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**Employment Dynamics in Germany:  
Lessons to be learned from the Hartz reforms**

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## **Abstract**

This paper sets out to explore the black box of recent employment dynamics in Germany and thus to identify positive and negative implications that might be of interest for future policymaking. The starting point of our analysis is the question as to whether recent employment growth in Germany is the result of labour market reforms or is instead a mere by-product of the general economic upswing. In order to tackle this question, we assess German employment performance over the last ten years and also compare the determinants of the latest two economic upturns (1998–2000 and 2005–2007). Guided by an analytical framework that stresses the complementarity of institutions responding to shocks, we examine possible factors behind employment dynamics. The following step is to sum up and discuss the major aspects of the recent German labour market reforms (the so-called Hartz reforms). Taken together, our empirical evidence indicates that the recent employment growth might indeed have been facilitated by the labour market reforms. The reforms have led to considerable improvements, but they also demonstrate serious shortcomings.

## **Zusammenfassung**

Das vorliegende Papier versucht die Hintergründe der aktuellen Beschäftigungsdynamik in Deutschland aufzudecken und Implikationen für die künftige Politikgestaltung zu identifizieren. Der Ausgangspunkt der Untersuchung liegt in der Frage, ob das aktuelle Beschäftigungswachstum in Deutschland das Ergebnis der jüngsten Arbeitsmarktreformen oder lediglich ein Nebenprodukt des allgemeinen wirtschaftlichen Aufschwungs ist. Im Lichte dieser Problematik wird die deutsche Beschäftigungsperformanz der vergangenen zehn Jahre beleuchtet; außerdem werden die Bestimmungsfaktoren der letzten beiden Aufschwünge (1998–2000 und 2005–2007) miteinander verglichen. Auf Grundlage eines analytischen Rahmens, der die Komplementarität von auf Schocks reagierenden Institutionen betont, werden mögliche Erklärungen für die aktuelle Beschäftigungsdynamik diskutiert. In einem weiteren Schritt werden die wichtigsten Punkte der jüngsten deutschen Arbeitsmarktreformen (der sogenannten Hartz-Reformen) zusammengefasst und diskutiert. Alles in allem zeigt die empirische Evidenz, dass das aktuelle Beschäftigungswachstum tatsächlich von den Arbeitsmarktreformen gestützt wurde. Die Reformen führten zu beachtlichen Verbesserungen, leiden jedoch auch unter schwerwiegenden Mängeln.



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## 1. Introduction

It is not long ago that Germany was considered the ‘ill man’ of Europe. In nearly every study ranking EU member states or OECD countries, Germany trailed the pack. The country seemed to be the prototype for an over-regulated labour market, the prototype for low growth dynamics, the prototype for low employment intensity of growth, and the prototype for a business-unfriendly bureaucracy. Today, though, Germany seems to be back on track:

- In 2006, for the first time, Germany was named one of the 20 most business-friendly bureaucracies in the world in the World Bank’s ‘Doing Business Indicator’.
- Economic growth was 2.9 percent both in 2006 and in the first half of 2007, thus surpassing for the first time the average growth rates of the 15 old EU member states.
- The employment intensity of economic growth has been high: 630,000 regular jobs were created in 2006, and 430,000 new jobs were created in the first half of 2007 alone.
- Unemployment fell from 4.8 million in July 2005 to 3.4 million in October 2007.
- Most notably, the employment rates of older workers (aged 55–64) leaped from 37.2 percent in 2000 to 52 percent in 2007.
- The government deficit of 3.6 percent in 2005 has been dissolved and is expected to amount to zero or even move into positive figures in 2008.

Many claim that this success is the result of the recent labour market reforms – the so-called Hartz reforms and the ‘Agenda 2010’ programme initiated by former Chancellor Gerhard Schröder – while others maintain that it is due to the impact of additional reforms launched by the Grand Coalition government, especially those reforms proposed by the conservative Christian Democrats. A third view sees the success as the result of the economic upswing, in other words, as the mere reflection of good luck, and many are still worried that Germany’s inability to tackle basic reforms will become apparent with the next downturn.

It is impossible to untie this Gordian knot, and at the same time it would be of no help to cut through it like the famed Alexander the Great. Drawing conclusions requires at least some basic understanding of how the German model works. And even if the truth is that ‘there is no such model’, at least not of a consistent and stable kind, then there are certainly still general traits that provide clues as to ‘what works’ and ‘what does not work’ with regard to the creation of sustainable employment.

The paper addresses this task proceeding in four steps. First, we present some in-depth information about Germany’s employment performance over the last ten years. In a second step, we outline the possible factors behind success or failure against the background of an analytical framework, and we apply this framework to Germany by including an inventive assessment of its employment dynamics. The third section provides detailed information on the recent German labour market reforms and presents

circumstantial evidence of their effectiveness. Finally, we suggest lessons that can be learned and we generalise our results on the basis of the analytical framework.

## 2. Stylised facts about the German employment performance

Looking at employment rates in Germany, the old EU member states and the USA, it becomes evident that in terms of employment Germany is actually not doing so badly. Since 1997, the employment rate has risen by more than 5 percentage points and is slowly approaching the U.S. level. In comparison with other EU-15 countries, Germany's rate slightly exceeds the average (Figure 1, Appendix). However, the overall employment rate is only one of many indicators that measure employment performance. This section, therefore, briefly outlines the broader picture of employment-related indicators in Germany.

When we look at unemployment rates, the comparison between Germany, the EU and the USA turns out quite differently. For the last ten years, Germany has been exhibiting significantly higher unemployment rates than both the EU-15 and the USA (Figure 2, Appendix).<sup>1</sup> Closer inspection reveals that the most problematic features in Germany are the high share of long-term unemployment (more than 50 percent of the unemployed have not worked for more than a year) and the concentration of unemployment in eastern Germany and some regions in the northwest of Germany, especially.<sup>2</sup>

The risk of unemployment is also unevenly distributed according to social group. Looking at gender, women surprisingly have slightly lower unemployment rates than men, although this trend only turned round during the last decade. Education is now the most important determinant of individual unemployment. In 2005, unemployment rates were exorbitantly high among unskilled workers and considerably lower for persons with secondary education (Figure 3, Appendix). Among persons with tertiary education, unemployment rates were below 5 percent. The skill gap is even more sharply reflected in Germany's employment rates. Whereas between 80 percent and 90 percent of highly skilled people are employed, only between 40 percent and 70 percent of the low skilled have a job; at 54.1 percent (for the 25–64 age group), Germany is among the low performers in this respect.

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1 The reader should bear in mind that dealing with unemployment figures can be treacherous in international comparisons, especially because of different counting methods. The official German figures are based on registration at the public employment service, which includes, for instance, unemployed people working less than 15 hours a week. According to the strict ILO concept, which – for instance – does not count people as unemployed if they work regularly at least one hour per week, the seasonally adjusted unemployment figure in June 2007 was only 2.65 million, and the corresponding unemployment rate 6.3 percent, compared to 3.81 million (or 9.1 percent) according to the registration concept.

2 Breaking down Germany's regions into the approximately 180 administrative units of the public employment service, the unemployment rate gap ranged from 4.3 percent in Freising (near Munich) to 24.1 percent in Sangerhausen (Sachsen-Anhalt in eastern Germany) in 2005.

The focus on particular age groups is endorsed by the European Employment Strategy (EES), which has set specific numerical benchmarks to be attained by all member states. By 2010, total employment rates should exceed 70 percent, while the employment rates of people aged 55–64 should surpass 50 percent. The EES did not set quantitative targets for young adults, however, because differences in youth employment are mainly related to the diversity of educational systems.

As regards older employees, employment rates have increased significantly during recent years. Due to extensive use of early pension options during the 1990s, the rate of employment for 55–64 year-olds dropped to 38 percent in 1999. By 2006, this figure had risen by 10 percentage points, most recently even exceeding the Lisbon goal and surpassing the EU-15 average (Figure 4, Appendix).

Employment has expanded remarkably in Germany as stated at the beginning of this paper, but what kind of jobs has been created? How far is the argument justified that the quantity target is achieved at the cost of job quality, favouring the creation of often inadequately insured ‘atypical’ jobs (such as marginal, part-time or temporary employment) instead of ‘regular’ jobs subject to social security contributions? The data for the last decade show that the number of standard employment relationships indeed declined in Germany. As indicated above, however, this trend was reversed during the most recent upswing (Figure 5, Appendix).

Looking at self-employment, the Hartz reforms sought to render this employment option broadly accessible. A new self-employment grant – called ‘Ich-AG’ – was established to this end (see Section 3). Since the introduction of the measure in 2003, self-employment has increased remarkably. As for employees with fixed-term contracts, it can be said that temporary employment as a form of non-standard employment is on the rise, as is part-time employment. Part-time employees already represent one quarter of all employees, and there is an evident upward trend (Figure 5, Appendix).

Along with the introduction of the Hartz reforms, the legal parameters of marginal employment have been overhauled as well. The overarching goal was to open up new job opportunities within the marginal employment sector so as to increase the incentive to take up gainful employment. A distinction was made between ‘mini-jobs’ and ‘midi-jobs’. Mini-jobs are defined as employment with monthly earnings of up to € 400, whereas midi-jobs refer to monthly wages of between € 400 and € 800. Analysing the numbers of midi-jobbers over recent years, it emerges that marginal employment is on the rise, both in terms of exclusive and sideline jobs (Figure 6, Appendix).

The Hartz reforms were not only about creating more jobs, but about creating jobs entailing coverage under the social security scheme. However, since social security contributions in Germany are paid by employers and employees in equal measure, there is a trade-off. On the one hand, it is common sense that as many employees as possible should be covered by social security and that the social security funds should take in as many contributions as possible. On the other hand, employees are reluctant to take up marginal jobs that are subject to social security contributions, for contributions disproportionately reduce their gross incomes.

The concept of midi-jobs was introduced in order to do justice to both of these two conflicting goals. Midi-jobs are marginal employment relationships with monthly earnings of between € 400 and € 800. Unlike regular employment relationships, the share of social security contributions paid by the employee is not a fixed percentage, rather varies – according to monthly earnings – between 4 and 21.5 percent. Since their introduction in 2003, the number of midi-jobs has grown constantly (Figure 6, Appendix), and the overwhelming majority have been occupied by women.

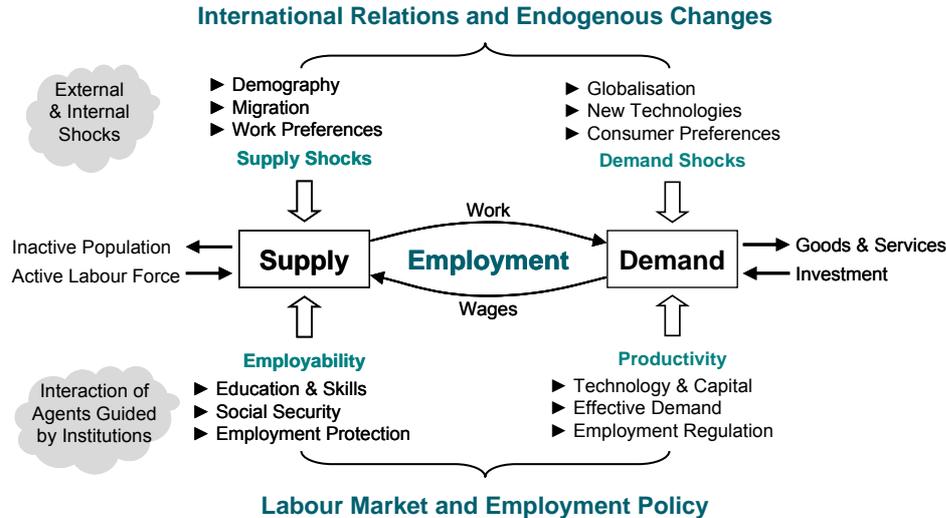
Finally, the increasing share of non-standard employment related to total employment is also reflected in labour productivity. Compared to the 1980s and early 1990s, when Europe had equal or even higher productivity growth rates than the USA, the dynamic of labour productivity per hour has weakened considerably over the last decade. On average between 1997 and 2006, labour productivity per hour increased only by 1.5 percent in the old EU-15 and by 1.6 percent in Germany compared with 2.4 percent in the USA.

So is there necessarily a trade-off between employment growth and productivity as this last evidence seems to suggest? The aim of the following section is to examine this question and to discuss possible determinants.

### 3. An analytical framework and possible determinants

Learning lessons from the experience of one country requires some kind of theoretical model, especially if countries with very different cultures and levels of economic development are compared. This is, however, not the place to outline such a model at any length.<sup>3</sup> The following figure is only a brief and superficial sketch of a possible analytical framework and its main propositions.

Figure 1: An analytical framework of employment dynamics



3 For more details, see Chapter 2 in Schmid (2002) and Chapter 3 in Schmid (forthcoming).

As the analytical framework indicates, employment dynamics are the result of a complex set of labour market and product market institutions responding to external as well as internal shocks. Whether their responses are successful or not in terms of sustainable employment growth and corresponding prosperity ultimately depends on their fit to the external environment. The debate on optimal institutions is dominated by two particular schools of thought. On the one hand, the regulation school argues that the market has to be domesticated by law and state intervention. On the other, the deregulation school advocates free markets and objects to any intervention, with the exception of minimum standards and measures to mitigate poverty. We introduce this framework accompanied by the proposition that both schools are one-sided and that ‘flexicurity systems’ based on complementary institutions are a more appropriate structure. This proposition is based on four central assumptions.

First, institutions – considered, very generally, as commonly acknowledged rules of behaviour (North 1991) – not only *restrict* individual or collective agents in their activities (*negative freedom*), but also *enable* individual and collective agents to interact or to cooperate successfully (*positive freedom*), especially by providing material and legal infrastructure. Institutions thereby extend the expectation horizon of agents by means of mutual trust, collectively usable resources and the guarantee of a safety net. For instance, employment regulation – through health and safety standards, restriction of child labour, minimum wage settings, employment protection by means of prohibition of unfair dismissals and discrimination, and mandatory contributions to unemployment, health and pension insurance – can alter the incentives of employers in a favourable way. Under a carefully regulated system, the interest of employers lies in improving workforce productivity by adopting safety and health standards, for instance, and by training workers. And because the rules hold for all employers and are enforced by the state, there is no possibility of cut-throat competition by means of drastic reductions in quality standards. On the other hand, the existence of a universal safety net also relieves employers of a quasi-feudal type of responsibility for their employees and enables them to adjust the size of their workforces according to economic necessity.

On the supply side, labour law recognises the bargaining power disadvantage of most workers compared to employers by ensuring individual rights such as maximum working hours, entitlement to vacations and training, and collective rights such as freedom of association and collective bargaining. Under such carefully regulated systems, it is in the employees’ own interest to cooperate with fellow workers, to be loyal to the employer and to reveal their preferences by voice and not by exit. Moreover, social security regulations, as well as universal vocational and educational standards, improve the ability of employees to contribute to functional flexibility and, if necessary, to regional mobility.

Second, continuous economic and social change (the external and internal ‘shocks’ in our framework) requires institutions that are able to quickly adjust to new situations and uncertainties. State regulation is too inflexible to this end. ‘Flexicurity systems’, therefore, are characterised by *negotiated flexibility* and *negotiated security* (Schmid 2007), which leaves the social partners, non-governmental organisations and other civil

agencies or decentralised governmental agencies substantial scope for self-regulation in setting wages, employment and environmental standards on both the labour and product markets. If there is one common element in the European Social Model in general, and among the successful European employment systems in particular, the most prominent feature is the ‘social dialogue’ in industrial relations (Freeman 2006). Apart from the Scandinavian countries and the Netherlands as obvious strong cases in participatory economic democracy, the recovery in Germany’s employment dynamics to a large extent can be traced back to the basically still intact strengths of social partnership. Even the UK can be cited as good practice for social partnership in relation to the successful implementation of a National Minimum Wage (Metcalf 2007).

Germany provides an important example of negotiated security especially with respect to vocational qualification standards that enhance (following successful bargaining eventually legalised by the state) labour market transparency and occupational mobility. As far as negotiated flexibility is concerned, the deep involvement of German employers and trade unions in the apprenticeship system is still an asset in ensuring that skills are flexibly adapted to market needs. Even if one has to acknowledge increasing skill deficits in Germany (especially at the level of engineering and other high-tech skills), it is important to note the high presence and visibility of the social partners at the local and regional level in Germany. This feature – and this is of particular interest for developing countries – not only ensures that small and medium-sized enterprises (SMEs) in rural areas are endowed with marketable skills, it also prevents young people from migrating (too early) into the large cities where the wages, but also the risk of unemployment, might be higher. It is also important to note that social partnership is playing an important role in harmonising (or at least furthering the mutual acceptance of) vocational or professional standards between EU member states. This not only fosters international labour mobility, but also the international competitiveness of SMEs.

Third, there is *not one* optimal ‘*flexicurity system*’, rather there are several possible combinations depending on the state of economic and technological development, on the local culture and on other historical predispositions. ‘Flexicurity Legoland’ Denmark, for instance, so highly praised these days as a best-practice model, represents just one possibility among others. Based on the so-called ‘golden triangle’, the Danish labour market is characterised, first, by high job turnover made possible through low job security; second, by a generous welfare system, especially in the form of high unemployment benefits; third, by an active labour market policy aimed at enhancing employability and thereby employment security, especially through education and training measures.<sup>4</sup> However, the Danish flexicurity system can certainly not serve as a blueprint for all European countries. Three aspects that might prevent other countries from imitating this model have to be emphasised: first, high budgetary costs based on excessively high taxes;<sup>5</sup> second, long-established relationships of trust between the social part-

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4 The best references for the Danish model are Bredgaard and Larsen (2005) and Madsen (2006).

5 These, incidentally, led to tax evasion, which was reflected in a high share of illegal work, as the European Commission most recently reported on the basis of Eurobarometer surveys (Süddeutsche Zeitung, October 10, 2007, p. 22).

ners; and, third, a high average skill level among workers combined with a production system dominated by SMEs.

Nevertheless, even if the Danish flexicurity system seems to be an outstanding model, and for the developing countries may even represent a kind of utopia, it contains messages that can be generalised and adapted to other countries. One of these messages is that high external flexibility can be traded in against high income security in the case of intermittent unemployment, as well as against high public investment in the employability of workers through vocational education and training measures. The lesson from the German counterpart is that low external flexibility can be traded in against high internal numerical and functional flexibility. An essential element of the German success is the fact that the German trade unions as well as the German works councils have negotiated many collective agreements at sectoral or firm level in which employees can trade in working-time flexibility (for instance, through long-term working-time accounts)<sup>6</sup> and even wage flexibility for employment security.<sup>7</sup>

Fourth, sustainable employment dynamics depend on a combination of demand- and supply-side policies. Without effective demand, supply-side strategies will dry up or lead to high unemployment or underemployment, and without employable supply, demand-side strategies will fall short or lead to wage inflation. The new growth theory (Aghion et al. 1999) provides persuasive arguments and empirical evidence that education & skills combined with high technology & capital is the most important driver for sustainable employment dynamics. In addition, the theory of spatial economics (Krugman 1991) draws attention to the fact that in the long run, equal distribution of investment among regions and social groups is more effective than aiming these investments at only a few localities or specific social classes. One reason that Germany is lagging behind the USA for productivity growth rates is the slow diffusion of new information and communication technology, which, in turn, is the consequence of unequal distribution of investment in education and technology.

In a nutshell, we argue that employment is the outcome of interactions between labour supply and labour demand. Supply and demand are constantly exposed to external and internal shocks, and these shocks are absorbed by the interactions of thousands of agents guided by institutions. How did the German employment system react to these shocks?

### **3.1 Recent employment boom: a result of successful reform or merely induced by the economic upturn?**

There is an ongoing debate about the driving forces behind the recent employment growth in Germany. Some people claim that the recent employment miracle and the

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<sup>6</sup> See, for instance, Wotschack and Hildebrandt (2007).

<sup>7</sup> For a discussion of the strategy of ‘flexicurity’, which the European Commission has adopted as an overarching guideline for the European Employment Strategy (EES), see Auer (2007), European Commission (2006, 2007) and Schmid (2002, 2007, forthcoming).

visible decline in unemployment are the result of the Hartz reforms. Others maintain that the favourable situation has nothing to do with these reforms. On the contrary. They argue that the recent increase in employment is weaker than in the last economic upswing (1998–2000), and that the decreasing unemployment rates are nothing but the result of a demographically induced shrinking of labour force supply. For the time being, there is no reliable empirical analysis offering support for either of the two competing perspectives. Even the German Council of Economic Experts (*Sachverständigenrat*) is at loggerheads over this question. Drawing on detailed descriptive data, the majority of the council holds the view that the Hartz reforms are likely to have brought about a positive employment effect, while a minority vote, namely, Peter Bofinger, has presented his own calculations supporting the view that the recent employment growth is merely a consequence of the general economic upswing. According to him, the rosy picture is the result of ‘an extraordinarily dynamic world economy’. In the same vein, he maintains that the fall in unemployment is caused by demographic change as well as new ‘make-work’ measures under labour market policy (Sachverständigenrat 2007, pp. 325–343).

To shed more light on this important question, we carry out a simple but powerful empirical exercise which consists in breaking employment dynamics down into its main determinants. Decomposing GDP per capita into productivity per hour (efficiency indicator), working hours per employed person (work-sharing component), employment rate per working-age population (behavioural component indicating the degree of labour market integration), and working-age population related to total population (demographic component) allows us to compare economic growth within the two latest upswings (1998–2000 and 2005–2007) and, hence, enables us to open to some extent the black box of employment dynamics (Table 1).<sup>8</sup>

*Table 1: Decomposition of the yearly change in economic growth into indicators of efficiency, work-sharing, labour market integration and population structure, 1998–2000 and 2005–2007*

$\Delta \ln(\text{GDP}/\text{P}) = \Delta \ln(\text{GDP}/\text{H}) + \Delta \ln(\text{H}/\text{E}) + \Delta \ln(\text{E}/\text{WAP}) + \Delta \ln(\text{WAP}/\text{P})$								
1998–2000	2.31	=	1.83	+	–1.02	+	1.78	–0.28
2005–2007	2.99	=	2.71	+	–1.08	+	2.50	–1.13

GDP/P = Gross Domestic Product per Capita (basis: current prices, current PPPs)

GDP/H = Gross Domestic Product per Hour

H/E = Working Time per Employed Person

E/WAP = Employment Rate

WAP/P = Working-Age Population related to Population

Sources: Sachverständigenrat (2007); Statistisches Bundesamt (2006, 2007); authors’ calculations. For the raw data (explaining small rounding errors in this table), see Tables 1 and 2 in the Appendix.

<sup>8</sup> For the original figures, see Tables 1 and 2 in the Appendix.

The average annual growth rates of GDP per capita are almost the same in the two periods: 2.31 percent in the 1998 to 2000 period, and 2.99 percent between 2005 and 2007. In both periods, working time per employed person decreased further at the same rate, thus contributing negatively to economic welfare per capita. In both periods, the demographic change had a negative impact, albeit much more so in the more recent period. In both periods, these negative factors were more than compensated by productivity growth and the greater activity of the working-age population, hence, by a rising employment rate. The more recent period, however, was in both respects – labour market efficiency and labour market integration – significantly more favourable.

This evidence seems to support the more optimistic view shared by the majority of the German Council of Economic Experts. In order to make the assessment more solid, we cast a glance at the components of volume of work per capita (H/P), which increased in both periods, albeit more slowly during the recent economic upswing (0.28 percent per annum compared to 0.49 percent between 1998 and 2000) (Table 2).

*Table 2: Decomposition of the yearly change in per-capita working time into indicators of working-time preference, utilisation of the workforce, labour market inclusiveness and demographic structure, 1998–2000 and 2005–2007*

	$\Delta \ln(H/P) = \Delta \ln(H/E) + \Delta \ln E/(E+U) + \Delta \ln(E+U)/WAP + \Delta \ln(WAP/P)$								
1998–2000	0.49	=	-1.02	+	0.61	+	1.17	+	-0.28
2005–2007	0.28	=	-1.08	+	1.35	+	1.14	+	-1.13

H/P	= Working Time per Capita
H/E	= Working Time per Employed Person
E/(E+U)	= Utilisation of Active Labour Force (U=Unemployment)
(E+U)/WAP	= Labour Force Participation Rate
WAP/P	= Working-Age Population related to Population

Sources: Sachverständigenrat (2007), Statistisches Bundesamt (2006, 2007), authors' calculations. For the raw data (explaining small rounding errors in this table), see Tables 1 and 3 in the Appendix.

As expected from the previous analysis, the contribution of working time per employed person to the volume of work was substantially negative in both periods. The same is true of the demographic component, but the negative contribution was much higher in the recent period (-1.13 percent per annum versus -0.28 percent between 1998 and 2000). Thus, for demographic reasons, one would have expected much slower growth in the volume of work in the most recent period. In order to clarify why the discrepancy is lower than expected, two other components of the volume of work need to be investigated, namely, labour force participation and utilisation of the active labour force. It turns out that the behavioural component – labour force participation – is of the same positive size in both periods. Hence, the answer lies in the utilisation rate of the active labour force, which is much higher in the ongoing upswing.

Again, the analysis adds another piece of circumstantial evidence in favour of the view that the Hartz reforms improved labour market efficiency. Two arguments might contradict this conclusion: first, productivity growth slowed down due to higher labour force activity; and, second, the higher utilisation of the labour force is a result of ‘make-work’ measures under labour market policy. However, the first argument is not convincing: productivity growth was higher in the recent period than during the previous upswing. The second argument has more plausibility given that the average number of people in ‘make-work’ measures was slightly higher in the recent period than in the former period.<sup>9</sup>

Our first empirical outline has shown that there is some – albeit not very strong – circumstantial evidence of a positive impact based on the Hartz reforms. The following section looks at various possible explanations viewed from the perspective of analytical framework in order to gain some insight into which parts of the Hartz reforms might positively affect the employment dynamics.

### **3.2 Possible factors explaining German employment dynamics: external and internal shocks or institutional misfit?**

As the analytical framework suggests, employment is determined by many factors. We can only briefly touch upon the main factors by relating them to German peculiarities, on the one hand, and by explaining the related empirical evidence in theoretical terms, on the other. We will come back to a more generalised view in the final section of this paper and will try there to formulate possible lessons.

(1) Starting with ‘external shocks’, *globalisation* generally increases competition and forces the German economy to restructure. However, two German peculiarities are of interest here. First, due to the establishment of the *euro zone*, Germany has lost its sovereignty in the field of monetary and fiscal policy, which has consequently led to a loss of influence in the realm of employment policy. Unlike, for instance, the UK or Sweden, German governments are no longer able to make use of common instruments such currency devaluation in order to become more competitive in foreign trade. The appliance of Keynesian demand management is restricted by the Maastricht Treaty’s Growth and Stability Pact. Second, the tremendous costs of German reunification need to be taken into account. The restructuring of the former *East German command eco-*

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9 We include under ‘make-work’ measures job-creation schemes that are not precisely comparable between the two periods. The public employment service reports for the years 1998 to 2000 a yearly average of 274,000 persons in ‘*Arbeitsbeschaffungsmaßnahmen*’ (job-creation measures). The figures under the same label between 2005 and 2007 are in the order of about 320,000 persons. The bulk of these ‘*Arbeitsgelegenheiten*’ (work opportunities), however, has a higher turnover than the former measures (*Arbeitsbeschaffungsmaßnahmen*). Only a rigorous comparison of transition rates from ‘make-work’ employment to ‘regular’ employment could decide whether the slightly higher level in the recent period is improving or damaging the employment dynamics in the long run; such a study does not exist.

nomy,<sup>10</sup> which is still in progress, as well as the fiscal adjustment to the Growth and Stability Pact, have led to a dramatic decrease of public investment in Germany (from about 3.5 percent to 1.5 percent of GDP), which was at the very root of plummeting employment in the first half of this decennium.

(2) There are also ‘internal shocks’ that can be summed up by another ‘megatrend’, namely *individualisation* – demographic change provoking an ‘ageing of society’, a small but slowly increasing migration within and between EU member states, and a shift in work preferences reflected in a steady rise of women’s labour force participation. Its impact on German employment and employment policy is threefold. First, a paradigm shift, with the abandonment of early retirement and the extension of working life at least up to the age of 67, has taken place, but is differentiated by growing diversity in terms of preferences and abilities. Second, the issue of the work-life balance, most notably the compatibility of family life and working life, is becoming more and more important. Employment policy has to be modified in the direction of a life-course policy and must tackle the problem of the compressed working careers of young adults who need to comply with different social roles at the same time. Third, in line with the principle of ‘freedom of mobility’, the EU-15 countries are opening their borders to the new member states in Central and Eastern Europe. From the perspective of the new member states, the emigration of the highly skilled is leading to a ‘brain drain’, which is a highly unfavourable situation for aspiring economies. From the viewpoint of the old member states, immigration increases competition and triggers social tensions.

(3) *Wages* are, from the employers’ point of view, an important cost factor. This might depress demand for labour and provide incentives to substitute labour with capital. From the employees’ point of view, however, wages are the central income factor, which increases demand for goods and services and thereby employment. Moreover, wages are also an incentive factor for both employees and employers. Efficiency wage theory claims that employees work harder and are more cooperative if they receive good and fair wages; and employers invest more in education and training if they have to pay high wages. The balance between these two sides of the sword is difficult to achieve and has to be constantly renegotiated between the social partners. This is the reason why the state does not interfere in wage bargaining; the autonomy of the social partners is even constitutionally legitimised in Germany and not contested by any of the major political parties. However, for various reasons, the power of German trade unions has weakened considerably during the last two decades. This again is one of the reasons why wage costs have remained moderate. The annual growth rates of real average wages per full-time and full-year equivalent dependent employees have been below the average of most EU member states during the last ten years (OECD Employment Outlook 2007, Table I).

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10 Since 1990, annual net transfers from western to eastern Germany amounted to about 100 billion euros, which is about 40 percent of GDP; in other words, eastern Germany produces only about 60 percent of its GDP in expenditure terms. Average labour productivity in eastern Germany is still only 79 percent of the western German level.

Modern labour economics perceives wage moderation in a large country like Germany as problematic. From the point of view of the neighbouring trading partners, wage moderation is considered a ‘beggar-my-neighbour policy’; from a Keynesian perspective, wage moderation is accused of depressing effective internal demand. It is for this very reason that Germany is at the same time both a champion in exporting and a champion of low growth related to employment-intensive services on the local and regional market. Germany is one of the few EU member states without a legally mandated *minimum wage*, an issue that is hotly debated. Minimum wages have been established by the government for sectors that are increasingly exposed to international competition and migration. Industries such as construction, roofing, painting and building cleaning are subject to minimum wage regulations. Depending on the specific industry, the mandatory minimum wage varies between € 6 and € 12 per hour.<sup>11</sup> However, since the basic security transfer (*‘Arbeitslosengeld II’*, see below) represents a de facto minimum income, more and more people are faced with a situation in which their job pays them less than state transfers would. In fact, there are sectors with standard wages of only € 3 per hour.<sup>12</sup> In order to uphold incentives for gainful employment, wages that fall below the ‘basic security’ limit are topped up by social transfers.<sup>13</sup>

(4) In general, Germany is considered an overly regulated country. As far as labour market regulation is concerned, international comparisons such as the Economic Freedom of the World Index, show that Germany is indeed ranked at the upper end of the scale. And yet the Hartz reforms did bring about some deregulation, especially in relation to temp-agency work and business start-ups. The partial opening of the labour market had positive effects such as an increase in both self-employment and temp-agency work. The flip-side of the coin, however, is the low coverage of the self-employed under social security schemes, as well as misuse of temp-agency work by employers in terms of dumping wages and not caring about their workers’ long-term job perspectives.

As regards dismissal protection, little change can be reported. Apart from the fact that the German trade unions and the majority of the Social Democratic Party (and even some Christian Democrats) strongly oppose change, both empirical evidence and theoretical arguments suggest that job protection might have no negative employment effects if it is set in the proper institutional context, for example, if combined with vocational education and training, with internal working-time flexibility and – maybe – with corresponding wage flexibility (see, for instance, OECD 2007a, Chapter 2).

(5) Many claim that the *welfare state* is the main cause of Germany’s employment problems. This argument has two facets: First, work does not pay when seen in com-

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11 For up-to-date information on minimum wage regulations in Germany see Hans-Böckler-Stiftung, WSI-Tarifarchiv [www.boeckler.de/cps/rde/xchg/SID-3D0AB75D-54374908/hbs/hs.xsl/275.html](http://www.boeckler.de/cps/rde/xchg/SID-3D0AB75D-54374908/hbs/hs.xsl/275.html) (consulted 23.10.2007).

12 Extraordinarily low wages are paid in industries such as hairdressing, floristry, transportation and security. Depending on the region, standard wages for hairdressers start at 3.05 euro/hour.

13 The British national minimum wage (NMW) introduced in 1997 and implemented by the Low Pay Commission (LPC) – proportionally composed of representatives of the employers, the trade unions and academics – is considered as good practice since it improved the situation of low-income earners (equity) without having a negative impact on employment (efficiency) (see Metcalf 2007).

parison to welfare entitlements; second, non-wage costs (above all, social security contributions) are too high and impede job creation, particularly in the low-wage sector. For many low-wage earners, especially for non-working families with children, the gap between social transfers and possible wage incomes was indeed not ‘making work pay’. This fact explains to some extent the poor employment rates of low-skilled people, and possibly also the increasing amount of informal and illegal ‘black’ work. The Hartz reforms altered this situation to some extent by reducing welfare payments (especially for the long-term unemployed), on the one hand, and by improving the possibilities for earning in addition to welfare payments, on the other. With respect to non-wage costs, there is evidence that the creation of jobs in wage-intensive services (e.g., household, retail, hotel and restaurant services) was blocked or retarded (Scharpf and Schmidt 2000).

(6) Inefficient *active labour market* policies, specifically weak placement services and falsely targeted employment-promotion measures, are likely to induce low employment dynamics or permanent long-term unemployment. Germany was one of the highest spenders in terms of active labour market policy in the 1990s, first and foremost due to the transformation of the former East German command economy into a market economy. In this period, employment fell dramatically in eastern Germany and unemployment rocketed to a level of up to 35 percent in some regions due to the privatisation of state enterprises, drastic cuts in the bureaucratic state sector and lack of private investment. In such transition periods, bridging measures under active labour market policy in the form of large-scale temporary public jobs or wage subsidies can play an important positive role, especially when they are combined with public and private capital investments in regional restructuring or development. Many developing countries, especially those with ‘socialist’ experiments, face an overly large public sector or nationalised industry. The few evaluation studies carried out during the transition period in eastern Germany in the 1990s, therefore, may have more lessons to teach for developing countries than the most recent labour market reforms, which are particularly affected by the specifics of highly industrialised (OECD) countries.<sup>14</sup>

In fact, however, temporary public jobs, employment subsidies, short-time allowances, and partly also continuous vocational education and training measures were often misused in order to park people in measures or to ‘prepare’ them for early retirement. This was the reason for modernising the public employment service (PES) and for cutting or redressing active measures by means of the Hartz reforms.

(7) As the high unemployment and the low employment figures of low-skilled people show, *vocational education and training policies* play a crucial role in employment performance. And yet, unlike most of the EU member states, Germany’s youth unemployment rates are still favourable, although they have recently been disimproving. The historically well-established apprenticeship system based on the combination of practical learning in firms and formal learning in schools (the ‘dual system’) is the main

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14 Brinkmann (1995), Rabe (2000) and Wiedemann et al. (1999) provide the best reviews on labour market policy experiences in eastern Germany.

reason why most young adults in Germany still manage the complicated transition from school to work, except for those with extraordinarily low skills and school drop-outs. In particular, young migrants are for the most part excluded from this system and are thus of great concern for current policy reforms (see, for instance, OECD 2007b, Chapter A, Indicator A6).

(8) Finally, the *political economy* may also play a role. Germany, for instance, has a strong federal system, on the one hand, which gives each of the 16 individual states (*Länder*) a high degree of freedom to run their economy and education systems; on the other hand, the unemployment insurance system is centralised, so that high unemployment regions – especially in eastern Germany – are cross-subsidised by low unemployment regions, found especially in the south of Germany. In addition, Germany has, in contrast for instance to the UK, a proportional voting system which favours voters with preferences for generous unemployment benefits. This feature is emphasised by the fact that Germany's system of vocational education and training favours firm-specific skills in contrast to generalised skills. This in turn increases workers' interest in income redistribution as a social insurance device, in general, and in job protection or status-preserving unemployment benefits, in particular (Cusack et al. 2006).

The following section digs a little deeper into the current German labour market reforms by evaluating them against the background of the proposed analytical framework.

#### **4. German employment policy: the major reforms**

The Hartz reforms were adopted in 2003 and 2004. At the core of these reforms were a series of fundamental reforms of the PES based on proposals put forward by the 2002 Hartz Commission on 'modernizing employment services' (Hartz et al. 2002). In addition, two types of non-standard employment were promoted – self-employment and marginal jobs. In the following, the major elements of these reforms will be briefly described and assessed.<sup>15</sup>

(1) The new *start-up subsidy* (in Germany also called the '*Ich-AG*') supplemented the already existing *bridging allowance*, which capitalised unemployment benefit entitlements in order to support the unemployed in setting up their own businesses. Whereas the individual amount of bridging allowance was derived from the unemployment benefit plus a lump sum of € 300 per month for social insurance and was paid for only six months, the *Ich-AG* subsidy was paid as a yearly decreasing lump sum for three years, provided that the recipient's annual income did not exceed € 25,000. The risk associated with self-employment was cushioned by the fact that eligibility for unemployment benefits persisted for a period as long as four years.

The take-up of the start-up subsidy was much higher than expected, and against certain initial reservations, it did not replace the bridging allowance. In addition, from

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15 Unless indicated otherwise, the empirical evidence is based on the first evaluation report of the Hartz reforms (Bundesministerium 2006).

the perspective of employers, the possibility of hiring a self-employed instead of a dependent employed person is an attractive option, since dismissal protection does not apply to this category of workers. Furthermore, bureaucratic thresholds for employment creation were loosened: all business start-ups had the option of hiring additional employees on the basis of fixed-term contracts for up to four years.

Regarding the security dimension, minimum income security was provided in the form of a monthly allowance of € 600 in the first year, € 360 in the second year, and € 240 in the third year. Concerning social security, it is important to note that in contrast to regular self-employment, social insurance was obligatory as long as the *Ich-AG* founders were in receipt of the corresponding allowance. Although at first sight the *Ich-AG* seemed to provide the founder with minimum income security for three years, from the second year on the allowance only sufficed to cover the cost of social security contributions.

Even though evaluation research has given credit to this component of the Hartz reforms, the *Ich-AG* scheme was abolished in 2006 and merged with the even more efficient bridging allowance to create an overall ‘Start-up Allowance’ for the unemployed. The new regulation tightened the conditions and excluded most of the long-term unemployed from the programme; this alone brought about a decline in the cases promoted from about 300,000 to 200,000 (Baumgartner and Caliendo 2007).

(2) As mentioned above, the area of marginal employment (*mini-* and *midi-jobs*) has also been transformed by the Hartz legislation. Different objectives were envisaged with these reforms: the curtailment of illegal work, especially in private households, and the strengthening of marginal employment as a stepping stone to regular jobs (BMWA 2003, p. 4; Bundesregierung 2003, pp. 2–4). As part of the reform, the 15-hour limit on weekly working hours has been abolished. Hence, marginal employment can be carried out in addition to regular employment without becoming subject to social security contributions.

Prior to the latest reforms, full social insurance contributions became mandatory on passing the € 325 income limit. Now employees’ contributions amount to 4 percent of their earnings when they earn at least € 400.01. For incomes between € 400 and € 800, contributions increase linearly until hitting the regular rate of 21 percent. Meanwhile, full social insurance entitlements are gained. Employers are compelled to making full contributions for mini-jobs, usually amounting to 25 percent (Rudolph 2003; Oschmiansky 2004). As a result, employers might theoretically be inclined to transform mini-jobs into midi-jobs.

The overall evaluation of marginal employment by employer representatives turns out positively. Mini-jobs, especially, are recognised as a cost-efficient and very flexible measure for dealing with peak periods and extended opening hours. In this context, competitive branches such as retail, cleaning, catering and tourism, but also private households, take advantage of this measure. In particular, small businesses appreciate the aspect of flexible and rapid use of marginal employment at relatively low costs (Fertig and Friedrich 2005, pp. 129–130). Whereas these aspects already existed before

2003, the Hartz reforms abolished the limitation on weekly working hours for mini-jobbers and thus helped to strengthen internal numerical flexibility. The doubling of declared marginal employment in private households within one year is an indicator of the success of this strategy.

From the employees' and trade unions' point of view, however, there is great concern about mini-jobs offering employers the possibility to substitute regular employment and to keep outsiders in a low-income and dead-end trap which eventually also leads to low social security entitlements and poverty in old age. Midi-jobs, on the other hand, lead to a somewhat higher share of upward transitions, but too few people are engaged in this type of employment relationship. Furthermore, as mentioned above, midi-jobs are for the most part carried out by women (in 2006, 75 percent of all midi-jobbers were women). The outcome, thus, is ambivalent. Marginal employment today enables many mothers to combine paid and unpaid family work, but at the same time counteracts principles of 'gender mainstreaming' and sustainable individual security entitlements.

(3) The first part of the administrative reforms can be subsumed under the strategy to *activate the unemployed* by 'supporting and demanding' (*Fördern und Fordern*) measures. The supporting measures were mainly the improvement of placement services, especially through a larger and better-trained staff responsible for placement services and employment promotion. The demanding measures mainly consisted in tightening the rules on accepting a 'suitable' job and in reducing unemployment benefits for older people. In this context, it should be noted that prior to the Hartz reforms, older employees were eligible for wage-related benefits for up to 32 months. As a consequence of this particular legal condition, employers frequently made use of the 'golden handshake'-option, thus shifting their older employees into early retirement. Such arrangements were facilitated by the pension system, which allowed retirement at the age of 60 without a corresponding actuarial reduction of pension benefits. Both rules were adjusted: the duration of unemployment benefits was cut to 12 months, or to 18 months for people aged older than 55 years. Furthermore, in cases of early retirement, the pension regulations now foresee an actuarial reduction of benefits. It is – at least partly – due to these new regulations that in the course of the economic upswing the employment rates of elderly employees have risen, while their unemployment rates have decreased significantly.

(4) *Profiling* is used to divide jobseekers into client groups (job-ready, counselling, and intensive-service clients) according to their distance from the labour market. The classification of the clients serves as a basis for individual action plans and for allocating labour market services. The clients' streamlining is organised according to strict schedules in order to ensure individualised counselling and to avoid waiting queues. These measures have certainly improved the lot of the first two groups. The 'intensive-service clients', however, are even more neglected than before.

(5) *Services to employers* are improved through time-budget allocation for such services (at least 20 percent of the agencies' time) and 'premium' clients, faster reaction times,

prior contacts to both employers and jobseekers, referral of a limited number of qualified contacts, follow-up contacts, an improved vacancy data base and monitoring of the matching process. The central goal lies in obtaining employers' attention and willingness to cooperate and, thus, in increasing the share of notified vacancies. These measures have also considerably improved matching efficiency.

(6) The reform also puts emphasis on *privatisation* in the form of outside provision of placement services. Most of the corresponding instruments, however, especially the Personnel Service Agencies (PSA), have not been successful (Hess et al. 2006). PSAs are temporary work agencies for the unemployed established on a contract basis with a local service provider, which is in many cases part of the temporary work industry. This instrument, however, has failed to live up to the Hartz Commission's great expectations, mainly because the amalgamation of placement and temporary work functions sent ambivalent signals to both the PES agencies and their clients. After a process of learning and calibration, the instrument of issuing placement vouchers to persons who had been unemployed for more than six weeks turned out to be partially successful. Private agencies are paid a maximum of € 2,000 for placing the unemployed person in employment of at least 15 hours per week: € 1,000 after employment duration of at least six weeks and an additional € 1,000 after duration of at least six months.

(7) The main, albeit ambivalent, impact was due to the *merging of unemployment assistance and social assistance*. Prior to the reform, the PES administered two types of benefits, which de facto defined its clientele for active measures: *unemployment benefits*, which provided payments at a level of about two thirds of previous net wages for 12 months (or up to 32 months for older employees), and *unemployment assistance* after eligibility for regular unemployment benefits had expired. Unlike unemployment benefits, unemployment assistance was means-tested, amounted to 53 percent to 57 percent of previous net wages, and was paid for an unlimited period. A third type of benefit was the so-called *social assistance*, in other words, means-tested benefits at the subsistence level. Social assistance for unemployed people who were not eligible for PES benefits was funded and administered by the local authorities, the counties and the larger municipalities. On average, about 80 percent of total social assistance expenditure was funded by the local authorities, while the remaining 20 percent was funded by the German federal states (*Länder*).

The unlimited allowance of means-tested, yet wage-related, unemployment assistance turned out to have negative effects on work incentives, especially for those unemployed with relatively high prior earnings. As mentioned above, this regulation also encouraged the use of 'golden handshake' options. Moreover, the elaborate system of benefit provision had important consequences for the provision of job-brokering and other active measures for the unemployed in Germany.

First, more and more unemployed were no longer eligible for regular unemployment benefits, rather only for means-tested unemployment assistance or social assistance. Second, the PES focused its active programmes de facto on its own core clientele of unemployment benefit recipients, who were getting funded through the PES budget;

other unemployed were either eligible for unemployment assistance administered by PES, but financed by the national government, or had to apply to the local authorities for social assistance; recipients of social assistance administered by the local authorities and other unemployed persons not eligible for PES benefits were generally excluded from PES active programmes. Third, as a response to the unemployed who depended on social assistance, local labour market programmes for long-term unemployed were mushrooming under the auspices of the local authorities. Fourth, many of these local programmes were explicitly aimed at shifting the unemployed back under the responsibility of the PES; this was possible by creating intermediary jobs lasting up to 12 months, thereby entitling the participants to re-gain eligibility for unemployment benefits and thereafter unlimited unemployment assistance. In the end, the losers of this shifting of responsibilities (labelled by some experts as ‘organised irresponsibility’) were the long-term unemployed, especially low-skilled and older people, which was reflected in over-proportional unemployment rates in these target groups.

The Hartz reforms overhauled this highly flawed incentive system by replacing unemployment assistance with a so-called ‘basic (income) security’ (*Grundsicherung* or *Arbeitslosengeld II* [ALG II]). ALG II is a means-tested and flat-rate allowance for *all* jobseekers who are not entitled to unemployment benefits, no matter whether they are clients of the local authorities (formerly social assistance recipients) or clients of the PES (formerly unemployment benefit recipients).

The administrative reform, however, was not successful in establishing corresponding ‘job centres’ or one-stop shops for all of the clients under the clear responsibility of the PES, as the Hartz Commission had recommended. Due to the complex interrelationships under German federalism and a political stalemate between the leading parties, a compromise emerged which again established fragmented responsibilities between the PES and the local authorities with respect to the recipients of ‘basic security’ – so-called *Hartz IV*.

For a needy single unemployed person, *Hartz IV* (since July 2007) pays an allowance of € 347 plus costs for accommodation (about € 320). In the case of a family, unemployed partners receive 90 percent (€ 320) of the basic allowance (€ 347), children under the age of 14 receive 60 percent (€ 277), and children from 15 to 18 years receive 80 percent. Furthermore, all ‘basic security’ recipients are entitled to active labour market policy – almost to the same extent as recipients of regular unemployment benefits.

Thus, a family with two children aged 15 and 17, and in which both partners are unemployed and have passed the means test, receives a transfer income of at least € 347 + 320 + 277 + 277 = € 1,220; this corresponds to a gross wage of about € 8.60 per hour. Under certain circumstances, additional allowances can increase the amount of the transfer income. The transfer recipients can also earn some additional income up to a certain amount. As a result, incentives to work for low-income earners turn out to be rather low or even negative.

Taken all together, this element of the Hartz reforms created losers as well as winners. The losers are mainly relatively well-paid former unemployment assistance

recipients; the winners are former social assistance beneficiaries who are now also eligible for active labour market policy measures.

For the time being, there are at least four unresolved problems: first, the problem of long-term unemployed who are disadvantaged either by age, low skills or limited work capacities; second, the depressed employment rate of low-skilled people, which is reflected on the other side of the coin by increasing informal or even illegal ('black') work; third, the growing problem of the working poor, whose earnings (often despite full-time work) fall below the minimum income and who therefore receive 'basic security' to top up their incomes; fourth, the problem of the older unemployed who, after 12 or 18 months, end up in the potential poverty trap of *Hartz IV*. Recently, there was a heated debate on this latter problem. It was argued that people who had made contributions to the unemployment insurance system over many years should be eligible for benefits for an extended period of time. The debate resulted in an agreement by the current Grand Coalition government to further extend the benefit duration for older unemployed to two years. The likely impact of this decision, however, is ambivalent. Extending benefits for older recipients goes against the logic of insurance and might again increase incentives to enter early retirement. There is not much evidence that marginally changing one single element in the package of employment policies actually contributes to either increasing employment or to decreasing unemployment. The story told so far should have shown that it is the interaction between complementary institutions that is responsible for sustainable employment dynamics. The final section will deliberate on this point on a more general level.

## **5. Lesson to be learned from recent German labour market reforms**

Having reviewed some theoretical foundations as well as the current policy reforms, the remainder of this paper will seek to identify a set of lessons to be derived from the German experience. What are the major insights yielded by our analysis? Which parts of the reform can be viewed as successful? What, on the other hand, went wrong? In the following, we briefly sketch the positive and negative aspects of the reforms.

The first good practice that deserves mention is promoting the transition from unemployment to employment through *self-employment as a stepping stone* to entrepreneurship or back to gainful dependent work. We believe – apart from the general lesson – that developing countries, especially, that are faced with the problem of transforming informal employment into formal employment can learn much by studying the strengths and weaknesses of this programme. Evaluation research, for instance, showed that follow-up measures in terms of counselling, networking, training, marketing and, especially, a proper financing infrastructure are of utmost importance for the sustainability of self-employment.

The second good practice is the successful modernisation of placement services in Germany. Evaluation research indicates especially the importance of early assessment of the skills and competences of jobseekers, individual case management, the availabil-

ity of one-stop job centres where jobseekers can find multiple job services, and the strong employer orientation of placement officers.

The third lesson in this respect – and this also corresponds to experiences in the Netherlands, the UK and Australia – is that privatisation is not a panacea for improved employment services. Transaction costs can be prohibitive, and the oft-detected lack of quality in private services is a warning against placing exaggerated hope in privatisation or in contracting out these services. Nevertheless, on a general level, Germany in this respect also teaches that proper public-private partnership arrangements can serve to bring even the most disadvantaged people back into the labour market. It takes a long time to create a competitive market of high-quality private employment services. In view of state or policy failures that also loom large compared to market failures, it is worthwhile investing much in the framework conditions of excellent private providers of employment services.

The fourth – at least partly – positive example is the flexibilisation of the labour market through mini-jobs and midi-jobs that serve, metaphorically speaking, to ‘grease the wheels’ of the labour market. Also, the partial deregulation of temp-agency work, on the one hand, and the submission of these hybrid employment relationships to the law of collective agreement, on the other, has increased the status of potentially modern employment relationships. However, we also noticed substantial risks related to this kind of flexibilisation if it is not combined with new securities, for instance active labour market policies supporting transitions into regular or stable employment relationships, tax and social security provisions avoiding gender discrimination, and substitution of regular employment through dumping of wage and labour standards. Despite the success, it is therefore beyond dispute that the reforms have also brought about disappointment and failure. Since these failures might perhaps have even more to teach us than the successes, the final section will sum up the main mistakes.

The most prominent mistake of the Hartz reforms is the failure to establish transparent administrative structures for integrating the long-term unemployed. The present lack of institutional accountability is one of the main reasons why hard-to-place people are clearly disadvantaged in the present system. The second big mistake was reducing investments in active labour market policy, especially in continuous vocational education and training, not only for the unemployed, but also for the low-skilled employed facing high unemployment risks. A third failure was the late response to the lack of effective demand related to public investment and stimulating private investment. Only the Grand Coalition succeeded in turning the steering wheel toward stimulating the economy through a huge investment programme of € 25 billion.<sup>16</sup> The fourth mistake and major future challenge for reforms seeking stimulate a sustainable employment dynamic is the funding of the welfare state. The burden on employees’ income is still too large, especially with regard to low and medium income-earners. In order to *make work pay*, the financing of social security has to be shifted more in the direction of consumption

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16 For more details on this point, see several contributions in Schettkat and Langkau (2007).

taxes or general income taxes, including higher effective taxation of properties or un-invested capital.

In the long run, the modern world of work requires a new full employment goal which is no longer based on permanent full-time work over the whole life course, but on flexible employment relationships that allow transitions between various jobs, variable working-time regimes and changing forms of employment. The proper institutional change would be to transform unemployment insurance into employment insurance, covering not only the income risks of unemployment but also the income risks of changing employment relationships during the life course, and thus, *making transitions pay* (Schmid forthcoming).

Finally and returning to the analytical framework, the central message of our essay is simple and threefold. First, prior to superficially linking empirical observations to institutions or policies in a causally relevant way, it is important to get the empirical facts right by identifying exogenous and endogenous factors that determine employment, and to evaluate institutions and policy measures with rigorous methods before eventually drawing tentative policy conclusions on the basis of a rich set of circumstantial evidence. Second, theory suggests that successful employment strategies depend on the proper interaction between institutions that influence employability on the supply side and productivity on the demand side. Employability obviously depends above all on education & skills, but less obviously, and more controversially, also on social security and employment protection. Productivity evidently depends on technology & capital, but less obviously, and more controversially, on effective demand and employment regulation. Third, the empirical evidence of the German case supports our starting proposition that neither regulation nor the deregulation theory provide a proper framework for explaining employment dynamics. It is instead the complementarity of institutions that enhances flexibility and security in employment relationships, on the one hand, and stimulates the economy through product innovation and human capital investment, on the other.

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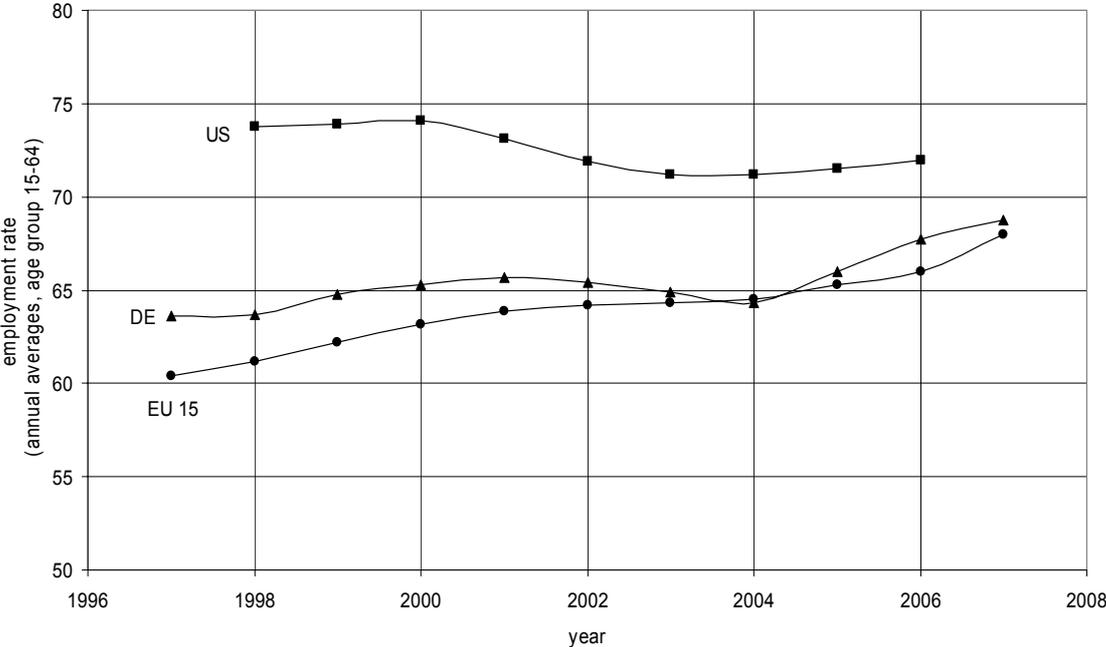
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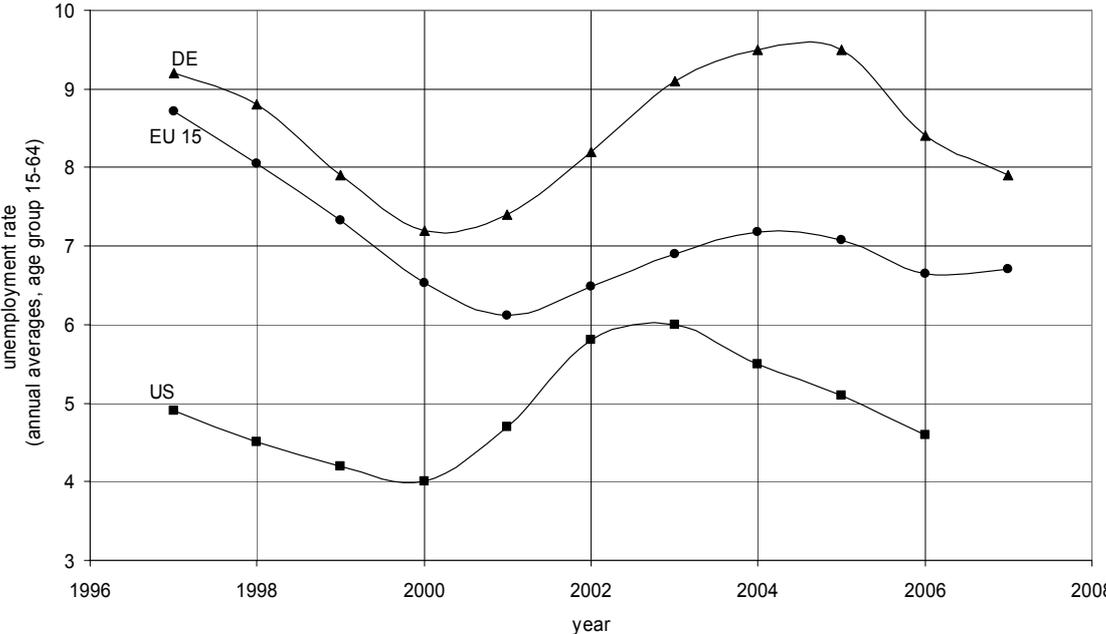
# Appendix

Figure 1: Employment rates in the USA, the EU-15 and Germany, 1997–2007



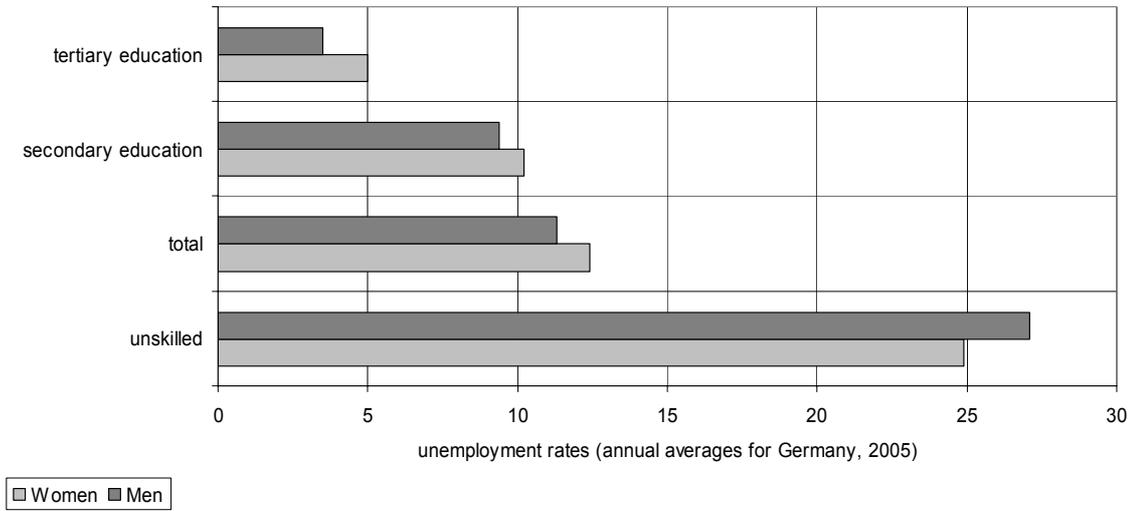
Sources: European Union Labour Force Survey; Data for United States: OECD Employment Outlook 2003, p. 302, and OECD Employment Outlook 2007, p. 246.

Figure 2: Unemployment rates in USA, EU 15 and Germany, 1997–2007



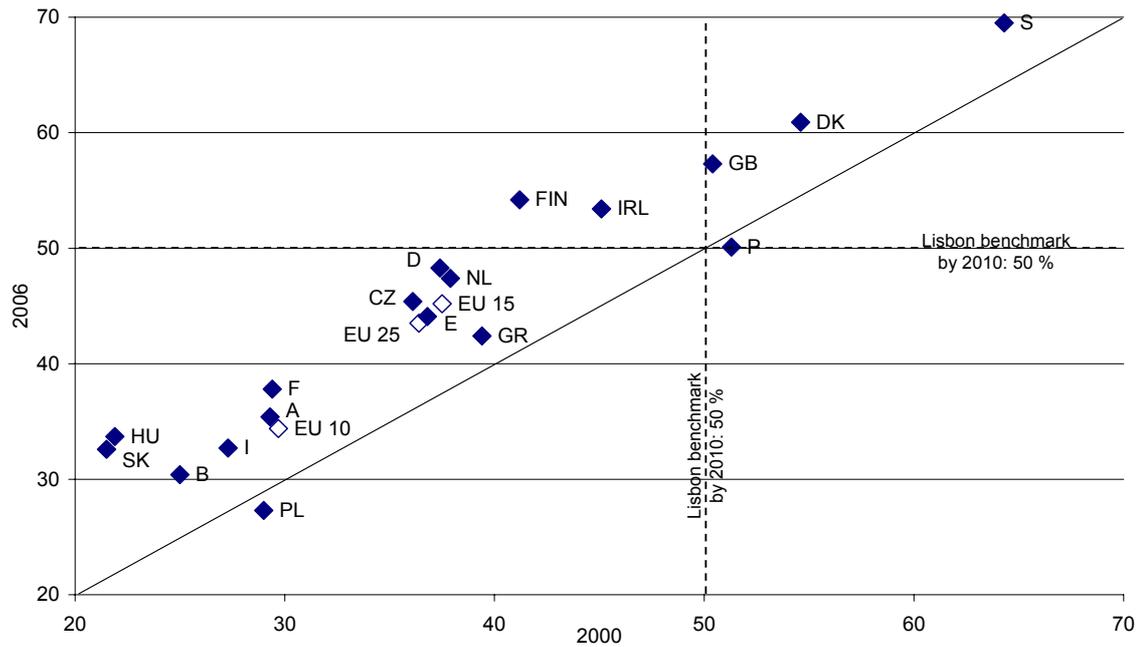
Sources: OECD Employment Outlook 2007, p. 245; Data for 2007: European Union Labour Force Survey and Bundesagentur für Arbeit.

Figure 3: Unemployment rates by level of education, 2005



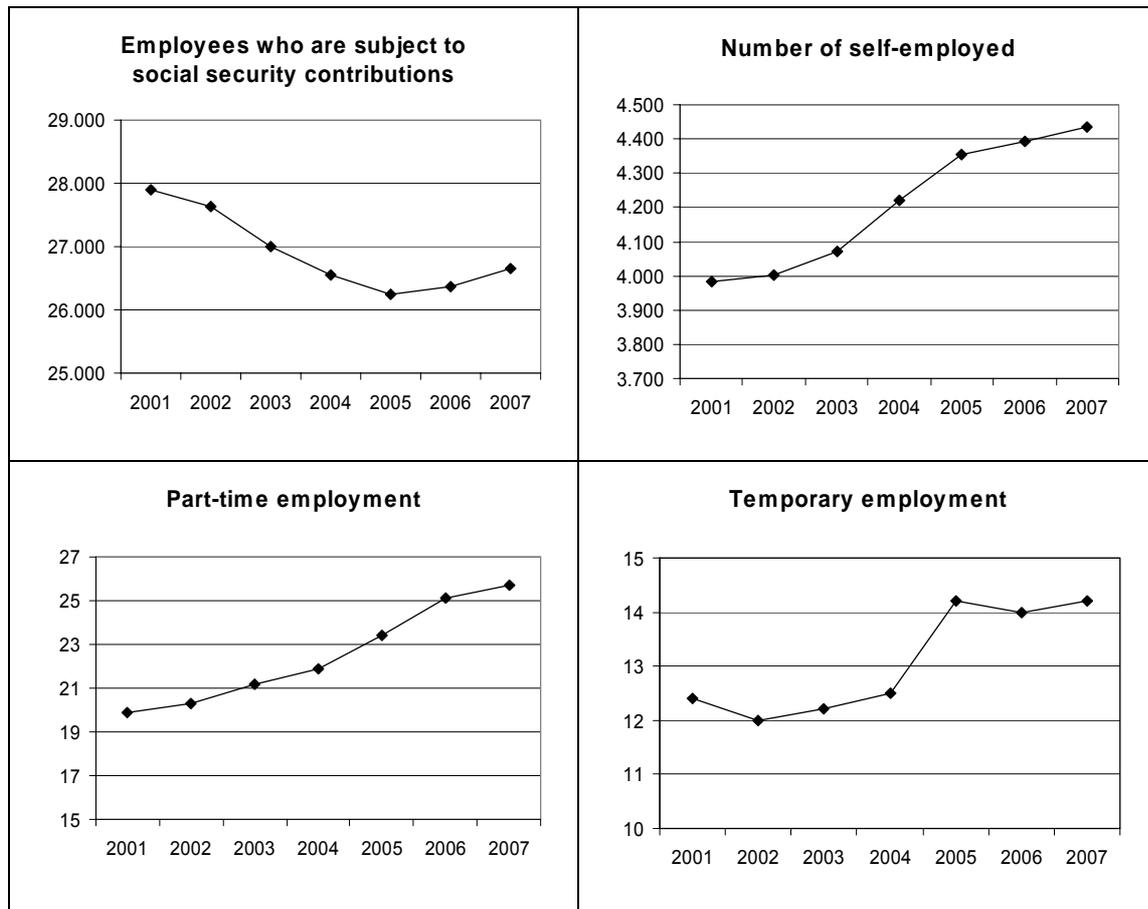
Source: Institut für Arbeitsmarkt- und Berufsforschung, IAB-Kurzbericht Nr. 18/2007.

Figure 4: Employment rates for people aged 55–64 in 2000 and 2006



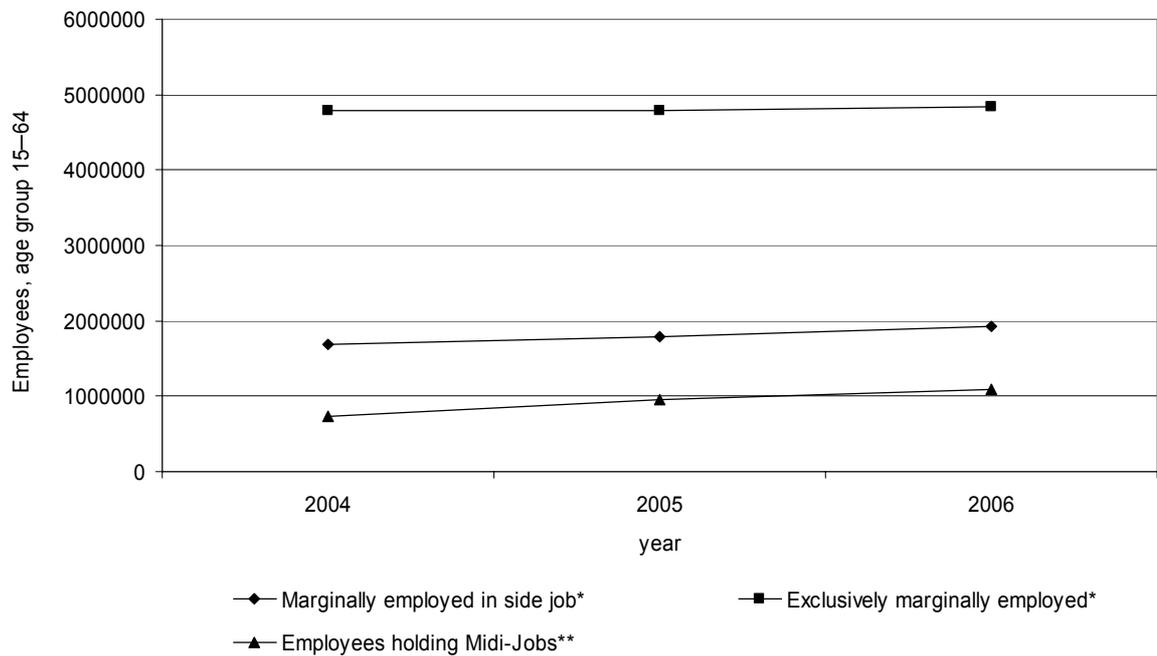
Source: European Union Labour Force Survey.

Figure 5: Standard and non-standard employment



Sources: Statistik der Bundesagentur für Arbeit, Beschäftigung in Deutschland, Tabelle 1; IAB. Daten zur kurzfristigen Entwicklung von Wirtschaft und Arbeitsmarkt, September 2007, S. 18; European Union Labour Force Survey.

Figure 6: Standard and non-standard employment



\* *Marginal employment refers to employment relations with monthly earnings up to € 400.*  
 \*\* *Midi-Jobs are employment relationships with monthly earnings between € 400 and € 800 and are subject to social security contributions.*

Sources: Statistik der Bundesagentur für Arbeit, Nuremberg 2007; Arbeitsmarkt in Zahlen, Beschäftigte Ende Dezember 2006 in Deutschland; Bundesagentur für Arbeit: Mini- und Midijobs in Deutschland. Bericht der Statistik der BA. Nuremberg, May 2007.

*Table 1: Raw data for measuring the employment performance in Germany, comparing the upswings 1998–2000 and 2005–2007*

	<b>1998</b>	<b>1999</b>	<b>2000</b>
GDP (in €)	1,965,380,000,000	2,012,000,000,000	2,062,500,000,000
Resident population (P)	82,029,000	82,087,000	82,188,000
Hours worked (H)	56,992,000,000	57,317,000,000	57,659,000,000
Employed persons (E)	37,911,000	38,424,000	39,144,000
Working age population (WAP)	55,990,000	55,915,000	55,788,000
Unemployed persons (U)	4,280,630	4,100,499	3,889,695
	<b>2005</b>	<b>2006</b>	<b>2007</b>
GDP (in €)	2,241,000,000,000	2,309,100,000,000	2,371,445,700,000
Resident population (P)	82,464,000	82,366,000	82,197,000
Hours worked (H)	55,740,000,000	56,001,000,000	55,876,000,000
Employed persons (E)	38,823,000	39,090,000	39,769,000
Working age population (WAP)	54,918,000	54,574,000	53,515,000
Unemployed persons (U)	4,860,877	4,487,057	3,783,000

	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
GDP/P	23,960	24,511	25,095	27,175	28,035	28,851
GDP/H	34.49	35.10	35.77	40.20	41.23	42.44
H/E	1,503	1,492	1,473	1,436	1,433	1,405
E/WAP	0.6771	0.6872	0.7017	0.7069	0.7163	0.7431
WAP/P	0.6826	0.6812	0.6788	0.6660	0.6626	0.6511
E/(E+U)	0.8985	0.9036	0.9096	0.8887	0.8970	0.9131
(E+U)/WAP	0.7536	0.7605	0.7714	0.7954	0.7985	0.8138
H/P	695	698	702	676	680	680

Main sources: Sachverständigenrat (2007), Statistisches Bundesamt (2006, 2007).

*Table 2: Decomposition of per capita GDP (GDP/P) into indicators of efficiency, work sharing, labour market integration and population structure in 1998, 1999, 2000, 2005, 2006 and 2007*

	<b>GDP/P</b>	=	<b>GDP/H</b>	*	<b>H/E</b>	*	<b>E/WAP</b>	+	<b>WAP/P</b>
1998	23,960	=	34.49	*	1,503	*	0.6771	*	0.6826
1999	24,511	=	35.10	*	1,492	*	0.6872	*	0.6812
2000	25,095	=	35.77	*	1,473	*	0.7017	*	0.6788
2005	27,175	=	40.20	*	1,436	*	0.7069	*	0.6660
2006	28,035	=	41.23	*	1,433	*	0.7163	*	0.6626
2007	28,851	=	42.44	*	1,405	*	0.7431	*	0.6511

GDP/P	GDP per capita
GDP/H	GDP per hour
H/E	Working time per employed person
E/WAP	Employment rate
WAP/P	Demographic component (working age population related to total population)

Main sources: Sachverständigenrat (2007), Statistisches Bundesamt (2006, 2007); authors' calculations.

*Table 3: Decomposition of per capita working time (H/P) into indicators of working time preference, utilisation of the work force, labour market inclusiveness and demographic structure in 1998, 1999, 2000, 2005, 2006 and 2007*

	<b>H/P</b>	=	<b>H/E</b>	*	<b>E/(E+U)</b>	*	<b>(E+U)/WAP</b>	*	<b>WAP/P</b>
1998	695	=	1,503	*	0.899	*	0.754	*	0.683
1999	698	=	1,492	*	0.904	*	0.761	*	0.681
2000	702	=	1,473	*	0.910	*	0.771	*	0.679
2005	676	=	1,436	*	0.889	*	0.795	*	0.666
2006	680	=	1,433	*	0.897	*	0.798	*	0.663
2007	680	=	1,405	*	0.913	*	0.814	*	0.651

H/P	Working time per capita
H/E	Working time per employed person
E/(E+U)	Labour force utilisation
(E+U)/WAP	Labour force participation rate
WAP/P	Demographic component (working age population related to total population)

Main sources: Sachverständigenrat (2007), Statistisches Bundesamt (2006, 2007); authors' calculations.

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