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New Politics in German Labour Market Policy?

**The Implications of the Recent
Hartz Reforms for the German Welfare State**

February 2005

ISSN Nr. 1011-9523

Wissenschaftszentrum Berlin
für Sozialforschung (WZB)

Forschungsschwerpunkt:
Arbeit, Sozialstruktur und Sozialstaat

Abteilung:
Arbeitsmarktpolitik und Beschäftigung
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Bestell-Nr.: SP I 2005-101

Acknowledgement

We would like to thank Günther Schmid and Reimut Zohlnhöfer for comments on earlier drafts of this paper.

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ABSTRACT

The twin predicaments of German labour market performance and welfare state performance triggered an ongoing debate on reforming the German model. Recently, this debate has yielded an outcome in the form of the so-called Hartz laws, a bundle of labour market policies aimed at the reduction of unemployment and the decrease of non-wage labour costs. The Hartz reforms have played a prominent role in the public discussion, but are they really a watershed as both optimists and pessimists claim? In this article we argue that the Hartz reform is one of the most ambitious German reform projects since World War II, and embed it in an international context. We discuss three views of policy reform: reform as a process of policy-learning, as a process of competitive realignment and as a process of reinforcing path dependence. We show which of the three paradigms accounts for what part of the political result. We find evidence for both policy diffusion and retrenchment, but these follow a traditional German pattern: reforms within institutions rather than of institutions.

ZUSAMMENFASSUNG

Die Probleme des deutschen Arbeitsmarktes und Sozialstaates als Ganzes haben eine anhaltende Debatte über die Reform des deutschen Wohlfahrtsstaatsmodells ausgelöst. Die Hartz-Reformen können als ein wesentliches Ergebnis dieser Debatte angesehen werden. „Hartz“ hat mehr als jede andere Reform die öffentliche Diskussion der vergangenen zwei Jahre bestimmt. Aber sind die Reformergebnisse wirklich das, was Optimisten und Pessimisten von ihnen erwarten? In diesem Artikel argumentieren wir, dass die Hartz-Reformen tatsächlich eines der ehrgeizigsten Reformprojekte in Deutschland seit dem 2. Weltkrieg sind und beleuchten die Reformen dabei aus einer internationalen Perspektive. Als analytischen Bezugsrahmen diskutieren wir drei Sichtweisen von Politikreformen: Reformen als Policy-Lernen, Reformen als Anpassungsprozess im globalen Wettbewerb und Reformen als Prozess, der die Pfadabhängigkeit weiter stärkt. Wir zeigen, welches Paradigma welchen Teil der Reform erklären kann. Es lassen sich sowohl für das Policy-Lernen als auch den Rückbau des Sozialstaates Anhaltspunkte finden, allerdings folgen diese einem typisch deutschen Muster: eher Reformen innerhalb der Institutionen als die Reform der Institutionen selbst.

Table of Contents

1. Introduction.....	1
2. The Contents of the Hartz Reforms.....	3
2.1 Organisational Reform of the PES	3
2.2 Reform of the Unemployment Benefit System.....	5
2.3 Activation Measures	7
3. Theory: Learning, Competing or Continuing – a Wholly Trinity in Characterising Policy Reform.....	8
4. Different Interpretations of Hartz.....	12
4.1 Policy-Learning: Catching Up with the International Mainstream	12
4.2 Competitive Realignment: The Beginning of an Age of Retrenchment?.....	15
4.3 Path Dependency: Reforms within the Institutional System	16
5. Conclusion	19
Bibliography	20

1. Introduction

In 2003, *West European Politics* published a special issue on the German situation at the beginning of the twenty-first century. Germany was characterised as a country unable to proceed with the pressing reforms needed to react to declining economic performance. In general, the German crisis of stagnation was ascribed to 'ingrained over-commitment to old institutions and historical entitlements' (Kitschelt and Streeck 2003: 28). At that time, the Hartz Commission was seen only as a political manoeuvre of Chancellor Schröder in the run-up to the next elections. Now, two and a half years after the commission delivered its report in August 2002, the Hartz reforms can be seen as the most ambitious German reform project in social insurance policy since World War II. For optimists, it marks a first step away from stagnation and proves Germany's ability to make fundamental reform. For pessimists, the outcome of the reform shows either that institutional inertia is still too great to allow for more fundamental reforms or that the reform already has gone too far by opening Pandora's box of neoliberal deregulation.

The Hartz Commission was set up by Chancellor Schröder to reform the inefficient Public Employment Service (PES)¹ and labour market policy more generally. The establishment of the commission was a direct response to a report from the German Federal Audit Court (*Bundesrechnungshof*) which discovered that officials of the PES falsified their placement statistics in order to announce higher activity levels. Given the reputation of the PES for its chronic budget deficit and its low level of efficiency, the media transformed this revelation into the so-called placement scandal (*Vermittlungsskandal*). The scandal became a rare window of opportunity (Kindgon 1984). The Schröder government used this window of opportunity to appoint a Commission for Modern Services on the Labour Market, which became known as the Hartz Commission, named after its chairman Peter Hartz, the human resources director of Volkswagen. The fifteen members were drawn from a broad spectrum of society, including the sciences, the social partners, business consulting companies, large enterprises and politics. This strategy indicated a shift away from former tripartite reform approaches, such as the Alliance for Jobs (*Bündnis für Arbeit*) from late 1998 to 2001, which built exclusively on efforts by the social partners to find solutions to the unemployment crisis in Germany (Streeck and Hassel 2003). In contrast to the Alliance for Jobs, though, the commission's task was narrower, as it was only to suggest policies for institutional reform of the PES and active and passive labour market

1 The German PES was called the Federal Institute for Employment (*Bundesanstalt für Arbeit*) but was renamed the Federal Agency for Employment (*Bundesagentur für Arbeit*) as part of the Hartz reforms.

policy. It was not the task of the commission to deliberate about the entire set of labour market and employment policies, especially not about macro-economic policy (e.g. wages) or employment protection regulations.

After six months the Hartz Commission (2002) presented its report, which consisted of thirteen modules for reform. Chancellor Schröder made the Hartz reforms one of the top priorities of his second term in office and promised to implement the proposal 'one to one', that is, without major compromises pressed for by the social partners, in particular the unions; his own party, the Social Democrats; or his smaller coalition party, the Greens. Following public discussion and difficult negotiations, in particular with the Christian Democrats, who had to agree to the acts in the Second Chamber of Parliament, two-thirds of the modules were finally implemented (with varying degrees of modification). The other third was dropped. Among other things, parliament decided not to introduce a U.S.-type bonus system into the unemployment insurance system for employers that have low dismissal rates, and it also did not take away responsibilities from the state-level offices (*Landesarbeitsämter*) of the PES (Jann and Schmid 2004).

So the question remains whether and in what sense this reform truly is a milestone in the evolution of the German labour market regime, and possibly the welfare state in general. For that reason the focus of our article will be predominately on the implemented reform outcomes, which can be classified around three clusters.² First, and stemming from the original task of the commission, the reform has introduced and further strengthened New Public Management ideas in the PES, the largest public bureaucracy in Germany with almost 90,000 employees. Second and most far reaching, the unemployment insurance system has been changed fundamentally. Third, a number of smaller policy measures were introduced to increase labour market participation by 'making work pay' and activating jobseekers through job search and a take-up requirement with respect to jobs offered.

This article considers these reform clusters in an international and theoretical perspective. We aim to answer two related questions. First, in what respect does the Hartz reform impose substantive policy change in the German labour market? Second, how might this reform be placed in the large body of literature comparing labour market and welfare regimes across countries? To this end, we discuss three different characterisations of policy reform: reform as a process of policy-learning, as a process of competitive realignment and as a process of ongoing path dependence. We show which of the three paradigms accounts for what part of the political result. We conclude by suggesting that policy diffusion and retrenchment follow a traditional German pattern: reforms within institutions rather than of institutions.

2 For a detailed and comprehensive analysis of the road from the Hartz Commission's proposal to its actual implementation, see Jann and Schmid (2004).

2. The Contents of the Hartz Reforms

The commission's proposals were translated by parliament into four acts, colloquially known as Hartz I, II, III and IV.³ Their main contents are summarised in Table 1. Rather than discuss each act separately, we focus on the outcome by distinguishing three clusters: first, the reform of the PES; second, the reform of the unemployment benefit system; and third, policy reforms to increase labour supply. The three bundles have the potential to change the German labour market and the welfare state more generally. For this reason, we briefly describe them in more detail.

Table 1: The Four Hartz Acts

Hartz I (effective 1 January 2003)	
Cluster 1 (Placement)	- <i>Personal-Service-Agentur</i> (temporary work agency) - Training voucher
Cluster 2 (Benefits)	- Tighter definitions of suitable work - More flexible sanction regime
<hr/>	
Hartz II (effective 1 January 2003)	
Cluster 3 (Activation)	- Tax/Benefit incentives through <i>Mini-Jobs</i> - Self-employment <i>Ich-AG</i> ('Me plc')
<hr/>	
Hartz III (effective 1 January 2004)	
Cluster 1 (Placement)	- Internal organisational reform of the German PES
<hr/>	
Hartz IV (effective 1 January 2005)	
Cluster 2 (Benefits)	- Reform of unemployment benefit and social assistance system

2.1 Organisational Reform of the PES

The starting point for the establishment of the Hartz Commission was the placement scandal and the urgent need to reform the organisation of the PES. The traditional PES was seen as a large, sleepy and inefficient public bureaucracy restricted by law and regulations and a lack of performance measurements and competitive incentives. The Hartz reforms were thus designed to increase the efficiency of the organisation and the effectiveness of labour market policy.

3 The official title for the acts is the First (Second, etc.) Act for Modern Services on the Labour Market (*Erstes [Zweites, etc.] Gesetz für moderne Dienstleistungen am Arbeitsmarkt*).

The German PES is organised into 10 regional directorates and 180 local PES offices. In contrast to other larger OECD countries that have adopted decentralised strategies for the implementation of employment programmes, the German PES has remained a relatively centralised national organisation. Early models (such as the 'Arbeitsamt 2000' programme) that were designed to change the internal structures were abandoned because implementation was lagging chronically behind due to internal organisational resistance at different levels.

The proposals of the Hartz Commission which actually were laid out in the Hartz III Act were thus another attempt to change the internal structure. The German PES traditionally has been governed by a tripartite system consisting of an administrative committee of fifty people. The operational business was administered by an honorary executive board elected from this committee and consisted of representatives of the social partners, whereas day-to-day operations were dealt with by a high civil servant. This structure was replaced by a business-like set-up with a chief executive officer and a management board appointed for five years. The tripartite administrative board was transformed into a supervisory board with extended information rights but fewer formal executive functions.

From 2005 on, the Ministry of Economics and Labour will negotiate an agreement of objectives (*Zielvereinbarung*) with the German PES. This management by objectives is aimed at separating policy formulation from implementation and should give the PES the autonomy needed to implement the necessary measures without interference from politics. This management by objectives should trickle down the whole organisational chain and give district offices an increased level of autonomy, too.

The Hartz reforms aimed at increasing the focus on individually tailored assistance. Profiling has been introduced as a key instrument. Profiling is a management tool that assesses a jobseeker's situation through interviews or questionnaires, which then are matched with aggregate statistical data to estimate the jobseeker's needs. The Hartz Commission also proposed the creation of one-stop customer centres (*Job Center*) that bundle all services related to the labour market, including counselling and support services from the social welfare office, the youth welfare office, the housing office and the advisory office for drug addicts. At the same time, the centres need to offer a point of access for employers that wish to announce their vacancies. The implementation of these customer centres did not work as it should have. In particular, recipients of different kinds of benefits are still dealt with in different offices (see below). Moreover, related to the stronger focus on active placement services is the cutback in traditional labour market programmes, such as long-term vocational training and job creation programmes.

A final thread of reforms in the organisation of the PES is the increased use of market mechanisms and the contracting-out of services (Bruttel forthcoming;

Konle-Seidl forthcoming). Although the German PES has – unlike the Netherlands, for instance – never delivered training or job creation programmes itself but always contracted private providers, this process was often carried out without public tendering and based on familiarity with the provider. In particular, many observers claimed that training providers operated by the social partners had been preferred by local offices, which also were governed by a tripartite board. Since the placement scandal, various new instruments have been introduced to strengthen the market. Even though the quantitative volume is still rather small, proponents of the reform claim that it is a first step towards a stronger public-private mix to provide placement services.

The most prominent examples for this new practice are the placement voucher (*Vermittlungsgutschein*) and the PSA (*Personal-Service-Agentur*). Jobseekers are entitled to a placement voucher if they are unemployed for more than six weeks. With the placement voucher, which has a value of 2,000 euros, a jobseeker can mandate a private placement agency to find him or her a job. Private providers are only paid if they successfully place a jobseeker. The PSA is a publicly funded temporary work agency to which the local PES refers jobseekers. The PSAs receive payments from the PES in exchange for employing and lending out jobseekers. The expectation was that they would find a permanent job through the attachment effect that could be observed in other programmes using temporary work as a transition tool. The PSA, which was once thought to be a primary instrument for reducing unemployment, has turned out to be of little significance. The same is true for the placement voucher, of which few are actually successfully used by jobseekers to gain new employment.

2.2 *Reform of the Unemployment Benefit System*

Whereas the organisational reform of the PES was relevant for political actors (in particular the social partners), the reform of the unemployment benefit system was a major topic for the public at large.⁴ Even though 'Hartz' has become synonymous with labour market policy reform in Germany as a whole for many observers, it is Hartz IV specifically that triggered the strongest public awareness and reactions.

In the past, Germany has known three kinds of assistance for unemployed people: unemployment benefits, unemployment assistance and social assistance. The unemployment benefit system in Germany builds on an insurance principle according to which both employees and employers currently pay 3.25% each of the gross salary into the unemployment insurance funds. In cases of unemploy-

4 As a matter of fact, 'Hartz IV', the colloquial term for this part of the reform, was selected as the 'Word of the Year 2004' by the Society for German Language (*Gesellschaft für deutsche Sprache*) because it was said to be most suitable for characterising public opinion during the past year.

ment, employees received 60% of their last-earned net salary (67% if they have dependent children) for up to 32 months (that is, until the reform effective as of 1 January 2005). The duration of benefit payment depended on the age of the jobseeker and the length of time over which he or she had been employed in the seven years before unemployment. Once the period of unemployment benefit had expired, the jobseeker then moved to means-tested unemployment assistance, which was 53% of his or her last-earned net income (or 57% if there are dependent children). Whereas unemployment benefit was contribution-based and limited in its duration, unemployment assistance was tax-financed and paid for an unlimited period. In addition to unemployment benefits and unemployment assistance, there was means-tested social assistance for which municipalities bore responsibility and which served as the ultimate social security benefit payment a person could receive in Germany. Social assistance usually was paid to those jobseekers who did not qualify for unemployment benefit and unemployment assistance, both of which required a certain contribution period. It secured a minimum standard of living above the poverty line and was paid for an unlimited period.

Through the Hartz IV Act, this system has been changed radically. First, the income-related unemployment benefit (now called Unemployment Benefit I) is limited to a maximum of 12 months (18 months for people older than 55). After its expiry, jobseekers move to the so-called Unemployment Benefit II, whose benefit level is fixed at the level of the former social assistance and thus is independent of the former income. This departure from the former income is the actual break from previous practice, because workers who earned good salaries before becoming unemployed will now face a drastic decline in their benefits in comparison with the former unemployment assistance, which was linked to former income and paid for an unlimited period. For a single adult, Unemployment Benefit II amounts to 345 euros per month in western Germany and 331 euros in eastern Germany, plus housing costs, social insurance payments and additional payments in case of pregnancy, single parenthood or disability. All people who are classified as able to work will receive this new benefit, whereas social assistance will be limited to those who are not able to work for more than three hours a day.⁵ Thus, for those having received social assistance before, the new legislation actually allows them to receive marginally more money (and access to job placement services).⁶ Unemployment Benefit II will be administered by consortia (*Arbeitsgemeinschaften*) between the local offices of the PES and the municipalities. The problems arising from the cooperation between these very differently organised institutions with quite different inclinations are manifold. However, in 69

5 As a direct (statistical) consequence, the number of officially registered jobseekers crossed the five million mark in January 2005.

6 For the first two years of the reform, a supplement payment is paid to jobseekers moving from unemployment assistance to Unemployment Benefit II, in order to guarantee a smooth transition rather than a radical change for existing benefit recipients.

cases (in comparison with 343 consortia), the municipalities will take over the responsibility for Unemployment Benefit II completely.

2.3 *Activation Measures*

The third cluster of reforms concentrates on the low effective labour supply in Germany. From a European perspective, Germany has a relatively low employment rate. With only 65% it falls short of the goal agreed on in the Lisbon Strategy of 70% for the year 2010. Thus, the Hartz Commission called for two ways to increase effective labour market supply in particular for lower qualified people, whose employment rates are especially low. On one level, new programmes and instruments should reduce tax burdens for low-wage earners and jobseekers becoming self-employed and thus attract more people into the labour market and give jobseekers greater financial incentives to take up work or to leave the black economy. Besides these incentives, another important factor in activating jobseekers is individually tailored assistance that can help jobseekers find new employment. On another level, in order to strengthen the push factors to increase labour supply, jobseekers should face a stricter regime with respect to job-search activity requirements and the obligation to take up suitable work.

The main instruments that should make work pay are the *Ich AG* ('Me plc'), formally called the *Existenzgründungszuschuss* (grant for setting up businesses), and *Mini-Jobs* (Oschmiansky 2004). The *Ich AG* was designed to facilitate the transition from unemployment to self-employment as a new, effective exit from unemployment. Unlike former programmes, the grants are now attractive for lower qualified jobseekers, too, which is in line with the aim of creating small forms of self-employment (*kleine Selbständigkeit*). The *Mini-Jobs*, as the second major incentive programme, should facilitate employment for low-wage earners in general (not just the unemployed) and at the same time allow employees to take more money home than before. To this end, jobs up to 400 euros per month are tax- and social-contribution-free for employees; employers have to pay a flat 25% of the wage in charges for tax and social insurance contributions. In addition, there are *Midi-Jobs* with an income between 400.01 and 800 euros, in which employees have to pay increasing social insurance contributions starting from 4% up to the usual 21% at the upper limit of 800 euros.

Preliminary evaluations show that both instruments are used to a considerable degree. In fact, incidence was so high as to suggest enormous windfall gains. Hence, the unconditional access to the grants has been changed to a more restrictive regime in which business plans are assessed by the local PES office before they are approved. The *Mini-Jobs* also are used intensively, with more than 900,000 new *Mini-Jobs* in the first three months after the act had been passed. However, initial evidence suggests that many of these jobs have only replaced regular employment that is subject to social insurance contributions

(RWI 2004). And indeed, the number of employees in Germany has been constant since the introduction of the reforms, which partially supports these findings.

While *Ich AG* and *Mini-Jobs* should make the take-up of new jobs more attractive, the Hartz legislation also contains measures that increase the pressure to take up a job. Although the reduction of benefit levels and durations is certainly the most striking change, other smaller changes, such as the definition of suitable work and the sanction regime, are relevant, too. The definition of suitable work was altered with the introduction of the new Unemployment Benefit II. Once jobseekers are out of work for more than one year (18 months for older workers) and thus receive Unemployment Benefit II, they are obliged to take up any job regardless of the wage level as long as it is not illegal in terms of work content. The law states explicitly that the inferiority of the new job with respect to formal qualifications or previously occupied positions cannot serve as a reason to reject the job. In addition, wages can be below local standards or collective agreements. The lower limit is defined only by the 'immoral wage', which is about 30% below the customary wage. The change of the sanction regime is the second push factor to activate jobseekers. Compared to Public Employment Services in other countries, the German PES sanctioned relatively few jobseekers (OECD 2000b). One reason for this tendency was a very inflexible regulation that allowed only the imposition of a twelve-week sanction with the full withdrawal of all payments. Since the reforms, sanctions can now be imposed for three, six or twelve weeks, and there is initial evidence that the PES indeed uses sanctions more often than before to activate jobseekers (Bruttel and Sol forthcoming).

3. Theory: Learning, Competing or Continuing – a Wholly Trinity in Characterising Policy Reform

Before assessing the recent changes in German labour market policies, this section first gives an overview of the major contending approaches to policy reform and political gridlock. We distinguish between three broad characterisations of reforms. They are clearly not mutually exclusive, and subsume at times rival approaches, but they help guide the following discussion by introducing an analytic separation according to changes in preferences, constraints and institutions. Any policy outcome, and policy reforms in particular, may be viewed as a combination of changes in the set of beliefs and interests of governments, the relative costs each of the policy alternatives entails for them and the nature of the (institutionalised) political setting that governments have to respect in the process of imposing the reform (e.g. Scharpf 1997).

A preference-based approach deals with the idea of policy-learning. Governments update their beliefs in the efficiency of certain policies or follow certain ideational trends (Hall 1993). In studies on labour issues, the interest in investi-

gating 'best practices' and applying techniques of 'international benchmarking' has been advanced in particular by the European Employment Strategy (De la Porte et al. 2001; Mosher and Trubek 2003). Political processes are seen as a means of problem-solving in that they successfully adapt old policies to new information. A constraints-based approach focuses on the issue of competition and the need for adjustment. Policy diffusion directly concerns the capacity of states to implement independent policies, and adjustment is driven through a competitive process. Hence, it is more the feasibility, the costs of a given policy, rather than the actors' preferences for that policy, which change under competition. According to this perspective a country gives way to restrictions imposed on policy-making. Finally, and somewhat opposed to the latter approach, the idea of institution-based path dependency rejects easy, dramatic changes and maintains that policy reform requires a long horizon and follows an essentially predetermined trajectory. We shall briefly elaborate these approaches in some detail and relate them to the case of the German welfare state.

The idea of path dependency figures prominently in the work on welfare state regimes (Esping-Andersen 1990). Socio-cultural or politico-economic differences have induced diverging sets of institutions that regulate the labour market and the welfare state across countries. These institutions are characterised by remarkable temporal persistence and have led to the adoption of the term path dependence, most prominently in the work of Pierson (1996). Path dependence changes the nature of the political game in welfare states because new policy programmes create their own clientele which supports them. In general, path dependencies are processes with positive feedback loops that create hurdles against their own alteration (Pierson 2004). The exact causal mechanism may vary: increasing returns to scale, high sunk costs and coordination failure among political agents all lead to policies that basically run unchallenged. In times of high political distress this has led to the notorious concept of political gridlock or, more neutrally, policy stability (Tsebelis 2002).⁷ The initial adoption of such a path-creating policy may have completely different objectives, as the institutionalisation of a policy frequently is assumed to be unintentional. Cognitive processes such as learning and adapting to a particular environment are also likely candidates for causing such persistence. Either way, a policy reform is a political change that is said to reinforce given paths, rather than lead to quick deviations.

In this vein, Germany has always been one of the pillars of comparative welfare state analyses and a 'model' of its own (Streeck 1997). The particularities of the German political economy have led to a characteristic welfare and employment regime heavily dependent on passive social transfers, a sector-wide organised labour market and a consensus-oriented political process that guarantees the

7 Among economists the high persistence of European unemployment has frequently been related to institutions in the labour market and the welfare state (e.g. Siebert 1997).

continuation of policies. A complex set of institutional checks and balances, ranging from the intertwined competences of fiscal federalism to a corporatist bargaining structure and a powerful supreme court, guarantee a high level of institutional inertia. Viewed from such a perspective, the Hartz reform should be thought of either as much ado about nothing or as the very reinforcement of the specific paths in German labour market and social policy.

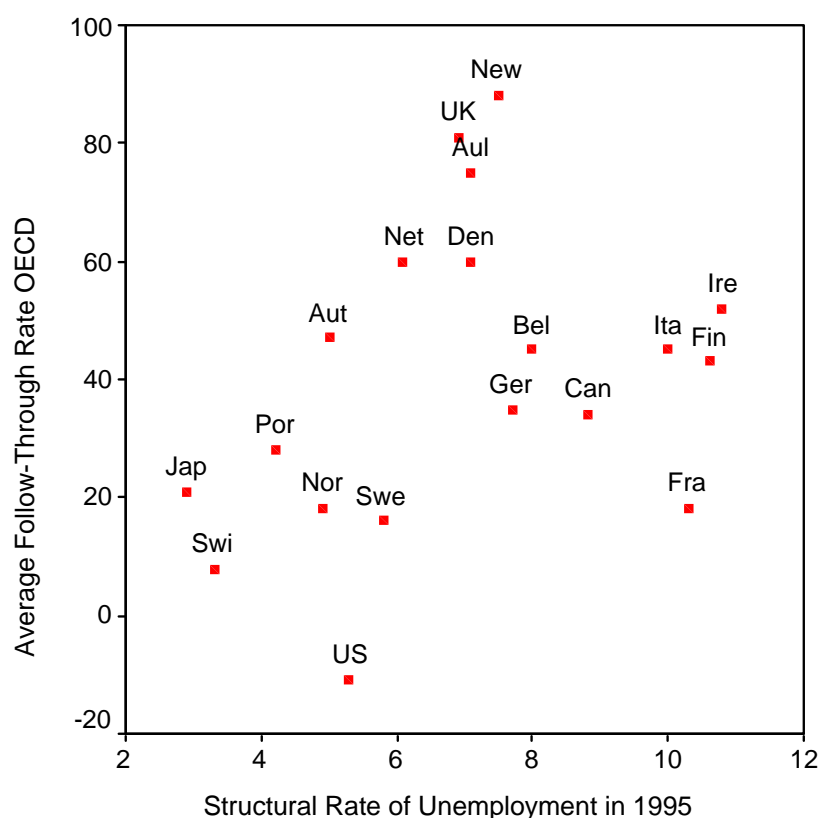
In the wake of a growing academic interest in the role of ideas (Hall 1993), the concept of learning has gained renewed prominence in explaining policy reforms. When seen as a process of problem-solving (Hecló 1974), policy reforms require expertise in order to adjust policies to changing environments. In this respect both nation-states and international organisations attempt to learn by adopting new forms of governance and monitoring. Two main approaches have figured prominently in this respect. Quantitative-oriented benchmarking has become a key currency for evaluating the performance of national labour markets on an international level (OECD various years; Eichhorst et al. 2004; Schmid et al. 1999). Qualitative-oriented best practices is a more eclectic approach focusing on particularly successful policies that are worth being imported into other countries.

In recent debates both concepts have led to numerous discussions of successful or only allegedly successful countries (Green-Pedersen 2001; OECD 2001; Schmid 1997; Visser and Hemerijck 1997). Germany traditionally has been considered a 'net exporter' of ideas, as the case of the Bismarckian system of social insurance, the dual education system and the German 'social market economy' (*Soziale Marktwirtschaft*) since World War II show. In the wake of persistent high unemployment, however, Germany has begun to copy some (minor) labour market policies, such as the promotion of part-time or temporary work. A natural response is, therefore, to ask whether the Hartz reform can be viewed in a similar way: as a process of learning from other countries.

Of course, policy-learning also has a more mundane connotation in the form of competition. It frequently is associated with market-driven trends towards deregulation and the retrenchment of the welfare state. Key international bodies such as the European Union (with its European Employment Strategy) and the OECD (with its Jobs Study) often act as policy endorsers. Though one should not neglect the relatively positive view of the European Employment Strategy on the welfare state and its focus on a more integrated approach for successful employment and economic policy, both bodies share 'extensive similarities in the diagnoses and in the recommendations' (Casey 2004: 348). Hence, key endorsers and the role of (technocratic) ideas may enhance or even create this competitive pressure. For the European Union, the Lisbon targets set out the goals for employment policies. Because the European Union is at risk of failing these ambitious goals, an Employment Taskforce (2004) chaired by Wim Kok proposed policies, taken from best-practice examples, aimed at making the European Union the most competitive economy in the world.

On the level of material restrictions and economic costs, competition directly aims at the capacity of the nation-state to implement independent policies and therefore to maintain national particularities (Scharpf 2000). The most important causal mechanism is economic integration, as it increases the opportunity costs of inefficient national policies. When analysing the politics of the welfare state, one has to assume that the resilience against deep reforms will be higher and, at least in countries with fragmented political systems, that the likelihood of tough reforms will be low (Tsebelis 2002). Nevertheless, most political institutions should only slow down the process of adjustment rather than completely inhibit it.

Figure 1: *Implementation of OECD Jobs Study and Structural Rate of Unemployment*



Notes: The figure is based on data from Elmeskov et al. (1998) and OECD (2000a). 'Average follow-through rate' is a summary index measuring the degree to which countries implemented policy recommendations endorsed by the OECD; 'structural rate of unemployment' is more formally known as the non-accelerating inflation rate of unemployment and attempts to purge unemployment rates from the influence of business-cycle fluctuations.

As Figure 1 shows, Germany is not exceptionally fast nor perfectionist when it comes to implementing OECD-based recommendations on how to reform labour

markets. The figure plots a summary measure of the average follow-through rate for the OECD Jobs Study against the level of structural unemployment in 1995. Countries such as Denmark and New Zealand exhibit much higher levels of implementation, yet their rates of unemployment were fairly similar to the German case in 1995.

In general, popular support for the welfare state is high (Boeri et al. 2001), and the political system entails a complicated set of checks and balances leaning very much towards gradual solutions rather than 'cold turkey policies'. Hence, reforms in German labour market and social policy have tended to be slow or, in some cases, blocked altogether by political opposition (Zohlnhöfer 2001). Nowhere has the tradition of German continuation become more obvious than in the case of reunification. Despite the severe economic problems of transition, the territory of the former German Democratic Republic ('East Germany') imported the corpus of social and labour market policies almost completely. In this respect, the final question on the Hartz reform is whether it is a sign of the incipient trend towards retrenchment or whether, once more, world market pressures and domestic economic pressure have bounced off the core of German political economy (Manow and Seils 2000).

4. Different Interpretations of Hartz

4.1 Policy-Learning: Catching Up with the International Mainstream

The Hartz reforms show several indications of policy-learning. An important point of departure is the overhaul of the system of unemployment benefits. Until Hartz IV, the German system was exceptional on the international level. Together with Belgians and Austrians, German workers were the only ones in the OECD who received unemployment assistance that was both linked to their former wage and unlimited in duration (OECD 2004a). As a result, net replacement rates for very long-term jobseekers were the highest in the OECD (see Table 2). Net replacement rates show the proportion of in-work income that is maintained for someone becoming unemployed (capturing direct effects of all relevant types of taxes and benefits).

The combination of benefits related to former wages and infinite benefit duration is seen as one of the reasons for the high level of structural unemployment. Workers from older industries who received high salaries (e.g. in the metal or coal industry) had little incentive to take up new jobs that paid below their old wage, given their high benefits. The reform of the unemployment benefit system is in line with academic research and policy recommendations alike. The empirical evidence suggests that long transfer periods negatively affect job search behaviour and put an upward pressure on wages from employees (Fredriksson

and Holmlund 2003; Nickell 1997). Nevertheless, it can be argued that during the first months of unemployment, generous unemployment benefits (coupled with job-search requirements) can act as an efficient search subsidy that allows job-seekers to find an appropriate job and that improves job-matching between the jobseeker's qualifications and the job's requirements (Gangl 2002). This possibility could explain why the new Unemployment Benefit II starts after twelve months rather than after six months or two years.

Table 2: Net Replacement Rates and Share of Long-term Unemployment in Specific Countries

	Net replacement rate after one month unemployment	Net replacement rate after three years unemployment	Share of long-term unemployment
Australia	32	32	22.1
Austria	55	51	19.2
Belgium	66	55	49.6
Denmark	59	50	19.7
Finland	64	51	24.4
France	71	41	33.8
Germany	61	61	47.9
Netherlands	71	58	26.7
Portugal	78	24	35.5
Spain	70	27	40.2
Sweden	81	51	21.0
Switzerland	72	51	21.8
United States	45	45	23.1
United Kingdom	56	7	8.5

Source: OECD (2004a: 94, 98), OECD (2004b: 293).

Notes: Base year 2002. The net replacement rates refer to a single 40-year-old worker with a 22-year employment history and a former income of 100% of the average production worker wage (APW).

The reform of the unemployment benefit system is also in line with recommendations from both the OECD Jobs Strategy and the European Employment Strategy, which have acted as strong vehicles of policy transfer in recent years (Casey 2004). The OECD (1994) recommended that countries reduce after-tax replacement ratios where these are high, restrict unemployment benefit entitlements to the period when job search is intense and rapid job take-up remains likely, and impose restrictive conditions on indefinite-duration assistance benefits for employable people. The European Employment Strategy advises Member States to 'review placement rates and benefit duration' (EU 2003: 20).

In addition to the cutback in unemployment compensation, the Hartz Commission also has tried to learn lessons from other countries' experience of making work

pay. The United Kingdom and France are an interesting example of policy convergence in this field (Erhel and Zajdela 2004). The Mini- and Midi-Jobs can be seen as attempts to make low-wage work more attractive, a strategy that has been called for by political parties and economic advisors alike (SVR 2002: 241).

Both the Jobs Study and the European Employment Strategy also urge governments to ensure early and effective activation for jobseekers. The European Employment Strategy Guidelines on active and preventative measures for the unemployed sets out that 'at an early stage of their unemployment, all jobseekers benefit from an early identification of their needs and from services such as advice and guidance, jobs search assistance and personalised action plans [...] with special attention [...] to people facing the greatest difficulties in the labour market' (EU 2003: 18). The Hartz Commission proposed to create so-called one-stop shops that integrate all services for all jobseekers at one place (including benefit claims, job placement, rent assistance, drug and debt counselling, etc.). This recommendation is in line with a general international trend towards single gateways for social and labour market assistance (Clasen et al. 2001). The main examples for Germany were the Centres for Work and Income in the Netherlands and Jobcentre Plus in the United Kingdom (Fleckenstein 2004).

The one-stop shops should also streamline assistance. Jobseekers will be classified according to their needs, and the hardest to help will be subject to case management, a highly individually tailored form of assistance. For those with the greatest distance from the labour market, one case manager will be responsible for 150 clients. In the old system, due to problems of missed targeting, job counsellors had caseloads of up to 700 jobseekers. Thus, the stricter benefit regime is accompanied by a higher level of assistance and activation. The targeting of assistance and the activation of jobseekers again draws from experience in other, more successful, countries such as Denmark and the United Kingdom (Fleckenstein 2004). However, in the transition period jobseekers will be affected by the new benefit rules from the outset, whereas the higher level of assistance will only be phased in over the next one or two years. This is a clear indication of who has to shoulder the major share of the costs of adjustment, namely, the unemployed themselves.

Finally, policy-learning is also evident in the New Public Management reforms of the PES structures. New Public Management is a rather loose term for deliberate changes to the structures and processes of public sector organisations, with the aim of increasing their efficiency and effectiveness (Pollitt and Bouckaert 2004). Although one-stop shops certainly can be seen as part of this reform agenda, a more recent development is the use of contracts for the governance of public employment services (Sol and Westerveld forthcoming). In this vein, we can interpret the introduction of the agreement of objectives between the Federal Ministry of Economics and Labour and the PES (Fleckenstein 2004; Mosley et al. 2001) as an introduction of contractual arrangements. In addition, the contracting of private providers for the delivery of placement services is an international trend

that has been taken up reluctantly by the PES but is now evident as well, for instance in the placement voucher and the PSA (Bruttel forthcoming).

4.2 *Competitive Realignment: The Beginning of an Age of Retrenchment?*

The overhaul of the unemployment benefit system has not been uncontroversial, however. After the Hartz IV Act was passed, more than one hundred thousand people protested on the streets for several weeks in a row, the vast majority of them in cities in eastern Germany.⁸ These demonstrations were not led by large organisations, such as the trade unions, but were grassroots protest actions. They revealed people's fear that Hartz IV will have substantially negative consequences for their life, even though protests faded away once it became clear that the political parties were not prepared to turn away from their compromise on the new benefit legislation.

The fact that demonstrations took place mainly in eastern Germany can be explained by the benefit composition among East German workers. Most East German jobseekers became unemployed after reunification and were thus eligible for the comparatively generous wage-based unemployment assistance of unlimited duration. Hence, Hartz IV did affect their status and benefit income in particular, as their benefits will be reduced to a new flat rate that represents clear losses for people depending on social transfers. The cuts in unemployment benefits for the long-term unemployed show that the system of status orientation, arguably the backbone of the German welfare system, has been relinquished for a large share of the dependent population.

In addition to the lower benefit levels, the Hartz legislation also increased the pressure on jobseekers to take up jobs. In particular for long-term jobseekers, definitions of 'suitable work' have been tightened. The requirement to take up jobs irrespective of a jobseeker's occupational status before becoming unemployed is again a radical break from Germany's status- and occupation-oriented unemployment benefit regime. Whereas unemployment compensation usually was designed to allow jobseekers to maintain their standard of living, Hartz IV only guarantees them a level of benefits that is high enough to secure a subsistence level. The changes in the definition of suitable work may be the basis for a stronger 'work first' orientation in labour market policy, which would follow Anglo-Saxon traditions in which any job is seen as a better outcome than no job at all

8 Actually, some of the organisers tried to link these demonstrations to the tradition of the so-called *Leipziger Montagsdemonstrationen* (Leipzig Monday Demonstrations), political protest rallies that ultimately toppled the former East German government in 1989.

(Bruttel and Sol forthcoming). The changes underway in the rather lax sanction regime are also part of this development.

For some observers, in particular trade unions, the reduction of unemployment benefits is the wrong approach to combating unemployment in eastern Germany, as they assume that the chronic shortage in vacancies is the actual cause of unemployment. Most economists, on the other hand, argue that lower benefit levels and shorter benefit durations will be able to create new jobs in the low-wage sector because the gap between actual wages and unemployment benefits will increase (SVR 2002). In fact, Sinn and Westermann (2001) even argue that eastern Germany is similar to the Italian Mezzogiorno in that high transfer payments inhibit sustainable economic growth. Low benefit levels may be able to change the wage structures and occupational mobility, especially for long-term job-seekers. Spill-over effects into the labour market regime itself may emerge, because greater and more intense search activities by unemployed persons will necessarily influence wage bargaining on the lower end of the scale.

The reform of the unemployment compensation system also was designed to reduce non-wage labour costs. Though never officially stated, the Hartz reform was not just a labour market reform but also a reform to consolidate German social expenditures, of which labour affairs represent some 12%.⁹ The Hartz package initially was expected to reduce transfers to the PES by some 5 billion euros – not very much given the size of the social budget, but a noticeable cut nonetheless. All in all, the massive protests against the Hartz reform, notably after and not during the bargaining period, as well as the toughness of Hartz I and IV suggest that the reform was not merely cheap talk and that it has a considerable component of retrenchment attached to it.

4.3 *Path Dependency: Reforms within the Institutional System*

Hence, there is some retrenchment generated by the Hartz laws, but it is not substantive given the size of the German welfare state. This prompts the questions of whether path dependency posed serious obstacles to an ample reform, and to what extent the Hartz reform is a policy change along the lines of the German historic trajectory, conserving the so-called German model. To answer these questions we must change the analytic focus and also investigate the political failures and political ‘non-decisions’, that is, those crucial questions that have been either suppressed or dropped from the political agenda, when the Hartz legislation was in the bargaining phase. In addition, the reform as it has finally been implemented differs in some respects from the proposals of the commission.

⁹ Total expenditure for labour market policy was about 65 billion euros in comparison with a ‘social budget’ of 540 billion in 2001 (BMGS 2001).

The most important example is again linked to Hartz IV. The Hartz Commission's intention was to give the responsibility for all jobseekers to one institution (which they called a 'Job Center'). For the sake of coherence, it was suggested that the PES should take over this role and be supported by the municipalities. The establishment of such a structure, which would have taken away responsibility from the municipalities, was stopped by the conservative opposition party.

Indeed, the outcome of the organisational arrangement of Hartz IV is a prime example of the German political economy, which has been described as 'interlocking federalism' (*Verbundföderalismus*) that spreads financing, decision-making and political responsibility across all federal levels. Unlike in previous cases in which the opposition party blocked the initiation of major reforms completely, for example in the realm of taxation and public finances in the latter half of the 1990s (Zohlnhöfer 2001), the Hartz reform enjoyed the consensus of the two dominant political parties, the Christian Democrats and the Social Democrats. And yet, federalism proved to be a decisive hurdle on the level of implementing the reform. The one-stop shop idea has so far been very much diluted by conflicts about finances and autonomy among municipalities and the local PES branches. Instead of a coherent framework for all jobseekers, recipients of Unemployment Benefit I will stay with the *Kundenzentrum* (customer centre) in the PES structure, whereas recipients of Unemployment Benefit II will be dealt with in the Job Centers, which are organised by consortia between the local PES offices and the municipalities.

The consortia themselves resemble more a patchwork than a well-governed agency. Their artificial creation is a compromise between the Social Democrats' plan to give full responsibility to the PES, which was in line with the Hartz proposal, and the Christian Democrats' demands to give municipalities responsibility for the new Unemployment Benefit II. The Christian Democrats argued that the municipalities would be closer to the regional and local labour markets and the needs of the jobseekers. In addition, they argued, they would have a stronger incentive to reduce the number of benefit recipients because the benefit costs are at least partly borne by their own budgets, whereas the PES receives its funds from contributions and the federal budget. Putting the municipalities in charge of Unemployment Benefit II would have resulted in a weakening of the involvement of the social partners: they would have lost influence because they are not represented in municipal administrations. By setting up consortia with rather unclear governance structures and very diverse policies, the opportunity for a coherent concept has been missed. Instead, highly complex and sometimes impracticable structures have been created.¹⁰ In other words, this process is a typical reflex of a

10 To complicate issues further, 69 municipalities were given the option to take over all Unemployment Benefit II recipients. Thus, in these 69 municipalities the conservative opposition's concept is tested and will be evaluated against the results of the consortia. This could prove to be one of the few cases of competitive federalism in Germany.

corporatist welfare state with a long-established tradition of creating self-administrated authorities.

The same path dependency seems to hold for the organisational reform of the PES. The aim of the reform of the PES was an increase in autonomy for the local offices. The opposite has emerged since the reform: the number of directives from the headquarters increased from 69 in 2001 to 136 in 2003 (Vaut 2004, own research). In addition, the new instruments for the contracting-out of employment services are still used by the PES in a legalistic 'commissioning tradition' rather than in a modern management approach in the spirit of 'quasi-markets' (Konle-Seidl forthcoming). In future it will be interesting to observe whether a large public bureaucracy like the German PES is able to adopt to new organisation and management cultures. Most notably, the Hartz reform did not break with the influence of corporatism and the industrial partners on the PES and, thus, the unemployment insurance. In other countries, such as the Netherlands, the state has ended tripartist governance of social insurance bodies because the social partners did not seem to act in the general interest but rather acted in favour of their own advantage at the expense of the general public (De Gier and Ooijens 2004). For Germany, the resignation of the new chief executive officer of the Federal Agency for Employment, Florian Gerster, under the pressure of the trade union members of the supervisory board raised doubts about how far the social partners really limit themselves to supervisory functions and how far they actually are pursuing their own interests.

Another example of policy failure is the PSA. Initially, these public-funded temporary work agencies were thought to absorb up to half a million unemployed people, but during the negotiations of Hartz I it soon became obvious that the German industrial partners insisted on the insertion of these temporary employees into the collective wage system (*Tariflohnsystem*). The major fear was, of course, that effective PSAs could provide pools of cheap labour, thereby introducing a substantial low-wage sector in the German labour market that would, sooner or later, undermine the system of wage-bargaining so pre-eminent in the labour market regime. Because the autonomy of collective bargaining is one of the fundamental pillars of the German political economy, the path dependence of this aspect of the labour market regime is particularly strong. As a consequence, only some 40,000 jobseekers are currently employed by PSAs.

Path dependencies are also obvious with respect to the activation measures whose aim is 'making work pay'. The policy concepts had an insular character. The Mini- and Midi-Jobs, for instance, reduced social contribution payments for low-wage earners but did not tackle the general problem of the financing of social contributions. It is interesting to note that these measures have never been considered in combination with a general reform of the tax and transfer system, even though the negative employment effect of social contributions, and not income taxation as a source of revenue, has been established (Ganghof 2004; Kemmerling 2005).

Last but not least, the reform of the unemployment benefit system itself is not only about retrenchment. Unemployment assistance as a policy programme was a 'stranger' in the German Bismarckian welfare state. On the expenditure side, it clearly was related to previous wages and therefore, like public pensions and unemployment benefits, was a case of status orientation. On the revenue side, however, it was financed exclusively through taxation, which makes it more akin to systems in Australia and the United Kingdom. To cut this instrument and to integrate it into basic income assistance is thus also a means of focusing scarce resources on the insurance aspect of unemployment benefits rather than on redistribution. In this sense, Hartz may prove to have a reinforcing rather than a path-switching effect in the mid to long term.

5. Conclusion

What started as a political scandal about falsified placement figures of the PES turned out to be the instigation of the most significant reform of the German welfare state in recent decades. For our analysis, we have clustered the Hartz reform into three bundles: the organisational reform of the PES, the reform of the unemployment benefit system and the measure of activation. We have found indications for policy-learning in all areas, either from best practices or from policy proposals by the European Union and the OECD, which themselves stem from extensive international theoretical and empirical research. At the same time, the Hartz reform was not a decisive rupture of the institutional system but rather a reform of policies within this system with the same set of key actors and institutions involved as before. Typical path-dependent structures of the German welfare state, in particular fiscal federalism between the PES and the municipalities and the internal structure of the PES, have inhibited a broader, large-scale policy transfer.

Notwithstanding institutional path dependencies, it is particularly the reform of the unemployment system (Hartz IV) that has affected the character of the German welfare state and led to claims of the first signs of retrenchment. This change is felt especially by individual jobseekers, whereas overall social welfare spending is affected relatively little in the short run. However, as we have argued, there has been a radical divergence from the German system of wage-related welfare. In place of benefit levels that allowed unemployed people to maintain their standard of living, the new Unemployment Benefit II is designed to prevent poverty, not to secure previous living standards. The extent to which this reform will facilitate, for instance, the development of the low-wage sector is unclear at the moment. The break in the principle system design may open up new paths for future reforms that could go far beyond the labour market and relate to other fields of the welfare state, too.

Our analysis has dealt mainly with providing a broad overview of the Hartz reform and has placed this reform in an international perspective. We have found that the Hartz reforms indeed represent a substantial change and have outlined the basic direction of that change. We have thus prepared the ground for future research which should investigate the role of particular key actors such as political parties and interest groups in shaping the components of the Hartz package.

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