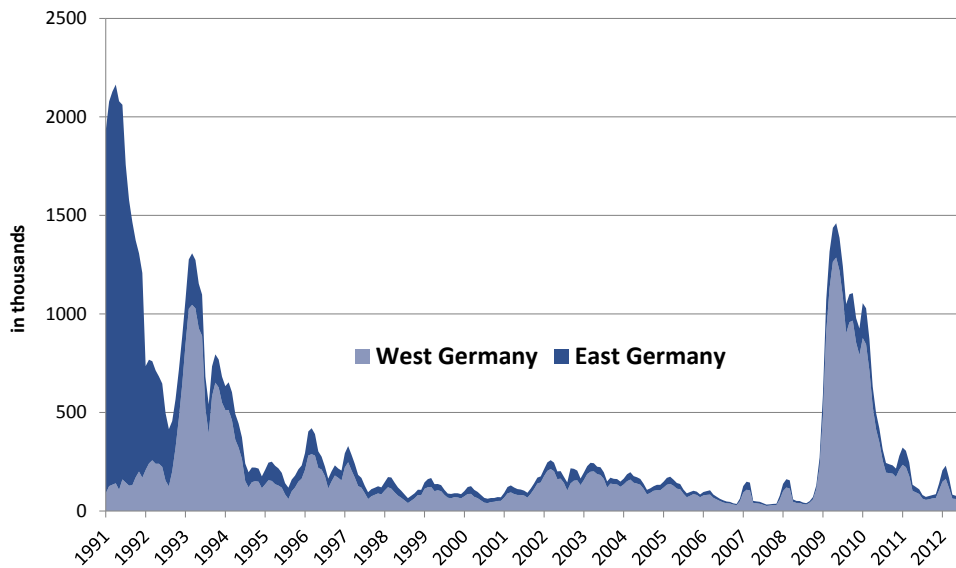
Unless the required political will is mustered, then even the consideration of all the other elements of the German approach to labor market reforms is of little use. These reforms are never just a technical exercise, and always a matter of generating sufficient political will among politicians and in the population.

Consider the instrument of *flexible rules for working time management, whether via overtime and short-time work arrangements, time accounts or labor hoarding*. Any such scheme, as successful as it has proven in German labor market practice, *requires a sense of common interests among employers, employees and unions*. Only because this sense of common interests was present in Germany, for example, short-time work could be used on such a massive scale as displayed in **Figure 4** (see also Brenke et al., 2013).

In the real world, a solid level of social cohesion is required in order to control critical determinants of economic success, such as unit labor costs. As long as certain domestic constituencies or lobbies believe that they can

game the system and get away with it, successful economic and labor market reforms are not just imperiled, but made impossible.

Figure 4: Stock of Short-time Workers (1991-2012).



Source: Federal Employment Agency.

Absent such an understanding of—pardon my use of another truism—“we are all sitting in the same boat,” an economy is bound to have difficulties in today’s ever more integrated global markets. That realization was certainly key in helping Germany to successfully escape the unemployment trap it was caught in for a couple of decades.

If and when this consensus does exist in a given country, then all the technical features of the German model, primarily *a reality-minded, incentive-oriented labor policy that is supported by effective program evaluation and evidence*, do indeed provide a useful roadmap to follow. But in the absence of a sense of common destiny, I do not believe that it is of much use to undertake labor market policies. They remain an abstraction and/or a losing proposition. Successful reform requires a fundamental reconsideration of politics as usual, i.e., the typical zero-sum games that are so often played out between two political camps.

Another key lesson from the German experience is to understand that reforms, once initiated, require *a long-term commitment to stay the course*. In

the 1980s, the world learned about the J-curve effect with regard to trade policy. Simply put, it takes time for any reform measures (such as a lower exchange rate) to show up in a country's trade performance. Even more disconcerting is the fact that economic statistics, after labor market reforms are launched, get worse before they eventually get better.

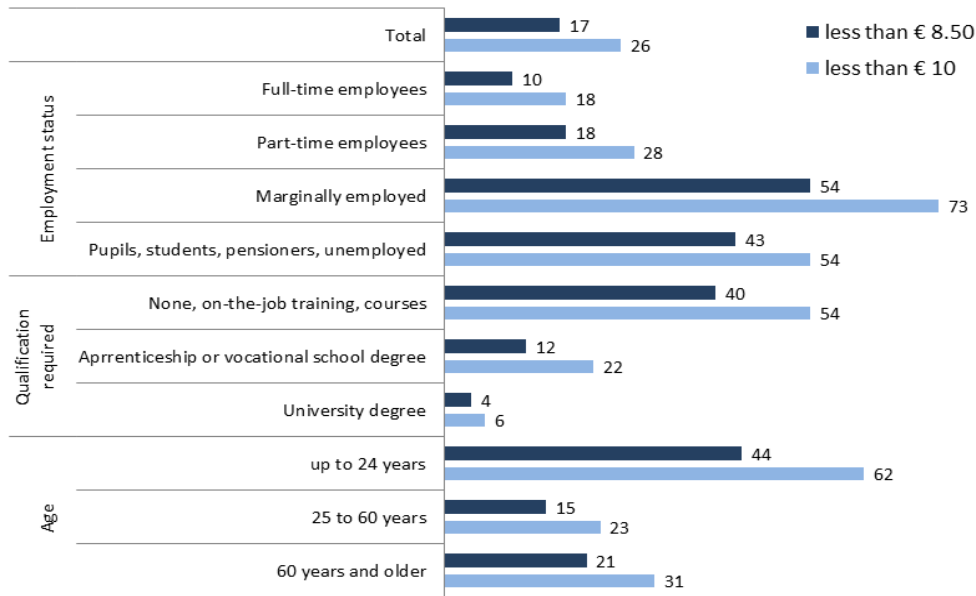
Today, we see the very same J-curve effect play out in the sphere of labor markets (Zimmermann, 2012). That is part of the process which Spain and Greece are currently undergoing.

On the other hand, the required long-term commitment to the reforms is currently in danger in Germany. The popular myth is that the reforms created a growing low-wage sector with precarious jobs. The introduction of a statutory minimum wage thus appears as the "silver bullet" in the political sphere to combat this unintended side effect. However, who would actually be affected by—and potentially benefit from—a minimum wage of 8.50 Euro or 10 Euro, which are the values being currently discussed?

Figure 5 shows that actually only a small fraction of full-time employees would be affected. On the other hand, larger fractions of marginally employed, of pupils, students, pensioners and unemployed, of employees in jobs requiring no formal qualifications and of younger workers would be affected (Zimmermann, 2012).

As a result, even a relatively high minimum wage of 10 Euro would reduce income inequality only by 1 percent (Brenke and Müller, 2013). There are a number of reasons why this is the case. Low-wage employees are not concentrated in poor households, but are rather distributed along the net household income distribution. Many are secondary earners contributing additional income to relatively rich households. Hence, the effects of a minimum wage would be cushioned by the tax and transfer system as many low-wage earners face high marginal tax rates. Effects on income inequality would then be even lower assuming that a minimum wage increases the risk of becoming unemployed for the individuals who are affected. The youth unemployment consequences of the minimum wage are discussed by Cahuc et al. (2013) in the context of the French experience.

Figure 5: Low-wage Employees in Germany (2011).



Notes: In percent (excluding apprentices and persons in ALMP programs). The percentages refer to the total number of employed persons in the respective group. For example, 17 percent of all employed persons receive hourly wages below € 8.50, and 26 percent below € 10. Among full-time employees, these shares are 10 percent and 18 percent, respectively.

Source: Brenke und Müller (2013, Table 1), *DIW Wochenbericht* No. 39 (calculations based on GSOEP data).

Another popular myth in the German context is related to austerity. However, the German success story rather *combined structural labor market reforms with an absence of fiscal austerity*. Yes, you hear correctly—it’s the absence, not the presence (as is so often argued) of austerity that ultimately led to success (see also Rinne and Zimmermann, 2013).

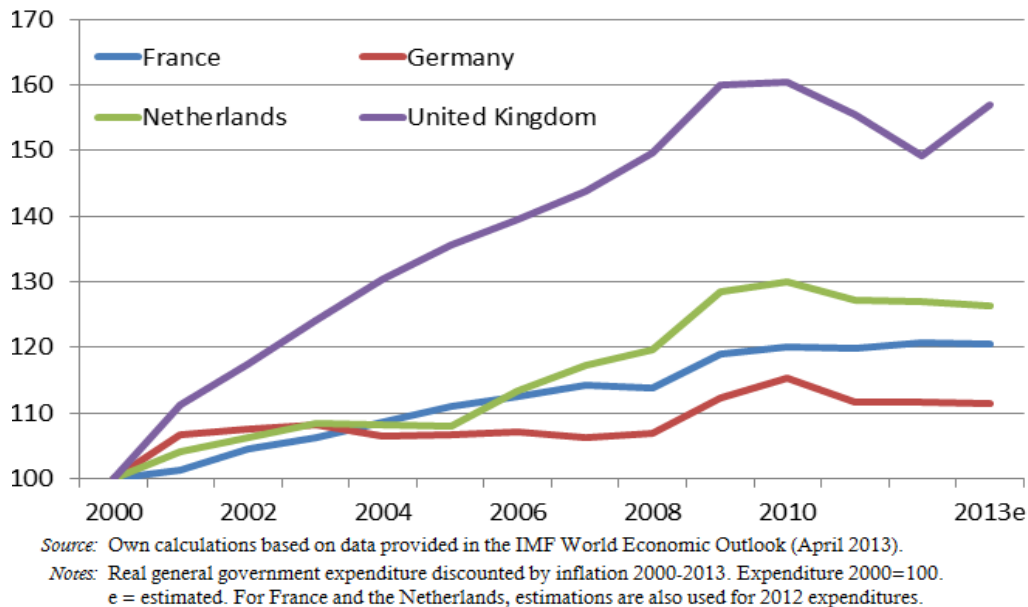
Although **Figure 6** shows that the country has admittedly been on a very moderate growth path in terms of public spending since 2000, there were no broad-based spending cuts made for their own sake.

Rather, what was done in Germany is best understood as pruning—adjustments to, and consolidation of, previous spending levels and programs. In practical terms, this meant that *ineffective labor market policies were abolished or their scope was substantially reduced* (Eichhorst and Zimmermann, 2007). This was the case, for example, with the so-called job creation schemes, which proved to create nothing more than a flash in the pan.

Government cannot really create jobs, at least not self-sustaining ones. Such schemes are now en vogue again, this time at the EU level and in

order to combat youth unemployment. But as important as this goal is, this is not the correct strategy. Evidence-based policymaking and clear-cut empirical results tell Europe's leaders all they need to know about the futility of job creation schemes. In the end, they create a hope that is going to be sorely disappointed—which is the last thing young people need today.

Figure 6: Real Government Expenditure (2000=100).



Based on the recent German experience, what is far more promising than such broad-brushed efforts of throwing (ever scarcer) public money at the problem is *to engage in more surgical intervention measures, including job search assistance via placement in apprenticeship schemes and monitoring.*

Having said all that, it is clear that no magic solution exists to solve the underlying employment problem. If the German approach proves the validity of one concept, then it is to be *willing to experiment*, try new things and throw policy ideas that are obvious failures overboard.

With regard to specific ideas from the German experience in combatting unemployment, there are quite a few features that other countries could closely investigate at home. However, it is equally clear that there is no one-size-fits-all solution. Instead, models and approaches have to be developed for the specific country context.

The most successful strategy in this entire area is what a Scandinavian finance minister once described as a gigantic invitation to copy and steal from each other what works in other countries. That is the ultimate bottom line of evidence-based policymaking—and also of the German experience.

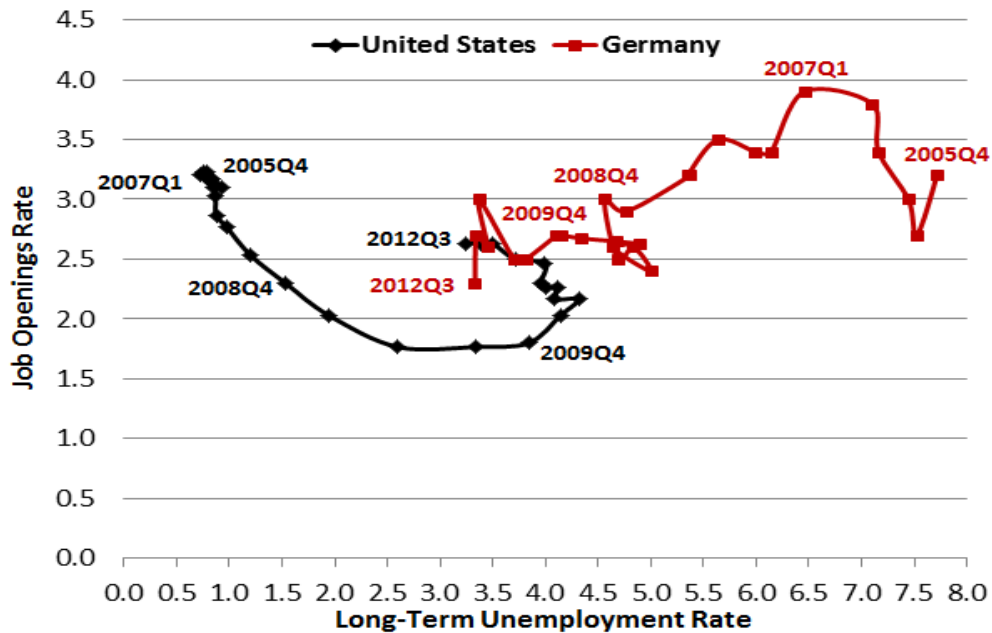
Germany did well because it was able, much to the surprise of many who saw—and see—the country as forever wedded to its traditions, to turn away from longstanding labor market, pension and social policy practices that no longer worked. To find a viable path to the future, one must be able to say goodbye to outdated parts of what constituted a successful policy mix in the past. Once the Germans abandoned their proclivity to think in terms of big, pie-in-the-sky designs, they were on to a winning formula.

The success of this “winning formula” is particularly remarkable in comparison with what was happening in other countries. **Figure 7** compares the job openings rates and the long-term unemployment rates of Germany and the United States (using the American definition of long-term unemployment—individuals who are out of work for six months or longer—for both countries). Remarkably, the current situation in Germany is very similar to the one the United States faces today. This is even more surprising when considering that the two countries were at strikingly different starting points before the Great Recession.

Still, the consensus in the United States is that there is no reason to believe that the country’s current long-term unemployment is structural; it is considered to be temporary. If so, one may argue that long-term unemployment in Germany has reached an internationally acceptable level.

As it happens, *modern labor market research, with its method of counterfactual analysis*, proved to be extremely valuable for the practical implementation of the German labor market reforms. Thorough scientific evaluation of each reform step, widely considered an Anglo-Saxon practice, was completely unprecedented in the history of German policymaking. This allowed politicians to recognize undesired effects early enough to adjust the parameters of certain policy tools, or discontinue programs that had turned out to be ineffective. Efficiency-based assessments of the labor market policy toolset also led to a more effective allocation of public funds.

Figure 7: Job Openings and Long-Term Unemployment Rate (2005-2012).



Source: Bureau of Labor Statistics, Eurostat, own calculations.

Notes: Quarterly data for Germany, quarterly averages (based on monthly data) for the United States. Long-term unemployment rate calculated for individuals who are at least 6 months unemployed. Job openings rate in Germany not available from 2010Q1 to 2010Q3 (linear trend assumed).

The German experience suggests that any future-oriented blueprint has to place a greater emphasis on work incentives, individual responsibility and flexibility. Making that switch undoubtedly carries substantial political risks. It certainly did in Germany's case. Gerhard Schroeder lost power and his party, the SPD, split into two. But the country as a whole benefitted from his completely unexpected display of courage and commitment to transforming the country's society and economy in order to better prepare it for the future. To get there, Germany traveled through a veritable political minefield.

But what emerged in that process continues to have great practical relevance in today's Europe. "Benchmarking"—that is, comparing the effectiveness of certain policy approaches across borders—became an almost magic formula. It could indeed be argued that embracing this approach is key for Europe's future.

As a matter of fact, no continent should be better prepared to engage in benchmarking. No continent has a better established institution to drive such an agenda forward. The current problem isn't so much that Europe

does not really understand itself as a true laboratory. I am quite certain that we should be able to revive that spirit.

Rather, the problem is that the European Commission—which is otherwise vested with so many powers in so many fields—lacks true authority in the field of labor market policy. It is strange to observe that the veil of fiscal sovereignty has been pierced by the Commission in the aftermath of the Eurozone crisis. However, the same cannot be said about Europe’s labor markets.

The latter continue to bask in splendid isolation, even though they are the key vehicles with which a truly integrated Europe will have to be built, one job at a time. We no longer have the luxury of continuing a practice that wastes large amounts of human potential.

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