

## The labour market in Germany: general developments seen in an international context

After several years of weak growth, the economic upswing in Germany has now also reached the labour market. There is a rising demand for labour from enterprises, employment subject to social security contributions is on the increase, and unemployment is going down. Despite this, the labour market situation still poses the greatest challenge in terms of economic policy. With this in mind, the question arises as to whether lessons from other countries can show us a way to boost employment.

This article outlines some general developments in countries of the euro area as well as in the United Kingdom and the United States. It is shown that the deterioration in the German position in the past ten years has been more relative than absolute, but has nevertheless been considerable. While some European partner countries have made notable progress in the labour market, this was lacking for a long time in Germany. One likely factor in this was the generally rather weak pace of growth in Germany during this period. It should be noted in this context, however, that a labour market which is sufficiently flexible will by itself generate positive stimuli for the economy, whereas rigidities prolong economic downturns.

## Comparison of labour market performance

*Germany in a worse position*

An economy's labour market performance can be assessed mainly by the degree to which it succeeds in meeting the population's wish to find employment with an adequate number of suitable, competitive jobs. For an international comparison, initial indications of this are provided by the unemployment and employment rates.<sup>1</sup> During the period under consideration from 1995 to 2005, a positive pattern (more people in work, fewer unemployed) is especially evident in the case of Finland, Ireland and Spain, and to a lesser extent also that of some other countries and the euro area as a whole (see chart on page 33). By contrast, the situation in Luxembourg, Portugal and Greece is characterised by a marked improvement in the employment situation as well as a certain increase in unemployment along with a rising labour supply. The United States and Austria are exceptions to these two patterns. In the USA, the reduction in unemployment was accompanied by a slightly falling employment rate. In Austria, the unemployment rate increased while the employment rate remained virtually unchanged. However, the two countries show a very similar, exceptionally positive labour market situation, with the USA performing even somewhat better than Austria.

In terms of the unemployment and employment rates, there were only relatively minor changes in Germany during the period under review. Both employment and unemployment showed a moderate increase.<sup>2</sup> Owing to the marked improvement in the labour market

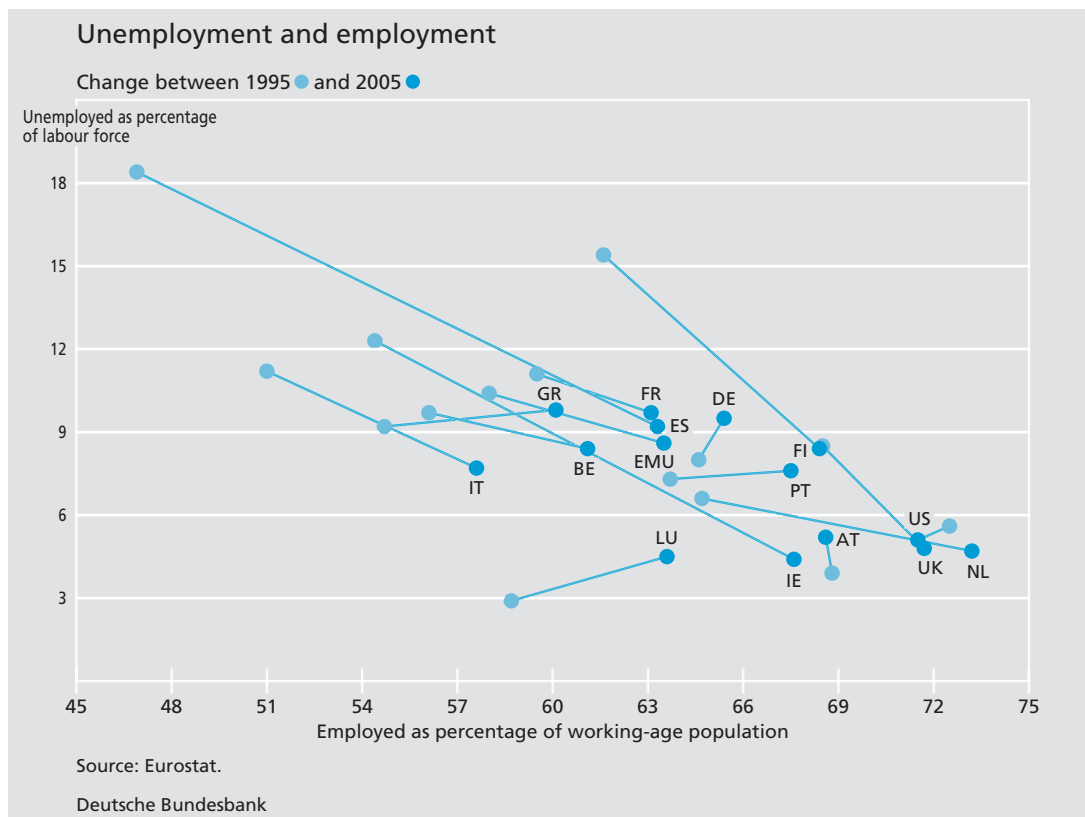
situation in a number of other euro-area countries, Germany's relative position deteriorated considerably, however. While the German unemployment rate in 1995 was still a good 2½ percentage points below the euro-area average, it was 1 percentage point above the corresponding average in 2005. Measured by the rate of employment, Germany was still 6½ percentage points above the euro-area average in 1995. But, in 2005, the figure was no more than 2 percentage points. Germany's position also deteriorated in relation to the United Kingdom.

As the labour market situation showed the greatest improvement in those euro-area countries in which it had been especially unfavourable in the mid-1990s, the spread of country-specific unemployment rates within the euro area narrowed perceptibly from between 3% and 18½% in 1995 to between 4½% and 10% in 2005. With regard to the employment rates, too, there was a general rise along with a simultaneous convergence; the spread between the countries with the highest and lowest job density declined from 22 percentage points to 15½ percentage points. This strong labour market convergence was due to a clear divergence in employment growth. While employment in Ireland, according to the figures of the national accounts, went up by no less than 55% in the period under review – ie around 4½%

*Convergence of labour market conditions in the euro area*

<sup>1</sup> For the data sources, see the explanatory notes on "Data and methods" on pages 34-35.

<sup>2</sup> The unemployment rate calculated on the basis of the Labour Force Survey went up by 3 percentage points in the ten-year period under review. However, this is also due to the statistical break from 2004 to 2005. The adjusted harmonised rate increased by "no more" than just under 1½ percentage points in the observation period.



per year – the figure for Germany as a whole was merely 1½% (or ¼% per year). In the euro area as a whole, employment increased just as quickly, at 1¼% annually, as in the USA. Especially in the period following the cyclical low in the second quarter of 2003, euro-area employment growth was bolstered by the fact that labour costs showed only a moderate rise (see explanatory notes on pages 38-39). Nevertheless, the starting position in Europe with an average unemployment rate of 10½% and an employment rate of 58% in 1995 was markedly poorer than in the USA (5½% and 72½% respectively). Although the differentials had narrowed by 2005, they were still considerable (unemployment rate 8½% compared with 5%, employment rate 63½% compared with 71½%).

An analysis restricted to the number of persons in work is of no more than limited informative value, however. For example, the relatively favourable growth in per capita employment in Germany is due exclusively to what was – even in international terms – a sharp increase in jobs with reduced working hours, in particular, the expansion of “mini-jobs” in two surges from 1997 to 1999 and from 2003 to 2004. This idiosyncratic effect is also reflected in the average annual working hours of part-time workers, which has been falling in Germany over the past few years and is now clearly below the euro-area average. Furthermore, there has been a comparatively strong increase in the percentage of part-time workers who would actually prefer

*Rising part-time employment particularly in Germany*

## Data and methods

For an international comparison of the situation and development of national labour markets, a large degree of comparability between the relevant data is required. For unemployment rates, there are figures conforming to the International Labour Organisation (ILO) standard. Employment data in the national accounts must meet the minimum requirements of the European System of Accounts (ESA 95), which is modelled on the System of National Accounts (SNA 1993). These data are primarily based on regular surveys of the workforce which distinguish between those in employment, the unemployed and the economically inactive on the basis of ILO criteria. A person is categorised as employed if he or she has worked as an employee or in self-employment in the reporting period. Those who have not been in paid employment but have actively sought work and were immediately available to the labour market in the reporting period are considered to be unemployed. The remaining persons are categorised as economically inactive.

These indicators, which are based on numbers of persons, are problematic in that employed persons who do not work many hours may want additional employment. Disincentives stemming

from taxes, social security contributions and social security benefits can also lead to a reduction in labour participation. Consequently, it is also necessary to compare data on the desired number of working hours and actual working hours of persons in employment.<sup>1</sup>

The data underlying this report are largely consistent with the adjusted results of the Labour Force Surveys published by Eurostat.<sup>2</sup> The OECD's LFS (Labour Force Survey) database has also been utilised. However, owing to various statistical breaks and only partially standardised methods of data collection, these data are not entirely comparable over time and across all countries.<sup>3</sup> The advantage lies in the deeper breakdown of results.

Of the labour market indicators, the number of persons unemployed and the corresponding unemployment rate – as a percentage of the labour force – usually receive the greatest public attention. However, a given unemployment rate may be accompanied by high or low labour force participation, which is calculated as a quotient of the number of persons in the labour force and the working age population (usually defined as those aged from 15 to 64).<sup>4</sup> In turn, the number

<sup>1</sup> From a growth perspective, the quality of labour in relation to formal education and training should also be taken into account. See G Schwert und J Turunen, Growth in Euro Area Labour Quality, ECB Working Paper no 575, January 2006. — <sup>2</sup> However, owing to a difference in the reference variable, the ensuing unemployment rate for Germany differs from the unemployment rate calculated in accord-

ance with the ILO method which is published by the Federal Statistical Office. The Federal Employment Agency's unemployment rate, which is not referred to in this study, records registered unemployment and is therefore not directly comparable with the rates based on survey findings. — <sup>3</sup> For example, in the time series for Germany

of persons in the labour force also depends on the tax, social security and transfer system. Policies which encourage non-participation in the labour market could possibly keep the unemployment rate low owing to a reduced labour force participation rate – through generous regulations on early retirement or disability benefits, for example. Tax and social security contributions policy may also stand in the way of greater participation in the labour force. A comparison of unemployment as defined here would therefore be incomplete.

While for unemployment it is the current rate – as an indicator of imbalance – that receives the most attention, for the employment rate it is mainly the year-on-year percentage change. In parallel to the unemployment and labour participation rates, however, the corresponding employment rate (the ratio of persons in employment to the working age population) can also be calculated and observed over time. This combination, whereby both the level and the development over time are observed, particularly lends itself to international comparisons. For example, a robust increase in the number of employed persons in a country may be due to a sharp rise in the population, and the employ-

ment rate may therefore remain unchanged. Such an increase could also be the result of a successful reform in economic, labour market and social policy, and would then be accompanied by an increase in the employment rate. Conversely, in countries that have a weak population dynamic but have traditionally had a successful labour market policy (low unemployment rate, high employment rate), it is highly unlikely that the number of persons in employment will increase significantly.

The year 1995 has been selected as the reference year for the intertemporal comparison. The publication of the OECD Jobs Study in 1994 had heralded an international reorientation of labour market policy, aiming for deregulation of labour and product markets and a reform of social security systems. In Germany, the special effects of reunification were also already less pronounced in 1995 than in previous years. The data currently available from the Labour Force Surveys extend up to 2005. Alongside the countries the euro area (in its 2005 composition), the comparison also includes the United Kingdom and the United States, which, in contrast to most continental European countries, have less heavily regulated labour and goods markets and a “leaner” welfare system.

there is a statistical break between 2004 and 2005 owing to an adjustment to the microcensus – the German labour force survey – with the consequence that some developments are somewhat overstated, although trends are not seriously distorted. For the adjusted Eurostat series, the earlier results of the microcensus were retroactively

adjusted on the strength of newer survey results. See M Rengers, Die monatliche Erwerbslosenzeitreihe der ILO-Arbeitsmarktstatistik, *Wirtschaft und Statistik*, vol. 10/2005, pp 1049-1070. — 4 In addition, in the case of labour force participation, a distinction should be made between general availability for work and the number of hours.

longer paid working hours.<sup>3</sup> In this respect, the sharp increase in jobs with a small number of working hours in Germany points to structural problems in the labour market. The total number of hours worked in the economy as a comprehensive measure of labour utilisation does show a comparatively sharp decline for Germany (-3¼%) in the period under review. According to OECD estimates, the total number of hours worked in Germany's European partner countries has, by contrast, increased (ranging from 3¼% in France to 37% in Ireland). The figure went up by 9½% in the USA and as much as 7% in the United Kingdom.

*Labour force participation and unemployment*

The labour force participation rate, defined as the percentage of the working-age population that is either actually in employment or actively seeking paid work (labour force), expresses – as a measure of willingness to participate in the labour force – the relative proximity of the population to the labour market. Nevertheless, the distinction between members of the labour force and persons outside the labour force invariably represents no more than a rather blurred “snapshot”, since a greater or smaller number of individuals make an effort to find paid employment depending on the general situation in the labour market. Moreover, the participation rate varies with the age structure of the population.

In all of the countries under consideration – with the notable exceptions of the United States and the United Kingdom, where participation in the labour force has, in any case, traditionally already been much higher than

the euro-area average – the propensity to participate in the labour force showed a marked increase in almost all age groups during the period under review. This means that trend labour force participation in the euro-area countries is approaching the high US and UK rates. In Germany, the increase in labour force participation during this period was rather below average, although the participation rate had been clearly above the euro-area average in 1995. This lead decreased slightly in the years that followed.

The increase was particularly marked in those countries – for example, Spain, Ireland and the Netherlands – which recorded sharp growth in employment along with a simultaneous decline in unemployment. When comparing countries, too, there is a statistically significant negative correlation between the propensity to participate in the labour force and the corresponding unemployment rate. Even though, given the existing mutual dependencies, one should guard against hasty conclusions about causalities, it is apparent that an increasing supply of labour does not necessarily lead to higher unemployment. By the same token, there is not a great deal to indicate that a policy geared to reducing the supply of labour can be effective in combating unemployment.

The flexibility of an economy's labour market is revealed mainly by how easily certain groups of persons find access to paid employment. In virtually all the industrial countries, prime-age males who have completed voca-

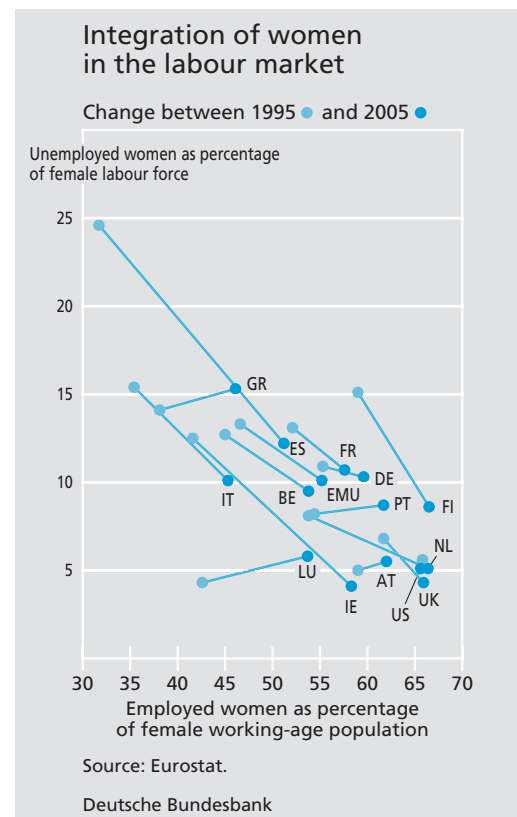
*Labour market performance by groups of persons*

<sup>3</sup> According to OECD data, however, in 2005 this was still lower than the euro-area average.

tional training are comparatively successful in doing so. The same now increasingly applies to women with a continuous work history. By contrast, individuals entering the workforce for the first time or wishing to re-enter it are often faced with particular problems. At the end of a person's working life, very generous wage substitutes – such as a more than average extended period of entitlement to unemployment benefits or early retirement programmes – may create negative incentives for active participation in working life. Wage structures favouring seniority rather than productivity make enterprises inclined to let go of senior staff when making redundancies. Persons without vocational training or whose vocational training is of diminished value are often exposed to unstable employment relationships with frequent spells of unemployment. Making greater active use of this potential and making access to the labour market easier for these groups of persons offer the prospect not only of boosting prosperity in general but also, in particular, of reducing fiscal burdens and coping more easily with demographic change.

*Increasing  
female labour  
market  
participation*

The key reason for the increase in the average labour force participation rate, which has been seen in all the countries of the euro area over the past few years, is the greater involvement of women in the labour market. Their participation rate rose from an average of 54% in 1995 to 61½% in 2005, while, in the case of men, there was only a slight increase, albeit starting at a significantly higher level, from 76½% to 78%. Simultaneously, there was a certain convergence in women's occupational patterns across the euro area. The in-



crease in labour force participation tended to be particularly marked in those countries where it had been very weak at the beginning of the observation period. There was an especially sharp increase in Spain, where only 43½% of women aged between 15 and 64 had been available to the labour market in 1995, whereas the figure in 2005 was 58½%. In the ten-year period under review, the propensity of women to participate in the labour force increased somewhat more slowly in Germany than the euro-area average but was clearly above the mean figure in both 1995 and 2005. A further rise in female labour market participation means that Germany has now largely caught up in this respect with the reference countries, the United Kingdom and the United States.



## Euro-area labour market dynamics in the current economic cycle

Following the economic upswing at the turn of the millennium, the euro-area economy went through a protracted period of weak growth. Real gross domestic product (GDP) increased by little more than ¾ % year on year in both 2002 and 2003. Although the pace of expansion picked up in the two years which followed, it failed to exceed the potential rate. It was not until 2006 that actual output showed a noticeably sharper increase than production potential with growth of approximately just over 2½ %. The labour market also benefited from this, with employment likely to have risen by some 1¼ %. Whether – and to what extent – the current upswing differs from earlier recovery periods is to be made clear below.

Making such a comparison requires a precise dating of the economic cycles in the euro area. The Business Cycle Dating Committee of the Centre for Economic Policy Research (CEPR), which was set up especially for this purpose, has identified three recessions since 1970 and pinpointed the first quarter of 1975, the third quarter of 1982 and the third quarter of 1993 as cyclical low points.<sup>1</sup> In September 2003, the latest downturn was still a new phenomenon and the Committee had not yet dated its cyclical low. There is, however, much to suggest pinpointing it as the second quarter of 2003.<sup>2</sup> The subsequent recovery is here compared with the average of the three earlier cyclical upswings identified by the CEPR's Business Cycle Dating Committee.<sup>3</sup>

This reveals that, in the past few years, real GDP has been noticeably lagging behind the figures for earlier periods of recovery. It was only during 2006 that there was a perceptible increase in the pace of growth of the economy as a whole. The weak upward movement in the years prior to this should also be seen against the background of the comparatively mild downturn, however. At the low point of earlier cycles, real GDP was, on

average, 1 % down on the year, whereas it still showed an increase of ½ % between the second quarter of 2002 and the second quarter of 2003.<sup>4</sup>

The different patterns in the numbers of persons in work are also striking. In earlier downswings, employment showed a marked decline and began to increase again slowly during the recovery only with some time lag. In the most recent cycle, however, there was virtually no recordable fall in employment in the euro area. The rise in employment did falter temporarily in the wake of the cyclical slowdown, but accelerated perceptibly from the second quarter of 2003 onwards. This means that, on the whole, the development of employment was considerably more positive than in earlier cycles.

In order to determine more precisely the reasons for this stronger growth in employment, a simple labour demand function (in terms of rates of change) is estimated for an aggregate of the four largest euro-area economies over the observation period III/1980 to III/2006:

$$l_t = 0.72l_{t-1} + 0.18y_t - 0.16w_t$$

(14.80)
(6.89)
(-4.74)

Accordingly, the expansion rate of the number of persons employed ( $l$ ) depends positively on the concurrent percentage increase in real GDP ( $y$ ) and, with a time lag, on itself. The rate of expansion is, however, slowed down by a rise in real labour costs per employee<sup>5</sup> ( $w$ ) in the same period.<sup>6</sup> Given the relatively weak pace of growth, developments in employment in the past few years have therefore been supported, in particular, by restraint in wage increases. In actual fact, real labour costs per employee remained almost constant, whereas they had shown a distinct increase in earlier recovery periods.

1 In some cases, the European Commission's Directorate General for Economic and Financial Affairs assumes a different dating of the economic cycles in the euro area. See European Commission, Directorate General for Economic and Financial Affairs, Annual Report on the Euro Area – 2006, p 7 ff and <http://www.cepr.org/data/Dating/>. — 2 Between the third quarter of 2002 and the second quarter of 2003, there was barely any change in seasonally adjusted euro-area real GDP. The Hodrick-Prescott filter, too, identifies the second quarter of 2003 as the cyclical low point. — 3 Where available, seasonally adjusted Eurostat data from the national accounts for the euro area were used. However, in some cases, especially for earlier periods, our own estimates also

had to be used. — 4 For this reason, it cannot be said unequivocally whether this was actually a recession or, rather, a marked, extended period of weak growth. It was only in the second quarter of 2003 that real GDP showed a marginal fall on the quarter. — 5 Nominal labour costs were adjusted using the GDP deflator. — 6 The estimated coefficients are all statistically highly significant (t-values in brackets). If the preceding growth rate of the number of persons in work is dropped as an explanatory variable, lags of real GDP and of real labour costs per employee also become significant. Their impact is summarised in the lagged endogenous variable. This simple relationship provides quite an accurate description of the percentage increase in the number of



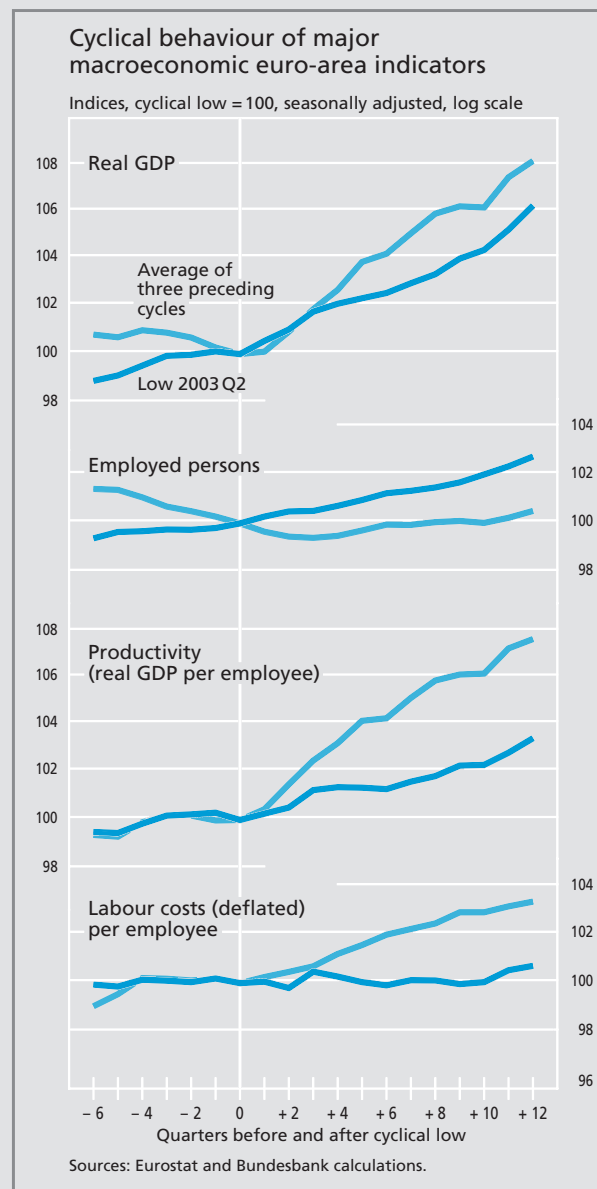
The subdued rise in labour costs is likely to be linked to labour productivity, calculated here as the ratio of real GDP per employee. This stagnated in the most recent downswing, its pattern nearly completely matching that of comparable parts of prior business cycles. The robust growth in employment in this period thus primarily reflects the mild cyclical slowdown. But even after the economy had bottomed out, the productivity gains achieved in the past few years – in contrast to earlier cycles – were no more than modest.

This development could indicate that the rise in the number of persons in work is due in large part to the increase in part-time work and marginal employment. In this case, the number of hours worked per employee ought to have shown a marked fall. According to the Bundesbank's estimates of the total number of hours worked in the euro area, the average number of hours worked per employee has hardly changed in the past few years, however.<sup>7</sup> This contrasts with an almost continuous decrease in earlier cycles.<sup>8</sup>

These factors suggest that a relatively weak growth in hourly productivity, which cannot be explained by cyclical factors alone, are behind this finding.

Exogenous factors may also have had an impact on the labour supply side. For example, in the past few years there has been quite a sharp influx of immigrants in some euro-area countries, particularly in Italy and Spain. Furthermore, labour market reforms have been introduced in some member states, above all, with the aim of increasing employment among the low-skilled. As a result, the overall productivity growth rate may have been dampened or the employment content of GDP growth may have been raised. However, this has reduced the expansion of leeway in income distribution, at least in the short term.<sup>9</sup>

persons in work over the entire estimation period, with a good three-quarters of its variability being explained overall. A similar regression can also be estimated for the rate of change in the total number of hours worked. — <sup>7</sup> ECB estimates arrive at a similar outcome. See ECB, Recent developments in total hours worked in the euro area, Monthly Bulletin, September 2006, pp 59-61. — <sup>8</sup> Upon closer inspection, the number of hours worked per employee fell relatively sharply during the downturns of the 1970s, 1980s and 1990s, whereas they more or less stood still in the first few quarters of each of the recovery periods. This probably points to the "hoarding" of labour in a downswing, when the number of hours is reduced more sharply than the number



of persons employed in order, say, to avoid redundancy costs (and, later, recruitment costs). At the start of the upswing, labour is then deployed more intensively. — <sup>9</sup> The European Commission's Directorate General for Economic and Financial Affairs has presented an econometric estimate of the demand for labour in the euro area which contains a structural break in the form of an upward level shift in the second half of the 1990s. Labour market reforms are likewise cited in explaining this break. See European Commission, Directorate General for Economic and Financial Affairs, Quarterly Report on the Euro Area – III/2006, p 30 ff.

Over the past few years, the additional supply of female labour has been successfully integrated into the employment process. Although the average unemployment rate for women in the euro area was, at 10%, higher than that for men (7½%) even in 2005, the differential had halved compared with 1995 (2½ against 5 percentage points respectively). The improvement in Germany was even more obvious: the differential in the gender-specific unemployment rates narrowed from 5 to 1½ percentage points. Nevertheless, the percentage of women in jobs with reduced working hours is especially high in Germany, and an increasing percentage of women in part-time work would like to work longer hours. This contrasts with the USA where, for some time now, there have not been any marked differences in men's and women's risk of unemployment. In Austria, the United Kingdom and, recently, Ireland, too, the rates for women are, in fact, lower than those for men. By contrast, women in Greece, France and Italy spend more time than men looking for paid employment.

*Labour market problems at the start of working life*

For young people, the transition from school to vocational training and then into working life in each case poses high hurdles. Discovering and developing individual abilities and skills, reconciling individual wishes with the conditions of the labour market and finding a first, suitable employer who is willing to recruit can sometimes be a protracted process. Accordingly, unemployment among young people is typically higher than average. In countries with a two-track vocational training system (such as Germany), it was possible for a long time to ease such transition problems

and make the entry into working life easier. In 1995, the unemployment rate among under 25-year-olds in Germany was, at 15%, below the euro-area average (23%), approximately same as that of the United Kingdom and only slightly higher than in the USA.<sup>4</sup> Whereas youth unemployment in the euro area has since fallen to (what is still a high figure of) 17½%, there has been no improvement in Germany. Germany's traditional advantage in integrating younger persons into the labour market has therefore largely been lost. Moreover, Germany has fallen behind the UK and USA.

At the same time, young adults' participation in the labour force has gone down – from 52% in 1995 to 49½% in 2005. This may be seen as an indication of the declining importance of the two-track vocational system over the medium to long term. With the sectoral transformation and shift away from industrial production and crafts towards the tertiary sector, vocational training colleges (*Berufsfachschulen*), specialised colleges of higher education (*Fachhochschulen*) and universities are becoming more and more important. A longer period of time spent in secondary and tertiary education generally also means a decline in younger persons' participation in the

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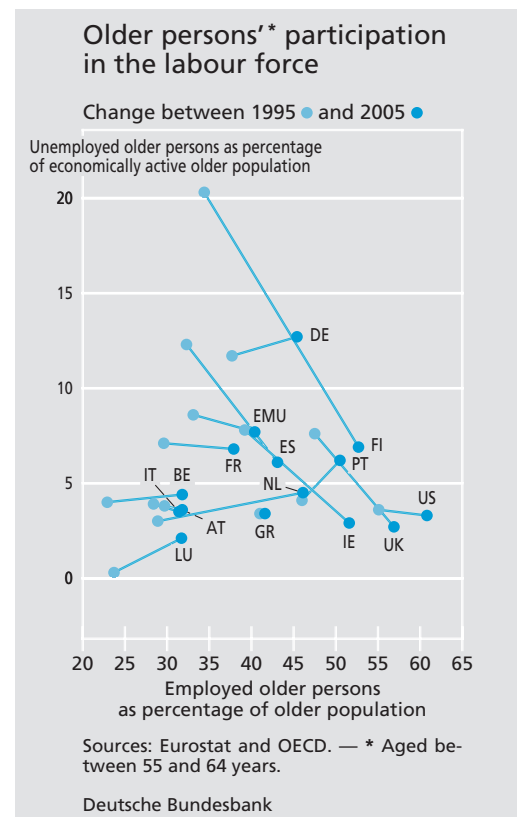
<sup>4</sup> OECD data – derived from the original data of the labour force surveys – produces a somewhat different picture with regard to youth unemployment in Germany. According to these data, it was still at only 8% in 1995, but then almost doubled by 2005. The reason for the large deviations in the 1990s is that the Eurostat series were subsequently adjusted upwards on the basis of Federal Statistical Office calculations because more recent surveys point to an underrecording of youth unemployment in the earlier microcensus. See Martina Rengers, Die monatliche Erwerbslosenzeitreihe der ILO-Arbeitsmarktstatistik, Wirtschaft und Statistik, Heft 10/2005, pp 1049-1070.

labour force. Remarkably, the labour force participation rate as well as the actual employment rate are higher in the United Kingdom and the United States – two countries with widespread secondary and tertiary vocational training – than in Germany and most other euro-area countries. This is probably due in part to the shorter training periods in the UK and USA, but may also indicate that the low participation rate of young persons in some European countries is a reflection of the difficult conditions in the labour market.

*Labour market problems towards the end of working life*

As at the start of working life, the labour market policy problems also increase as the end of working life approaches. First, after losing a job, older persons generally find it more difficult to find new, regular employment again. Second, the social security systems often generate incentives for premature retirement from working life. Given the associated fiscal burdens and rising life expectancy, it will be crucial to induce more persons in the 55 to 64-year-old age group – and, in the light of demographic developments, even beyond that in future – to remain active in the labour force. Over the past few years, measures to achieve this have been initiated in a number of countries, including Germany. As a result, the participation and employment rates of older persons showed an increase in all the countries included in the analysis. The increase in the Netherlands and in Finland was very sharp. In Germany it was somewhat above the euro-area average.

When analysing the age-specific unemployment rates, Germany appears to perform very poorly in terms of the labour market situation



for older persons. Although the unemployment rate for 55 to 64-year-olds, at just over 12%, has remained largely unchanged in Germany since 1995, this is clearly higher than the current euro-area average (7½%) and far higher than the level for the UK and USA (both at roughly 3%). At the same time, the participation and employment rates of older persons in Germany, at 52% and 45½% respectively, are above the euro-area average. While there is a negative correlation between unemployment and employment rates in terms of the working population as whole, there is no similar relationship in the case of older persons. This is probably due to the fact that, in many countries, drawing social benefits, say, in the form of a disability or early retirement pension, represents a quite feasible alternative to working or seeking em-

## Is the labour market situation for formally low-skilled persons in Germany exceptionally unfavourable?

In Germany, the labour market situation for “low-skilled” individuals is usually regarded as being particularly unfavourable. This would suggest that labour market policy should focus on this section of the population. However, the question arises as to the extent to which the statistical evidence supports this theory.

In international comparative studies, those who have completed no more than a level two education (ie lower secondary education) on the six level ISCED (International Standard Classification of Education) scale are categorised as “low-skilled”. In Germany, this includes all persons without school-leaving certificates as well as those with school-leaving certificates from a lower secondary or intermediate secondary school or with an intermediate grammar school qualification, who do not, however, have any vocational training or further aca-

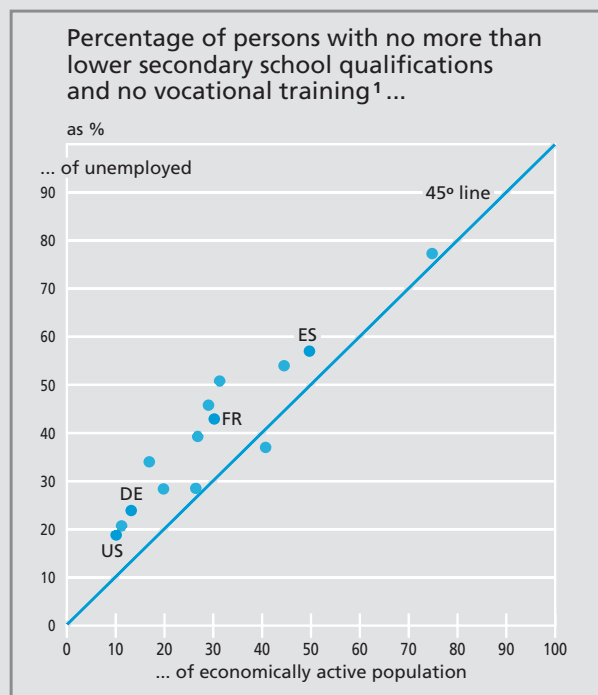
demical education. Although this purely formal criterion in itself says little about the actual skills and productivity of this group of persons, experience shows that vocational training or further academic education improve individuals’ chances on the labour market and their job prospects – in some cases, significantly.

Indeed, according to OECD data, in 2004 the specific unemployment rate for individuals in Germany falling within this definition and aged from 25 to 64 was, at 20½ %, far higher than in most other OECD countries (see chart “Unemployment of selected groups”, in main text).<sup>2</sup> Furthermore, a smaller proportion of this section of the population was in paid employment in Germany than in other countries.

How can this situation be accounted for? First, the high specific unemployment rate for those with no more than lower secondary school qualifications and no vocational training could reflect the general above average underemployment in Germany. This would explain the differences to countries with a successful employment policy, such as the United States. However, one would then expect that in countries with a similarly problematic overall labour market situation this group would be at the same risk of underemployment as in Germany.

Nevertheless, in France and Spain, two countries with similar overall unemployment rates to Germany, the situation for low-skilled persons seems considerably more favourable. At 12 % and 11 %, respectively, the specific unemployment rates in France and Spain are not only significantly lower than in Germany, they are scarcely higher than in the United States (10½ %), despite the generally poorer labour market situation in these countries.

However, the OECD data shows that while the percentage of the labour force with qualifications of no more



<sup>1</sup> Persons aged from 25 to 64 classified as having ISCED level two qualifications. Data for 2003 (2002); euro area, the United Kingdom and the United States. Source: OECD-LFS database. — <sup>2</sup> The study is restricted to persons aged from 25 to 64 because younger persons have in many

cases not yet completed their education. The specific problem of young persons lacking further education or training is discussed in the context of youth unemployment in the main text. — <sup>3</sup> This can also be

than ISCED level two in 2003 was slightly higher in Germany (13 %) than in the United States (just 10 %), it was still distinctly lower than in France (30 %) or Spain (50 %). Thus, in Germany and the United States formally low-skilled persons are in a relatively small group, while in France just under a third and in Spain half of the labour force falls into this category.

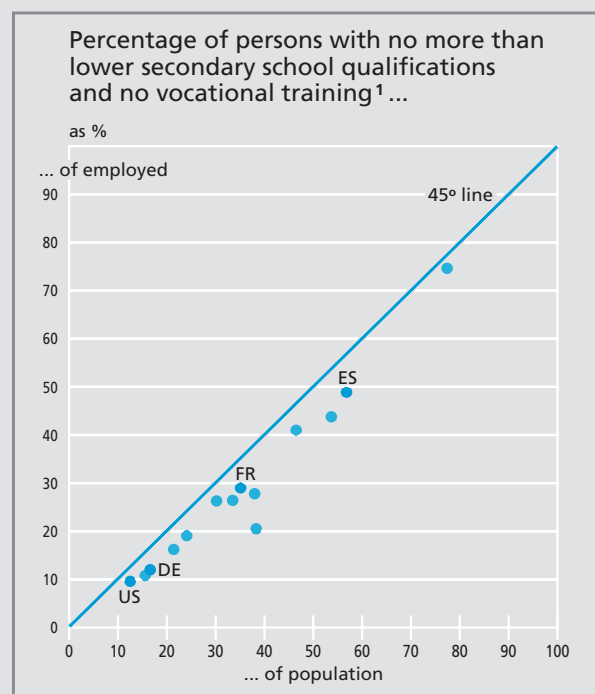
This puts into perspective Germany's unfavourable position in comparison with France and Spain. As it can be assumed that, in terms of labour market risk, the boundaries between the individual qualification groups are fluid and that there is a similar distribution of ability in the various countries, the group with no more than a lower secondary education is likely to include more persons with comparatively high productivity and a lower labour market risk in France and Spain than in Germany or the United States.

In order to establish whether the labour market situation for this group is particularly unfavourable in Germany, the percentage which this group accounts for in the unemployment (and employment) figures is compared with their share in the labour force aged between 25 and 64 and with the total population in this age group. This factors out the disparate overall unemployment level.

As expected, the corresponding ratios reveal that the relative contribution of persons with fewer formal qualifications to overall unemployment (overall employment) is above (below) average; similarly, the expected disproportionately low increase in this contribution in the case of the proportion of formally low-skilled persons in the labour force (and the population as a whole) is confirmed. The charts suggest that, although the relative contribution of those with no more than a lower secondary education and no vocational training to

overall unemployment (overall employment) in Germany is high (low), it is not exceptional.<sup>3</sup>

In summary, it can be seen that there is no clear empirical basis for the claim that the labour market situation in Germany is exceptionally unfavourable for those often categorised as "low-skilled". While the specific unemployment rate for this group exceeds almost all international comparative values and the corresponding employment rate is lower than average, the ratio of the group to the labour force is at the same time unusually low. In addition, overall unemployment in Germany is higher than in many reference countries. If allowance is made for these two factors, a comparative analysis of different countries reveals that there is barely any indication of a particularly unfavourable situation in the low-skilled segment of the German labour market.



demonstrated using econometric methods. The picture for Germany is even more favourable if one considers the fact that a particularly large proportion of participants in the Labour Force Surveys in Germany do

not specify their level of education. The specific unemployment rate for this group is lower than that of the "low-skilled" group, but higher than that of the group with the next level of qualification.

### Unemployment of selected groups

Position: 2005



Sources: Eurostat, OECD and Bundesbank estimates. — 1 Persons with no more than a lower secondary school education and without vocational training. Position: 2004.

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ployment. Among its European partner countries, only Finland, Ireland and Portugal exceeded the German rates. In the UK and USA, however, 57% and 61% of the population in this age group respectively were in employment at the end of the period under review.

The employment prospects of the lower-skilled and the long-term unemployed are other major indicators of labour market performance. In collective pay bargaining, there is a tendency to keep wages for unskilled work high. The incentive distortions generated by the social security system may also have a greater impact on persons who can earn no more than comparatively low wages on account of poor productivity. If periods of unemployment last for a long time, returning to the labour market becomes more and more difficult owing to the increasing devaluation of previously acquired skills.

*Low-skilled and long-term unemployed*

In the case of both the unemployment rate of “formally” low-skilled persons (defined here using the international standard classification as persons aged between 25 and 64 who have no more than a lower secondary education and do not have any vocational training) and the long-term unemployed (percentage of the unemployed who have already been without work for more than one year), Germany compares very unfavourably with the other euro-area countries. It should be noted, however, that, according to OECD data for 2003, in Germany the group of persons with no more than lower secondary education and no vocational training is – relative to the working population – significantly smaller than in all the other euro-area countries. It

should not then be surprising that the specific unemployment rate in this small subgroup is higher than in countries in which a larger part of the population is classified in this category (see the further explanatory notes on pages 42-43).

In 2005, every second person out of work in Germany had already been unsuccessfully looking for a job for more than one year. A similarly high percentage of long-term unemployed is to be found in Belgium, Greece, Italy and Portugal. While it has been possible to reduce the scale of unemployment in these countries – with the exception of Greece – the level has increased in Germany. Thus, not only was there a rise in the number of persons out of work in the ten-year period under review, the figure also included more and more long-term unemployed. Precisely the reverse development took place in Ireland and Spain where the periods of unemployment became shorter in parallel with the reduction in unemployment. In terms of the length of periods of unemployment, too, the United Kingdom and, above all, the United States perform noticeably better than the countries of the euro area.

### Institutions and reforms

#### *Employment protection*

Virtually all of the figures used here reveal a better labour market performance in the United Kingdom and, above all, the United States than in the euro-area countries. The UK and the USA are characterised by a lower density of regulation in the labour and product markets as well as a more “frugal” social

security framework. Something like “freedom of contract” applies in the UK and US labour markets, for instance.<sup>5</sup> The lack of extensive employment protection does, on the face of it, reduce job security. However, lack of flexibility harbours greater risks when entering or returning to the labour market. This probably explains why the specific unemployment rates in the UK and the USA – mainly that of older persons, although it also applies to younger persons – diverge less sharply from the general unemployment rate than in the euro area. By contrast, more stringent unemployment protection runs the risk of entrenching unemployment.<sup>6</sup>

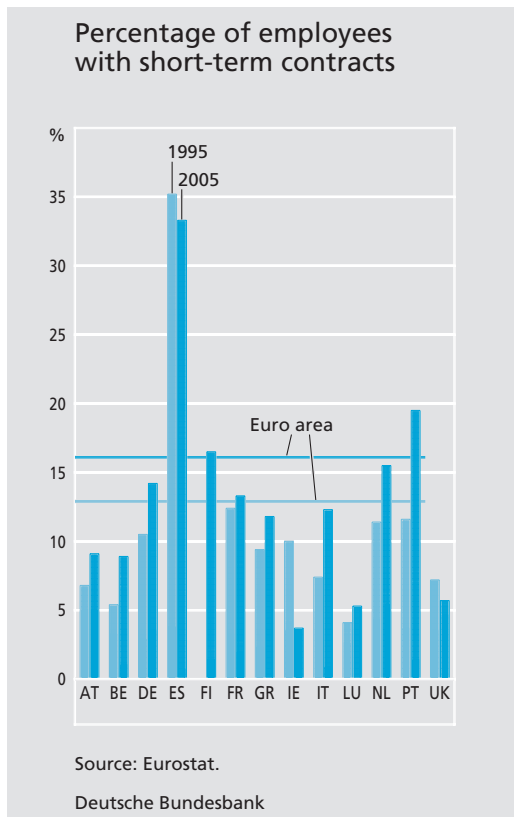
In the past few years, a number of euro-area countries, including Germany, have reduced the statutory employment protection of existing or new employment relationships. However, the reforms are geared to the regulation of “atypical” forms of employment such as temporary employment, fixed-term employment or new forms of self-employment. They encourage job creation but have some

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<sup>5</sup> The synthetic indicator of statutory employment protection calculated by the OECD assumes the value of 0.7 for the USA in 2003. The figure for the UK is 1.1. The countries of the euro area range between 1.3 (Ireland) and 3.5 (Portugal): 2.1 for Finland, 2.2 for Austria, 2.3 for the Netherlands, 2.4 for Italy, 2.5 for Belgium and Germany, and 3.1 for Spain.

<sup>6</sup> On the poorer labour market prospects of young persons, women, migrants and the long-term unemployed given strict employment protection regulations, see, for example, G Bertola, F D Blau and L M Kahn, Labor Market Institutions and Demographic Employment Patterns, NBER Working Paper No 9043, 2002, and OECD, Employment Outlook, Paris, 2004. Furthermore, there is empirical evidence that employees feel their position in the labour market to be more uncertain if stricter employment protection is in place. A likely factor in operation here is the perception of more difficult access and/or re-entry into protected jobs, see A E Clark and F Postel-Vinay: Job Security and Job Protection, IZA Discussion Paper No 1489, 2005.





problematic side-effects. The most notable example is that of Spain in the mid-1980s when fixed-term contracts were largely de-controlled with general regulations on job protection remaining in place. Even now, despite certain efforts at containment, one-third of all employment contracts in Spain are fixed-term, which is roughly twice as much as the euro-area average. As employment protection for permanent employees is still very strict, adjustments take place mainly in the deregulated subsector, in which workers experience alternating spells of employment and unemployment. As a result, long-term unemployment is at a comparatively low level. However, those affected are exposed to a high degree of income uncertainty, and there is underinvestment in career and firm-specific human capital.<sup>7</sup>

The growing discrepancy between the unchanged protection of traditional, unlimited full-time employment and the waning protection as well as increasing spread of other forms of employment have fostered a growing segmentation of the labour markets, which was one of the reasons for the current European Commission consultations on the modernisation of labour law.<sup>8</sup> In Austria, however, it has long been possible to terminate employment contracts without specific grounds provided given notice periods are complied with. In 2003, the obligatory customary severance payments were replaced by regular payments by employers to funds allocated to each employee. These funds can then be paid out in the event of job loss. If not sooner, the amounts saved in this way fall due upon retirement. The low flexibility costs are likely to be one reason why Austria's performance, measured against a large number of criteria, is not very much poorer than that of the United Kingdom or the United States.<sup>9</sup> The fact that countries such as Finland, Ireland and the Netherlands perform comparatively well should also be seen in this context.

In the USA and the UK, both the amount and the (maximum) duration of unemployment benefits as well as the basic social safety net are set at a much lower level than in most

*Wage substitutes*

<sup>7</sup> An overview of the effects of the isolated deregulation of fixed-term work contracts may be found in J J Dolado, C García-Serrano and J F Jimeno, Drawing Lessons from the Boom of Temporary Jobs in Spain, *Economic Journal*, 112, 2002, pp F270-F295, 2002.

<sup>8</sup> Commission of the European Communities, Modernising labour law to meet the challenges of the 21st century, Green Paper, Bruxelles 2006.

<sup>9</sup> On the Austrian "puzzle", see A Stiglbauer, Die (neue) OECD Jobs Study: ein Einführung und Bewertung, in *Geldpolitik und Wirtschaft Q3/06*, pp 66-84.

euro-area countries. In the United States, welfare benefits are granted only for a limited period. At the same time, wage subsidies exist in both countries: in other words, low-wage earners have their labour income supplemented by transfer payments – not reduced by taxes and social security contributions. How tight the social security safety net should be and at what level and for how long unemployment benefits should be granted are questions that give cause to reflect on a variety of factors. It should be remembered, however, that wage substitutes and the basic social safety net have inherent incentive effects. At the individual level, being entitled to draw benefits for long periods, in particular, leads to the unemployed becoming less persistent in looking for a new job.<sup>10</sup> At the same time, there is an increase in the reservation wage level – ie the level of remuneration that a new job vacancy has to be exceed in order to be accepted. The more generous such social transfers are, the more difficult it is to contain unintended side-effects of this kind or to counteract them with other measures, such as the obligation to attend training courses or take part in government-assisted work schemes. Seen in this light, it is hardly surprising that, in euro-area countries which have a comparatively generous benefit system, unemployment tends to be higher and labour force participation lower than in the UK and the USA.

Over the past few years, reform efforts in the euro area have been geared to reconciling the continued existence of a large degree of social security with the demands of the labour market. In Germany, for example, this

was the reason why, at the second level of social security in the event of unemployment, flat benefits were introduced in place of benefits based on previous earnings from employment.<sup>11</sup> The new “unemployment benefit II” can be understood as a kind of wage subsidy, although the withdrawal rate is markedly higher than in the US and UK model. However, a flatter withdrawal rate would necessitate a reduction in the basic allowance level if the fiscal burdens are to remain limited. If – in contrast, say, to the United States – a comparatively generous, unlimited basic allowance is to be granted on higher principles, it is then necessary to use active measures to counter their undesirable incentive effects.<sup>12</sup>

In the United Kingdom and the United States, both social security and employment protec-

*“Flexicurity” –  
a possible  
solution?*

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<sup>10</sup> The unemployment-swelling effect of transfer payments has been established in large number of studies, such as A Bassanini and R Duval, *Employment Patterns in OECD Countries: Re-assessing the Role of Policies and Institutions*, OECD Economics Department Working Paper No 486, 2006, and in S Nickell, L Nunziata und W Ochel, *Unemployment in the OECD Since the 1960s: What Do We Know?*, *Economic Journal*, 115 (500), pp 1-27, 2005. Nevertheless, the prolonged duration of periods of unemployment can have the side-effect that subsequent employment relationships last longer and yield a higher income since the benefit recipients have more time to find a suitable job. See R G Ehrenberg and R L Oaxaca, *Unemployment Insurance, Duration of Unemployment, and Subsequent Wage Gain*, *American Economic Review*, Volume 66, 1976, pp 754-766, and K Tatsiramos, *Unemployment Insurance in Europe: Unemployment Duration and Subsequent Employment Stability*, IZA Discussion Paper No 2280, August 2006.

<sup>11</sup> Nevertheless, there is still an additional sum based on previous earnings in the first two years in which “unemployment benefit II” is drawn.

<sup>12</sup> See, for example, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (German Council of Economic Experts), *Arbeitslosengeld II reformieren: Ein zielgerichtetes Kombilohnmodell*, Wiesbaden, 2006, and H Bonin and H Schneider, *Workfare: Eine wirksame Alternative zum Kombilohn*, *Wirtschaftsdienst* 10/2006, pp 645-650.

### Selected labour market reforms in euro-area countries since the mid-1990s

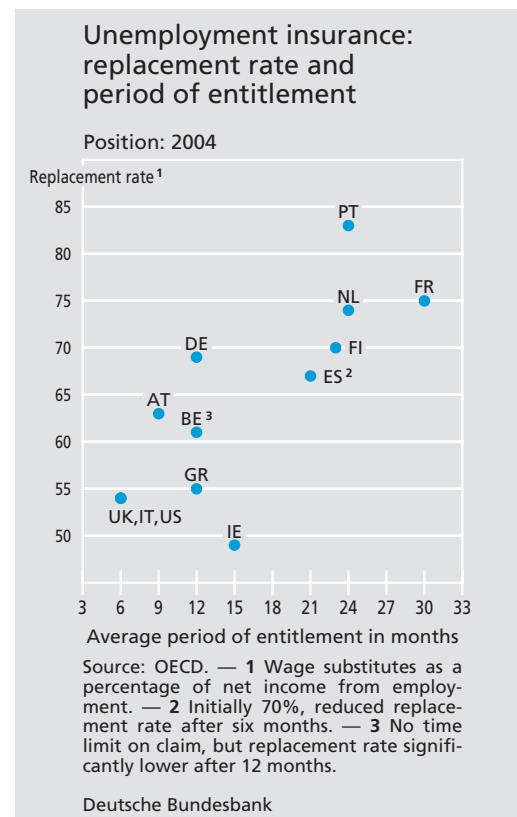
Country	Year	Reform
Austria	2003	Transfer of compensation claims to new employer, relaxation of rules governing fixed-term contracts, liberalisation of regulations governing working hours
	2004-05	Stricter work availability criteria in the unemployment insurance scheme, longer periods to qualify for entitlement, waiting periods introduced, wage subsidies
Belgium	1994	Relaxation of regulations governing fixed-term contracts and temporary employment
	1999-2003	Reduction in weekly working hours with more flexible regulations governing working hours
Finland	1995-2001	Reform of unemployment insurance: lower replacement rate, stricter work availability requirements, longer periods to qualify for entitlement, introduction of a waiting period
France	1998 to 2002	Reduction in weekly working hours, simultaneous liberalisation of arrangements concerning working time accounts and part-time work
	2000	Reform of unemployment insurance: <i>de facto</i> raising of replacement rate in the event of longer unemployment, stricter work availability criteria, wage subsidies
Germany	2003 to 2005	Hartz Acts I-IV: new arrangements for active labour market policy, promotion of low-paid part-time employment, liberalisation of part-time work and temporary employment, reorganisation of public employment service, new arrangements for basic allowance tightening of work availability requirements
	2006	Shortening of period of entitlement to unemployment insurance
Ireland	2000	Introduction of minimum wage
Italy	1997	Reorganisation of public employment service, increased regulation of temporary employment, part-time work and fixed-term contracts
	2001	Introduction/raising of entitlements to unemployment insurance benefits
	2003	1997 regulation revoked
Netherlands	1995	Act on working hours to promote part-time employment
	1999	Reduction in employment protection legislation, deregulation of fixed-term employment and temporary employment, tightening of access to unemployment insurance, stricter work availability requirements, introduction of a market for job placement and programmes of measures
Portugal	since 1992	Gradual liberalisation of working hours arrangements, time limits on work contracts, part-time employment, possibilities of early retirement
Spain	1994/1997/2001	Restriction on granting fixed-term work contracts, lowering of redundancy costs and of social insurance contributions for permanent jobs, temporary employment with rates of pay applicable in seconded sector
	2001	Legalisation of illegal immigrants and integration measures
	2002	Stricter work availability requirements for unemployed persons

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tion are rather modest by international standards. By contrast, various combinations are found in continental Europe: comparatively high unemployment benefit entitlements with reduced employment protection (mainly in northern Europe), very strict employment protection and weak social protection (mainly in southern Europe), and a medium level of both employment protection and wage substitutes (mainly in western and central Europe). The north European model – termed “flexicurity” – has become increasingly popular in recent years. The particular attraction of this approach lies, first, in the labour market being allowed to have greater flexibility and, second, in the individual employee being protected by public transfer payments against severe losses of income. Nevertheless, a system of this kind depends on the recipients of benefits making every possible effort to find paid work again and on the relevant payments actually being claimed only in an emergency. This will most readily be the case if wrongful benefit claims are regarded as unfair. Surveys show that this is largely true of countries in northern Europe, but only to a limited extent of most west and central European countries, and tends to be even less the case in southern Europe. This means that a key requirement for implementing the flexicurity model is lacking in these countries.<sup>13</sup> Even in northern Europe, however, considerable resources have to be expended as part of active labour market policy in order to get the unemployed back into paid employment.

Minimum  
wages

An additional feature which the USA and the UK have in common is the existence of a general statutory minimum wage. In the coun-



tries of continental Europe, on the other hand, management and labour in many cases lay down de facto sector-specific minimum wages in pay negotiations. Besides this, there are, however, also some – mostly quite high – statutory minimum wages. The US Federal statutory minimum wage is only US\$5.15 (about €4), although some US states do, nevertheless, set a higher minimum wage. By contrast, the UK minimum wage is as much as £5.35 (roughly €8), although there are exceptions for school and college leavers and persons re-entering the labour market. According to OECD calculations, in 2003 the regular minimum wage in the USA and the

<sup>13</sup> Y Algan and P Cahuc, Civic Attitudes and the Design of Labour Market Institutions: Which Countries can Implement the Danish Flexicurity Model? IZA Discussion Paper No 1928, January 2006.

UK was around 33% and 45%, respectively, of the median wage rate.<sup>14</sup> In those euro-area countries which have a statutory minimum wage, the figure was mostly higher (in France, for example, it was roughly 60% of the median wage, and in Belgium, Greece and the Netherlands roughly 50%; Ireland, at not quite 40%, and Spain, at just under 30% of the median wage, are exceptions). Moreover, the minimum wages in continental Europe coexist with generally more restrictive employment protection, which reinforces the potentially adverse effects of minimum wages. If the minimum wage is set too high, work will not be found by persons whose productivity is too low to cover the labour costs. If restrictive employment protection is added to this, there is a deterioration in the employment prospects of everyone who is expected not to be able to perform a certain job of work. According to the German Institute for Economic Research (DIW), the median wage in Germany in 2003 was €13.60 per hour.<sup>15</sup> A minimum wage of €7.50 per hour, for which calls are often made, would amount to roughly 55% of the median wage and, compared with the otherwise customary wage rates in Germany, would therefore be significantly higher than in the USA, the UK and most European countries.<sup>16</sup>

*Active labour  
market policy*

Spending on active labour market policy – in other words, government measures designed to get unemployed persons (back) into work, such as vocational training schemes, training courses and government job creation programmes – is rather modest in both the USA and UK. According to OECD figures, their expenditure on such measures is less than 0.2%

of GDP.<sup>17</sup> By contrast, the figure for a number of euro-area countries lies between ¾% and 1¼% (Belgium, Finland, France, Germany and the Netherlands).<sup>18</sup> Seen in this light, it is reasonable to ask how productive this use of public resources is. A recent study on behalf of the European Commission evaluated 137 analyses of the effectiveness of active labour market policy.<sup>19</sup> The outcome was that taking part in public employment programmes reduces the probability of successful reintegration into the labour market. No more than minor positive effects were found in the case of traditional training and reskilling measures. Assistance in job finding, sanctions for failing to demonstrate sufficient personal initiative, and wage cost subsidies – which are comparatively expensive – performed better. To a considerable extent, these measures help to offset the adverse side-effects generated by restrictive employment protection and high wage substitutes.

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<sup>14</sup> More recent data from the OECD are unavailable. The median indicates the middle wage rate in the distribution of individual wage rates. Precisely one-half of employed persons receives lower wages and the other half receives higher wages. Given an annual median wage of £11.12 in 2006 (see National Statistics, 2006 Annual Survey of Hours and Earnings, First Release, 26 October 2006), the UK minimum wage was latterly 48% of this reference value.

<sup>15</sup> J Göbel, P Krause, J Schupp, Mehr Armut durch steigende Arbeitslosigkeit, DIW Wochenbericht No 10/2005.

<sup>16</sup> Moreover, the high level of unemployment in Germany indicates that wages in Germany are generally still too high despite the many years of moderation.

<sup>17</sup> OECD Employment Outlook 2006 – Boosting Jobs and Incomes, Paris 2006, Statistical Annex, Table H, labour market programmes.

<sup>18</sup> Austria, Ireland, Italy and Portugal spend roughly ½% of GDP on active labour market policy. The figure is somewhat higher in Spain.

<sup>19</sup> J Kluge et al, Study on the Effectiveness of ALMPs, Research Project for the European Commission, DG Employment, Social Affairs and Equal Opportunities, Final Report, RWI, Essen 2005.

## Summary

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The economic upswing in Germany has now also reached the labour market and – in contrast to earlier years – with the advancing cyclical recovery there is also likely to be an improvement in the labour market situation in Germany in relation to its partner countries. Germany will benefit from the fact that the many years of wage restraint has led to a marked fall in relative labour costs. The reforms of recent years – such as the lifting of restrictions on the hiring out of labour – have also reduced the adjustment costs in the labour market, at least in some areas. Furthermore, the reservation wage has been lowered by cuts in transfer payments to the long-term unemployed. Inefficient public job creation

programmes have been scaled down and the incentives for older persons to participate in the labour force have been strengthened. All of this should help to alleviate the problems of the labour market in Germany. Despite this, it is not to be expected that low unemployment figures similar to those in the USA and UK or some European partner countries can be achieved without further reforms. With regard to the idea of implementing successful reforms from abroad in Germany, isolated elements of a model that has been successful in another country as part of an overall package cannot be adopted without taking account of the interdependency involved. This applies to both minimum wages and wage subsidies.