

## Greater flexibility on the German labour market

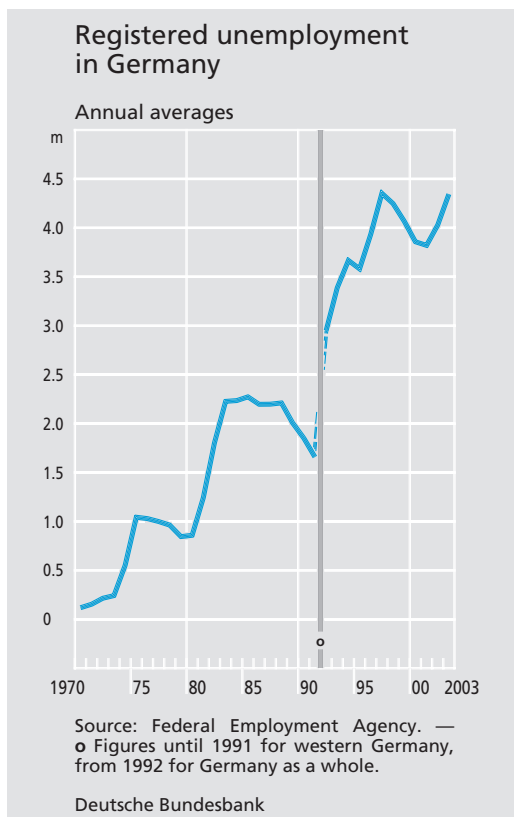
The German labour market has been characterised for a long time now by a high degree of persistent structural unemployment. Up to the middle of the 1990s, the number of unemployed persons rose from one business cycle to the next. This phenomenon cannot be explained by macroeconomic shocks alone. Institutional factors also have to be taken into consideration. The continuously high level of unemployment is a clear indication that the German labour market is not functioning properly. This has become increasingly apparent in the past few years. A number of measures have been taken at company level as well as by the social partners and legislators. These measures are aimed at overcoming rigidities and obstacles by improving framework conditions and increasing flexibility on the labour market, with a view to reducing unemployment and raising the rate of employment. This article gives an overview of the adjustment steps that have been taken to date. However, it also demonstrates that there is a further need for action in order to achieve a comprehensive and lasting reduction in involuntary long-term unemployment.

### Major imbalances on the labour market

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Unemployment in Germany rose stepwise between the early 1970s and the mid-1990s. With each economic downturn the number

*Growing array  
of problems*



of unemployed increased significantly. The number of registered unemployed persons went up from an initial figure of just under 300,000 in 1973 to over 1 million in 1975 and then from around 900,000 in 1980 to 2.2 million in 1982. In the first half of the 1990s, pan-German unemployment increased again from around 3 million in 1992 to almost 4.4 million in 1997. Although unemployment then dipped below 4 million persons, it has latterly returned to its 1997 level if definitional changes are disregarded. This underlying pattern reveals – at the macroeconomic level – a clear failure to reintegrate the increased number of unemployed persons into the production process in any of the subsequent recovery periods, even allowing for the fact that the labour supply in Germany has increased sub-

stantially over time. Furthermore, the shortage of competitive jobs should be estimated as being higher than the unemployment rate suggests since a large number of employment contracts are subsidised and many other non-occupied persons should be at least partly allocated to the labour supply.

This empirical finding is a clear indication that the German labour market is not functioning properly. Germany's relatively poor labour market performance is evident not only from considering its evolution over time, but also when comparing it with that of other countries in the European Union. According to the standardised EU definition, Germany currently has one of the highest unemployment rates (9.9% seasonally adjusted) in the euro area. A high level of unemployment not only results in large fiscal burdens in the form of wage substitutes and lost revenue from wage tax and social security contributions, it also entails considerable financial losses and social costs for the individuals concerned.

For the economy as a whole, a high or increasing level of unemployment means that the growth potential to improve the overall standard of living is not being fully exploited. If people who lose their jobs during an economic downturn do not succeed in finding a new job during the subsequent upturn, the initial cyclical unemployment will become increasingly entrenched and will ultimately be transformed into structural unemployment. The longer the latter persists, the more difficult it is to eliminate, especially as the human capital represented by the unemployed is at

risk of being devalued over time and motivational problems may occur.

### Tasks for the social partners and legislators

*Tasks and  
division of  
duties*

Improving the functioning of the labour market requires cooperation from both the legislators and the social partners. The legislators are responsible for creating incentive-compatible legal and institutional framework conditions. The social partners have to ensure that the terms and conditions of employment contracts conform to market standards. All endeavours should ultimately be measured by the extent to which they make a lasting contribution to increasing the level of employment, thereby lowering unemployment. The objective should not be solely to compensate for the jobs lost in the last few years, but to significantly reduce unemployment on a permanent basis.

*New measures*

In view of the pressing problems on the German labour market and against the background of the intensification of the international division of labour – which has increased in recent years and may be expected to sharpen further in the future – a series of measures were taken in the past few years – initially by the social partners – aimed at raising the flexibility and improving the functioning of the German labour market. This was partly a response to the growing number of employers withdrawing from the national federations and the waning influence of collective labour contracts. In terms of legislative changes, besides efforts to lower non-wage

labour costs, the German parliament recently implemented a series of proposals drawn up by a group of experts known as the Hartz Commission.

### Collective labour agreements continue to be of great importance

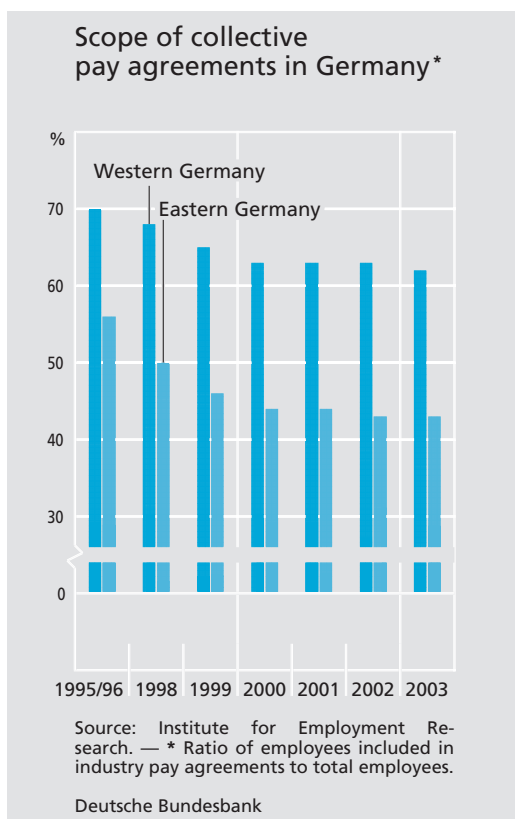
Achieving a permanently higher level of employment primarily requires action from the social partners. Collective labour agreements between employer federations or companies and trade unions perform a key function in this context. According to data from the Federal Ministry of Economics and Labour, there were almost 60,000 industry or company agreements in force at the end of 2003. These regulate both general working conditions – such as working hours, bonuses and holiday entitlement – in the form of master labour agreements, and the level of wages and salaries in the form of wage agreements.<sup>1</sup> According to the Federal Ministry of Economics and Labour, around 90% of employees who are subject to social security contributions are employed under collective industry and company labour agreements.

According to the findings of the Institute of Employment Research (IAB), the scope of coverage of industry-wide labour agreements declined noticeably, especially in the second half of the 1990s. Whereas in the mid-1990s 70% of employees in western Germany worked in a company covered by a sector-wide collective labour agreement, since 2000

*Scope of  
coverage of pay  
agreements:  
findings of the  
IAB*

*Sector-wide  
labour agree-  
ments*

<sup>1</sup> See Federal Ministry of Economics and Labour, *Tarifvertragliche Arbeitsbedingungen* (2003).



this figure has stood at only 63%. A similar trend is apparent in eastern Germany, albeit on a considerably smaller scale: only just over two-fifths of employees there work in a company covered by an industry-wide labour agreement. In both western and eastern Germany the adherence to collective labour agreements correlates positively with the size of the enterprise. The smaller the company, the less likely it is to be covered by a collective labour agreement. In businesses with between five and nineteen staff, merely half of the employees in western Germany and only one in three employees in eastern Germany are covered by sector-wide labour contracts. Looking at the individual sectors, adherence to collective agreements in western Germany is particularly high in industry, construction, financial intermediation and general govern-

ment, and low in the sectors “other business services” and “other services”. In eastern Germany, the scope of coverage of collective pay and labour agreements is significantly lower than in western Germany in the industrial and construction sectors, in particular.

Besides these industry-wide labour agreements, there are numerous company-specific pay agreements. These apply to 7% of employees in western Germany and 12% in eastern Germany. However, according to the IAB many companies which themselves have no collective labour contract nonetheless gear the remuneration of their workforce to scales laid down in collective agreements. In 2002 this was the case for 16% of employees in western Germany and 23% in eastern Germany. Including this group of people, the earnings of 86% of employees in western Germany and 78% in eastern Germany are based on collective agreements.

*Company-level agreements; benchmark function of collective agreements*

### Negotiated pay rates, wage drift and actual earnings

The continuing central importance of collective agreements in shaping wage formation in the German economy suggests that negotiated pay rates should be the focal point of any analysis of wage trends. Concentrating on hourly pay rates suggests itself for two reasons. Firstly, this is the relevant yardstick used by companies to assess labour costs. Secondly, it enables due account to be taken of the effects that changes in working hours – for example as a result of the increasing significance of part-time employment – have on

*Analysis of hourly rates of pay as from 1995*

the level and development of earnings. Furthermore, it is advisable to begin the analysis in the mid-1990s because, particularly in the first half of the last decade, the pan-German wage trend was driven to a large degree by the objective of harmonising wages in eastern Germany with those in western Germany.<sup>2</sup>

*Negotiated pay rates*

According to figures from the Deutsche Bundesbank's pay rate statistics,<sup>3</sup> negotiated hourly earnings – including agreed supplementary benefits, such as holiday pay and Christmas bonuses – in Germany increased by 19% altogether between 1995 and 2003 (2¼% per annum). Broken down according to region, this reflects an average increase of 2% in western Germany and 3% in eastern Germany. A comparison of economic sectors<sup>4</sup> shows that negotiated earnings in the production sector (excluding construction) rose the most. The average annual increase of 2¾% exceeded the macroeconomic average by ½ percentage point each year, with the metal-working and electrical engineering industries recording the strongest growth. By contrast, negotiated pay rates in the service sectors financing, renting and business services as well as in the public and private services sectors showed a marginally below-average increase over the past eight years. The smallest agreed wage increase (1¾% per year) occurred in the construction industry, which has been in an acute adjustment crisis for years. Particularly between 1997 and 1999, negotiated pay rates in this sector were significantly lower than the overall rate. In 1997 this was due to the cut in holiday pay and Christmas bonuses in the west German

construction industry. Two years later Christmas bonuses were lowered again, whereas holiday pay was raised.<sup>5</sup>

The sectoral spread of annual negotiated pay rises was – measured by various statistical ratios – somewhat narrower in the last few years than in the mid-1990s. This could be an indication that those sectors which recorded comparatively high wage settlements in previous years came under stronger pressure and the trade unions were accordingly no longer able to achieve above-average wage agreements. Another possible interpretation is that the social partners oriented themselves more closely to macroeconomic benchmarks, in which case the deviations have sector-specific causes or reflect the balance of power between employer federations and trade unions. On the whole there are a number of

*Sectoral spread of negotiated pay rises somewhat narrower*

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2 According to statistics from the Federal Ministry of Economics and Labour, the contractually agreed basic rates of (monthly) pay in eastern Germany rose from 60% of west German negotiated earnings at the end of 1991 to 87% at the end of 1995. By the end of 2003, this figure was 93.5%. See Federal Ministry of Economics and Labour, *Tarifvertragliche Arbeitsbedingungen* (2003).

3 For more details, see Deutsche Bundesbank, The trend in agreed pay rates and actual earnings since the mid-eighties, *Monthly Report*, August 1994, pp 29-44; Deutsche Bundesbank, The trend in labour income since the beginning of the nineties, *Monthly Report*, October 1997, pp 19-32; Deutsche Bundesbank, Determinants and macroeconomic significance of product wage and consumption wage, *Monthly Report*, July 2000, pp 15-27.

4 Industry classification system A6 in accordance with the definition of NACE, Rev 1, but excluding agriculture, forestry and fisheries because, in terms of the number of employees, those industries are rather small compared with the other sectors.

5 This seemingly paradoxical increase in holiday pay with a simultaneous cut in Christmas bonuses has to be seen in the context that in the construction sector holiday pay is generally binding, whereas Christmas bonuses are not. The purpose of this shift – according to the social partners – was to partly lessen competitive distortions which disadvantage companies with collective labour agreements.

## Negotiated wages, wage drift, actual earnings on an hourly basis

Germany; annual percentage change

Year	Overall economy	of which				
		Production sector excluding construction	Construction	Wholesale/retail trade, hotel and restaurant service, transport and storage	Financing, renting and business services	Public and private services
<b>Negotiated earnings <sup>1</sup></b>						
1992	+ 11.5	+ 13.2	+ 9.9	+ 9.6	+ 9.4	+ 11.4
1993	+ 7.5	+ 9.3	+ 8.1	+ 6.0	+ 5.1	+ 6.4
1994	+ 3.3	+ 3.8	+ 3.9	+ 3.3	+ 3.0	+ 1.9
1995	+ 4.9	+ 6.1	+ 5.1	+ 4.3	+ 4.4	+ 4.4
1996	+ 2.6	+ 4.1	+ 2.9	+ 2.7	+ 1.8	+ 1.2
1997	+ 1.5	+ 2.4	+ 0.4	+ 1.6	+ 1.4	+ 1.2
1998	+ 1.9	+ 2.1	+ 1.0	+ 1.9	+ 1.6	+ 2.4
1999	+ 2.9	+ 3.6	+ 0.9	+ 2.7	+ 2.9	+ 2.8
2000	+ 2.0	+ 2.2	+ 1.4	+ 2.6	+ 2.3	+ 1.5
2001	+ 2.0	+ 1.8	+ 1.8	+ 2.8	+ 2.3	+ 1.6
2002	+ 2.7	+ 3.5	+ 2.1	+ 2.9	+ 2.1	+ 2.3
2003	+ 2.0	+ 2.5	+ 3.2	+ 2.1	+ 2.1	+ 1.4
<b>Wage drift <sup>2</sup></b>						
1992	- 2.2	- 3.5	- 2.8	+ 0.8	- 1.2	- 1.8
1993	- 1.3	- 1.9	- 1.6	- 0.6	+ 0.9	0.0
1994	- 1.1	- 0.3	- 0.7	- 1.4	- 1.3	- 0.5
1995	- 0.4	- 1.3	- 2.0	- 0.8	0.0	+ 1.0
1996	+ 0.4	+ 1.2	- 0.5	- 0.2	- 0.1	+ 0.6
1997	- 0.5	- 1.0	- 1.6	- 0.8	- 0.1	0.0
1998	- 0.5	- 0.6	- 1.2	- 1.1	- 0.3	- 0.4
1999	- 0.5	- 1.1	+ 1.0	- 0.4	- 0.7	- 0.3
2000	+ 0.8	+ 1.1	+ 2.2	- 0.1	- 0.6	+ 1.0
2001	+ 0.6	+ 1.5	+ 1.0	- 0.4	- 0.2	+ 0.4
2002	- 0.6	- 1.2	+ 0.6	- 0.6	- 0.1	- 0.5
2003	- 0.8	- 0.5	- 1.4	- 0.9	- 1.2	- 1.1
<b>Actual earnings <sup>3</sup></b>						
1992	+ 9.1	+ 9.3	+ 6.8	+ 10.4	+ 8.2	+ 9.4
1993	+ 6.1	+ 7.2	+ 6.4	+ 5.4	+ 6.0	+ 6.3
1994	+ 2.1	+ 3.4	+ 3.2	+ 1.8	+ 1.6	+ 1.4
1995	+ 4.5	+ 4.7	+ 3.0	+ 3.5	+ 4.4	+ 5.4
1996	+ 3.0	+ 5.3	+ 2.5	+ 2.4	+ 1.7	+ 1.9
1997	+ 1.0	+ 1.4	- 1.3	+ 0.8	+ 1.3	+ 1.1
1998	+ 1.4	+ 1.5	- 0.2	+ 0.7	+ 1.3	+ 1.9
1999	+ 2.3	+ 2.4	+ 1.9	+ 2.3	+ 2.2	+ 2.5
2000	+ 2.8	+ 3.3	+ 3.6	+ 2.5	+ 1.6	+ 2.5
2001	+ 2.7	+ 3.4	+ 2.8	+ 2.3	+ 2.0	+ 2.0
2002	+ 2.1	+ 2.2	+ 2.8	+ 2.3	+ 2.0	+ 1.8
2003	+ 1.2	+ 2.0	+ 1.7	+ 1.2	+ 0.9	+ 0.3

<sup>1</sup> Including incidental payments (holiday pay, Christmas bonuses, employee saving schemes and old-age provision payments). — <sup>2</sup> Difference between actual hourly wage

and negotiated hourly wage. — <sup>3</sup> Gross wages and salaries per employee per hour in Germany. Source: Federal Statistical Office.

factors indicating that the trend in pay rises is still primarily determined by the traditional pattern of annual pay rounds in which the first pay settlement in one of the larger economic sectors serves as a key benchmark for subsequent pay agreements.

*Macro-economic wage drift*

The level of and increase in actual gross earnings are defined largely – but by no means entirely – by the conclusion of collective pay agreements. Depending on the relative strength of the demand for labour, both the level and the evolution of actual wages and salaries differ from the negotiated rates. The percentage difference between actual wages and salaries per employee per hour and negotiated hourly wage and salary rates is reflected in what economists call the wage drift (likewise on an hourly basis). This can also be seen as a certain corrective to the pay agreements.

In the period under review between 1995 and 2003, a slightly negative cumulative wage drift (calculated on an hourly basis) of 1 percentage point – or 0.1 percentage point per year – was recorded. There were, however, strong fluctuations in the wage drift over time. A markedly positive wage drift was observed in 1996 and, above all, in 2000 and 2001. On the one hand, prompted by the joint declaration of the Alliance for jobs, training and competitiveness of 9 January 2000 – which recommended an employment-oriented and longer-term wage policy – the agreements in the 2000 pay rounds produced moderate settlements, often running for two years, with further – likewise moderate – pay rises in the subse-

quent year. On the other hand, the buoyant cyclical conditions necessitated more overtime work – paid at higher rates. In 2002 and 2003, by contrast, the increase in actual earnings – calculated per hour – was  $\frac{3}{4}$  percentage point per year lower than the rise in negotiated wages. This gap widened to  $1\frac{1}{4}$  percentage points in the first half of 2004. Evidently, companies have recently been using the wage drift as a corrective to negotiated pay agreements which they felt were too high or in order to generally enhance their profitability. In the light of the German economy's long-running stagnant underlying tendency and its very restricted scope to pass on price increases – even against the background of increasing competition from foreign firms with significant cost advantages – the sole option to stabilise profitability was to curb wage costs by squeezing non-core wage components.<sup>6</sup> On balance, there is much to suggest that the wage drift – at least during the period under review here – contains a certain cyclical component but also reacts elastically to the level of the pay settlements in relation to the overall economic situation.

Broken down by sector, the production sector (excluding construction), construction and public and private services all exhibit, on bal-

*Sectoral wage drift*

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<sup>6</sup> According to IAB figures, in 2002 43% of companies bound by collective labour contracts in the private sector in western Germany paid their employees more than the standard agreed pay rates. The average wage spread, ie the degree by which actual wages and salaries exceed negotiated rates, amounted to almost 11%. In eastern Germany, just under 20% of companies bound by collective labour contracts paid more than the negotiated pay rates, with an average wage spread of 10%. For more details, see S Kohaut and C Schnabel (2003), *Verbreitung, Ausmass und Determinanten der übertariflichen Entlohnung*, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung* 36, pp 661-671.



ance, a very similar pattern to that of the overall economy – albeit with some considerable differences in the individual years. By contrast, the wage drift in the wholesale/retail trade, hotel and restaurant service, transport and storage sector and in the financing, renting and business services sector has been persistently negative since 1995. In the case of the wholesale/retail trade, hotel and restaurant service, transport and storage sector, this may have been the result of a structural effect. The growth rate of actual hourly wages is likely to have been depressed considerably by the increasing significance of low skilled labour, for example in the form of low-paid part-time jobs (“mini-jobs”) – an effect which was mirrored insufficiently in the pay rate statistics owing to their concentration on average earnings. In the case of the financing, renting and business services sector, the sector’s comparatively low level of coverage by pay agreements probably played an important role; this means that there is more scope for flexibility which was obviously also exploited by the companies. Overall, it is clear that the relative sectoral wage drift is often negatively correlated year on year with the relative position of the sectoral negotiated salary increases. This, too, supports the hypothesis that the wage drift plays an important role as a corrective of collective pay settlements.

#### Actual earnings

On balance, actual earnings per hour worked rose by just over 2% per annum between 1995 and 2003, which was only marginally lower than negotiated pay rates. With regard to the individual sectors, only the production sector (excluding construction) recorded an

above-average increase. In all other sectors, the average growth rate of wages per hour worked was below the 2% mark. As a result of the wage drift, the sectoral spread of the annual percentage change in actual earnings is narrower than that of negotiated pay rates.<sup>7</sup>

### Wage flexibility

It is remarkable that, despite high unemployment, practically no decreases in actual earnings were observed at the sectoral level during the period under review. The sole exception was the construction sector in 1997 and 1998, when average hourly earnings were 1.3% and 0.2%, respectively, lower than in the previous year. For 1997 this was attributable to the aforementioned cut in holiday pay and Christmas bonuses. In 1998, too, various elements agreed as part of the pay settlement to lower costs noticeably dampened the income trend, as a result of which hourly earnings declined marginally.<sup>8</sup> In addition, the reduction in the minimum wage introduced in September 1997 for workers in the construction industry is likely to have had an impact.

This phenomenon that nominal wages are largely sticky downwards is evident not only

*Decreases in wages remain an exception*

<sup>7</sup> In a microeconomic and more deeply disaggregated sectoral analysis Bellmann and Gartner come to the conclusion that in the 1990s in “western and eastern Germany the sector-specific wage differentials increased in those economic sectors already paying high wages.” For more details, see L Bellmann and H Gartner (2003), Fakten zur Entwicklung der qualifikatorischen und sektoralen Lohnstruktur, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung* 36, pp 493-508, especially p 506.

<sup>8</sup> However, average per capita earnings remained unchanged as a result of the simultaneous increase in average working hours.



*Empirical  
evidence of  
wage rigidities  
based on micro  
data*

at the sectoral level but also at an individual level. Admittedly, evaluations of the 1% sample of employed persons undertaken by the IAB for the period from the mid-1970s to the mid-1990s shows that some employees did indeed see their earnings drop. However, the cross-workforce distribution pattern of annual wage modifications shows a peak at precisely zero in almost each year of the period under review. Microeconomic studies based on this data set likewise indicate the existence of considerable downward nominal wage rigidity.<sup>9</sup> In an environment of low inflation rates, such as in Germany, real wages can then perform their market-clearing function to a limited extent only.

*Reasons for  
nominal wage  
rigidities*

On the one hand, nominal wage rigidities can be explained by institutional factors. For example, the validity of pay settlements persists even after a contract has expired or been terminated, so that its provisions remain in force until a new contract has been concluded. On the other hand, fairness considerations also play a role. Since employment contracts regulate salary levels but do not concurrently specify the details of the work to be carried out by employees, cuts in salaries could negatively influence their performance and quality of work. According to surveys of companies, such considerations play a significant role in the avoidance of salary cuts – even when these are deemed necessary.<sup>10</sup> A salary cut is contemplated and also accepted by the employees only when it is a necessary measure to ensure the survival of the company and consequently to save the jobs in question.

The empirically attested high rigidity of nominal wages nevertheless obscures the fact that to some extent it is also possible to achieve wage flexibility within collective labour agreements. Besides the escape clauses that have been agreed in several sectors, which provide for a reduction in working hours and salaries in individual companies if this is necessary to safeguard jobs, these measures also include the suspension or postponement of pay rises in companies which find themselves in a difficult economic situation, pay ranges, performance-related wage components and lower entry-level pay rates.<sup>11</sup>

*Wage flexibility  
in collective  
labour agree-  
ments*

With regard to wage flexibility, pay settlements agreed in the chemical industry are worth mentioning in particular. Back in 1994, lower entry-level pay rates were agreed for the first year of employment for long-term unemployed persons (90%) as well as for new staff and school/college leavers (95%). In mid-1997 a wage corridor was introduced as part of the master collective pay agree-

*Lower entry-  
level pay,  
pay ranges*

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<sup>9</sup> See, for example, C Knoppik and T Beissinger (2003), How Rigid are Nominal Wages? Evidence and Implications for Germany, in: *Scandinavian Journal of Economics*, Vol 105, pp 619-641; T Beissinger and C Knoppik (2003), Sind Nominallöhne starr? Neuere Evidenz und wirtschaftspolitische Implikationen, Forschungsinstitut zur Zukunft der Arbeit, *IZA Discussion Paper* No 800; T Bauer, H Bonin and U Sunde (2003), Real and Nominal Wage Rigidities and the Rate of Inflation: Evidence from German Micro Data, *IZA Discussion Paper* No 959; F Pfeiffer (2003), Ausmass und Konsequenzen von Lohnrigiditäten, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, 36, pp 616-633.

<sup>10</sup> See, for example, W Franz and F Pfeiffer (2003), Zur ökonomischen Rationalität von Lohnrigiditäten aus der Sicht von Unternehmen (The Rationale for Wage Rigidity: Employers' Viewpoint), in: *Jahrbücher für Nationalökonomie und Statistik*, Vol 223, pp 23-57.

<sup>11</sup> For a comprehensive overview, see Federal Ministry of Economics and Labour, *Tarifvertragliche Arbeitsbedingungen* (2003).

ment; this has been exploited since 1998. Under certain conditions, it allows the employer and workers' council to lower earnings and working hours for a limited period by up to 10% vis-à-vis the negotiated rates.<sup>12</sup> In contrast to comparable escape clauses in other industries, these exceptional measures can be triggered by the need to improve competitiveness in Germany as well as the aim of safeguarding employment.<sup>13</sup> This includes investing in German sites with the objective of maintaining and promoting employment and avoiding a relocation of production or investment abroad.<sup>14</sup>

*Variable salary components*

In several economic sectors deviations from the standard Christmas bonus provisions are permitted at plant level. For example, companies in the west German chemical industry, depending on their commercial performance, may lower the "thirteenth monthly salary" – which according to the pay agreement should total 95% of a month's income – to 80% or raise it to 125%. In the private banking industry there is a similar sliding range which likewise allows lower and higher deviations. In 2002 the option of a performance and profit-related variable remuneration system was also introduced in this sector. On the basis of in-house agreements, 4% of an employee's annual remuneration, ie around half of one-month's salary per year, can be coupled to individual performance criteria. This example makes it clear that collective pay agreements and in-house wage flexibility are not mutually exclusive.

No progress has been made in the past few years, however, with regard to the wage

structure according to different skill levels.<sup>15</sup> In almost all cases the negotiated pay rates for all skill levels in a given sector were raised by the same percentage. Adequate wage flexibility and wage differentiation, especially at the lower end of the qualification scale, would, however, be appropriate in order to create more employment opportunities for low-skilled people with low labour productivity.<sup>16</sup>

*Rigid pay rates with regard to different skill levels*

### Increased working time flexibility

The degree of flexibility achieved so far is considerably greater in terms of working hours than in terms of earnings. Labour agreements in most economic sectors contain provisions for deviating from the standard weekly working hours. These notably include working time accounts, which in many cases were introduced some time ago. The accounting period over which the average negotiated working hours must be achieved is at least twelve months and in some sectors is much longer. The key advantage of working time

*Working time accounts*

<sup>12</sup> These in-house agreements must also be approved by the social partners.

<sup>13</sup> A comparable clause exists solely in the east German construction sector, although it has only a low scope of coverage by collective labour agreements according to the IAB.

<sup>14</sup> In 2000 a comparable provision was included in the master labour agreement. It relates to competitiveness vis-à-vis labour agreements in other sectors and specifies no ceiling for lowering earnings.

<sup>15</sup> The sole exception is the construction industry where in 2002 the three lowest pay groups were amalgamated to form one new – lower – wage group.

<sup>16</sup> See, for example, B Fitzenberger and W Franz (1998), *Flexibilität der qualifikatorischen Lohnstruktur und Lastverteilung der Arbeitslosigkeit: Eine ökonomische Analyse für Westdeutschland*, in: B Gahlen, H Hesse and H J Ramser (eds), *Verteilungsprobleme der Gegenwart*, Tübingen, pp 47-79.

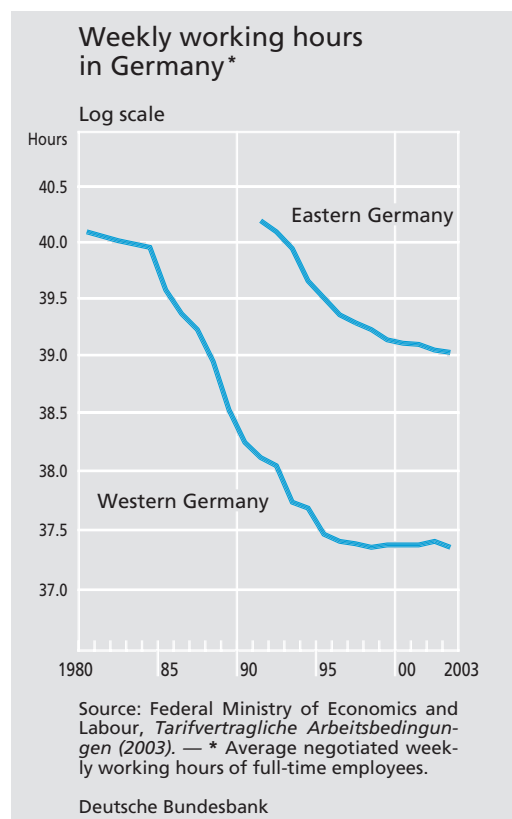
accounts is that they allow the regular working hours, which are paid at standard rates, to be more effectively adjusted to the firm's operational requirements. Avoiding the need to pay overtime bonuses at times of full order books cuts costs. When demand is weak, the working-time buffer contributes to stabilising employment. However, this greater working-time flexibility may also mean that, in some circumstances, employment will react somewhat more slowly to an improvement in the economic situation if the flexibility with regard to the working-time component is initially exhausted.

*Sliding range for regular working hours*

Besides the instrument of working time accounts, several economic sectors provide for the possibility of varying the regular working hours for all or part of the workforce. For example, companies in the chemical industry can define the standard weekly working hours for the entire workforce as a sliding range between 35 and 40 hours on a permanent basis. In the metal-working and electrical engineering industries it is possible for firms with a highly skilled workforce to extend the working week for a maximum of half the employees to up to 40 hours, with a commensurate increase in the wage but paid at standard rates.

*Extending working hours without increasing pay*

In mid-2004, a company belonging to a major electrical engineering group raised the regular weekly working time of all its employees from 35 to 40 hours with no corresponding increase in their wages. Furthermore, holiday pay and Christmas bonuses are to be replaced there by a profit-related annual payment. This example makes it clear that cuts in



hourly wages – in order, say, to improve competitiveness and safeguard jobs in Germany – are more likely to be accepted if they come in the form of an extension of working hours and a possible reduction in bonus payments, but the monthly salary is kept broadly unchanged. The same pattern was observed ten years ago (albeit involving a shortening of working time in that case) with the introduction of the four-day week by an automobile group, when the cut in wages accompanying the reduction in working hours was achieved by decreasing the special annual bonuses, leaving the monthly remuneration unchanged.

## Reorientation of labour market policy

*Implementation of proposals from the Hartz Commission*

Last year the Federal Government started to make the labour market infrastructure more flexible with the first two Acts Promoting Modern Labour Market Services. The effectiveness of job placement activities undertaken by the labour exchanges is to be increased through more intensive support for unemployed persons, through greater contact with companies and through the additional acquisition of vacancies. The monthly earnings ceiling for jobs qualifying as low-paid part-time work ("mini-jobs") was raised from €325 to €400 on 1 April 2003 and the tax and social security rates applying to such jobs were lowered (especially when carried out as an ancillary activity to a full-time job). The employer merely pays a lump-sum to the statutory health and pension insurance schemes and in wage tax totalling 25%. In order to more fully exploit the employment potential in the field of household services, "mini-jobs" undertaken for private households are subject to lower taxes and social contributions totalling only 12%. In addition, "mini-jobs" for households are tax-subsidised. As a general rule, in addition to a main job which is subject to social security contributions, one low-paid part-time ancillary activity may now also be taken up without the earnings from this being subject to the full social security contribution rate. This corresponds to the previous regulation that applied before 1 April 1999.

*"Midi-jobs"*

Moreover, to promote employment in the low-wage sector, a sliding scale for employee contributions to the social security funds was

introduced in jobs which pay between €400 and €800 ("midi-jobs"). The employee contribution increases progressively and linearly from 4% at the bottom of the scale to the full employee contribution of currently 21% at the top-end of the scale.

Through greater support for unemployed persons, more extensive contacts with companies and the acquisition of additional vacancies by the Federal Employment Agency, the placement of jobless persons is to be speeded up and hence overall unemployment lowered. To mobilise the employment reserves, greater use is to be made of temporary jobs (subcontracted workers). For this purpose, personnel service agencies (PSA) were introduced throughout Germany. The function of the PSAs is to subcontract unemployed persons to interested companies and to qualify and train unplaced persons in between phases of subcontracted employment. The employment contract must last at least nine months and should not exceed twelve months as a general rule. When the personnel service agencies were introduced at the beginning of 2004, restrictions on hiring out of labour were lifted. The special time limitation ban, the reemployment ban, the synchronisation ban and the restriction of the transfer time to 24 months were all abolished. Instead, the adoption of negotiated wages was made compulsory.

*Federal Employment Agency's placement efforts stepped up*

*Introduction of personnel service agencies*

*Restrictions on subcontracting lifted*

*Promoting self-employment*

A further element of the labour market reforms is the introduction of additional assistance for setting up new businesses ("Me plc") for a three-year test phase. Any unemployed person who re-enters the labour

market by setting up a new business as a self-employed entrepreneur is entitled to a monthly start-up grant, whereby certain income ceilings apply for earnings from self-employment. Furthermore, the setting up of a business in the craft industry was made generally easier. As a rule, the stipulation of a master craftsman's qualification now applies to only 41 instead of 94 craft professions.

*"Promote and push"*

As a result of the reorientation of labour market policy, traditional instruments, which include in particular job creation schemes and structural adjustment measures, have decreased in importance. They are being increasingly superseded by a range of measures which aim to integrate people directly into the primary labour market. Furthermore, under the motto "Promote and push" stricter criteria were introduced for registering as unemployed; this began with the *Job-AQTIV* law (an act designed to get people back into work).

*Restructuring of unemployment benefit and social assistance*

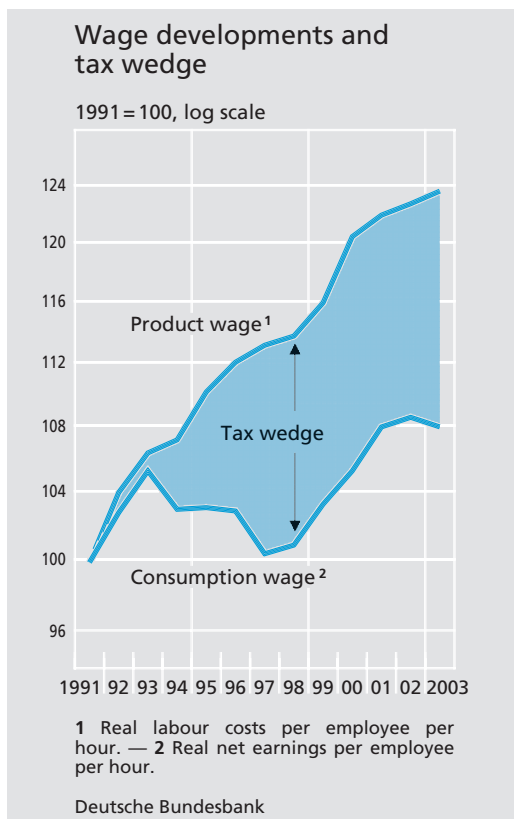
At the beginning of 2005, unemployment assistance and social assistance for those people able to work but needing financial help will be replaced by the so-called "unemployment benefit II". This new subsistence allowance will be means-tested and will normally equal the level of social assistance. With regard to the labour market, every job will be deemed reasonable for recipients of unemployment benefit II to take up. Earning allowances in addition to the benefit are intended to motivate recipients to take on regular employment. Finally, as from 2006 the maximum period of entitlement to unemployment benefit will be generally reduced

to 12 months (and 18 months for people over the age of 55); this should likewise boost the incentive to find a job.

All measures must be assessed by the extent to which they make a permanent contribution to a more efficient labour market clearing process, thus promoting growth and structural change. It is especially important to improve the labour market opportunities of the long-term unemployed and of low-skilled people in order to more effectively combat the potential emergence of new long-term unemployment.

*Initial assessment*

As the measures that have been introduced have had little time to show an impact and as some changes will not come into force before 2005 or 2006, the success of the overall package of measures cannot yet be gauged. For one thing, many reform measures require time before their full impact will be felt. Another difficulty is that there are still gaps and ambiguities in the statistical base. For example, there are differences in the figures on low-paid part-time jobs as recorded by the Federal Employment Agency and the Miners' Federal Statutory Health Insurance Scheme, which has been the central reporting office for such jobs since April 2003. Figures on "midi-jobs" are currently only available based on data from the IAB. According to those figures, 3% of employees in western Germany and 4% in eastern Germany have "midi-jobs". The new form of self-employment has met with a high take-up rate according to evidence from the Federal Employment Agency. Thus in July, 150,000 people claimed the government grant for setting up a "Me plc".



However, it remains to be seen how many of these new businesses will be able to hold their own on the market. The personnel service agencies were recently supervising only around 26,000 people. Pure placement ratios, which are often cited, are not very informative, especially since – quite apart from the “bandwagon” effect – they cannot give any information for the duration of the employment contract. This also makes it clear that the real placement success cannot be deduced from the number of supported persons.

However, the statistical picture does at least show that, at long last, things have started moving again on the labour market. Furthermore, the abandonment of the old-style active labour market policy is to be welcomed.

That policy entailed high fiscal costs but effectively produced rather meagre results. The stronger pressure on the unemployed to actively seek work is likewise conducive to improving the job-hunting process and should make the unemployment statistics more informative.<sup>17</sup> Not least, alleviating the “progression trap” in the field of transfer payments as a result of the new earnings allowances when re-entering the labour market is a step in the right direction. The modified regulation of “mini-jobs” and “midi-jobs” also highlights the important role of labour costs, particularly for low-skilled people and jobs.

### Further action needed for labour market policy and wage policy

The key need now is to generally reduce the tax wedge on the labour market. Particularly as a result of the significant rise in contribution rates to the social security funds, the ratio of taxes and social security contributions to labour costs went up from 43% in 1991 to 48½% in 1997; this undoubtedly had a negative impact on the demand for labour. Although the burden of taxes and social security contributions had gone down marginally to 47¼% by 2001, another rise to just over 48% was recorded in the past two years. This means that for every euro incurred by an employer as labour costs for his employee, the employee receives less than 52 cents. In real terms, the evolution of the tax wedge

<sup>17</sup> The associated statistical effect does, however, make it temporarily more difficult to interpret the unemployment figures.

over the past 13 years is even more unfavourable. This is because consumer prices, which for consumers are the crucial yardstick for determining their real net labour income, increased by just under 2% on an annual average and thus almost ½ percentage point per year more sharply than producer prices before tax, measured by the GDP deflator at factor costs. On balance, real hourly labour costs per employee per hour have risen by over 24% since 1991 (or by 1.8% per year), whereas real net earnings per employee per hour have gone up by only 8% (or 0.7% per year).

*Need for  
reform remains  
great*

The measures taken in the past few years have certainly resulted in the German labour market becoming more flexible, both with respect to the institutional framework and as regards collective wage bargaining and working hours. To that extent there is reason to hope that the incipient economic recovery in Germany will also give a fillip to the labour market following a certain time-lag. It is dubious, however, whether this will be sufficient to reduce unemployment in Germany to any significant degree. In particular, the ever-sharper international competition for investment in manufacturing locations and jobs means that the pressure to become more adaptable will remain strong or even increase further in the future. Hence further efforts are needed in the field of wage structures if

the labour potential which until now has remained untapped is to be put to productive use. In addition, the across-the-board cuts in weekly working hours made during the past 20 years, and which were unsuccessful in employment policy terms, should be superseded by provisions which better accommodate operational requirements and are also more in the employees' interests.

The German parliament is also called upon to make its contribution to a more flexible labour market. A prime consideration in this context is that employment protection legislation has a considerable impact on firms' recruitment policy. Furthermore, the "favourability principle", which only allows deviations from the collective labour agreement if they are in the employees' best interests, should be more broadly interpreted to include job-saving aspects. This must be accompanied, as planned, by further narrowing the tax wedge on the labour market. In the process the individual freedom of contract should be enhanced. It is not advisable, by contrast, to introduce a statutory minimum wage. Wages should primarily perform a steering function on the labour market and not be used for social policy aims through legislative interventions. From the point of view of employment policy, a minimum wage would be counterproductive and would conflict with the objectives of the current labour market reform.



