Kiel Institute for World Economics
Duesternbrooker Weg 120
24105 Kiel (Germany)

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The Failure of the German Labor Market

by

Horst Siebert

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Abstract: The paper analyzes why Germany experiences the high and sticky unemployment. It looks at wage policy and proposes a new approach to measure productivity growth when unemployment increases. It studies the position of trade unions and the institutional set-up of the labor market. It looks at the role of the reservation wage for the lower segment of the labor market and discusses the impact of contributions to social security on the demand for labor.

Zusammenfassung: Der Beitrag analysiert, warum die Arbeitslosigkeit in Deutschland so hoch ist. Er diskutiert die Rolle der Lohnpolitik und schlägt eine neue Methode vor, das Produktivitätswachstum bei zunehmender Arbeitslosigkeit zu messen. Die Machtposition der Gewerkschaften und das institutionelle Regelwerk für Arbeit werden erörtert. Ferner wird die Bedeutung des „Reservation Wage“ für das untere Segment des Arbeitsmarktes und der Beiträge zur Sozialversicherung für die Nachfrage nach Arbeitskräften behandelt.

Keywords: Unemployment, institutional arrangement, reservation wage, social security.

JEL classification: J0, I3.

Horst Siebert
President Emeritus
Kiel Institute for World Economics
24100 Kiel, Germany
Telephone: +49/431/8814-567
Fax:+49/431/8814-568
E-mail: siebert@ifw-kiel.de

The Failure of the German Labor Market

The poor growth performance of the German economy in the period 1995 – 2002 is partly linked to high unemployment with 4.4 million[1] officially unemployed in 2003 and 1.7 million[2] in labor market schemes of different sorts. An important economic resource, labor and human capital, is wasted, and the economy's production capacity is not fully utilized.

Unemployment has ratcheted upward in the last three and half decades from 0.7 per cent in 1970 to a maximum value of 11.4 per cent in 1997. It was at 10.4 per cent in 2003 (Figure 1); this is 8.5 per cent according to the OECD standardized rate. In heads, this is an increase in West Germany from 150 000 persons to 2.8 million. In each of the three recessions in the 1970s, 1980s and 1990s, roughly one million were added to the unemployed in Western Germany, and the high unemployment was not reduced during the boom years in a noteworthy way so that the next recession started from a higher level of unemployment. It can be expected that the same phenomenon will happen in the next recession. With unification, the structural unemployment problems in Eastern Germany were added shifting the unemployment curve upward. Although unemployment in Eastern Germany is severe with 18.1 per cent in 2003, the German unemployment problem has evolved in a long-run process over more than three decades. It cannot be attributed to unification.

Figure 1: Unemployment Rate in Germany[a]

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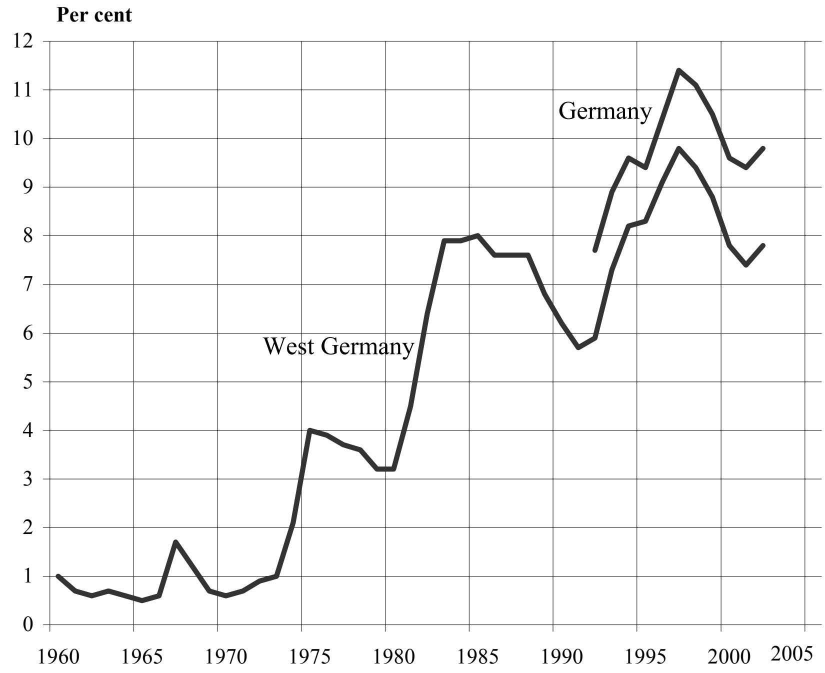
1 Forecast for 2003 as of April 2003.

2 2002.

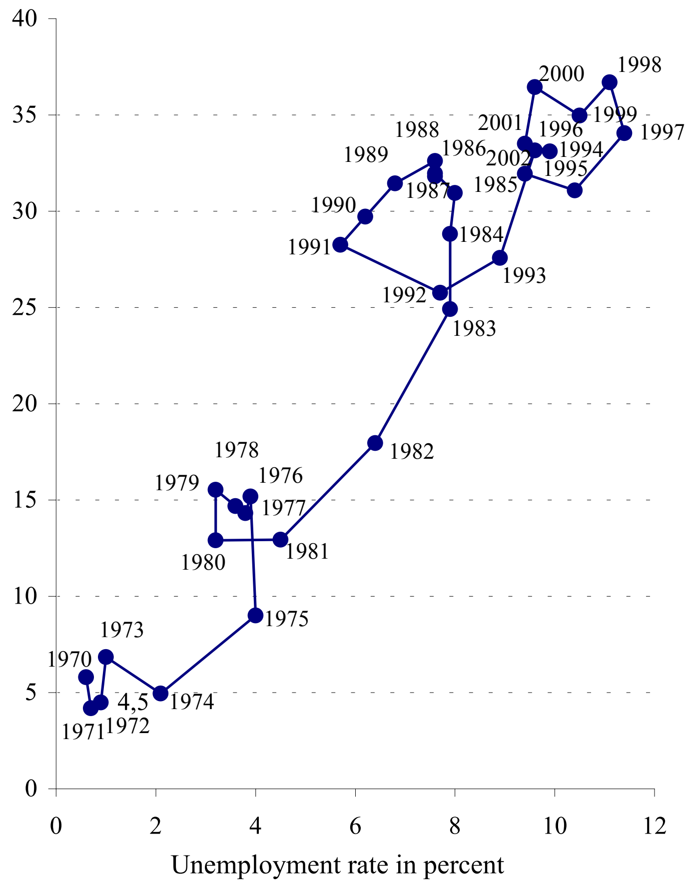


[a] Unemployed in per cent of all civilian employees.

Source: Council of Economic Advisers, Annual Reports, 2003: Forecast.

Long-term unemployment, that is the proportion of those without a job for more than a year among the unemployed, has also ratcheted upward from about 5 per cent of total unemployment to more than thirty per cent. As with unemployment, in each of the three recessions long-term unemployment moved upward and hardened; there are three loops in which the proportion of the long-term unemployed reduced somewhat, namely in the late 1970s, the late 1980s and the late 1990s, but this improvement was only temporary, and the unfavorable trend quickly picked up again (Figure 2). It now also extends to the middle age group starting with the age of 35.

Figure 2: Long-term Unemployment



[a] Long-term unemployed in per cent of the unemployed.

Source: Bundesanstalt für Arbeit.

The stepwise increase in unemployment is linked to negative shocks that hit the economy. Demand for exports can fall abruptly in a downturn of the world economy (demand shock), the price of an important resource such as oil can jump up when a resource scarcity evolves or when the property rights for extraction change as in the 1970s (supply shock), when a financial crisis breaks out in other countries, when important policy instruments are changed in the world as in fiscal or monetary policy and when sectorial crises such as global over-investment require adjustments or when secular sectorial shifts leave a trace. Such shocks are normal to occur, and they hit other countries as well. It is remarkable, however, that the German economy reacts somewhat differently than other economies to these shocks. Whereas in the US job creation sets in shortly after the recession, it takes much longer in Germany until employment picks up. In addition, it now also takes longer in Germany than in the 1970s and the 1980s until employment starts to rise after a recession. Thus, it lasted five years after the 1993 recession until employment began to increase again whereas in the recessions of the 1970s and the 1980s employment started to increase after two or three quarters[3].

Apparently, the response of the German economy to shocks has changed over time. It can be argued that Germany is relatively open compared to other economies such as the United States; it is thus affected by international phenomena more intensively. Moreover, Germany's openness measured as the share of exports in GDP has increased in the last three decades, from 22 per cent in 1970 to about 35 per cent. This means that global change has a stronger impact. Furthermore, the nature of shocks may be different now. But other countries face similar shocks. The shocks of the 1990s could have been asymmetric for Germany, and this holds for the impact of unification on the fiscal policy stance. But this argument is not convincing with respect to unemployment if one looks at the long-run and

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3 German Council of Economic Advisers, Annual Report 2000, Figure 40.

step-wise increase of unemployment in Germany in the last three decades. Finally, the nature of the German economy could have changed so that it can no longer digest shocks so easily. Or other countries have altered their institutional set-up so that an external shock, that is symmetric in principle, has become asymmetric for Germany.

There was nearly no net job creation in Germany in the last three decades except for the jump in employment figures due to German unification. The labor force measured in heads stagnated in the 1970s and decreased slightly in the 1990s; it only increased in the 1980s with a rather low rate (Table 1). Total hours worked, another measure of aggregate labor demand, decreased in the three decades with a rate of 0.5 per cent per year[4]; only in the late 1980s and the late 1990s did Germany experience an increase in total hours worked (Figure 3). This is in stark contrast to other countries where net job creation was higher, for instance in France by half a percentage point per year, in the United States by two percentage points in the 1970s and 1980s and one percentage point in the 1990s (Table 1). Part of this difference can be explained by population growth including immigration which turns into an augmentation of the labor force. Another aspect of the low rate of job creation is a potentially different response to negative shocks. The low growth performance is yet another factor because as a rule employment is related to growth. Moreover, sectorial change is a candidate of explanation, for instance from manufacturing to services. As we have seen in chapter 3,

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[4] 0.6 in the 1070s and 1980s and 0.5 in the 1990s. Calculated with the formula $r=(z_t/z_o)^{(1/n)}-1$ where r is the rate of change, z_t is the number at t and n is the number of periods.

German industry has reduced its work force by 2.5 million[5] people in the 1990s, i.e. by nearly one fourth. Apparently, other countries experiencing a similar sectorial change have managed to create more new jobs in the service sector. Whereas all these arguments may be discussed, the observed weak performance in job creation is also the flip side of increased unemployment. To look for the causes of unemployment means to know why job creation is low.

Table 1: Job Creation - Annual growth rate of employment in per cent

	1970–1989	1970–1979	1980–1989	1990–2001	1990–1995	1996–2001
Germany	0.25	–0.01	0.38	–0.12[a]	–0.81[a]	0.49
France	0.36	0.55	0.19	0.71	–0.15	1.65
Italy	0.41	0.45	0.27	–0.05	–1.45	1.26
European Union 15	0.35[b]	0.26[b]	0.53	0.47	–0.59	1.51
United Kingdom	0.40	0.28	0.58	0.37	–0.68	1.29
United States	2.01	2.35	1.85	1.09	0.90	1.22

[a]Germany: Data for 1991-2001 and 1991-1995 instead of 1990-2001 and 1990-1995. — [b]EU15: Data for 1970-1979 and 1970-1989 without Greece, Portugal and Netherlands.

Sources: OECD Statistical Compendium 2/2002 CDROM: Labour Market Statistics; Labour Force Statistics 1981-2001.

The stepwise ratcheting upward of unemployment signals that Germany's institutional design for labor is malfunctioning. There are three major aspects: One is the institutional design for wage formation, another is the role of the reservation wage; finally, the demand for labor is systematically weakened. We will address these issues now.

5 In plants with more than 19 employees.

Wage Policy

The term 'wage policy' may be surprising to the international and especially the Anglo-Saxon reader who is used to the idea that wages as a price for labor are determined in the market. But in Germany 'wage policy' plays a decisive role; wage formation is not left to the markets but determined by the social partners, the trade unions and the employers' associations, in a sector-wide bargaining process. The typical procedure is to start wage negotiations for a specific sector in a specific region, and then to apply the negotiated wages to all the other regions of the same sector. Normally, negotiations are started in economically strong regions. Usually, the sector-wide wage contracts are mimicked in the other sectors of the economy including the public sector. As a result, the bargaining process is *de facto* nation wide. The length of wage contracts varies; its duration is usually a year at the minimum, sometimes holding for two years. Since the length of the contract of individual unions varies, different unions may start the wage round. Usually, the larger unions begin the negotiations, either the metalworkers' union or the service sector union.

Besides the branch contract between the trade unions and the employers' association, trade unions can also contract with individual firms (firm contract). About 21.5 million workers are covered by 2 731 branch contracts (2002), about 3.5 million by 4 853 firm contracts. This means that roughly 70 per cent of the dependently employed are covered by contracts.[6] It is estimated by the Institute of the Employment Office that the contracts

6 According to the 2001 IAB- panel of 15 000 firms being representative for 2.1 million firms 63.1 per cent of the employees are covered by branch contracts in West Germany and 44.6 per cent in East Germany. With respect to plants, the respective figures are 22.1 and 5.5.

serve as an orientation for an additional 15 per cent of the work force. In addition to the 7 584 wage contracts there are 23 961 contracts referring to conditions of the work contract such as working hours and days of vacation.

The negotiated wage is not necessarily identical to the market wage. Whereas in the 1950s and 1960s there was a positive wage drift in the sense that the effective wage increase determined by the market was higher than the rise of the negotiated wage, this can no longer be observed in the 1990s. This suggests that the negotiated wage increase became more and more binding on a macroeconomic scale. It may be argued that the unions could get a noticeable pay rise more easily in the first decades of the last half century when productivity growth was strong without negatively affecting employment. It may have become harder for them to obtain a noticeable increase later on.

Trade unions have not accepted what the German Council of Economic Advisers has proposed as an orientation for union wage policy: According to the Council's concept, a clue to more employment is the increase in the real wage that the firm has to pay (*Arbeitnehmerentgelt)* including social security contributions paid by employers per hour, i.e. the labor costs or the producers wage, relative to the productivity increase per hour.[7] When the producers real wage income rises more than productivity, i.e. when we have wage overshooting, labor demand is likely to fall; if the wage rate rises less than productivity, i.e. if we have wage moderation, labor demand

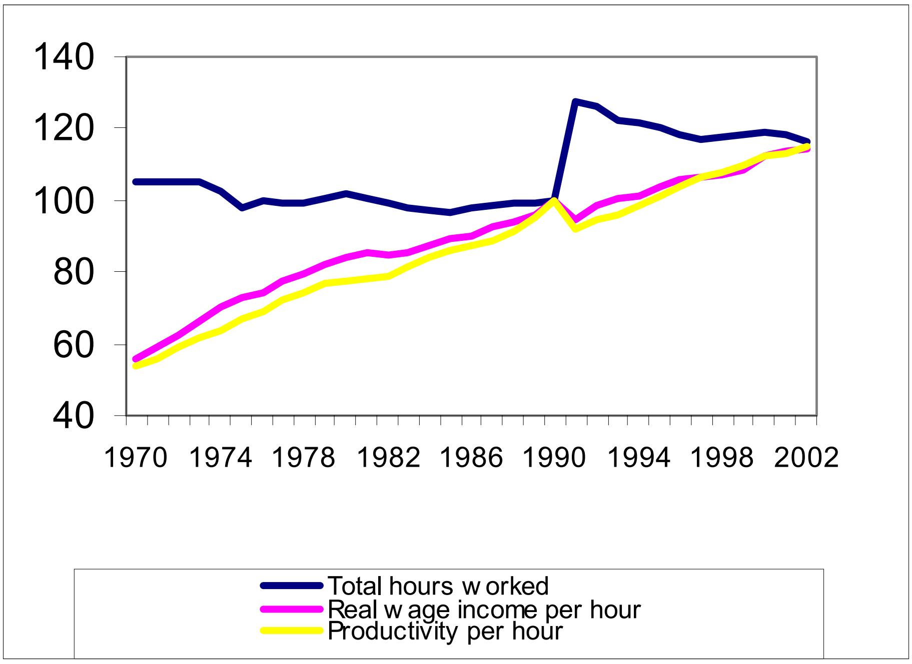
[7] The correct measure is marginal productivity per hour. For simplification we here use average productivity per hour.

increases. Whereas in a situation of full employment real wages can increase with the growth rate of productivity without generating unemployment, wages should not be raised according to the observed trend in the growth of labor productivity per hour when unemployment is high. Instead, the wage increase should remain below that trend in order to bring the unemployed into employment. That means that a discount should be applied to the trend of productivity growth. To put it differently, the expected increase in labor productivity is different from the observed past trend when unemployment is high. The expected increase in labor productivity should not be calculated by dividing output by the hours worked by those employed but by also including in the numerator of the productivity measure the potential hours of the more than 6 million who are in official and hidden unemployment.

Admittedly, wage policy becomes more difficult for the trade unions when the contributions to social security rise. These contributions are part of the labor costs from the point of view of the firms. And together with the gross wage income before tax they must be covered by productivity. If the government is forced to raise contributions to social security as during German unification this absorbs part of the productivity growth. The remaining potential for pure wage increases is squeezed.

Of course, labor demand is influenced by a whole set of factors, for instance the business cycle situation, the growth rate, the institutional set-up, but in general a relationship exists between wage overshooting and the weakness of labor demand measured in hours worked (Figure 3). From 1970 to the end of the 1980s, real wage income per hour was at a higher level than productivity, setting the variables for 1990 equal to 100. Labor demand measured in total hours worked declined. Only at the end of the 1980s, productivity came closer to labor income; then labor demand rose. In the first part of the 1990s, labor income in Germany was at a higher level than productivity, again labor demand declined. Since the mid-1990s, the productivity level was higher. This picture is more or less confirmed if another base year instead of 1990 is chosen. Note that the sharp increase in total hours worked as well as the decline in productivity and the real wage per hour in 1990 reflects German unification.

Figure 3: Real wage income, labor productivity and labor demand[a], 1970-2002[b].

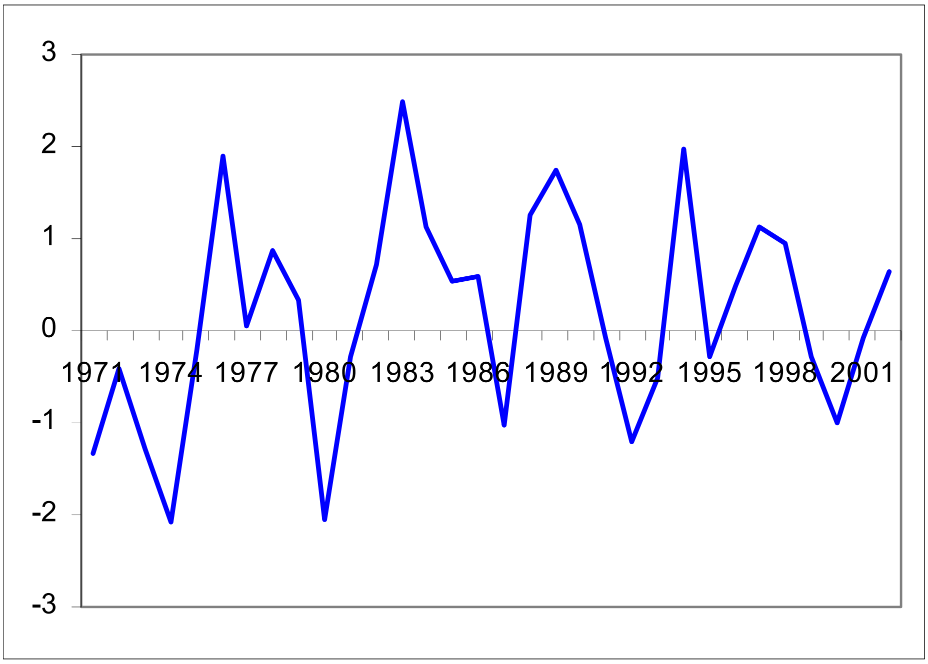


[a]Hours worked. — [b]1991=100.

Source: Statistical Office, Volkswirtschaftliche Gesamtrechnungen Revidierte Ergebnisse 1970 bis 2001. 1970-2001.

Looking at the rate of wage moderation on an annual basis, i.e. the productivity increase per hour minus the augmentation of real labor income per hour, the early part of the 1970s shows strong wage overshooting, especially during the first oil crisis (Figure 4). There is wage moderation in the second part of the 1970s, but overshooting again in 1980–81 in the second oil crisis. It seems that the real wage overhang continues to have an impact into the mid eighties. There was wage overshooting again in 1987, 1992, and also to a smaller extent in 1995, 1999 and 2000 (see below). Looking at wage policy over the three decades, periods of overshooting and wage moderation follow each other. Since for the firms hiring a worker is a long-term decision like an investment given the German institutional set-up of lay-off constraints, the firms need some stability in their expectation on wage moderation. Cycles in wage policy with overshooting and moderation are not helpful in this respect. With unemployment rising, it is telling that wage moderation of more than 1 per cent was only applied in the years 1976, in 1983/84 (in and after the recession), in 1988–1990, in 1994 (after the recession) and in 1997. Of these moderations of at least one per cent, only the moderation in the late 1980s lasted for a longer period, namely of three years; it showed a positive impact for employment.

Figure 4: Wage moderation[a]



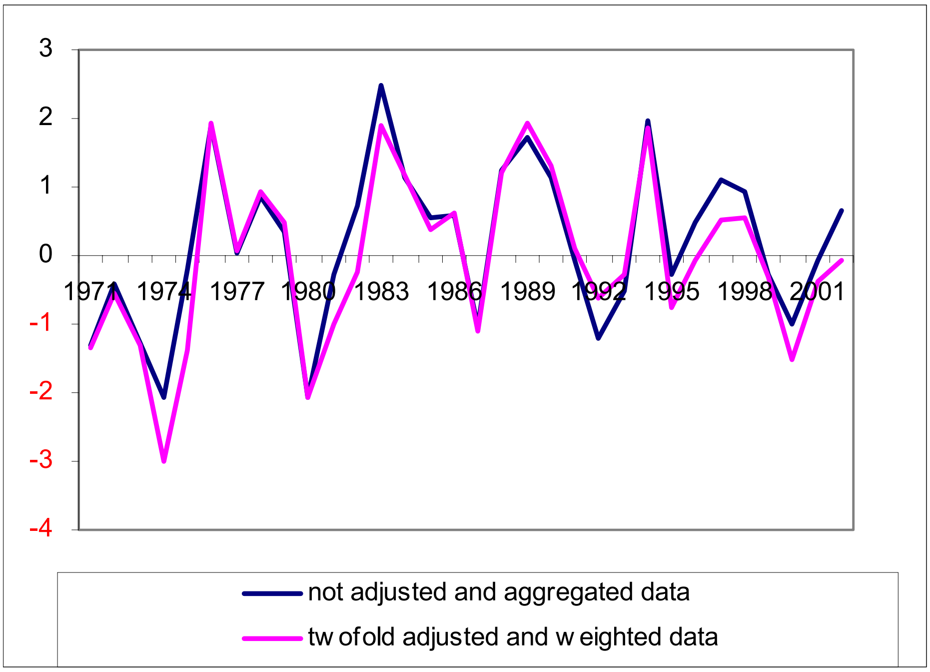
[a]Not adjusted for unemployment, aggregate data for Germany since 1991.

Comparing the increase in the statistically observed productivity and in labor income is, however, a distorting measuring rod for wage policy since part of the observed productivity increase is due to the rise in unemployment. An increase in unemployment means moving up the marginal productivity curve of labor; consequently, labor productivity increases when unemployment rises. To put it ironically, productivity would be highest if only one person would work in an economy. Consequently, the annual measured productivity increase must be adjusted downward in order to account for the rising unemployment. When this is done, the curve of wage moderation shifts downward (Figure 5).[8] The

[8] The annual wage moderation has been recalculated for the change in unemployment. It has been assumed that workers who are laid off have a lower productivity than the employed; their productivity is only 0.7 of those who are employed.

employment-adjusted productivity growth as a guide line for wage policy is lower for years in which more people are laid off; during unemployment it is higher for years in which unemployment is reduced. In the 1970s and in the early 1980s, the adjusted wage overshooting was higher and lasted longer than the non-adjusted overshooting; the adjusted wage moderation in the early 1980s was lower.

Figure 5: Wage moderation, non-adjusted and adjusted



Our analysis in which we use data for the German economy as a whole since 1991 for the levels and since 1992 for the rates includes yet another distortion. Eastern Germany was hit by a structural transformation shock, and consequently unemployment sky-rocketed especially in 1990 and the early 1990s. Looking at the rates of wage moderation in individual years for Eastern Germany in 1992 and after would not adequately account for the structural break. We therefore have two options to adjust the productivity growth: either calculate the wage overshooting for the year 1990 or to adjust the data for 1992 and after for the structural unemployment.[9]

Whereas a full employment situation implies that marginal productivity is equal to the real wage, there was a serious wedge between these two variables in Eastern Germany in 1990 and after. Define f as marginal productivity per hour, w as the nominal wage and p as the price level (with w/p as the real wage), then the equation

$$f(1+\alpha) = \frac{w}{p}$$

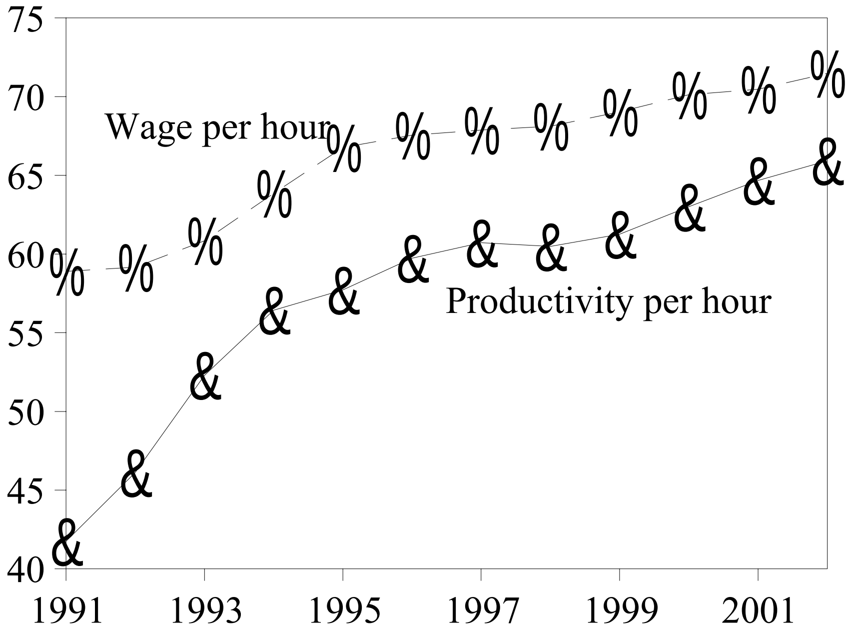
holds, where the wedge is defined as

$$\alpha = \frac{(w/p) - f}{f}.$$

Simplifying and using data for average instead of marginal productivity, the wedge α was 0.41 in 1991 in East Germany or the real wage was 1.41 times the productivity. This wedge is nearly identical to the wedge in wage income and the gross wage per head and unit labor costs of East Germany relative to West Germany. To put it differently, East German productivity per hour was at 42 per cent of the West German level whereas wage per hour was at 59 per cent. This is a sizeable gap. In Figure 6, the data for productivity and wage denote the East German level, setting the West German level equal to 100 in each year.

[9] Note that the approach of wage moderation applied here presupposes an initial situation of full employment as in 1970.

Figure 6: Productivity Gap in East Germany[a]



[a]West Germany = 100 for each year.

Such a high wedge between the real wage and productivity is, of course, a strong incentive to reduce jobs. And the observed growth rate of productivity in a given year does not represent the permissible rate for the wage increase. Quite to the contrary, a reduction must be made in order to melt down the initial wedge. Let us therefore assume that this wedge is to be reduced over a period of twelve years. If this correction in the calculation of wage moderation is made, it only partially affects the total German picture since Eastern Germany accounts for only about one fifth of the West German total hours worked in the early 1990s. But as a result, the curve of wage moderation is shifted downward (Figure 5).

The overall result is: Wage policy has contributed to the unemployment situation. It has not adjusted productivity growth for the increase in unemployment by applying a discount factor to the measured productivity increase. The unemployment-adjusted productivity increase is lower for years in which unemployment rises; correspondingly, it is higher for years in which unemployment falls. Wage policy is thus, together with other factors, responsible for the increase in unemployment.

Wage Structure

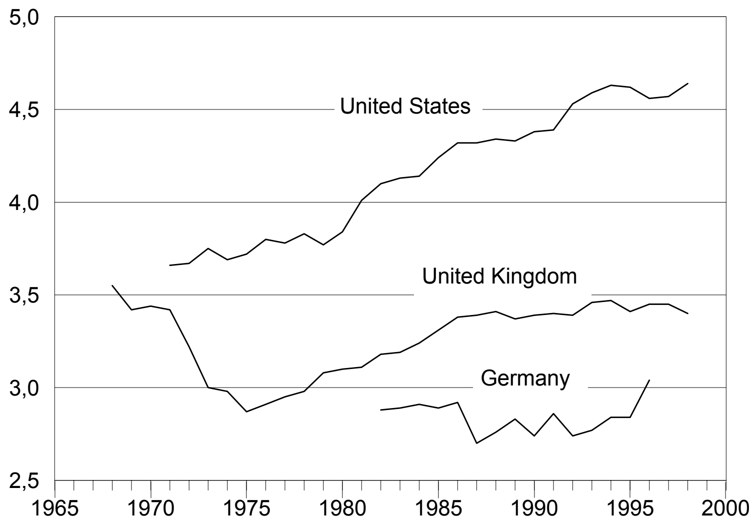
Another impact of the trade unions' wage policy is the lacking wage differentiation. An economy needs a differentiated wage structure so that the profiles of qualification of workers and the profiles desired by firms can be matched and an equilibrium between supply and demand obtains. It is realistic to expect that the nearly 35 million German employees exhibit different degrees of qualifications; the labor supply of an economy can be viewed as representing a productivity stair case where each step represents a different productivity level. Moreover, there is a strong shift in the structure of labor demand reflecting the sectorial change in the economy from the industrial sector to the service and information industries. This means that the existing qualifications are re-evaluated. Human capital becomes partly obsolete, and this should show up in a decline of the relative wage. If employees whose qualifications become obsolete cling to their previous wage, unemployment results. The wage structure must adjust to the change in the structure of wage demand.

We do not know exactly the complete set of wages or the wage structure for the whole economy that could bring about equilibrium in the labor market. However, there are some indicators that point into the direction of a serious misalignment in the German case.

First, wage differentiation measured as the relation of the highest to the lowest decile is low in Germany relative to the United Kingdom and the United States for the 1980s and the first part of the 1990s (There are no more recent internationally consistent data). Moreover, in the Anglo-Saxon world the spread has increased in the last twenty years (Figure 7). It is now agreed in the economics profession that all industrial countries were affected by a relative decline in the demand for low-qualified labor.[10] But whereas other countries have responded by increasing the spread, Germany's wage structure remained relatively stable. This is not only surprising against the background of the international experience, it is all the more surprising since Germany experienced an expansion in its labor force due to unification. This increase in the labor supply was not in high-qualified labor but in labor accustomed to obsolete physical capital. Thus, German unification was an additional reason for a more differentiated wage structure.

Figure 7: Relative Earnings[a]

[10] For instance in Germany, industry reduced 1.8 million jobs in the two decades since 1980, of which 1.6 millions were less qualified positions. The service sector has expanded employment by 3.7 million, of which 2.8 are qualified,. Siebert (2002) p. 115.



[a]Highest decile of gross labor income to lowest decile.

Source: OECD.

Second, there is a disequilibrium between the high and rising unemployment rate of the low-qualified and their relative wage. The low qualified, i.e. those without a formal school diploma, have an unemployment rate of 22 per cent (2000)[11] which has been has rising in the 1990s both in Western and Eastern Germany; yet the wage structure with respect to qualification remains constant for Western Germany in the last two decades and for Eastern Germany since 1993[12] (Christensen 2003). This means that the low- qualified are exposed to an increasing unemployment risk but that the relative wage does not respond to ameleriorate this situation. This result has been obtained from the data set of the 2001 Socio-economic Panel comprising more than 10 000 individuals in about 5000 households who are interviewed in waves in the

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11 19.4 in Western Germany and 50.3 in Eastern Germany in 2000.

12 There was an increase in the spread in the period 1990-1993.

period 1984-2001.[13] A wage equation including age, marital status, the level of qualification and other factors (West and East) has been estimated empirically. Earlier results for the period 1984- 1995 indicated a slight decline in the spread in terms of qualifications (Christensen and Schimmelpfennig 1998; Schimmelpfennig 2000). This indicates that, taking into account the relative decline in the demand for low-skilled labor, this segment of the labor force was priced out of the market; the wage structure with respect to qualifications is not adequate. This result came about partly by a wage policy favoring the lower income groups, negotiating for them an over-proportional increase. Moreover, the lowest wage group in industry was given up. In addition, the expansion of the welfare state (to be discussed later) has increased the reservation wage; this in turn made the informal minimum wage increase so that the lower segment of the labor market has dried up.

Third, the wage structure in Germany seems to be compressed from above. This in a way is implied nearly automatically when the lower floor of the wage structure is too high and when at the same time the financial means to compensate the negative effects of the wage structure in terms of unemployment and social welfare are compensated by expenditures that are financed by taxes on labor having a higher income. Then, effort and the incentive to build human capital is reduced. And the inducement to move to the underground economy is increased. Lacking wage differentiation thus is linked to the welfare state as will be discussed later, but at the same it is connected with the low dynamics of the economy.

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[13] For this specific analysis of unemployment, the data set comprised 2 893 in Western und 1 332 in Eastern Germany persons in mean for the period 1984–2001.

To sum up, wage differentiation is not sufficient in Germany. The trade unions' argument that the multitude of wage contracts gives enough flexibility in the wage structure of the economy relating them appropriately to the productivity level does not hold.

Trade Unions Lose Members

In the wage formation process as well as in many other aspects of the institutional set-up of the German labor market, trade unions play an important role. The DGB, the German Federation of Trade Unions, the umbrella organization of the sectoral trade unions, had 7.7 million members in 2002. Ver.di, the Unified Service Sector Union, and IG Metall, the Metalworkers' Union, with about 2.7 million members each are the dominating sectorial unions. Of the total work force, 17.9 per cent are organized in the DGB. Sometimes, a higher degree of organization of 30 per cent is mentioned. However, about twenty per cent of trade union members are retired, so that only 6.2 million are actually in the working age. This means that relative to the 34.6 million dependently employed, the degree of organization is as low as mentioned above. It may seem ironic, but the trade unions have about the same number of members as are in open or hidden unemployment.

Trade unions lose members. This is especially apparent in the 1990s. Since 1991, the DGB has lost 4.1 million members, more than a third (Table 2). IG Metall and the unions making up ver.di have lost more than a fourth of their members. This development, however, gives a somewhat false picture, since the trade unions nearly automatically attracted new members from Eastern Germany who used to be forced to belong to the trade unions under the Communist system. Thus, the high level of membership in 1991 is distorted due to German unification.

Table 2: Decline in union membership 1991-2002, in million

	DGB	IG-Metall	ver.di
1991	11.8	3.62	4.32[a]
2002	7.7[b]	2.64[c]	2.74
	–4.1	–0.98	–1.58

[a]The number represents the members of the unions that formed ver.di in 1991. — [b]The number includes the 451 000 members of the clerks union (DAG) integrated into the DGB in March 2001. — [c]The number includes the 183 000 members of the textile union as well as the 133 000 members of the wood and plastics union integrated in 1998 and 2000 into the IG Metall.

Taking into account a more long-run perspective, membership in 2002 is lower than in 1980 in spite of an increase in the labor force (dependently employed) by 10.5 million in the same period (Table 3). The degree of organization fell from 26.4 per cent of the dependently employed in 1980 to 17.9 per cent; it was 31.9 per cent in 1950. Again, for this calculation it has been assumed that 20 per cent of the trade union members are pensioners.

Table 3: Union membership in Germany[a] (in thousands)

		1950	1960	1970	1980	1990	1991	2000	2002
DGB	German Federation of Trade Unions	5 451	6 379	6 713	7 883	7 938	11 800	7 772	7 700
IG Metall	Metalworkers' Union	1 352	1 843	2 223	2 622	2 727	3 624	2 763	2 644
IG BCE	Chemicals. Energy and Mining Union					[1 041][b]	[1 425][b]	892	834
GCGPK[b]	Chemicals. Glass. Paper and Ceramics Union	410	520	599	661	676	877		
Ver.di	Unified Service Sector Union					[2 826][b]	[4 317][b]	[2 989][b]	2 740
ÖTV[c]	Public Services. Transport and Traffic Union	726	963	977	1 150	1 253	2 138	1 477	
DAG[c]	German Salaried Employees' Union	307	450	461	495	505	585	451	
DBB	German Public Servants' Federation	190	650	721	819	799	1 053	1 200	1 224
Estimated union density in Germany[d]		31.9	25.2	24.1	26.4	24.9	28.5	17.9	17.8

[ ]: The brackets show the hypothetical size of the union before its later formation. — [a]1950-1990: Data for West Germany. 1991-2002: data for unified Germany. — [b]GCGPK joined IG BCE in October 1997. — [c]ÖTV and DAG joined Ver.di in March 2001. — [d]Without DBB.

Sources: DGB; Bernhard Ebbinghaus (2002); Statistisches Bundesamt; German Council of Economic Advisers, Annual Report 1990/1991 and 1997/1998.

In order to become more effective, unions are consolidating since the 1990s. This partly reflects the structural change in the economy, i.e. the relative decline of employment in the producing sector and the rise of the service sector. It proves to be more difficult to organize employees in the service sector, especially in the new economy, where the traditional standardized work contract does not apply and where effort-oriented and profit-sharing arrangements are typical. The consolidation of unions also is a response to declining membership. In 1998, the 183 000 members of the textile union integrated into the IG Metall, in 2000 the 133 000 members of the wood and plastics union also joined the IG Metall. In March 2001, five unions of the service sector merged into the new union Ver.di, among them the ÖTV, the Public Services, Transport and Traffic Union with 1 477 million members, the DAG, the clerks union with 451 000 members, the IG Medien, the media union with 175 000 members, the HBV, the commerce, banking and insurance union with 441 000 members and the DPG, the Postal Workers' Union with 446 000 members. By this development, the clerks union, which has been separate from the DGB, came under the common roof of the German Federation of Trade Unions.

The power of trade unions does not only arise from membership. They also have a political influence in a country where it's the done thing to be a member of the trade union. For instance, Chancellor Schröder and part of his cabinet are union members. Of the 251 social-democratic members of the Bundestag in the period 2002–2006, 186 or 74 per cent belong to a trade union, some are still active in some function of the union in spite of their membership in parliament. For the PDS, the socialist party, the percentage is 50, for the Greens 24, for the Christian Democrats four, and for the Liberal Democrats two.

Union power also depends on the willingness of firms to remain members of the employers' association although firms can be forced into a firm contract. If firms leave their organization, the trade unions lose their counterparts and collective bargaining becomes less relevant. Anecdotal evidence suggests that smaller and medium sized firms are less willing to be a member of the employers' association. Some of the associations have split up into two clubs one of them without the role of wage negotiation. Data of the IAB-panel of 15 000 firms being representative for 2.1 million firms indicates that the number of employed covered by collective contracts is falling, for instance for the branch contract from 72.2 per cent in 1995 to 63.1 per cent in 2001 (West Germany). In Eastern Germany, only 44.4 per cent of the employed are covered by branch contracts in only 22.1 per cent of the plants. Branch contracts are especially relevant in coal mining, in construction, in the banking and insurance sector and among government employees.

Although the trade unions account for only a small proportion of the active work force of less than twenty per cent, nearly 70 per cent of the employed are covered by a union contract. Apparently, trade unions continue to have a decisive influence on wages and the wage structure, even when they are losing members. This is a puzzle, at least at first sight. They also have a strong impact on economic policy and the government. In a way, they can block major changes in the institutional set-up of the labor market and other regulations.

The Institutional Design for Wage Formation

The power of the trade unions is rooted to a large extent in Germany's institutional set-up. Let us take a closer look at some of the legal regulations that define the role of the collective contract and of the unions. The social partners, i.e. the trade unions and the employers' associations, have been granted the right to negotiate a collective wage contract relating to wages, working time, holidays, fringe benefits and other aspects of work. They have the right to strike and thus to force such a contract onto the firms if they have sufficient support from their members and the public. Membership is voluntary, but the result of collective bargaining is binding. Thus, the negotiated wage applies to all firms that are member of the employer's association and to all workers who are member of the trade unions. That means that the social partners are legally entitled to regulate labor relations as if they had parliamentary power to pass laws (*wage autonomy or Tarifautonomie*). The collective contract is defended by the courts; it even applies to the unemployed who can only take a job at the union wage. For the collective bargaining to be binding, it is required that both the workers and the firms are members of the respective organizations. But in practice, the collective contract has an impact beyond membership. De facto, firms do not differentiate wages according to union membership of workers or non-membership. Trade unions that have a high degree of organization in a firm can in a way force a firm to agree to a union contract; this then is not a branch contract but a firm-specific arrangement. Moreover, the negotiated wages set the standard for the non-unionized firms as well.[14] Thus, negotiated wages represent the norm for the economy, even for the unemployed. In addition, trade unions have power because they participate in co-determination and in worker's councils; the social partners are also assigned functions by law, either explicitly or implicitly. An example is that they are granted the right to regulate in a binding way how things have to be done in the firms. Another example is that retirement savings plans negotiated by the social partners receive a preferential treatment in terms of taxation.

Limitations on the deviation from the collective contract. The clue to grasp the German set-up is to know that the negotiated collective wage contract is legally protected by a number of provisions. These mechanisms prevent market forces from bringing about an equilibrium with less unemployment. They protect the insiders in their job with respect to the bargained collective wage income, in the security of the job, the working hours, holidays agreed upon and fringe benefits. But they effectively discriminate the outsiders, the unemployed. Discrimination occurs for the simple reason that the more protected the economic position of the employed, the lower is the inducement of firms to hire additional workers. These regulations define a wage cartel giving trade unions and employers' associations the right to set the wage but not making them institutionally responsible for the quantities that will result in the labor market, i.e., employment and unemployment.

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14 For instance, the Employment Offices mediate jobs for the unemployed according to the local customary wage that is influenced by the negotiated wage.

Constitutional freedom of coalition. Article 9 sec III of the German constitution defines the right to form a coalition. This positive freedom of coalition, the corner stone of all other legal stipulations with respect to the labor market, finds a limit in that nobody can be forced to become a member of a coalition (negative freedom of coalition).

To give the right to the social partners to set the wage does not guarantee that full employment results. Of course, there is moral suasion that they should take into consideration the impact of wages on unemployment. But besides moral suasion there is no explicit mechanism that prevents a wage policy ending up in high unemployment. No formal responsibility has been defined for the social partners. It would be extremely difficult to specify such a responsibility. For instance, they could have been obliged to increase wages in regions with high unemployment less than by the national average. Or they could have been asked to finance the unemployment benefits from their membership dues. Or it could have been established that the unemployed have some say on the collective results, at least if unemployment is extremely high. In any case, if one is not prepared to rely a little bit more on the market, the dependencies are somewhat blurred so that the responsibilities cannot be easily defined in legal terms. Nevertheless, the Constitutional Court has ruled that the social partners – although having norm-setting rights – do not have a norm-setting monopoly. Parliament may intervene in the *wage autonomy* of the social partners if other constitutional rights are violated. Reducing mass unemployment allows individuals to realize their constitutional right of the freedom of occupation (Article 12) and to develop their personality

(Articles 1 and 2). Thus, Article 9 and the positive right of coalition do not imply that some limits cannot be put on *wage autonomy*.

Limiting the individual's option to deviate. One basic legal principle, the *Günstigkeitsprinzip*, (the principle of the most favorable condition, § 4 Sec 3 *Tarifvertragsgesetz*) stipulates that the individual worker can as a union member deviate from the negotiated union wage contract if this is favorable for him. "Favorable", however, is interpreted in a narrow sense by the labor courts as a wage higher than in the union contract or as less working time. The risk of becoming unemployed or the security of the job can not legally be part of the consideration of whether to deviate from the union contract is favorable; this has been explicitly decided by the highest labor court (*Bundesarbeitsgericht)* in 1999. According to this decision, wages and working time on the one hand and the security of a job on the other hand are not allowed to be compared whereas any freshman of economics knows that the three variables: wage level, working time and the security of a job are strongly interrelated in economic reality. Moreover, all three variables can be expected to be argument variables in the utility function of workers. Limiting the individual's choice means rigidity in the labor market; it also contributes to the low degree of wage differentiation. To stipulate that the risk of losing the job should be taken into consideration or that the individual worker should have the right to decide for himself whether he wants to deviate from the union contract meets the strong opposition of the trade unions who fear to lose organizational power.

The analogon to these provisions for the employed is that the unemployed can only enter the labor market according to the rules of the collective contract, unless the social partners have introduced provisions that the unemployed can start a job below the collective pay scale. For instance, in the chemical sector such a provision holds with a discount of 10 per cent below the collective wage in the first year of employment. But in general, the existing collective wage is protected against the competition from the unemployed. This, of course, means that the protection of the insiders represents a hindrance of market entry.

Limiting the firm's option to deviate. Another legal provision is equally essential in establishing the role of the collective contract and the power of the unions. It stipulates that firms can not deviate from the union contract unless this is permitted in the contract itself (§ 77, Sec 3 *Works Council Constitution Act or Betriebsverfassungsgesetz*).[15] Thus, even if the workers of a firm agree with an overwhelming majority to work longer hours per week or to accept a lower wage in order to make their jobs safer, this is *verboten.* This regulation even applies to those firms that are not a member of the employers' association. Labor contracts including besides the wage also the security of the job have advantages both for the workers and the firm. In that sense they are efficient contracts; they allow a higher welfare than the union contract. Moreover, they give important signals to the market. But such efficient labor contracts are legally not feasible in Germany. Admittedly, firms and workers have disregarded this stipulation to some extent. But legal battles in the courts have sustained the law that

[15] This provision even applies to firms that are not members of the employers' association. It thus *de facto* violates the negative "freedom of coalition" guaranteed by the Constitution, i.e. that no one should be forced into union membership.

prevents efficient labor contracts. Again, trade unions oppose a change in this regulation for the fear of losing power.

Other mechanisms strengthening the collective contract. Firms are free to leave the employers’ association. However, they continue to be legally bound for the duration of the contract and even until a new contract is established. For contracts that specify the framework of labor relations, for instance with respect to holidays or extra pay and that tend to have a duration of five to seven years, this is a long time. Besides this legal aspect, trade unions can force a firm that has left the employers’ association and thus the branch contract, to sign a firm-specific contract if the trade union has enough organizational power in that firm. Therefore firms may be reluctant to leave the employers association.

Moreover, the labor minister has the right to declare wages mandatory if this is deemed to be in the public interest. In the past, this instrument has been used in the construction sector and low-paid occupations like window-and façade cleaners. These are labor-intensive and wage-sensitive activities. Declaring wages in these areas mandatory, is one of the reasons why the relative wage of the low-skilled has risen.

Finally, in a more recent law a minimum wage for the construction sector was enacted. This was intended to reduce the impact of low-skilled labor supply from other countries of the European Union such as Portugal and from the countries of middle and eastern Europe. Another recent law requires that private firms have to honor the results of collective bargaining irrespective of whether they are member of the employers’ association if they perform construction work for the government or if they provide services in local transportation. In this law, even product market regulations are used to enforce the collective contract.

Lay-off constraints. Another aspect is that lay-off restraints and the practice to get around them with a high severance pay represent an exit constraint that is anticipated by the firms in their demand for labor. Lay-offs are only permitted under specific conditions. Besides the case of individual misbehavior, a lay-off is allowed if it is warranted by a firm's economic situation. Then a set of social criteria relating to age, martial status and other aspects have to be observed. A severance pay has to be made varying with the length of employment in the firm and amounting up to up to one year's salary as a rule and up to 1 ½ year's salary for an adherence to the firm of 20 years. In the case of mass lay-offs, the severance pay is negotiated with the workers council in a social closing plan. The lay-off rules are subject to interpretation so that disputes typically are settled in the labor courts. The labor courts have developed the legal setting further (judge's law). Consequently, there is uncertainty for the firms in the case of lay-offs; only firms with less than six employees are exempt. This exit constraint for those employed represents an entry barrier for the unemployed; it weakens the demand for labor. The restraint is especially binding when in times of a crisis wages and working time are sticky downward for the individual firm.[16]

[16] Downward flexibility in working time with a reduction of pay can reduce the impact of lay-off constraints.

Codetermination and workers council. The power of trade unions is also partly rooted in codetermination in the boards of companies with more than 2000 employees and in the workers' councils. The board is the supervisory and not the operating body of a firm. In incorporated firms[17] with more than 2000 employees half of the seats are taken by the capital owners, the other half by the employees; there are six for both sides in firms with less than 10 000 employees. One of the position on the employees side is earmarked for the managerial employees; some positions (two of six and accordingly for larger firms) are reserved for the trade unions. The president of the board has two votes. In the coal and steel industry, 50 per cent of the seats are allocated to the trade unions. Here the president does not have two votes, but there is an additional "neutral" member. In firms of other legal forms employees must make up a third of the member of the board according to Works Council Constitution Act. The members of the board on the employee's side are elected by an electoral board. Trade unions have the right of nomination for their positions.

The workers council has a set of decision rights where its consent is mandatory according to the Works Council Constitution Act. These include the day-to-operations such as working conditions, the organization of working time and the work process as well as the introduction of new production processes. It is involved in lay-offs, social closing plans and all social issues of the employees. Its decisions are binding for all employees. Its members are elected; they are not necessarily representatives of the trade unions although the unions play a dominant role.

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[17] Including GmbH.

Rules on strikes. Trade unions have the right to call a strike. A precondition is that a collective wage contract does not exist or has expired. They do not have the right to strike during the contract period (although wild strikes may occur) and during a grace or peace period after the contract has expired and when negotiations are taking place. They also are not allowed to strike in a period of mediation for which both sides may call after the negotiations failed; the proposal of the mediator has to be accepted by both sides. If it is not accepted a strike is called. A strike is only allowed if 75 per cent of the trade union members agree to it; the negotiation result is final if at least 25 per cent of the members accept it. Striking union members receive a strike compensation from the union; non-union workers who are out of work due to the strike (for instance honoring the picket line) go without pay. The strike is the last possible means to come to a contract ("ultima ratio"). The government has nearly no legal means to prevent a strike. Recently "needlepoint" strikes or "warning strikes" preceding the negotiations were allowed by the labor courts. In these strikes, the union strike against selective firms picking them strategically, for instance firms that produce essential intermediate inputs whose non-availability will hurt other firms. The firms are allowed to lock out the striking workers but this instrument has not been used lately. It becomes less and less acceptable in public opinion. Besides, a lockout is not effective against needlepoint strikes that take advantage of highly densely networked firms.

Until 1986, the Employment Office paid unemployment benefits to workers who became unemployed due to the strike, because intermediate inputs could not be obtained for production, for instance when workers in other regions where no strike took place were affected. According to the new rule[18], the Employment Office must now be neutral in case of a strike. That means that employees being laid-off as a ramification of the strike can no longer collect unemployment benefits. To change this to the previous rule is a permanent request of the trade unions.

Labor courts. A feature of the institutional set-up of the labor market are the labor courts that are to deal with all sorts of labor issues, including disputes on the stipulations with respect to collective wage bargaining, the rules for strikes, lay-offs and other matters. The court system is structured vertically with three tiers, the Supreme Labor Court having the final say except for constitutional issues. The labor courts are a specific from of the administrative courts. They have developed legal rules in addition to the written law ("judges law").

The Reservation Wage and the Lower Segment of the Labor Market

An important aspect of the labor market in Germany is the institutional arrangement for those who do not find a job or who are unable to work in case of illness or for other reasons. This set-up protects people, but at the same time it influences the search behavior of the unemployed and the willingness to accept a job offer. All this has an impact especially on the lower segment of the labor market.

[18] § 146 Sozialgesetzbuch III.

Unemployment benefits. Germany has developed two types of unemployment support. Unemployment benefits of type I (*Arbeitslosengeld*) is at 67 per cent of the previous net income (unemployed with at least one child).[19] The duration of benefits varies with age and goes up to 32 months. 1.7 million received this type of benefit in 2001. Unemployment benefits of type II (*Arbeitslosenhilfe*) amounts to 57 per cent of the net wage.[20] It is paid when unemployment benefits of type I expire. This type of benefit is paid indefinitely. It is linked to the previous working income and requires neediness. This type of benefit was paid to 1.5 million in 2001.

Sickness pay is provided at 100 per cent of the previous gross wage for the first six weeks and 80 per cent thereafter.[21] v

Social welfare benefits (*Sozialhilfe*) represent payments to allow a life in dignity for those who cannot make their living by themselves. This includes the elderly without sufficient income, but this group has no relevance for the labor market. It also includes those in the working age who are unable to work, who do not find a job and for whom the unemployment schemes do not apply; this is highly relevant for employment and unemployment. Social welfare benefits require neediness meaning having no income and no wealth. Social welfare is defined by minimum requirements for living and is means-tested. The means test is different from the unemployment benefit of type II. Benefits consist of a

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19 60 per cent for singles. Benefits are adjusted according to wage increases, they require a minimum time of contributions paid.

20 With one child, 53 per cent in other cases.

21 It cannot surpass the net wage income. For the same illness it is limited to 78 weeks in a three year period.

regular monthly payment and specific payments for housing rents as well as heating costs that both are covered up to a limit. Specific payments are also made for obtaining household goods. For those recipients that are not covered by public health insurance, medical costs are covered. Payments are differentiated according to marital status and the number of children and their respective age.[22] Conceptually, benefits are linked to a price index for low-income groups though not automatically indexed to it. Actually, their increase is linked to the augmentation of pensions. For a worker, married with one child, the benefits make up 68.5 per cent of the lowest net wage in industry, 75 per cent of the crafts, and 100 per cent for low-paid professions such as jobs in the restaurant and hotel business. For a single, they are 42 per cent in industry and up to 67 per cent in the restaurant and hotel business (Boss 2002).

Out of the 2.7 million people who received social welfare payments at the end of year 2001, 1.6 million were in an age between 15 and 64 years, in which people tend to work. One third of those capable to work was younger than 30 years. Some of those were unable to work due to illness or handicaps, some were in training, 140 000 did work but work income was lower than welfare benefits[23], and 700 000 were registered as unemployed. Thus, 800 000 is roughly the figure of those who are able to work. In the age group between 15 and 64, the average duration is 27 months.

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[22] As of July 1st, 2002 the standard payment to the head of a household in Western Germany averages 292 euro per month. The standard payment for the spouse is 80 per cent of this amount. Depending upon their age, children will receive 50 to 90per cent of the payment made to the head of the household. Certain groups of individuals with special needs can receive additional support.

[23] Those social welfare recipients registered as unemployed some received unemployment benefits as well; these benefits were supplemented because they were lower than welfare.

Recipients of welfare tend to have a low qualification. More than 40 per cent of the 1.4 million households receiving welfare are singles.

Reservation wage. This set of government-provided incomes defines the reservation wage that an unemployed expects from his next job; it influences search intensity and the willingness to accept a job. The higher the income provided by government when people are not working, the higher the reservation wage. Empirical analysis of the unemployed in Germany shows that the reservation wage is at 1.2 of the wage when previously employed (Christensen 2001). This is unusually high for someone who wants to find a job, and it is high in comparison to other countries. Empirical analysis also shows that the reservation wage is not reduced with the duration of unemployment (Christensen 2002). This means that search intensity is lower and that the willingness to accept a job is reduced. The labor market dries up from the supply side.

At the same time, the described arrangements imply that neither workers nor their unions will accept a wage rate below the reservation wage. Thus, welfare benefits of the German type define a floor to the wage structure. Whereas the reservation wage is a variable defined for each individual, the wage floor is an institutional variable; it represents a *de facto* minimum wage. There is an implicit minimum wage without a minimum wage being formally defined. This means that wage differentiation is restricted. The lower part of the demand curve for labor is truncated. There is no effective labor supply nor demand below the minimum wage. Such an economy loses the lower segment of the labor market; the labor market simply dries up. Unemployment is the consequence. Moreover, a minimum wage has an impact on the labor market equilibrium because it determines wage bargaining behavior of unions.[24] Finally, since the minimum wage implies higher outlays of the social security system which *de facto* have to be financed by taxes on labor income it compresses the wage structure.

Mini jobs. Exemptions exist for mini jobs of up to 400 euro per month as of 2003. The employee pays no income tax and no contribution to social security. This income can be earned in addition to other income, for instance a regular job. The employer pays a flat rate of 25 per cent for health (11 per cent) and retirement insurance (12) as well as taxes (2). There are special provisions for an income range between 401 euro and 800 euro. In the previous, more restrictive arrangement 4.1 million mini jobs existed. Additional jobs are expected from the new regulation. The figures illustrate that a labor market can very well function in Germany. But it should be noted that these are additional jobs for pupils, students, retirees and housewives; the occupations are in distribution and trade, the housing sector (like janitors) and the hotel and restaurant businesses. The jobs require some qualification. Consequently, this law, though establishing some flexibility of the labor market, does not solve the problem of the less qualified in the lower segment of the labor market.

Social Security Contributions – A Tax on Labor

In addition to the two discussed institutional features of collective bargaining and the high reservation wage, yet another reason for the high unemployment in Germany is that the demand for labor is systematically

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[24] See German Council of Economic Advisers, 2002, Box 9.

weakened because the social security system is financed by contributions from labor income, paid by firms and by workers on a half and half basis. This causes a wedge between the gross and the net wage. Taking the tax on work income and the contributions to the social security system together, the marginal tax plus contribution rate for the average earner amounts to 58 per cent of gross income if he is married and 67 per cent for the single worker with an average income[25]. A large share is due to the contribution rate for the social security system. For instance, from the 58 per cent of marginal duties on gross labor income for the married average wage earner, 34 percentage points represent contributions to social security. The same percentage point applies to the single average earner.[26] This wedge has increased considerably over time as we will see in chapter 5.

A more detailed analysis shows the specific impact on labor demand and labor supply. In a way, the workers take part of their income not as net wage after contributions are being paid and before tax but as a 'social wage' representing a degree of insurance protection. On the demand side and from the point of view of the firms, both the net wage and the social wage must be covered by labor productivity. When the gross wage is higher than labor productivity, firms will attempt to bring the gross wage in line with productivity. They can do this by a set of adjustments: by laying off workers so that those remaining employed have a high enough productivity to cover the net wage plus the social wage, by not filling vacant positions, by substituting capital for labor, by looking for labor-

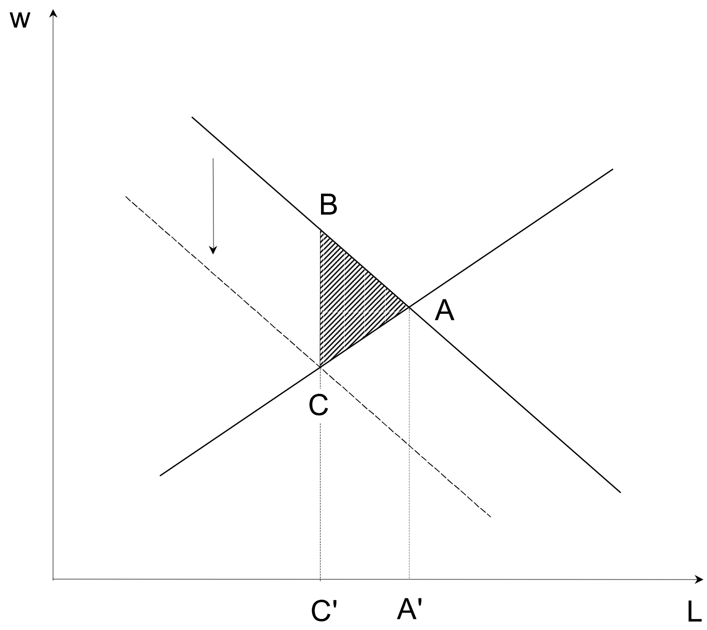
[25] German Council (2002) op. cit. p. 243.

[26] In the German system there is an income limit for mandatory health insurance beyond which the individual can choose to be privately insured.

saving new technologies and by shifting production abroad. From the point of view of firms, social security contributions shift the demand curve downward and when all adjustments have taken place in a general equilibrium, employment is reduced from point A' to C' and unemployment results (Figure 8). Thus, the worker bears the burden of adjustment. There is an efficiency loss in terms of production foregone in value terms as represented by the Harberger- triangle ABC.

Thus, the contributions to the social security system have a similar effect as a tax on labor; they weaken the demand for labor. Whereas the reservation wage affects the labor supply and the wage rate in the lower segment of the labor market negatively, mandatory contributions increase the costs of firms which shifts the labor demand curve of the economy as a whole downward or to the left.

Figure 8: Social Security Contributions as a Tax on Labor



On the supply side and from the point of view of workers, such high marginal rates represent wrong incentives for work effort and human capital accumulation of the work force. The negative impact on human capital accumulation is especially relevant in an information society where human capital and knowledge are the dominant sources of economic growth. The existing arrangement thus hurts the growth dynamics and it may well be a reason for the poor growth performance. Moreover, it is an incentive to officially take residence in low-tax places such as London. This affects locational advantage and is relevant for the modern services sectors (banking and insurance) or for research activities. Finally it is an invitation to move to the underground economy. The supply curve of labor is shifted to the left (not shown in Figure 8). This is an additional efficiency loss. The combined effect of the leftward shift of the demand and of the supply curve is a reduced level of official employment.[27] Note that the leftward shift of the supply curve affects the economic dynamics of the economy and thus influences also the demand for labor indirectly.

There also is an impact on the role of the minimum wage. Consider only the usual market diagram without indirect effects on dynamics. If the leftward shift in the demand curve is stronger than the leftward shift of the supply curve, excess supply of labor is increased. This means higher unemployment.

In the last three decades, the political parties have expanded the systems of social security in order to attract political votes. But simultaneously, they have raised the tax on labor and in this way increased unemployment. Ever increasing public benefits and the stepwise increase of unemployment were considered to be two different shoes, but in essence, they are the two sides of the same coin. The unemployed had to foot the bill. It is about time to acknowledge this interdependence.

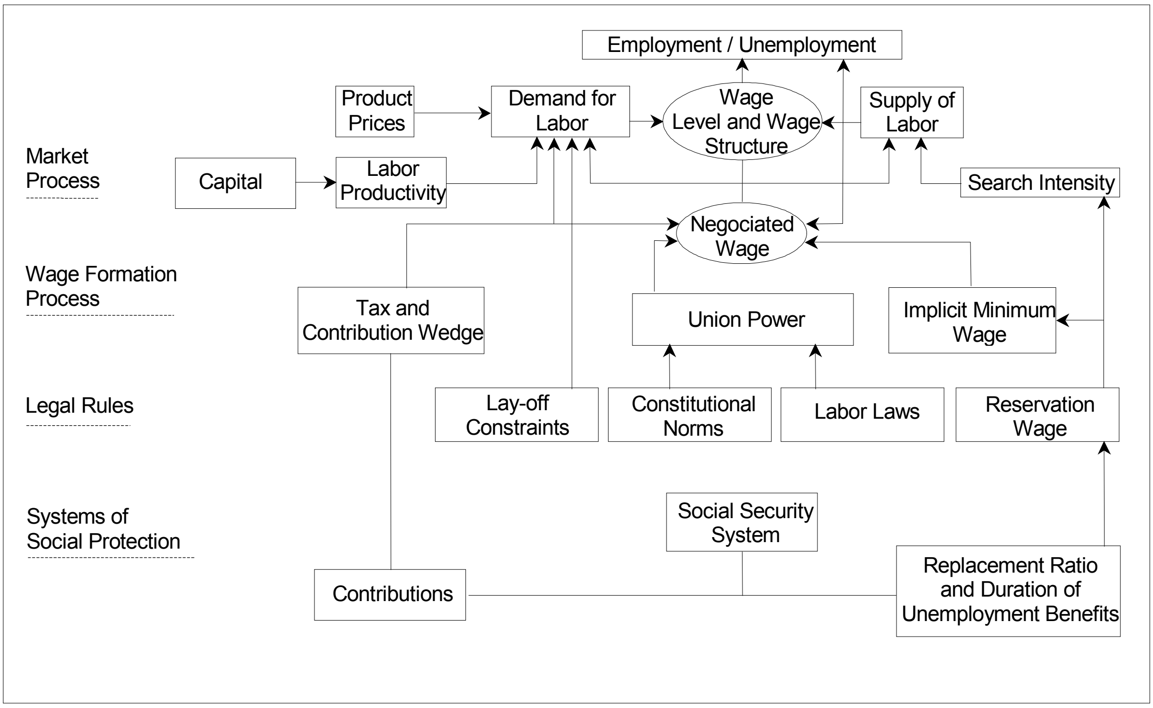
The Interplay of the Institutional Factors

To describe the institutional set-up of the German labor market, four different layers can be distinguished (Figure 9). The systems of social protection provide an income when people cannot or do not work. This influences the reservation wage on the supply side and simultaneously represents a tax and contribution wedge especially on the demand side. Legal rules, i.e. constitutional norms, the laws of collective bargaining and

[27] The impact on the market wage rate can go either way.

other labor market regulations such as lay-off constraints, define the institutional arrangement relevant for the system. This institutional set-up specifies the incentives of the system and the mechanics of the wage formation process. All these factors determine the negotiated wage which influences the wage level and the wage structure together with the capital stock, labor productivity, i.e. the production function, and with product prices. The final outcome is the level of employment and unemployment. Looking at this institutional arrangement, it is easy to recognize how far away the German system is from the market process that operates in other countries.

Figure 9: The Institutional Set-Up of the German Labor Market



The Need for Reforms

Reforms of the Germany labor market relate to the three areas discussed: the institutional design of wage formation, the unemployment insurance and social security influencing the reservation wage and the tax on labor from financing social security.

Reforming the institutional design of wage-setting. With respect to wage setting, the political task is to re-evaluate the given institutional arrangement and to reappraise the degree of protection that the employed receive. The protection of workers has developed since the 19th century in order to prevent his exploitation. Traditionally, the root of the labor market problems were seen in a conflict between capital and labor or between the firms' owners and workers. Meanwhile, it is recognized that flexibility in some aspects of the work contract, for instance in working time, generates productivity gains that may be to the benefit of the firm as well as of the worker. Moreover, the security of the job, or alternatively a lower risk to lose it, is an important aspect for the employee. In an open economy and in a world where external shocks prevail, the firms and the workers are confronted with a similar risk. They are sitting in the same boot. Whereas in the classical work contract, the firm carried the revenue risk guaranteeing the worker a more or less fixed income and — within limits — a secure employment, the modern work contract attempts some form of risk sharing being based on a common interest of both sides. This relates especially to income risk for the worker, for instance to income risk above a threshold guaranteed by the firm except in the extreme case of a lay-off. Therefore, the balance between protection and flexibility must take into account the welfare gains in terms of real income for the worker and long-run job security that are made possible by more flexibility.

The main conflict, however, now is elsewhere. The increased protection of the employed in a welfare state has given rise to a new clash, a conflict between the protection of the employed and the discrimination of the unemployed. The real political task is to appraise that conflict. The answer is: The protection of those employed should be reduced to such an extent that the discrimination of the unemployed disappears.

The solution to this problem lies in allowing more decentralized autonomy in the collective labor contract, both for the individual worker and for the workers of a firm as a group. Germany has to move a little bit in the direction of a market solution.

With respect to the individual worker, one has to allocate more decisions to him by allowing him to deviate from the collective contract if this can make his job more secure, for instance by a commitment from the firm that there will be no lay-offs say in the next three years. This requires to legally redefine the *Günstigkeitsprinzip* inserting a rule that the security of a job should be an aspect in the decision whether a deviation is favorable for the individual worker. A more radical solution is that the right to decide on the deviation from the collective is given the individual. Such a right would also apply to the unemployed who then is allowed to enter the labor market below the collective wage. At the same time, more individual, result-oriented elements should be introduced into the work contract without a link to the collective contract.

With respect to the workers of the firm as a group, they should be granted the right to deviate from the collective contract if a majority so desires. If no majority exists, the union contract holds. In order to protect the interest of the unions, the threshold of the necessary majority could be set high, for instance as two thirds. This means changing § 77 Sec III Workers Council Constitution Act (Betriebsverfassungsgesetz). In the legal sense, this alteration would refer to union members only. The decision to deviate would be their decision. This follows from the positive freedom of coalition: union members cannot be forced by non-union members into a contract they do not want. Therefore non-union members would not have a vote on the union contract. But of course they and the management would be free to enter into a non-union contract. In all these cases, the workers councils also play a role; they could become part of a practical solution in finding a majority. It should be noted, however, that each employee is by law bound by the decisions of the workers councils, so that strict wage setting by the councils would to some extent even represent more collectivity than by the trade unions whose membership is voluntary. Therefore, workers councils should only enter into wage formation in the form of a recommendation on which then individual contracts can be made.

These are the two central changes needed in the German labor laws in order to allow a greater decentralization of wage formation. They are not on the agenda of the Schröder government. Apparently, they would reduce the power of the trade unions. Consequently, the unions oppose these changes vehemently. But the organizational interest of the trade unions can not be the factor deciding the intensity of Germany's labor market reform.

Adjusting the reservation wage. Since the high reservation wage depends on the benefits provided by government when not working, the reservation wage can only be changed if the benefits are redefined. Solutions must distinguish between unemployment benefits of type I and II and social welfare.

With respect to the unemployment benefits of type I, it is proposed by many (Siebert 2002, German Council of Economic Advisers 2002) to reduce the maximum duration from 32 months to one year as was the case until the mid 1980s. This would still be twice as long as the duration in the United Kingdom and the United States.

For the unemployment benefit of type II, the most far-reaching proposal is to discontinue this type of support altogether. Those who do not find a job and whose unemployment benefit has expired will then receive social welfare. The government intends a different solution in which this type of unemployment benefit II will be continued with the following alterations: Neediness will be defined more strictly than so far, for instance with respect to the income of married couple if one of them receives a high market income. The benefit itself will be lowered, being fixed on a somewhat higher level than social welfare. After a heavy political debate of this proposal in the social democratic party, the level can be expected to be definitely higher than social welfare.

The new law to be passed in 2003 has two severe shortcomings: It will integrate those recipients of social welfare who are capable of working into this new type of benefit. Since this new unemployment benefit of type II is higher than the prevailing social welfare, this means an increase of entitlements and not a reduction. It is an expansion of the welfare state. Moreover, the law will change the organizational allocation of responsibilities between the municipal and the federal level for those recipients of social welfare who are able to work. Whereas the standards for social security are defined nationally, the welfare system is traditionally administered and financed by the municipalities according to the subsidiarity principle; the new system, however, is administered by the Employment Office which belongs to the central level. This means national financing. A task that is to be performed by the local level because the local community is better informed as well as directly concerned and affected by the expenditures is shifted to the national level. This is an additional false incentive in Germany's social system.

The adjustment of social welfare itself is the most complex issue. One approach would be to apply the existing criteria of eligibility for social welfare more strictly. Thus, the actual legal rule that welfare payments can be reduced if a job offered, for instance by a municipality, is not accepted could be enforced more actively. Moreover, the rules could be changed, for instance with respect to the level that the costs for rent are picked up. In addition, the procedure for the annual increase in benefits linked to a price index for low-income groups or following the increase in pensions could be changed. Benefits could be defined differently for the elderly and those with a long illness on one hand and those who are capable of working on the other hand. All this would represent a „psychological" redefinition of the income floor in the norm system of society and thus of the income level that people require from the government.

Another approach intends to use economic incentives for those who are able to work while leaving the social welfare level for others untouched.

The concept is to reduce the level of social welfare of those who are able to work, say by 25 or 33 per cent, and at the same time let those recipients who can earn a living in the market only lose a proportion of the social welfare with each additional euro earned. That means that like in the US Earned Income Tax Credit and the UK Family Tax Credit social welfare benefits are phased out with an increase in income. The double-sided approach of reducing the benefits and of granting a subsidy is intended to correct the false incentives that now exist. Specific proposals differ. The German Council of Economic Advisers wants to limit this measure to only those who receive social welfare under his new proposal. This would mean that the measure refers to 800 000 in social welfare (capable to work) and to 800 000 who received unemployment benefit II before and will now receive social welfare. Since both groups overlap, this is altogether 1.4 million for which an incentive problem exists. The proposal of the ifo Institute (Sinn et al 2002) goes much further. While also reducing benefits of the social welfare recipients, benefits are not formally limited to welfare recipients but are paid as a wage subsidy when income is low. Consequently, there is a wider phase-out range so that the program extends to 4.5 million people already employed plus 2 million newly employed.[28] This is a large group to solve the incentive issue relevant for 1.4 million recipients of social welfare according to the concept of the Council of Economic Advisers.

To what extent such proposals will solve the incentive problem depends on a set of factors. One is that trade unions must be prepared to reduce the

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[28] Table 3.5 op. cit.

implicit minimum wage. If they are not, the measure will not be effective. Unfortunately, trade unions may get a lever with which they can play strategically against the government. After all, with the new arrangement the government foots the bill of the subsidies if the trade unions do not find or accept the equilibrium wage in a differentiated structure according to the qualifications. People may get used to the idea that it is the government's obligation to pick up the difference between the desired wage and labor productivity. This is quite a contrast to the Anglo-Saxon world. Another issue is whether the Constitutional Court will accept the automatic reduction of social welfare for those who are capable to work. Related to this constitutional problem is the question what to do if someone who is capable of working does not find a job in the private market. Apparently, the constitutional issue would be less severe if the municipalities provide the jobs. This, however, has its own shortcomings because it is not the function of government to provide jobs.[29]

Of course, the idea of a tax-transfer mechanism stems from Friedman's (1962) concept of a negative income tax. Here a warning is in order because such a tax will not function in a continental welfare state. Assume a welfare recipients could retain fifty per cent of the additional market income that he earns. And neglect the criterion of neediness. This would define a wide range in which income is not taxable. Empirical analysis of the German tax system shows that this range contains a third of the German work force (Gern 1999, Siebert 2002). This is too much in order to solve an

[29] To the German Council the idea is acceptable nevertheless because government-provided jobs would require the full work week whereas a similar income could be gained in the private sector with half time.

incentive issue for 1.4 million welfare recipients. In the continental system it is unlikely that the benefit level can be reduced to the level of the Anglo-Saxon world.

Reducing the tax on labor. The third major task is to significantly lower the tax on labor. This, in turn, requires to reform the welfare state, a topic already touched upon in the context of the reservation wage. The reform of the welfare state is the issue of the next chapter.

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