

WORKING DOCUMENTS

W 133

---

**LABOUR PARTICIPATION AND  
UNEMPLOYMENT; A COMPARISON  
OF DEVELOPMENTS AND  
INSTITUTIONS IN GERMANY AND  
THE NETHERLANDS**

*Uwe Blien and Frank den Butter (eds.)*

The Hague, July 2003



## PREFACE

### *The Netherlands and the Federal Republic of Germany: an institutional comparison*

*Uwe Blien, Frank den Butter*

The present volume investigates the institutional structure of the Netherlands and the Federal Republic of Germany as this affects the labour market situation. Among the countries of Europe, these two nations are undergoing particularly dynamic developments. Following changes in the balance of power in Parliament, a new government has taken office in the Netherlands. In Germany radical reforms of the labour market have been discussed and a start made on them. For these reasons it is worth looking closely at the institutional framework of the labour market and the economy in general in both countries.

The Netherlands and the Federal Republic also lend themselves particularly well to comparison for other reasons: they are not just neighbours but many of their regulations have much in common. At the same time there are important characteristic differences, in which respect the question arises as to whether these are able to explain the major discrepancies that have characterised the development of the labour market in recent years. Can the fact that the Netherlands has achieved virtually full employment in recent years while unemployment once again exceeded the four million mark in the Federal Republic in the summer 2002 be explained in terms of the structure of the central institutions of the economy? This is the key analytical issue addressed by this volume.

The subjects examined by the individual articles are of interest for the light they throw on the background to the vigorous institutional reform process in both countries coming to an end at precisely the present time. How are we to provide an explanation for the functioning of institutions except by drawing a comparison between different countries? Since experiments on a macro-economic or societal scale are ruled out, one is obliged to turn to international comparison for an understanding of the way in which institutional arrangements work.

The growing internationalisation of economic processes and further European integration provide additional reasons for looking beyond national frontiers and drawing comparisons between countries. Not just the markets for goods but labour markets have long been internationalised and, for this reason alone, labour market research has been obliged to take an overarching perspective. The actors in the labour market have only a limited awareness of the limiting conditions under which they act. Whereas in the Netherlands, for example, pay settlements reached in neighbouring Germany have for some time provided a frame of reference for wage policy, there has to date been little evidence of any internationalisation of wage policy in the Federal Republic.

The majority of the individual contributions to this volume have arisen from papers given at a Workshop held in February 2002 organised by the Scientific Council for Government Policy (WRR) of the Netherlands and the Institute for Employment Research (IAB) in the Federal Republic. Participants in the Workshop were drawn from the staff of the institutions involved, collaborating academics and decision-makers in government and the Federal Employment Services.

The WRR is briefly introduced to the German public in a short message of greeting by its Chairman, Professor Scheltema. The Dutch Council corresponds only in the broadest sense with the Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (German Council of Economic Experts), as it works on an interdisciplinary basis and its reports are not so much concerned with the current state of the economy as with long-term economic and social developments.

The Workshop was arranged in such a way that current developments and the underlying institutional structures in each country were presented by a scholar in the context of that country. These roles were performed for the Netherlands by WRR member Frank den Butter and for Germany by Jürgen Kromphardt, a member of the Council of Economic Experts. Further to these leading papers commentaries were provided from the perspective of each country, with Ulrich Walwei discussing the developments in the Netherlands and Kees van Paridon those in the Federal Republic. Based on this round, two further papers reviewing a number of countries were presented: Rainer Fehn discussed the developments in the Federal Republic against the background of other OECD countries, while Ronald Schettkat drew a direct institutional comparison between the Netherlands and the Federal Republic. The articles in this volume are to be interpreted along corresponding lines, with just the addition of a further contribution by way of conclusion and completion by the authors of this foreword. The Workshop arose out of the cooperation between the authors over many years in the Executive Committee of the European Association of Labour Economists (EALE) and the shared interest in economic, social and labour market policy issues.

This volume is designed to present further analytical material for international comparison purposes. We thank all those who presented papers and the authors for their cooperation and permission to publish their contributions. We thank Frau Limberger-Katsumi for her cooperation with the translation and Frau Elsner and Frau Brehm for helping to organise the Workshop.

## *The role of the Scientific Council for Government Policy*

*Michiel Scheltema, chairman WRR-*

It is great pleasure for the delegates of the Dutch Scientific Council for Government Policy (WRR) to take part in this seminar, that is organised by our institutions to compare the German and Dutch policies in the field of employment and labour market institutions.

Let me say a few words about our Council, the WRR. In a way the Council is a part of the Dutch model that aims at consensus in the relations between the social partners. In general we pay much attention to reaching consensus in society on important issues of policy.

Scientific information can play an important role in reaching agreements or compromises between different parties. E.g. the Council on Social and Economic Affairs (SER) that advises the government on issues of economic and social policy, consists of representatives of the social partners, but also includes a number of independent experts, mostly professors in economics. Because of their participation the social partners are obliged to give sound arguments for their positions. Proposals that clearly do not meet the standards of good argumentation, cannot be upheld.

We can see the same influence of scientific information in the field of politics. The Netherlands has a number of institutions that do research in order to advise the government. Well known is the CPB, the Netherlands Bureau for Economic Policy Analysis (in Dutch still called Centraal Planbureau: CPB), that makes forecasts on economic developments and on the consequences of policy decisions. Even political parties ask the CPB to give an opinion about the economic consequences of their election-programs. It shows the influence that this kind of information has.

The WRR is the broadest of the 'think-tanks' for the government. It was set up in 1972 to advise the government on long term policy issues, on the base of scientific information. Members of the Council are mostly university-professors; they come from various disciplines like economics, law, sociology and biology. At this moment we have eight members; they spent about three days a week at the Council. The Council is funded from the budget of the government, but is independent in its advices. It chooses its own subjects after consultation with the government. The subjects are mostly very broad, which means that they are relevant for different ministries at the same time. Since the ministries always have troubles in looking outside their field of policy, the Council tries to take a broader look. Examples of recent reports are *Generationally-aware Policy* (dealing with the relationship between generations), *Safeguarding the public interest* (on privatisation), and *A continuing Growth of Labour Force Participation*. The last one is most relevant for our discussions today. The most recent reports deal with the

Enlargement of the European Union (*Towards a Pan-European Union*), and with the important problems around immigration and integration. I look forward to the discussion of today. I hope they will demonstrate that continuation of our contacts is in the interest of all concerned.

# CONTENTS

<b>Preface</b>	<b>3</b>
The Netherlands and the Federal Republic of Germany: an Institutional comparison <i>PD Dr. U. Blien, prof. dr. F.A.G. den Butter</i>	
<b>The role of the Scientific Council for Government Policy</b>	<b>5</b>
<i>Prof. mr. M.S. Scheltema</i>	
<b>1 Labour market institutions and employment in Germany</b>	<b>9</b>
<i>Prof. dr. J. Kromphardt</i>	
1.1 Introduction	9
1.2 Industry-wide wage agreement and employment	11
1.3 Wage restraint and employment: Council majority versus Council minority	13
1.4 On the demand for greater wage disparity	19
1.5 More flexibility on the labour market – but what kind of flexibility?	21
<b>2 The German labour market situation, form a Dutch perspective</b>	<b>25</b>
<i>Prof. dr. K. van Paridon</i>	
2.1 Unemployment: an unsolvable problem?	25
2.2 Is there a German labour market problem?	26
2.3 From combating unemployment towards increasing the employment rate: the changing economic and labour market perspective in the Netherlands since the early 80s	29
2.4 The German economic and labour market policies	33
2.5 Conclusion	38
<b>3 Labour participation and institutional reform in the Dutch Polder model; policy options for the next two decades</b>	<b>41</b>
<i>Prof. dr. F.A.G. den Butter, dr. C. Hazeu</i>	
3.1 Introduction	41
3.2 Why is further participation growth desirable?	43
3.3 Future labour dynamics	44
3.4 A scenario for further participation growth up to 2020	49
3.5 Restrictions to further participation growth and policy options to alleviate these restrictions	51
3.6 Institutional reform for illness and disability provisions	55
3.7 Conclusions: institutional reform in the Dutch polder model	57
<b>4 Development of employment and labour market institutions; the employment-policy success of the Netherlands</b>	<b>61</b>
<i>Dr. H. Werner, dr. U. Walwei</i>	
4.1 Countries with successful employment policy	61
4.2 Unemployment	62
4.3 Employment	63
4.4 Economic growth and employment	66

4.4.1	Working time	70
4.4.2	Wage development and wage structures	71
4.5	The significance of the institutional framework	72
4.5.1	More decentral wage determination and wage restraint	72
4.5.2	Activation of the unemployed	73
4.5.3	Wage subsidies for low-wage earners	74
4.5.4	Individual and flexible forms of working time reduction	75
4.5.5	More possibilities for flexible employment relationships	75
4.6	Conclusion: ways to gain more labour market flexibility	77
<b>5</b>	<b>Increased labour market flexibility and unemployment</b>	<b>85</b>
	<i>Prof. dr. R. Fehn</i>	
5.1	Introductory remarks	85
5.2	Wage policy and labour market performance	87
5.2.1	Wage moderation	87
5.2.2	Wage differentiation	89
5.3	Reform of the insurance and transfer payments to the unemployed	91
5.3.1	Individual unemployment insurance account	92
5.3.2	Shorter duration of receipt of benefits from the unemployment insurance	94
5.3.3	Abolition of unemployment assistance	95
5.3.4	Social assistance only when willing to work	95
5.3.5	Institutional competition in the transfer payments to unemployed people	96
5.4	How can the wage setting behaviour be disciplined?	97
5.4.1	Reduction of statutory dismissal costs	98
5.4.2	More decentralised wage negotiations	102
5.5	Concluding remarks	110
<b>6</b>	<b>Labour market flexibility and unemployment regulation and flexibility of markets; taking the Netherlands and the Federal Republic of Germany as an example</b>	<b>123</b>
	<i>Prof. dr. R. Schettkat</i>	
6.1	Introduction	123
6.2	Dismissal protection	127
6.3	Collective bargaining	129
6.4	Transfer payments, taxes, social-security contributions	133
6.5	Conclusions	135
<b>7</b>	<b>Scope for future employment policy and institutional reform in Germany and the Netherlands; a rejoinder</b>	<b>139</b>
	<i>PD Dr. U. Blien, prof. dr. F.A.G. den Butter</i>	
7.1	Introduction	139
7.2	Some main findings of the articles from this volume	139
7.3	Recent developments and political situation	143
7.3.1	The Netherlands	143
7.3.2	Federal Republic of Germany	146
7.4	Prospects	150



# 1 LABOUR MARKET INSTITUTIONS AND EMPLOYMENT IN GERMANY

*Jürgen Kromphardt*

## 1.1 INTRODUCTION

Although Germany's labour market and employment system show a whole string of weak points and problems, they are not as bad as they are made out to be. Reference is made here to the labour force participation rate and the unemployment rate. The labour force participation rate measures the proportion of the resident population of working age between the ages of 16 and 64 that wishes to take part in working life, in other words the proportion that finds participation in the labour market sufficiently attractive to perform a job or look for one. Table 1.1 below shows that in 2000 the labour force participation rate in Germany lies clearly above the EU average; it is also higher than in the Netherlands, whose labour force participation rate is below the average. If the unemployment rates as defined by the International Labour Organisation (ILO) are then examined, Germany's rate is only slightly better than the EU average of 8.2 percent. Here, though, the Netherlands come off far better with a rate of only 3.3 percent.

**Table 1.1 Labour force participation rate and unemployment rate in Germany, the Netherlands and the EU**

	Average 1974-84	1985	1991	1995	2000
<b>Labour force participation rates (a)</b>					
Germany	68.0 (b)	67.4 (b)	73.9	72.8	74.8
Netherlands	58.0	56.0	59.0	61.7	66.2
EU	66.9	66.3	68.5	67.9	69.9
<b>Unemployment rates (c)</b>					
Germany	-	7.2	7.9 (d)	8.2	7.9
Netherlands	-	8.3	5.8	6.9	2.9
EU	-	-	8.2	10.7	8.2

a) the labour force (i.e. people who are in work or seeking work) aged from 16 to 64 as a proportion of the resident population of this age

b) western Germany only

c) standardised unemployment rates

d) 1993

Source: OECD, Economic Outlook, No. 80, Dec. 2001, Tables 19 and 22

Compared with the EU average there is thus no reason to describe the German labour market as especially incapable, immobile or decrepit. If this occurs anyway, then it is due to the development in the 1990s. During that time the labour force participation rate and the unemployment rate hardly changed in Germany. In the Netherlands, on the other hand, the labour force participation rate

increased clearly and the unemployment rate fell clearly. The 1990s therefore did not bring any improvement in Germany's situation, whilst in the Netherlands the situation on the labour market improved very clearly, although it is known that when interpreting the figures it must be taken into account that part-time work has increased far more strongly in the Netherlands than it has in Germany and is in the meantime far more widespread there.

In view of the stagnation on the German labour market (measured in terms of the rates, not the absolute figures: in the 1990s both the size of the labour force and the number of people in employment increased) there are repeated demands for reforms and institutional changes to the German labour market institutions. Here I would like to begin by saying that Germany's labour market is characterised in institutional terms by four features:

- a) Wage determination occurs above all by means of industry-wide wage agreements which show only a small wage disparity. The state has little influence, as the collective bargaining autonomy is protected in the Constitution.
- b) The structure of wages shows a relatively small disparity according to qualifications.
- c) The unemployed and the economically non-active are relatively well protected.
- d) Dependent employment is made considerably more expensive by high social security contributions (above an income of € 325 per month).

As I have been invited as a member of the German Council of Economic Experts I would now like to present this Council's proposals for reforming the labour market and to take a critical look at them.

Statements of criticism and ideas for reform made by the German Council of Economic Experts with regard to these characteristics emerge most clearly from four consecutive sections of the 1999 annual report which are entitled "Keep wage increases below the level of productivity growth" (sections 332-340), "Facilitate downward wage differentiation" (sections 341-343), "A separate programme for the low-wage sector?" (sections 344-353) and "Gear the labour market system towards more employment!" (sections 353-365). With regard to the problem of the burden resulting from social security contributions the Council restricts itself to the low-wage sector.

The main bone of contention for the majority of the Council is the industry-wide wage agreement, which they see as playing a hampering role in all four problem areas. I will therefore deal with this institutional regulation first of all.

## 1.2 INDUSTRY-WIDE WAGE AGREEMENT AND EMPLOYMENT

The majority of the German Council of Economic Experts criticises the dominance of the industry-wide wage agreements in Germany because of their negative consequences on employment. I would like to sum up this criticism into four points:

1. The first point of criticism is that the industry-wide wage agreement reinforces the division between insiders and outsiders. The insiders are already protected against dismissals by the dismissal protection, and the industry-wide wage agreement prevents outsiders from undercutting wages in an attempt to get into the employment system by displacing insiders.

First of all this argument overlooks the fact that such a substitution does not increase employment. Secondly, although it is true that, as long as it is observed, the industry-wide wage agreement does not permit the undercutting of wages, it does not follow from this that there would be successful hirings on a large scale by means of wage undercutting if there were no industry-wide wage agreements. As Solow (1990) points out, in the USA – a country in which industry-wide wage agreements do not exist – there is a social norm that prohibits displacing someone from his or her job by undercutting the wage. Such a social norm was able to become established because an action such as wage undercutting puts a strain on the peaceful cooperation within the firm, which is why the person undercutting the wages is not accepted by the colleagues, and the employers can not expect to have employees who are satisfied and therefore motivated to achieve. Moreover the previous outsider, if he or she is accepted, immediately becomes an insider and will demand the same pay for the same work.

Irrespective of this it is misleading to associate the division of the labour force into insiders and outsiders with the idea that one is dealing with two solid blocks. The hurdle between insiders and outsiders is often overcome. One way in which this occurs is by workers voluntarily moving from a firm in which they were insiders to a different firm for which they were previously outsiders. However, there are no statistical data in Germany about the total number of such job changes within the employment system.

The other way to clear the hurdle consists of moving from unemployment into an employment relationship or (for previous insiders) by changing from employment to unemployment. According to the statistics of the Federal Employment Service (Bundesanstalt für Arbeit) (2001) about 2.84 million unemployed people moved into dependent employment in 2001 and 0.69 million unemployed people commenced a training relationship. In the same year 3.42 million employees became unemployed, as did 220,000 trainees, 145,00 of whom had successfully completed their training and 75,000 who had not.

These considerably high figures show that even without wage undercutting and in spite of existing dismissal protection there is a considerable exchange between insiders and outsiders, for these figures do not record the direct changes between two employment relationships.

2. According to the majority of the Council the industry-wide wage agreement and the lack of wage undercutting prevent cheaper outsiders being hired in addition. This would already change if there were lower entry-level wages for the newly hired. There is no evidence that firms would then hire additional workers however. The firms will only do this because of slightly lower wages if they expect their customers to buy the goods produced in addition by these additionally hired workers. It can hardly be assumed that the employers expect the workers they hire to spend their additional income entirely on the goods produced by these firms.

What supports my reservations is the fact that relatively little use has been made of the entry-level wages such as those which have been agreed in the German chemical industry. But even if they had been used this would still not be proof of an employment effect since the new entrants to the labour market might have been hired even without entry-level wages.

3. A third statement in the annual report criticises the industry-wide wage agreements with the argument that they force firms to make redundancies in the event of a crisis within the company as long as they do not contain hardship clauses; these clauses "serve to maintain the usual jobs of employees who would have been laid off if the collectively agreed wages were used" (section 358). It is necessary to point out with regard to this matter that such hardship clauses are already incorporated in many collective agreements. However, for good reason their use is dependent on the consent of the two sides of industry. This commitment to the consent of all parties makes sense because in this way it is ensured that a case of hardship, in other words a particularly precarious situation, really exists at the firm that wishes to make use of such a clause. Furthermore the firm applying for the use of this clause has to prove that it has a reorganisation concept that can lead the firm back out of the crisis again. In addition to this the consent regulation ensures that the clause is only used in real hardship cases; this guarantees that the firms which have got into difficulty also actually gain a competitive advantage over their competitors, which enables the firm to get out of the difficult situation again. If on the other hands the wages were lowered in general, then this firm would not have a competitive advantage.

As hardship clauses are not included in all collective agreements and they also often do not permit a reduction of the hourly wages, the majority of the German Council of Economic Experts (section 358) proposes "to permit by law emergency negotiations at plant level also without them being subject to consent from the two sides of industry". The path to such a change in the

collective agreements is via the annulment of § 4, section 3 of the Collective Bargaining Act and a reformulation of § 77, section 3 of the Industrial Constitution Act (*Betriebsverfassungsgesetz*) (see section 36of). The reason given for annulling the consent proviso is that this proviso results in “the effect on the remaining job-holders [being] decisive for the trade-union policy judgment on hardship clauses” (ibid). In contrast I assess the consequence as positive. Without a consent proviso, there would be a danger of the agreed wage reduction being applied to the other job-holders so that the advantage of the hardship clause, which is to give support to an individual firm that is in a desperate situation, would be cancelled again. In this respect I am keeping to my minority opinion that the proposed undermining of the industry-wide wage agreement should also be rejected because it would restrict the effectiveness of the hardship clauses. Furthermore, transferring the wage determination rights to the firms and thus to the works councils leads to serious legal and material problems because works councils have no right to strike but are subject to a duty to maintain industrial peace.

4. The central criticism levelled at the German industry-wide wage system, however, is that it makes it difficult to implement the wage increase rule demanded by the majority of the German Council of Economic Experts according to which the wage rises should remain behind the increases in productivity. By means of this wage restraint the productivity increases should be used to promote employment (annual report 1999, section 333). As the effects that wage increases have on employment constitute a complex subject I would like to discuss them in a separate section.

### 1.3 WAGE RESTRAINT AND EMPLOYMENT: COUNCIL MAJORITY VERSUS COUNCIL MINORITY

How wage restraint, in other words wage rises remaining behind the productivity increases, can be used to promote employment is not explained in the 1999 annual report; instead reference is made to the 1998 annual report, section 423ff. There reference can be found to the positive (but not specified) effects of wage restraint as an improvement of the supply conditions, and the statement that it is worthwhile “for the firms to set up more jobs as a result of the wage restraint” (section 425). This is an imprecise formulation however. To be precise the argument would have to be: it is worthwhile for the firms when setting up new jobs to organise them less capital-intensively. What remains unknown is why the firms should set up new jobs. The criticism of the demand-side reservations, which is presented in the same section, can at best justify the fact that demand in the economy as a whole does not decline if there is wage restraint – additional demand for goods is hardly likely to arise.

In the 1999 annual report, too, the majority of the Council once again concerned itself with the counterargument that when dealing with this issue it is also nec-

essary to take the demand side into account and then in my view (see my minority vote, annual report 1999, sections 366-373) comes to the opinion that a general wage reduction does not send out any signals to the employers that they should hire more workers because of expected increases in sales. The opposite is more the case because if a wage increase remains behind the increase in productivity, the purchasing power of the workers' households also remains behind it, with the result that the producers of consumer goods receive signals to produce less but no signals to produce more.

Wage restraint does not have a negative effect on the demand-side of the export trade. The effects of wage restraint on the sectors therefore vary greatly. This is also confirmed by a study conducted by Blien et al (2001), which is highly disaggregated according to region and which brings out the fact that of the 113 districts or towns in eastern Germany the ones which were positively affected by wage increases between 1993 and 1999 were those in which services for the domestic market dominate. In contrast the districts with a high level of industry density were negatively affected because their products are mainly sold outside eastern Germany, with the result that the negative cost effects are not offset by positive demand effects.

On balance therefore wage restraint does not result in any positive employment effects. What is behind the idea that wage restraint creates more jobs is therefore presumably the old neo-classical doctrine, which was formulated for example in the 1977 annual report and probably continues to play a role today:

14  
"Whatever may be a burden on the investment calculation, there is at any time a wage level at which no supply problems that may exist for other reasons make such a difference that full employment would become impossible"<sup>1</sup> (annual report 1977, section 288).

At that time, however, the German Council of Economic Experts considered itself unable to quote this wage level which would make full employment possible, instead it goes on to establish (annual report 1977, section 289):

"Nobody knows even afterwards how to say what the wage development should have looked like which would have guaranteed an adequate reaction of the supply in the economy as a whole in the course of the most recent upswing. However, this concession does not change anything about the thesis that from the supply-orientated point of view less wage would have resulted in more employment!"

Whereas at that time the German Council of Economic Experts was unable to quantify the aim but knew that it is approached by means of wage restraint, attempts have been made meanwhile to determine the necessary extent of wage reduction (always in relation to the increase in productivity). Relevant calculations can be found in Fitzenberger/Franz (2001). They show that in order to

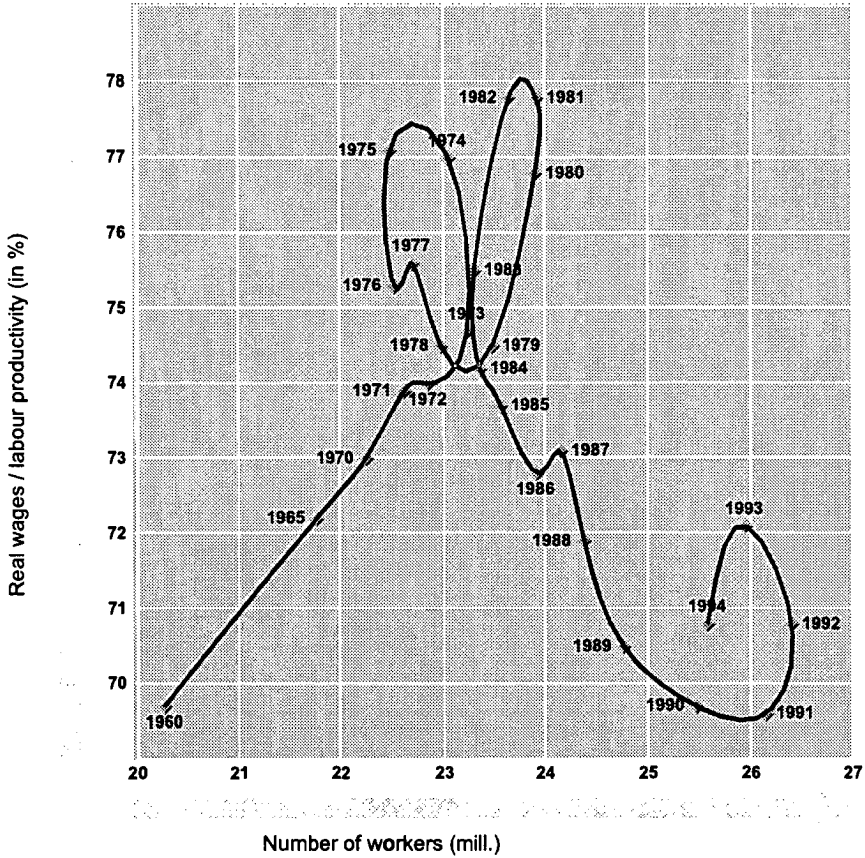
halve the respective unemployment figure it would be necessary to reduce wages by 37 percent in the lower wage sector and by 34 percent in the middle wage sector<sup>2</sup>. It seems reasonable to suppose that such large-scale or long-lasting wage restraint could not be carried through either with or without industry-wide wage agreements.

However, it would be wrong to think that the Germany industry-wide wage system prevents a wage restraint that lasts for many years. For this it is necessary to look at the temporal development of the real wage position in Germany in figure 1.1 on the next page; this is defined as a quotient of the real wage per employee to the production per worker, and the change in this quotient measures the extent of wage restraint or non-restraint. As the real income per employee is related to the labour productivity per worker, the changes in the two quantities measure at the same time the changes in the real wage position and in the adjusted wage ratio if – as is usual when calculating the wage ratio – the output is measured in terms of the national income and not the gross domestic product, since it applies that:

$$(1) \frac{L_r / A}{Y_r / E} = \frac{L_r}{Y_r} \cdot \frac{E}{A}$$

Although this real wage position improved steadily in favour of the employed in West Germany from 1960 to 1982, because the real wages increased more strongly than labour productivity, after 1982 the picture reversed. From 1983 until 1991 the real wages remained behind labour productivity generally in western Germany, with a small interruption in 1987. It was the unification boom that first resulted in an increase in the real wage position in 1992 and 1993. However, this constitutes only a short interruption in the wage restraint, as is shown in the figures for the whole of Germany in figure 1.2. Overall from 1982 to 1991 the real wage position fell in western Germany from just under 78 percent to below 70 percent, in other words by more than one tenth. If the majority of the Council is of the opinion that it is necessary to undermine the industry-wide wage, then obviously because in their opinion this wage restraint should be continued for as long as there is unemployment (annual report 2001, section 399).

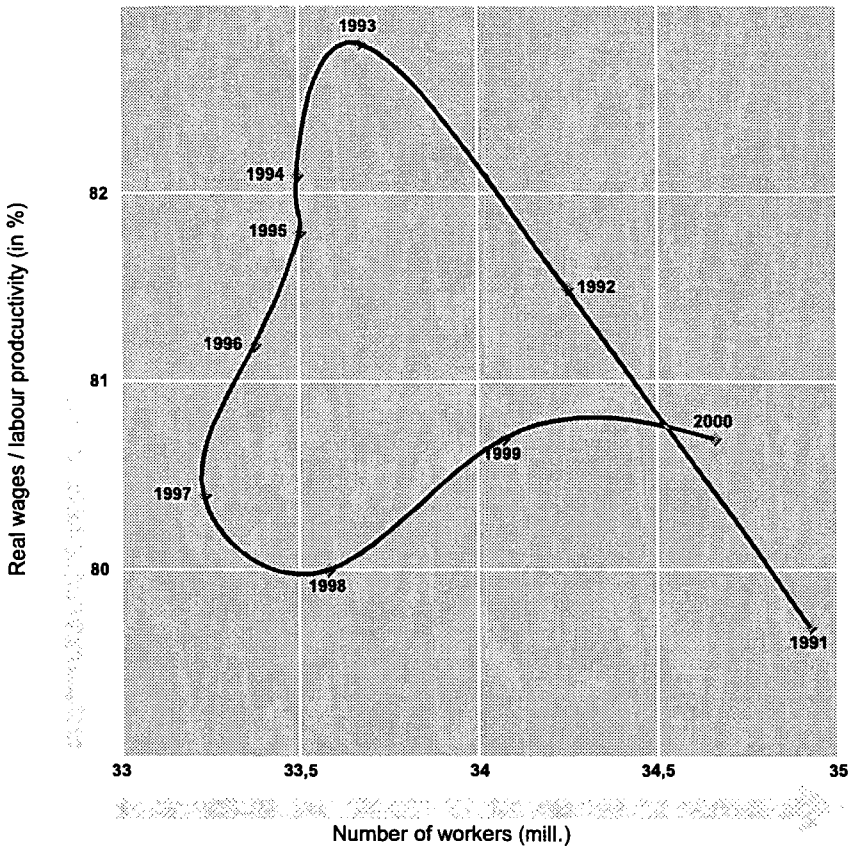
**Figure 1.1 Real wage position<sup>2, 3</sup> (relation between real wages and labour productivity) and Employment<sup>1</sup> - Western Germany 1960 until 1994**



1. Report of the German Council of Economic Advisers ("Jahresgutachten" des Sachverständigenrats) 2001, Table 2\* and 1998, Table 2\*
2. Wage of an individual worker, divided by the labour productivity
3. "DGB-Informationen zur Wirtschafts- und Strukturpolitik" No. 5/ 2000, Table 3. Calculated as the proportion of wages to the social product and adjusted for changes of the proportion of dependent workers to the complete economically active population



Figure 1.2 Real wage positions<sup>2,3</sup> and employment<sup>1</sup> - Germany 1991 until 2000



1. Report of the German Council of Economic Advisers ("Jahresgutachten" des Sachverständigenrats) 2001, Table 2\*
2. Wage of an individual worker, divided by the labour productivity
3. Calculated from "Jahresgutachten" 2001: Table 17a\*, 15\* and 22\*

In these two diagrams, from which it is possible to see the development of the real wage position from the ordinates, the number of workers is also entered on the abscissa. The diagram therefore shows not only the development of the real wage position but also the simultaneous development of the employment of workers. From this the remarkable result is obtained that from 1960 to 1982 the number of employed grew although the real wage position of the employed increased considerably as a result of expansionary wage policy. Then from 1982 until 1991 a process of wage restraint was under way during the course of which more workers found a job once again – albeit with a time-lag of three years. Wage restraint and expansionary wage increases are therefore both obviously compatible with increasing employment. This leads me to the supposition that it is not the changes in the real wage position that determine the development of employment but vice versa the development of employment determines the change in the real wage position. Thus there was high unemployment in

Germany from 1982. This weakened the bargaining position of the workers and their trade unions so considerably that they had to accept constant wage restraint until 1991. This process was only interrupted in the unification boom, in other words in a bargaining situation that was far more favourable for the trade unions, but afterwards the pressure of the high unemployment won through again.

In an international comparison, too, there is no indication at all that Germany's industry-wide wage system encourages an expansionary wage policy to any particular extent. As can be seen from table 1.2, which is based on EU figures, it is more the case that the development of the indicators shown occurred in Germany largely along the lines of the European Union average, with the exception of the 1960s, when the situation of full-employment and finally even overemployment led to the real wage position improving in Germany while it declined slightly in the EU in that decade.

**Table 1.2 Real wages, labour productivity and real wage positions in Germany, the Netherlands and the EU<sup>(a)</sup> - Annual average changes**

	1961-70	1971-80	1981-90	1991-2000
<b>Germany<sup>(b)</sup></b>				
Real wages (RW)	4.6	2.9	0.8	1.4
Labour productivity (LP)	4.2	2.6	1.7	2.0
RW-LP	0.4	0.3	-0.9	-0.6
<b>Netherlands</b>				
Real wages (RW)	5.1	3.0	0.2	1.0
Labour productivity (LP)	3.9	2.7	1.6	1.2
RW-LP	1.2	0.3	-1.4	-0.2
<b>European Union</b>				
Real wages (RW)	4.5	3.0	0.9	1.1
Labour productivity (LP)	4.6	2.7	1.9	1.7
RW-LP	-0.1	0.3	-1.0	-0.6

a) real wage per employee and productivity per worker

b) until 1990: Western Germany only

Source: Schulten/Stückler, 1999, Table 2

Compared with Germany and the European Union the development in the Netherlands, where a policy of wage restraint was agreed in the famous Wassenaar Agreement of 1982, proceeded considerably more unevenly. In the 1960s a very considerable overshooting of real wages over labour productivity could be observed in the Netherlands, which was far greater than that in Germany. The correction of this development then took place a decade later in the 1980s during which time the real wage position deteriorated even further in the Netherlands than in Germany. In the 1990s, when in Germany and the EU the wage restraint was continued in a slightly more moderate form, the real wage restraint in the Netherlands almost came to a standstill; it came to only a third of the value for Germany.

What is striking is the small increase in productivity in the Netherlands in the 1990s, which can be explained above all by the growth of part-time employment. Unfortunately it is not possible to gather from Schulten/Stückler how the productivity per hour developed.

I would like to point out that the wage restraint and its opposite are measured *ex post* here, i.e. in terms of the quantities that were actually realised. This development need by no means have corresponded to the intentions of the two sides of industry. For the response of the economic system to collective wage agreements, however, it probably depends above all on the actual development. I can not imagine that the economy, which in the case of Germany for instance knows that the actual wage agreements usually end up at half of the wage demand originally made, is impressed by high wage demands being made initially, such as this spring. Nevertheless this ritual of first putting forward high wage demands and then allowing themselves to be bargained down to roughly half of the amount is one of the negative sides of the industry-wide wage agreement system.

Another negative aspect of the wage development is concealed by the formation of averages over ten years, that is the considerable fluctuations in the annual rates of change. This applies firstly for the nominal wages: in western Germany in the 1990s the increase in nominal wages fluctuated between 6.1 percent in 1991 and 1.3 percent in 1997. These increases in the nominal wage also had an effect on the real wage position, which improved by two percentage points between 1991 and 1993 and then fell even more heavily until 1998.

19

These considerable fluctuations in the development of wages show what negative effects result if the respective market and power positions first of the one side and then of the other side are exploited heavily in the wage negotiations. It would be better if the two sides of industry were to agree upon a permanently viable wage formula, namely upon the formula of a real wage increase that is orientated towards productivity, where the real wage position and thus the (adjusted) distribution of incomes between workers and firms remains constant. Agreement on this formula, which makes sense in macroeconomic terms and is permanently acceptable for both sides, would lead to a greater continuity in the development of wages, thus making it easier for firms to calculate and predict the development of wage costs, which would in turn make their production and investment decisions easier.

#### **1.4 ON THE DEMAND FOR GREATER WAGE DISPARITY**

Concerning the demand for greater wage differentiation the German Council of Economic Experts starts out from the indisputable observation that the demand for labour is shifting at the expense of the lower qualified. This shift is reflected in above-average high unemployment rates of low-skilled workers. The Council suggests offsetting this trend of declining demand for low-skilled workers by

means of a greater downward wage disparity. This wage disparity should either occur in the collective agreements themselves or be made easier to implement by decentralising wage determination.

As regards the question as to the sectors in which low-paid jobs can be created it is hardly possible to consider industry since it will neither make sense nor be implementable to spread the wages in Germany so far downwards that production lines that are performed above all with low-skilled labour are produced as cheaply as in low-wage countries such as in Eastern Europe or in India. Therefore it would be pointless in the sectors where it is possible to shift production to prevent this occurring by means of a greater wage disparity in Germany.

Pushing through a wage structure that is spread more strongly downwards is not sufficient for a higher employment level, however. It is more the case that there are supposedly far too few people who are willing to perform low-paid activities. The Council sees disincentive effects arising from the current social assistance and unemployment assistance regulations as a key reason for this supply-side disturbance. In the case of social assistance these disincentives arise above all:

- a) as a result of the full deduction of earned income exceeding a low maximum amount;
- b) as a result of an insufficiently large gap between the wage of low-skilled people and the social assistance payments, especially those for families with children, since the small gap can be attributed above all to the different treatment of the maintenance costs for children. For instance the child allowance for working people amounts to DM 300, but social assistance is increased by up to DM 650 per child.

With regard to the deduction of earned income the Council suggests testing a deduction rate of 50 percent. Because of the different treatment of child allowance the idea seems to suggest itself of granting a child allowance supplement of DM 200 per child to workers who leave social assistance, as is being done in Rhineland-Palatinate in their pilot scheme. However, in the Rhineland-Palatinate scheme this supplement is limited to one year, with the result that the wage gap problem is only solved temporarily.

What must also be taken into consideration is that the enlargement of the gap between wage and social assistance by means of child allowance supplements or other measures can not prevent social assistance recipients who have suitable abilities from being in a better position if they draw social assistance and in addition do more or less occasional "clandestine" work. By means of the corrections named it is not possible to gain control of this possibility, which is of course not open to all social assistance recipients who are fit to work, but it may be at best moderated somewhat.

In addition to social assistance, the existence of unemployment assistance also creates undesired disincentives. Unemployment assistance is also linked to needs, but differs from social assistance in that the level of assistance is oriented towards the previous earned income. This orientation then creates problems when it is a matter of inducing unemployed people who previously worked in industry to accept low-paid jobs in the services sector. In industry they often earned a relatively high income owing to piecework and overtime, so that their unemployment assistance which is orientated towards this income (even if it only amounts to 57 percent of the net income) is so high that accepting a job in the services sector becomes unattractive. Therefore unemployment assistance should be amalgamated with social assistance, though the Council does not give any concrete information about details. The possibilities range from a degressive organisation of unemployment assistance, through the setting of time limits for it, to the abolition of unemployment assistance. This would take into account the necessary structural change from the production of goods to services. In this way the labour market would become more flexible.

## 1.5 MORE FLEXIBILITY ON THE LABOUR MARKET – BUT WHAT KIND OF FLEXIBILITY?

The subject of increasing flexibility is of great importance not only in the 1999 annual report, but is also taken up again in the annual reports of 2000 and 2001, whereby the annual report 2000 deals especially with the law passed in 2000 on part-time work and fixed-term employment contracts. In section 430 it is acknowledged that part-time work is welcome “in principle”, but the legal regulations are reproached for not adequately extending the flexibility within the part-time work regulation. In the case of fixed-term employment contracts, too, the Council demands (section 429) more flexible regulations (the same applies to the amended Industrial Constitution Act, section 431). The 2001 annual report, too, sends a reminder about more flexibility, without new arguments being produced for it.

The papers by Fehn and Schettkat (in this book) deal in detail with the flexibility of the German and Dutch labour markets. For this reason I would like to restrict myself to a fundamental reflection on the issue of flexibility on the labour market. It seems to me here to be very important for the discussion that a distinction be made between

- a) flexibility in terms of quantity and
- b) flexibility in terms of price.

Flexibility in terms of quantity refers to the use of hours worked. In view of the demand for labour fluctuating with the seasons and economic cycles it should be made possible to control the deployment of labour more flexibly than used to be the case. In particular annual working time accounts, which are becoming more and more widespread in the meantime, are of use within the firms in this

respect. With such accounts the maximum total number of hours to be worked in the course of a whole year is still established, but the division of this total across the individual months, weeks and days of the year can in contrast be geared towards the needs within the establishment. Such annual working time accounts have the advantage for the firms that they have to pay less overtime with its corresponding overtime premia, but have the same annual working time, since the additional hours worked in excess of the regular working week at certain times in the year are not judged as overtime but are balanced out by hours off at a later date.

By means of this balancing possibility the overall number of hours worked, in other words the total of working hours paid in accordance with and in excess of the agreed wage, can fall if, before the introduction of working time accounts, the overtime was worked and paid as overtime and was not balanced out by additional free time. In this respect the annual working time accounts can lead to a reduction of the actual annual working time. Whether positive employment effects are associated with this is probably disputed in the German Council of Economic Experts.

A flexibility of the deployment of labour outside the firm occurs through dismissals and lay-offs. As can be seen from the figures cited earlier, such a flexibility exists on a large scale, in contrast to what the insider/outsider discussion suggests. This flexibility is reinforced even further by the fact that in the meantime part-time work and fixed-term employment contracts are possible according to the law passed in 2000 that was mentioned above. The existing extent of quantitative flexibility does not rule out the fact that there are sensible ways to increase this flexibility even further, e.g. by means of mobility assistance for employees who have to move house in order to change their job or take up employment for the first time.

A flexibility in terms of price on the labour market (i.e. wage rates that can be changed for a short time) only makes sense in my view in individual cases, for instance in the hardship cases mentioned above. Otherwise, though, I consider a general flexibility in terms of price, in the sense of a flexible wage level, to be even harmful, since when unemployment is high it can lead to the economy coming close to deflation as a result of repeated reductions of the wage level, thus creating a danger of firms and consumers further postponing their demand for goods, especially for consumer durables, if they expect a further decline in prices and wages. Current demand is therefore absent, with the result that the market situation and thus the employment situation deteriorate further and the economy slides into a vicious circle. Japan is obviously in such a situation; there the government's repeated spending programmes only sufficed to offset to some extent the loss of private demand caused by the deflationary tendencies. So far they have not been able to reverse the trend.

## NOTES

- <sup>1</sup> In 1977 structural unemployment was not yet of any significance. Otherwise the Council would probably have spoken more cautiously at that time of the reduction of non-structural unemployment instead of full employmen.
- <sup>2</sup> Fitzenberger/Franz calculate in addition a clearly lower required reduction, but only if they set the output elasticity  $< 1$  estimated by them at equal to one, because they (mistakenly) regard the estimated value as implausible.

## REFERENCES

- Blien, Uwe u.a. (2001), *Neue Bundesländer: Einflussfaktoren der Regionalentwicklung*. Studie von IAB/DIW im Auftrag der KfW. Nürnberg/Berlin (/IAB/DIW).
- Bundesanstalt für Arbeit (2001), *Arbeitsmarkt in Zahlen. Aktuelle Daten*. Dezember 2001.
- Fitzenberger, Bernd/Franz, Wolfgang (2000): Jobs. Jobs? Jobs! Orientierungshilfen für den Weg zu mehr Beschäftigung. In: W. Franz u.a. Hrsg. (2001), *Wirtschaftspolitische Herausforderungen an der Jahrtausendwende*. Tübingen (Mohr Siebeck).
- Schulten, Thorsten/Stückler, Angela (2000): Lohnpolitik in Europa. In: *WSI-Informationen zur Tarifpolitik*. Düsseldorf (Hans Böckler-Stiftung).
- Solow, Robert (1990): *The Labor Market as a Social Institution*. Oxford (Blackwell).





## 2 THE GERMAN LABOUR MARKET SITUATION, FROM A DUTCH PERSPECTIVE

*Kees van Paridon*

### 2.1 UNEMPLOYMENT: AN UNSOLVABLE PROBLEM?

When back in 1973 the first oil crisis hit the OECD-economies, the fairy tale of full employment was shattered. Due to Keynesian theory and Keynesian oriented policies, the unemployment problem was more or less solved. All the people who wanted a job had one. The business cycle phenomenon was something of the past, many people believed. But reality was different after 1973, with stagnating growth and rising unemployment. Whatever governments tried to do in the late 70s to restore full employment and to bring the unemployment rate back to the desired levels, nothing seemed to work. With the 1981 crisis and each subsequent new recession the unemployment rate rose to new record levels. The ensuing upsurge was normally not strong enough to reduce this again to more acceptable levels. At the same time the employment growth was minimal. The economic and social problems increased in many European economies. The golden age of the 60s was definitely over. Due to the so-called 'jobless growth' development, the traditional goal of full employment seemed to have become impracticable. Furthermore, because national economies had become more open and more dependent on foreign influences, strict national policies had lost the power to control the economic development. Governments, unions and labourers had to accept, so the common opinion, that only through labour time redistribution policies a socially acceptable solution was still possible.

25

Although also affected by such negative opinions, a few countries tried to find a more positive solution for the unemployment problem. And they succeeded. Countries like Ireland, Denmark and the Netherlands were able to change their pattern of economic development. They showed a diverging labour market performance: there a remarkable employment growth could be observed, and the unemployment rate could be brought back to unexpected low levels. They demonstrated that it was still possible to realise a more attractive labour market situation. Other countries have been eager to observe what they could learn from these successful experiences. In Germany the Dutch experiences and its Poldermodel has attracted considerable attention. But so far it seems that Germany was not able to realise the same labour market performance.

This contribution comments the current German labour market situation from a Dutch perspective. The paper of Professor Jürgen Kromphardt for this conference has been a major focus in this respect<sup>1</sup>. My main argument is that the German economy is still at the beginning of a process of radical changes, not only at the labour market but also in other policy areas, necessary to make the economy competitive again and able to realise the goal of full employment. I'll start with asking the question whether there is a labour market problem in

Germany. Then I will make clear why a higher employment level is absolutely essential for the economic and social well-being of a developed economy, and what the requirements are for such a labour market. Using the Dutch experiences, I'll then comment the German efforts to improve their labour market performance, thereby also reacting on some of the remarks of professor Kromphardt.

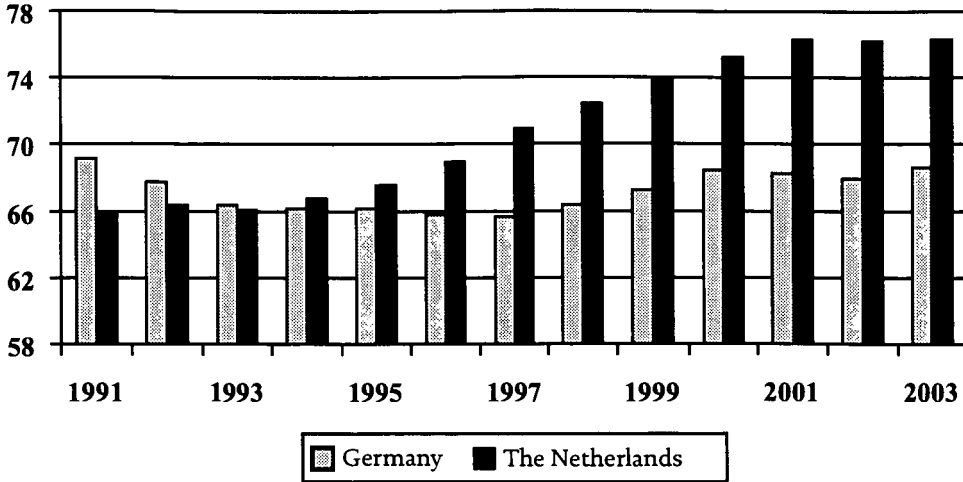
## 2.2 IS THERE A GERMAN LABOUR MARKET PROBLEM?

Jürgen Kromphardt starts his paper with the sentence that a lot of criticism on the German labour market and the German employment system is possible and that surely a number of weaknesses and problems can be indicated, but that the actual situation is better than the general opinion believes. Kromphardt shows a table with the development of the labour force rate and the unemployment. The labour force is the people with a job and the official unemployed. Divided through the total population this gives the labour force rate. There are good arguments to come up with this indicator. It shows the number of people willing to work. The data given by Kromphardt indicate that this number has increased, mainly due to the increase of female labour participation, and, even more important, by the reunification with the former GDR. There the labour force rate was much higher, above 80 percent.

Is the labour force rate an adequate indicator for the labour market performance? In my view the employment rate is more important. Only people with a job do earn their own income, and are able to contribute through taxes and premiums for the expenditures in the social security system, and so for the unemployment benefits. The more people do have a job, the lower the individual tax and premium rate can be fixed for a given social security level, the better the proper incentives will work at the demand- and the supply-side of the labour market, and the lower the labour costs will be. Furthermore, there are clear indications that employed people are happier and more content with their life situation than people without work. Therefore the employment rate is in my view a better indicator for the labour market performance than the labour force rate. Figure 2.1 indicates that the Dutch employment rate, with employment measured in persons, has shown a considerable increase in the last ten years, while the German employment rate remained at about the same level<sup>2</sup>.

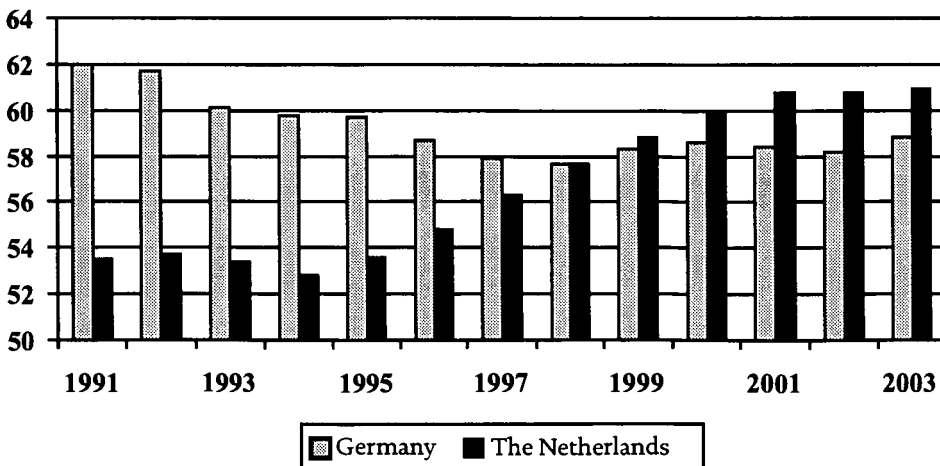
As is known, the number of part-time jobs in the Netherlands is remarkably high. They are also fully accepted. Whereas in many other European countries most people on a part-time job indicate that such a job is second choice, while no full-time job is available, the preferences of the Dutch are strongly part-time oriented. According to the Labour Force Survey of EUROSTAT, the Dutch employees working part-time have the least demand in the European Union for getting a full-time job. At the same time, Dutchmen with a full-time job have the highest demand for a part-time job<sup>3</sup>. Because the number of part-time jobs in the

Figure 2.1 Labour force participation rate (in %)



Netherlands is so high, it is relevant to calculate the employment rate in so-called full-time equivalents, for instance while people working part-time do also pay only part-time premiums. The employment rate, calculated in full-time equivalents, is in my view therefore for economic, productivity and budget reasons the best indicator on labour market performance. Figure 2.2 indicates that in full-time equivalents the Dutch employment rate has increased considerably in the last 10 years, and that its level is now higher than that in Germany.

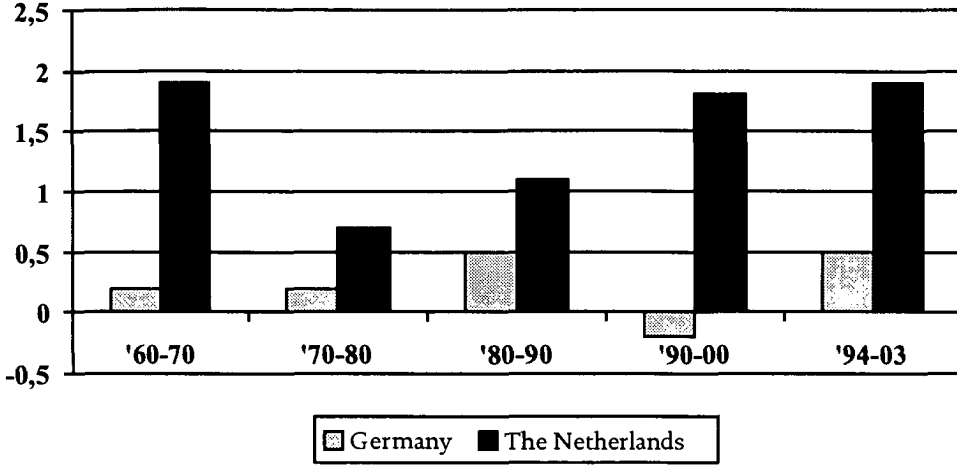
Figure 2.2 Labour force participation rate in full-time equivalents



Already since the 60s, the employment growth has been higher in the Netherlands than in Germany, as is shown in figure 2.3. This was partly due to

the higher population growth in the Netherlands, but the differences in the last decades have been the consequence of an increasing employment rate in the Netherlands, as is shown in figure 2.4. This fast employment growth contributed to a much lower official unemployment rate (figure 2.5). In the early 80s the current low level was thought to be impossible. The German unemployment situation is clearly much higher since the early 90s.

**Figure 2.3 Employment Growth**



28

**Figure 2.4 Labour force participation rate in the Netherlands**

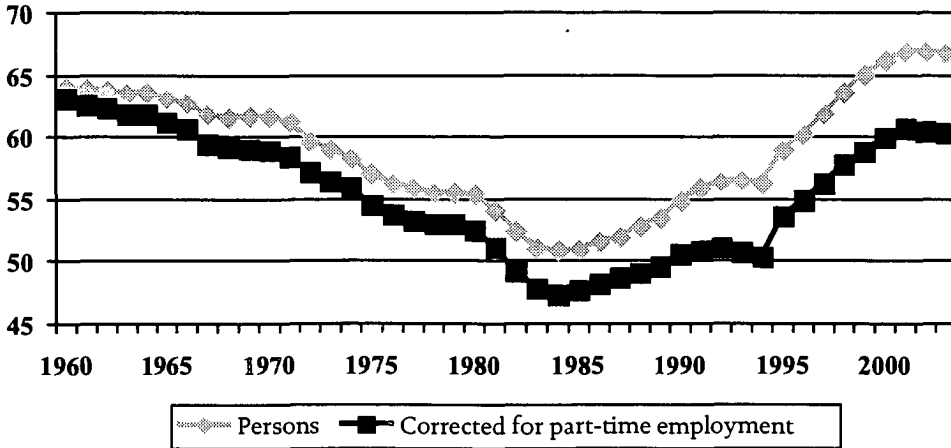
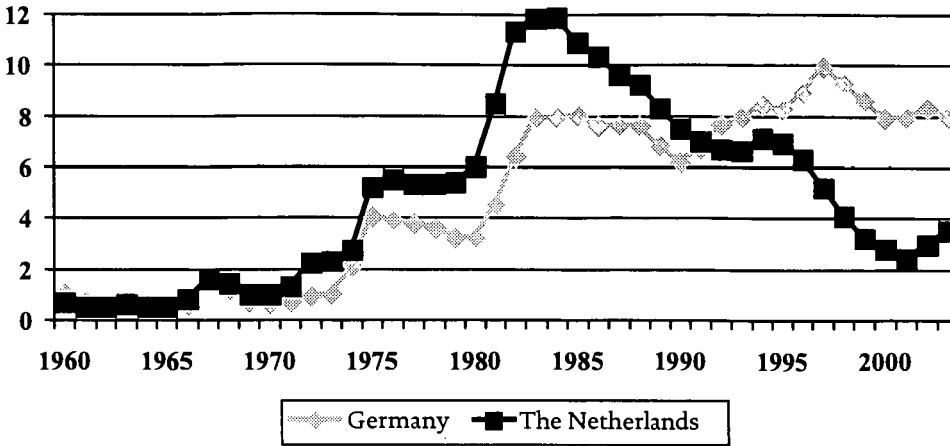


Figure 2.5 Unemployment rate



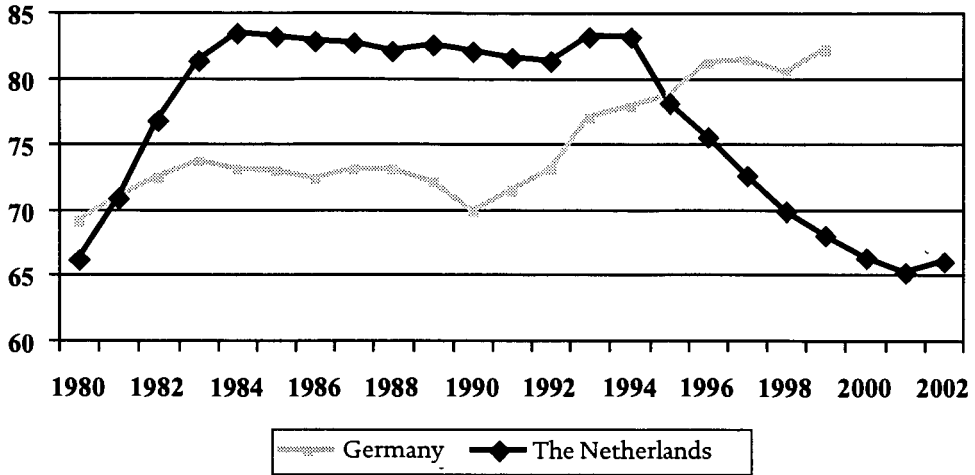
My conclusion therefore is that the German labour market situation is less positive than Kromphardt indicates. In line with Kromphardt observations, I agree that the German employment rate (in persons) has remained more or less stable. However, the demand for jobs has increased and will continue to increase. The number of unemployed people, the high preference for jobs in the new *Länder*, the ongoing emancipation and individualisation, and the need for more jobs because of the demographic changes, are all tending in the same direction, namely that more jobs should become available. In the last decades the German economy has not been able to create these new jobs. The picture becomes even more pessimistic when one looks at the slightly declining employment rate in full-time equivalents. A smaller group has paid the rising costs of social security in the recent past. This undermines German competitiveness. The conclusion is clear: something should be done to change the labour market situation of Germany. Before we try to answer that question, we return to the Dutch experiences.

### 2.3 FROM COMBATING UNEMPLOYMENT TOWARDS INCREASING THE EMPLOYMENT RATE: THE CHANGING ECONOMIC AND LABOUR MARKET PERSPECTIVE IN THE NETHERLANDS SINCE THE EARLY 80S

When the unemployment rate increased in the 70s and 80s towards very high levels, the main goal of social-economic policy was to bring down the unemployment rate. Initially it was tried with a demand-oriented policy, but in the 80s the emphasis shifted more towards supply-oriented economic policies. From 1983 a radical and broad strategy was applied, with wage moderation, expenditure cuts and subsequently tax- and premium rate cuts, with deregulation, and with painful changes in labour market and social security arrangements. In this

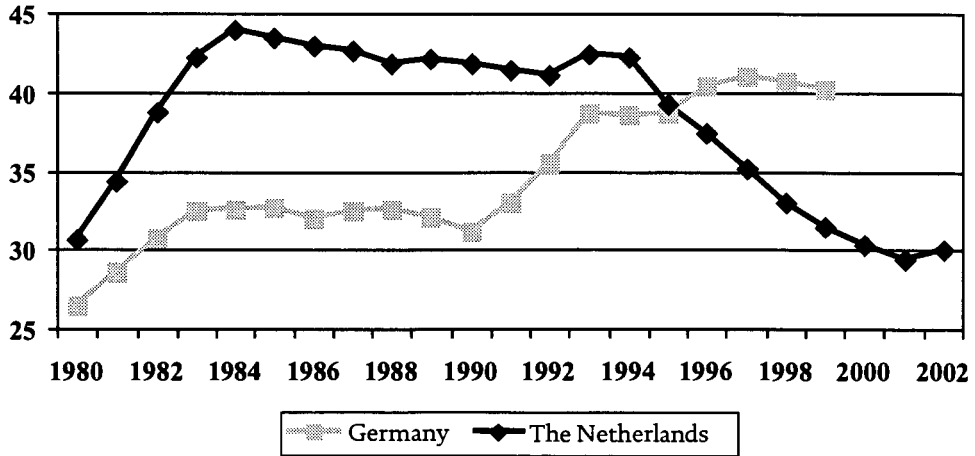
way the successive governments and the social partners tried to create more jobs and to realise a more acceptable unemployment level. Wage moderation was seen as essential to improve the competitiveness of exposed Dutch firms on the world market, but it was also judges as useful in sheltered service sectors because of the lower labour costs.

**Figure 2.6 Relation benefit recipients to Employment**



30

**Figure 2.7 Relation benefit recipients (age 16-65) to Employment**



Initially labour time reduction policies and early retirement schemes were also favoured. It was thought that through such policies new jobs for young people would become available. Only after a while it was learned that these policies hardly created any new job. Furthermore, such policies did increase the number of people dependent on social security. This raised the financial burden for the social security, with the consequence that labour costs remained high even

though wage increases were moderate. Also the wage wedge remained high, preventing many employers to offer new jobs and hindering many labourers to change jobs or to step into the labour market.

In the same period social security arrangements remained in their basic structure more or less unchanged. Still, social benefits declined in real terms, entrance requirements increased, and the instrument of sanctions became more applied. It did not produce however the right results: as figure 2.6 and 2.7 indicate, the relation between the number of people dependent on social security and those with a job remained quite stable for a long period of time. Even though after 1983 the employment increased considerably, the number of people dependent on social security increased as fast, so their relative proportion hardly changed for a long

Figure 2.8 Public spending rate

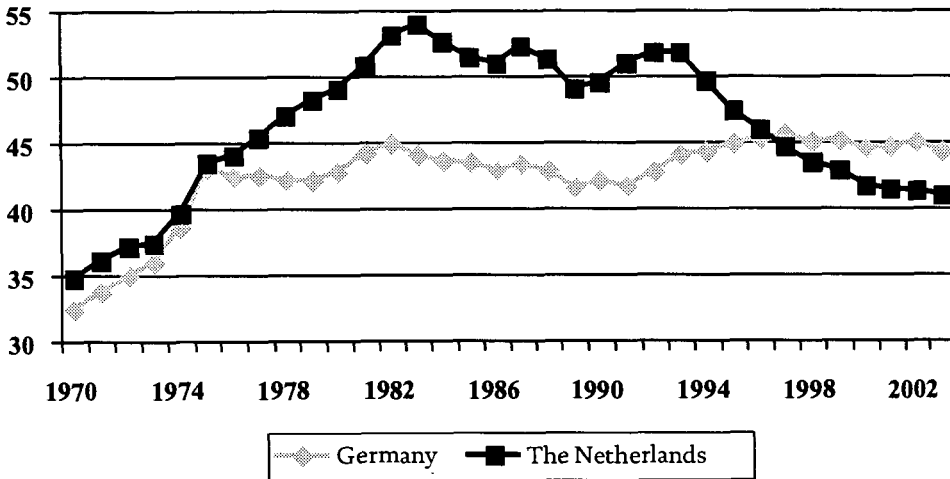
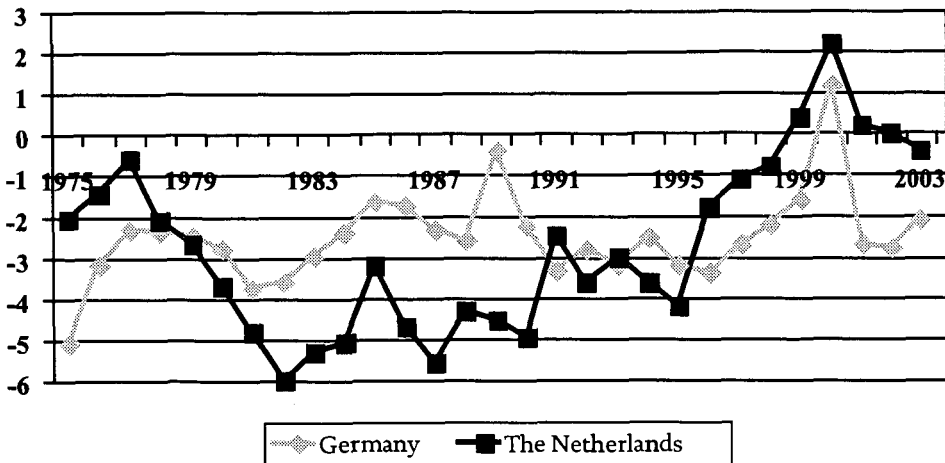


Figure 2.9 Budget deficit



It is absolutely clear that the costs of reunification have been a burden for the whole German economy. But the current weak position is more structural; it has been connected with the apparent inability to adjust the economy towards the new requirements. These are the rise of more knowledge-intensive and service-oriented sectors, the growing differentiation at all levels of production, the increasing individualisation at all levels inside German society and more decentral ways of decision-making. These trends have undermined one of the biggest German assets, its manufacturing sector. For already more than 150 years German manufacturing firms have dominated the European and world market. With their revival they made the *Wirtschaftswunder* possible, their innovativeness was famous. Because of these successes there was not so much incentive to change the basic elements. They remained characterised by internal financing and the absence of financing through shares, decision making remained centralised and hierarchical, and German firms were reluctant to outsource activities or to use foreign direct investment.

For a long time these characteristics had contributed to a very competitive economy, but now it seems that these basic elements have to be adjusted to make the German economy not only more competitive, but also less manufacturing-oriented. The individualisation and differentiation trends will continue, making standard practices and solutions less preferable. Due also to technological progress, European integration and marketing practices the need for more decentral decision making has increased. These trends require more flexibility inside firms and at product and factor markets, allowing more differentiation and more competition. It has to be expected that productivity increases in the manufacturing sector will remain high. In the recent years the manufacturing sector has brought about many changes. Their situation has certainly been improved, and the expectations are bright. But at the same time it is inevitable that they will provide less and less jobs. New jobs therefore have to be found in other sectors, especially the more knowledge-intensive and service-oriented ones. The impression exists that the German economy and society has found it difficult so far to bring about the necessary changes to make this possible.

The lack of sufficient changes has become visible in the labour market and in the social security system. Even though the manufacturing sector regained its strong position on the world market after the crisis in 1992, the employment growth in this sector remained low. New, extra jobs had to be created in the service sector, but their growth was low, too low to increase the employment rate and to bring down unemployment. Especially for lower educated people, for older employees, and for those specifically trained for manufacturing practices, the chances on the labour market have declined dramatically. For older employees in the new *Länder* the situation was even more difficult. In my opinion, these structural mismatches explain the high German unemployment rate (figure 5) and the undiminished high percentage of long-term unemployed.



While the employment growth was sluggish, the number of people depending on social security continued to increase. As figures 6 and 7 indicate, the proportion dependencies/employed people remained stable during the 80s, but increased in the 90s to a similar high and rather alarming level the Netherlands reached in the 80s. In the Dutch case a negative spiral in that time had contributed to this situation; firms already working at a high productivity level were confronted with new tax and premium increases, while more people became dependent on social security. So labour costs increased. To remain competitive, they had to fire the least productive employees to raise their productivity level. This, however, gave at the same time a new impulse to increase the premiums in social security. A similar negative spiral could have become relevant for Germany after 1990, due to the consequences of the reunification and of the dramatic restructuring in the manufacturing sector around 1992.

In that respect, the argumentation of Kromphardt regarding wage rate developments and employment growth I found not convincing. He stresses the development of collective wage agreements and of the real wage position of employees, but he neglects the development of total wage costs in relationship to productivity growth. According to IW, the German unit labour costs ranked fourth in the OECD area; even a high productivity growth could not compensate for the very high growing labour costs<sup>5</sup>. Furthermore, Kromphardt mentions, illustrated in two accompanying figures, that both in times of relative real wage increases and of real wage declines the employment increased. He concludes that wage rate increases are not harmful. I have two problems with this presentation. First, he should concentrate on labour costs and not on real wage rates, and second, he should use the employment rate instead of the number of people employed. Changes in population growth and in labour participation behaviour, for instance that of women, are so much better taken into account. The 30 percent increase in employment between 1960 and 1994 for West Germany was for instance surpassed by that of the population between 15 and 65. That grew in the same period with 32 percent. In figures 1 and 2 it was made clear that the recent development of the German employment rate, both in persons and in full-time equivalents, are not really encouraging. And, while the number of jobs only slightly increased, the number of dependencies on social security increased much more, so raising the proportion (figures 6 and 7). This meant further increases in wage costs, and so another incentive for the negative spiral already mentioned. And finally, Kromphardt emphasises the demand-aspect of wage increases. In his view this aspect is neglected, while only the supply-side is taken into account with labour costs and tax- and premium rates. Of course, Kromphardt is right in stressing the importance of the demand-effect, but he should not overstate it. In my view, consumer confidence is as important for consumption growth as wage increases. When that confidence fails, due to economic recession or because of negative expectations about individual labour market prospects, consumption growth will be moderate, whatever wage increase will be negotiated. On the other side, when consumer confidence is high, consumers will react accordingly even when wage increases are only moderate. Wage moderation is not only help-

ful in reducing labour costs, but also in improving the chances on extra jobs. If this works out well, consumer confidence and so demand will increase.

My conclusion therefore is that the need for adjustments is increased, at the firm and sector level, at product and factor markets, at the institutional level and at the state and *Länder* level with regard to economic and social policies. Without such changes it will become increasingly difficult to make the German economy sufficiently competitive again, sufficient in the sense of offering enough jobs to meet the actual demand and sufficient to the social security system demands. Such a policy advice is not new. In reports of for instance the OECD<sup>6</sup> and the German Council of Economic Advisors<sup>7</sup> similar recipes can be found. Yet, these advices seemed to be hardly noticed. Both the Kohl and Schröder administration have realised some changes, but they both have not been able to introduce and implement a much broader strategy, like the Dutch one. They did not come up with more and stronger policy changes, because they thought that the economic situation was not that bad, or because they feared the political consequences of such changes. My impression is that the last factor has been quite important. The factual situation, that the government majority in the *Bundestag* nearly always had to fight against a majority of the opposition parties in the *Bundesrat*, able to block important government proposals, have also hampered the decision making process. This factor of political reluctance should not be neglected. In that sense the German society seems to cope with the same problem many other successful countries and firms have been confronted with, namely the fact that all relevant actors – government, firms, employees, unions, ordinary people – have become so much accustomed to their current position and the related income that they resist any adjustment, and certainly the more painful ones, fearing that these losses will not be compensated. As long as the German government is frightened for the political consequences of a necessary, broader strategy, it has to be feared that the economic development will remain below potential.

Two other points have to be mentioned here, both points where clear differences between the Netherlands and Germany can be observed. The first point deals with the position and influence of advisory bodies. In the Netherlands there exists a number of such institutions, like the CPB Bureau for Economic Policy Analysis and the Scientific Council for Government Policy (WRR). Both are highly regarded and judged as independent. Their advices therefore can have a strong influence in the decision making process, especially with issues or policy areas with strong income (distribution) consequences or a longer-term impact. These advisory bodies have according to my opinion contributed to the rather pragmatic decision making climate, in which these issues are discussed in the government, parliament and society. Similar advisory bodies do not exist in Germany at the moment. There does not exist in Germany an independent and influential institute for the important long-term issues, like the Dutch WRR. Of course, the Germans have an independent Council of Economic Advisors and many other advisory bodies, but they seem less independent and powerful, and their opinions are therefore less influential for the public and political debate.

Furthermore, instead of just one CPB, there are many German economic institutes. Competition is valuable, but the problem here is that government and political parties are selecting institutes according to the results they expect. That is not fruitful for a pragmatic discussion. In combination with a more ideological approach in German parliamentary discussions, this situation does not seem fruitful to me for encouraging pragmatic discussions, decisions and implementation of painful, but necessary policy measures.

The second point deals with the role of the social partners, and their relationship with the national government. Here both countries have chosen a different path after 1945. In the Netherlands, employers' associations and unions decided in 1945 to start with the Labour Foundation, to discuss in this Foundation in a open and pragmatic way all relevant issues regarding collective agreements. In 1950 the Social Economic Council was set up, where representatives of employers' associations, unions and so-called independent persons discussed all social-economic government proposals. In such a climate, and of course helped by the difficult economic situation of that time, it was possible in the Netherlands to realise a centralised wage moderation policy in the 50s and early 60s. Regular informal contacts between social partners and the government were helpful to create a climate of trust. This economic policy contributed to the strong economic revival then. After 1963 wage moderation was given up, and for almost 20 years more ideological distance between the social partners could be noticed. Given the dramatic situation in the early 80s, it was however not a dramatic change when in 1982 the social partners decided to use that same wage moderation medicine again. In that way they hoped to create new jobs for outsiders. For all clarity, these institutional arrangements, these close contacts between social partners and government, have been frequently criticised, also in recent times, for instance because people feared that political responsibilities were blurred. Discussions in the SER could sometimes last almost indefinitely, or resulted in misty and useless advices. Social partners also sometimes misused their position to realise certain goals at the expense of other, i.e. the taxpayer. So, this 'Poldermodel' certainly has been helpful, but its role should not be overstated. The model helped, but the measures taken were decisive.

In Germany it was decided after the war to make a strict separation between the responsibilities of the government and the social partners. Experiences in the Weimar period had shown that too big a interference of these parties could undermine the political system. In 1949 the so-called *Tarifautonomie* was made law: employer's associations and unions were fully responsible for wage agreements, and the government should not intervene. On the whole this system has worked out well. Relatively moderate wage increases, a relatively low strike intensity and the well functioning of representative advisory bodies have certainly contributed to the good economic performance. Once, however, the economic development started to stagnate, it was very difficult to realise necessary changes which involved the social partners. To overcome this situation, Chancellor Kohl started in 1995 a so-called *Bündnis für Arbeit* to try to win the

cooperation of the social partners, but his attempt failed. Three years later, and influenced by the Dutch experiences, the new Chancellor Schröder did the same. The results so far have been rather meagre. Because the wage development was immediately declared a non-issue, in line with the *Tarifautonomie*, the meetings in this alliance have been focussing on relevant, but not always the central issues. Furthermore, it seemed often that they were not able or willing to solve them. Not all actors involved seem convinced yet that the economic situation is really problematic, and also they do not trust each other sufficiently yet to realise necessary breakthroughs.

## 2.5 CONCLUSION

For a long time Germany and the Netherlands have followed a quite similar pattern of economic development, with Germany with a slightly better performance. In the 70s both economies saw deteriorating economic results, but while the German economy remained relatively strong, the Dutch economy showed all signs of an economic crisis. This situation forced all Dutch actors in the early 80s to rethink their position and in the end to accept solutions that for a long time were unacceptable. This mixture, of drastic measures, of political courage to enforce them, of a sufficient social responsibility from the side of social partners to support these policies and of the willingness of the people to accept them for a rather long time, has turned the Dutch economy from a 'disease' into a 'miracle'. Especially the labour market performance has been outstanding.

At the same time the German economy has lost more and more of its brilliance. Gradually the economic problems increased. Economic growth slowed down, the unemployment rate increased again and again. That was already the case in the 80s. The situation became more dramatic with the reunification. The German economy was not able to meet this new, unexpected and huge challenge. The economic development worsened, and in recent years Germany showed up very low in the economic ranking among EU-countries. Old recipes did not work anymore, necessary changes could not be realised and the confidence of all actors was remarkably low. While the Netherlands under such circumstances was able in 1983 to change its economic policies, it seems that the Germans are not able yet to do the same. The broad strategy is still failing, political parties are reluctant, social partners are unwilling, and also the population gives the impression that they have already done their part of the deal. It seems that there is no clarity about the question, what the main problems, developments, challenges and solutions are, and strongly connected about the future of the German *Soziale Marktwirtschaft*. This indefiniteness, in combination with the huge problems, has created an atmosphere of distrust, which makes it even more difficult to arrive at a convincing and acceptable strategy. There is still a lot to do to revive the German economy.

## NOTES

- <sup>1</sup> J. Kromphardt, *Arbeitsmarktinstitutionen und Beschäftigung in Deutschland*, paper for the Nürnberg conference.
- <sup>2</sup> Data are mostly from the European Commission, statistical annex of the European Economy, spring 2002. Be aware that here all people with a job are taken into account. The Dutch official statistics do only count employed people with a regular job over 12 hours a week. Even then the employment rate in the Netherlands is now higher than in Germany. The data in figure 4 are from the Central Economic Plan 2002 from the CPB bureau of economic policy analysis.
- <sup>3</sup> EUROSTAT, Labour Force Survey 2000, Luxembourg.
- <sup>4</sup> In figure 6 the proportion of all people dependent on social security and those having a job is given, for Germany and the Netherlands. In figure 7, a similar proportion is presented, but now for those dependent on social security that belong to the age group between 15 and 65.
- <sup>5</sup> See Chr. Schröder (2001), 'Produktivität und Lohnstückkosten im internationalen Vergleich', *IW-Trends*, vol. 28, no.3, pp.93-109.
- <sup>6</sup> See the latest OECD Economic Survey on Germany (May 2001) and the OECD Jobs Study (1994).
- <sup>7</sup> See their annual reports, the latest titled *Für Stätigkeit - gegen Aktionismus*, published in November 2001.



### 3 LABOUR PARTICIPATION AND INSTITUTIONAL REFORM IN THE DUTCH POLDER MODEL; POLICY OPTIONS FOR THE NEXT TWO DECADES

*Frank den Butter and Cornelius Hazeu*

#### 3.1 INTRODUCTION

During the last fifteen years net labour participation (in persons) in the Netherlands witnessed a remarkable growth from an European low of 52 percent in 1985 to 65 percent in 2000, which is about European average. This labour participation growth can be regarded as a major indicator and consequence of the remarkable recovery from the 'Dutch disease' in the early eighties to what is now sometimes called the 'Dutch cure' or the 'Dutch miracle' (see e.g. Visser and Hemerijck 1997; Hazeu 1998; Schettkat and Reijnders 1999). The good performance of the Dutch economy in the last decades has raised the interest of the international economic profession in the so-called 'Polder model' which, for a large part, is held responsible for the recent economic success in the Netherlands.

For a proper understanding of these developments in the Dutch economy during the last fifteen years it should be noted that the Dutch disease was not so much a consequence of poverty as of richness. The bonanza of natural gas, combined with oil price shocks, induced an appreciation of the Dutch guilder, which worsened the competitive position of the Netherlands and led to a relaxation of the budgetary discipline. Social security provisions were rather generous and were not combined with active labour market policies, so that social security expenditures rose considerably and net labour participation even decreased in the early eighties (see also Hartog and Theeuwes 1993; Kapteyn and De Vos 1999).

Partly inspired by reports of the Scientific Council for Government Policy (WRR 1987, 1990), which underline the need for higher labour participation, a fundamental reversal of budgetary and labour market policy took place during the period of government of Prime Minister Lubbers (1982-1994). Finally this most prominent policy goal of the last decade was most explicitly reflected in the theme of the First Cabinet (1994-1998) of Prime Minister Kok: "*work, work, work*".

Amongst both Dutch and international analysts there is no unanimity about the principal blessings of the Polder model. It is, however, evident that part of its success has to do with the institutions of the Dutch labour market. In general five reasons can be mentioned which may explain this success. A first and very broad reason is that "the platform for discussion and negotiation between the social partners in order to come to positive agreements which are beneficial to common interest" acts as the basis for successful policy. It is obvious that this mechanism to come to a consensus plays a most prominent role in the success of the Dutch Polder model. Policy measures which technocrats believe to be benefi-

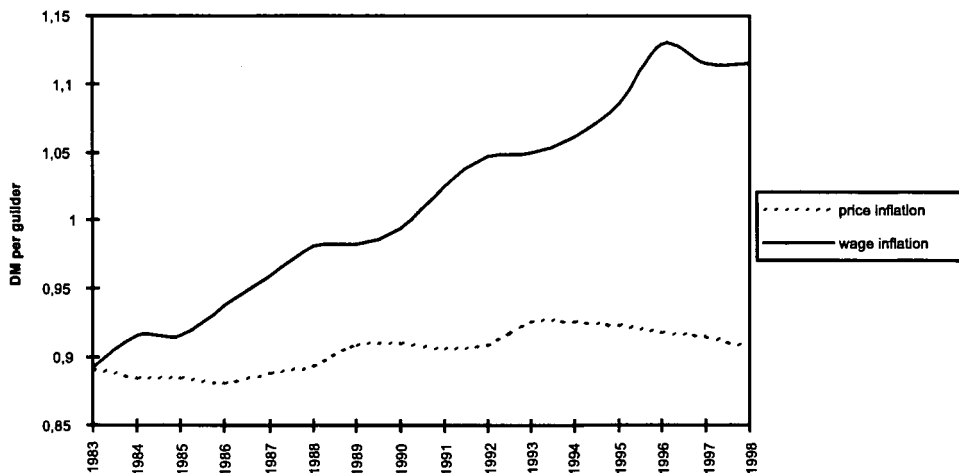
cial to society, but which have no broad public support, will never be very effective in the Netherlands.

Very much in line with this broad characteristic of the Dutch Polder model is the second reason for its policy success, namely the institutionalised framework for negotiations between the social partners in the 'Foundation of Labour' and the 'Social Economic Council'. These institutionalised policy discussions generate trust amongst the social partners and lead to the formulation of policy proposals which seem useful in the eyes of all concerned, so that it enhances the effectiveness of the policy conducted in line with these proposals.

The third and probably most prominent reason for the success is the sustained policy of wage restraint in the Netherlands. The basis for this policy was the so-called Agreement of Wassenaar in 1982 and the following string of collective agreements between the social partners which have never been in discord with the Wassenaar Agreement. Monetary policy has been a major condition to contribute to the success of the policy of wage restraint. As a matter of fact the long-term policy of fixing the value of the Dutch guilder to that of the German mark, has had the effect that the relative decrease of labour costs in the Netherlands due to the policy of wage restraint, has not been sterilised by a nominal appreciation of the guilder. So the result was that the Dutch guilder depreciated in real terms which was very beneficial to the competitive position, and hence to economic activity and employment. Figure 3.1 shows the hypothetical appreciation of the guilder vis-a-vis the German mark in the period 1983-1998, in case the guilder would not have been fixed to the German mark.

42

**Figure 3.1 Hypothetical appreciation of the Dutch guilder vis-a-vis the German Mark, given the relative wage or price inflation**



Source: OECD Main Economic Indicators



The fourth reason for the success relates to the role and preferences of the trade unions. As social welfare and employment are major policy goals, the trade unions in the Netherlands have not much used their bargaining power for negotiating wage increases when specific investments by employers resulted in enhanced productivity. In this way the hold-up problem was avoided so that employers did not underinvest and negative externalities at the macro level from higher wage demands at the local level were avoided.

The fifth and last reason for success is the institutional reform of social security conducted in the last decade. The system of passive and rather generous social security provisions became, – at least for a part – more activating, so that the negative spiralling mechanism with respect to the wedge between gross weight cost and net earned wages could be turned into a positive spiral, where total expenditure on social security relative to national income decreased and the wedge became smaller (see also Den Butter and Kock 2001).

The question now arises whether the policy for the next decade should be directed towards a further growth of labour participation, and if so, what policy measures for further institutional reform should be in order? This paper aims to answer these questions.

The contents of the paper is as follows. Section 3.2 provides two arguments why a further growth of labour participation should be desirable from the perspective of social welfare. However, in the public debate questions have been raised whether a further growth of labour participation is possible still and whether negative effects on welfare, such as enhanced traffic congestion, lack of time for unpaid care for children and the elderly, lack of education, and insufficient productivity of parts of the population will cause negative welfare effects that exceed positive welfare effects. In order to investigate these arguments we first, in section 3.3, give an impression of the role of labour in future life and of its characteristics. In order to quantify possible future restrictions we introduce in section 3.4 a scenario for further participation growth up to 2020 (WRR 2000). Section 3.5 discusses which restrictions may be encountered when the scenario is pursued, and what policy options may alleviate the restrictions. Section 3.6 pays special attention to the necessary reform of social security provisions for illness and disability, which seem to be the largest impediments for the scenario to be fulfilled. Finally some conclusions are drawn in section 3.7.

### **3.2 WHY IS FURTHER PARTICIPATION GROWTH DESIRABLE?**

In the academic debate and amongst policy makers there is a broad consensus that from the macro perspective a further growth of labour participation is desirable in order to enhance social welfare. This consensus is based on two arguments. The first argument concerns the basis of public revenues. The more people of working age are active labour participants, the larger is the basis for taxa-

tion and payment of social security premiums from which public expenditures, amongst which social security expenditure, can be paid. The greying of the Dutch population, and most specifically the demographic imbalances due to the high birth rates just after the Second World War (the baby boom), constitutes a major reason why having a good basis for public revenues will even gain importance in the near future (see also WRR 1999). Moreover, this argument includes a kind of 'double dividend': active participants will not rely on social security provisions.

The second argument relates to the external effects of labour participation. Besides income, work also generates social cohesion. When people have a paid job, it will stimulate them to coordinate their work with others including the giving and taking that goes along with it. In this way active labour participation yields positive external effects, whereas non-participation may have negative effects. Moreover, active labour participation enhances reciprocity in human behaviour at the social level. In spite of the secular increase in labour productivity, it remains utterly important to preserve the values and norms connected with labour participation that have been passed over from generation to generation. As a matter of fact no society can afford to have two conflicting systems of values: the system of values of those who earn the livings by hard work on the one hand, and the values of those who live like a leisure class during their working age on the other. Today there is no longer a closed wall between these two value systems so that the inclination to participate in paid labour and, by doing so, contribute to the provision of social security and other collective provisions, will always be undermined by such coexistence of conflicting value systems.

These two arguments in favour of a further growth of labour participation stem from the macro perspective, but may be somewhat at variance with the micro perspective where time spent in paid work is regarded as a disutility in the individual welfare function as compared to leisure time. The individual valuation of paid work, apart from the fact that it generates an income, may, however, heavily depend on the type of work and may change over time. Therefore, in the next section, we discuss how the character of work and the way it is appreciated as a part of life may develop in the near future.

### **3.3 FUTURE LABOUR DYNAMICS**

During the 20<sup>th</sup> Century the Dutch economy, as most Western economies, witnessed a rapid change. After a long period of orientation on the agricultural sector and the transition to an industrial economy, we have now come to an economy where services play a prominent role. Technological development followed the same path: from mechanisation through automation to the present era of robots and information. Obviously these developments have huge consequences for the way in which labour and labour organisations are shaped and for the functioning of people in these organisations. On the one hand mechanisation,

automation and new information technologies induce firms to concentrate on their basic activities with a core of personnel on fixed contracts. As a result the optimal firm size reduced. Firms became flatter, meaner and smaller. On the other hand, there is a tendency to enhance strategic cooperation between organisations by connecting them in networks and alliances. Modern communication technology stimulates these processes. It caused a fundamental change in the way labour is organised, and brought about spatial dispersion of organisations and flexible time management. To summarise, organisations are characterised more and more by dynamic processes, structural change and the strife for greater flexibility. Because firms also try to prevent large and expensive stocks, the factor time has gained importance as well.

A further change in the character of labour is that the amount of physical work has decreased and that skilled work increased (see e.g. Machin and Van Reenen 1998, on skill biased technical progress). The ICT component of work plays a major role in this trend. In production much routine work is nowadays performed by the computer and even in seemingly simple jobs today workers are often confronted with new and unforeseen situations which require a quick and proper response. The computer is used for the standard cases, and what remains are the hard and difficult cases which require discretionary decisions. For many workers it will mean a challenge and progress – less disutility from work in the individual welfare function – but it also implies that in the course of time a job which in name is the same, requires much higher skills and is much more difficult to perform. Functions which still demand highly practical skills, nowadays have also a higher cognitive component. For instance, automation of industrial processes implies that the operator is not so much handling a machine, but should be able to repair the machine when it breaks down. A further development, which is related to the previous one, is that in many professions the focus has moved from practical skills to the social skills of communication. This holds especially true in those jobs which involve frequent contacts with others, like clients, patients or pupils, who are nowadays much better informed than before and have a ready tongue. Good communication skills are also required for a proper co-ordination of the work with colleagues and contacts in co-operating. As much human knowledge of routines has been codified in computer software, its character has been changed from rival to non-rival. This implies that in the future knowledge that cannot be codified, i.e. implicit or tacit knowledge, will gain importance.

In the future labour participation and individual careers will be influenced by labour market dynamics even more than now. Increased demand for skilled labour and informatisation of the economy contribute to the fact that the life expectation of a job with the same characteristics will shorten. Changes in the contents of a job are an important aspect of labour market dynamics. But labour market dynamics also leads to job creation, job destruction and to job to job mobility. Due to these dynamics individual professional careers will show less and less standard patterns. More transitions will occur to various labour market

states, e.g. schooling for another job, a sabbatical for reorientation, or temporary non-participation for other reasons.

These dynamics in the labour market are linked to the dynamics in economy. Economies are constantly changing over time, due to shifts of preferences, new products that replace old products and due to new production technologies which replace old ones. Globalisation of the economy leads opens up new markets and, as a consequence, to enhancement of economic activity. On the other hand, at traditional markets product demand will decrease, resulting in a fall in economic activity. Sometimes existing firms will be sufficiently alert to move their activities from the old to the new markets, in other cases starting firms will be the first to discover and exploit challenges of new markets whereas existing firms are too slow and too late in their reaction to the changing context. This is what drives the processes of job creation and job destruction: structural change makes that at the same time some firms have to downsize their activities, other firms will expand and still other firms are able to keep their activities at the same level due to continuous processes of restructuring and reorientation (see e.g. Davis, Haltiwanger and Schuh 1996).

In this respect we mention two trends that, in a discussion on labour participation, are relevant from the perspective of labour market dynamics. First, in a knowledge society existing knowledge becomes obsolete much sooner than before, resulting in a faster depreciation of investments in human capital. Thus it is no longer most efficient that people acquire all general knowledge and the bulk of their professional knowledge in a period of schooling before the actual professional career starts. Instead it is preferable that a working career be interrupted from time to time for periods of schooling (see also Snower 1999). It also means that those who decide to interrupt their labour market participation for some time, e.g. for taking care of the children or other members of the family, should pay more attention than before to the maintenance of their skills and the acquisition of new skills when they wish to continue their career after the period of non-participation.

The second trend concerns the so-called implicit contract that exists in the labour relation between employer and employee, namely that at the start of the career wages are below productivity, which is compensated at later age when wages often are higher than productivity. A future with enhanced labour market dynamics implies that workers change jobs more often. It marks the end of lifetime employment, so that the implicit contract is no longer tenable in its present form. When in the time profile of wages the wage differentials between the young and the elderly do not change, it will become very costly for the employers to start or even to continue labour relationships with elderly workers. Probably this constitutes a major cause for the low labour participation at this moment in the Netherlands for the age group between 55 and 65: in this category one out of three (still) has a job. Moreover, this low labour participation was enabled by the institutional arrangements with respect to early retirement,

which were both beneficial to workers and employers since part of the expenses was passed on to collective burdens. Insight in the working of this mechanism is of importance for the design of policy measures that aim at enhancing labour participation of the elderly. As we will see in the next section, a further growth of labour participation in the future means that people in the 55-65-age category should stay longer on the labour market than at present.

It is clear that the extent of labour market dynamics has an essential influence on the way in which (potential) labour supply will participate in paid work. On the one hand one can think of a labour market with very little dynamics. Such a situation can, for instance, be characterised by high firing and hiring costs so that job duration is long and for that reason little frictional unemployment occurs. From a quantitative perspective labour participation may in that case be high, but potential productive capacity is not fully utilised. A main characteristic of such a labour market is the existence of unproductive labour relationships that continue to exist too long. Such a situation also leaves little room for the diffusion of new knowledge and for creative destruction of existing knowledge, which would enhance labour productivity.

On the other hand one can imagine a labour market with a lot of dynamics. In that case we have high frictional unemployment with considerable search costs and low job duration. In this labour market there is a risk that the specific investments in labour relationships will not become productive and that, in order to make these investments productive after all, employers will require a too high productivity from their workers. This leads to non-participation of those who are unable to comply with these high productivity demands.

These two extreme situations illustrate the complicated relationship between labour market dynamics and participation. This means that for a proper utilisation of the potential labour supply the golden mean has to be struck between a labour market that has too much and one that has too little dynamics. However, the position of that golden mean is not very well known, and depends on the institutional environment, on the social preferences which are constantly subject to change, and on the new information and communication technologies which allows a larger flexibility with respect to place and time in the activities of work. Obviously one cannot just speak of too much or too low labour market dynamics, but somewhere an equilibrium has to be found for the extent to which old jobs disappear and new jobs are created, for the choice between working and learning, and for a choice between acquiring general knowledge and job-specific knowledge.

These views on labour market dynamics are also of importance when judging the effectiveness of policy measures (see e.g. Blanchard and Diamond 1992, and Pissarides 2000, for modelling of labour market dynamics). When individuals choose between participation and non-participation, or when they consider a temporary break of their career for schooling so as to enable transition to another

job, expectations play an important role. These expectations relate, amongst others, to aspects of the future career, such as the probability of lay-off, or the probability of obtaining a better job in the future. These factors are related to labour market dynamics and are, besides wages, important determinants for the individual choice behaviour at the labour market. Policy, and also the judgement of the effectiveness of policy measures, has to reckon with these factors, especially now that the quality of labour obtains a larger weight in the decision to participate. For instance, the design of social security provisions should take into account the fact that good career prospects have a positive influence on a decision to participate. This can be called the irrigation function of social security. Good career prospects lead to a reduction of the reservation wage so that the choice between participation and non-participation will, given the wage offer, sooner be in favour of participation.

More in general it appears that preferences change with respect to labour flexibility and labour contracts. Because the character of work is due to gradual change, the social function of work is also subject to change. Some recent opinion polls indicate for instance that the wage level obtains a smaller weight as compared to other conditions of the labour contract. This argument also plays a role in recent proposals in the Netherlands to make it more attractive to work in the public sector. They indicate that in highly developed welfare states, work enables many people to develop both themselves and their knowledge base in line with personal interests. In many cases work isn't just a source of income, but it is also a factor that gives sense to life. The extent to which this qualitative aspect of labour is valued, will of course vary for different individuals; it depends on individual characteristics but also on the type of work people do and the sector of the labour market they are working in. From an analytical perspective it is relevant to observe that the individual labour supply is determined by three factors: the wage (material and immaterial), quality of labour and sacrificed leisure time. Therefore, a structural increase in the quality of labour has a positive effect on preferences for labour participation, so that the enhanced preferences for the quality of labour at the micro level are in line with the social preferences for high labour participation at the macro level. Certainly this will not fully alleviate the fallacy of composition between individual and social preferences, as some tension will remain between the public arguments to enhance labour participation and individual preferences or possibilities to participate. Obviously, in the future work cannot completely become a hobby and will not always and for everyone provide sense to life. Work requires efforts and brings about pressures too, so that, especially in some parts of the labour market, the utility attributed to leisure will always be larger than the utility of work. So, the tensions between the ideals and practice of work will certainly remain in the future.

### 3.4 A SCENARIO FOR FURTHER PARTICIPATION GROWTH UP TO 2020

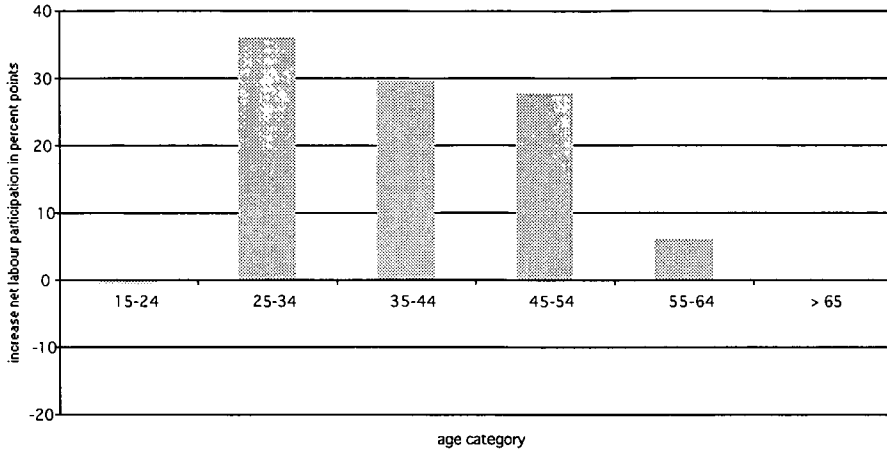
In order to investigate the seriousness of the restrictions that will be encountered when the participation rate in the Netherlands increases further – restrictions which are sometimes put forward in the public debate as arguments against a further growth of labour participation –, we constructed a scenario which shows conditions for and consequences of an increase in net participation from 65 percent in 2000 to 75 percent in the year 2020 (WRR 2000). This scenario, which we labelled ‘the further participation growth scenario’, implies that in twenty years a situation of ‘near full labour participation’, as we called it, will be reached. In essence this scenario is a technical exercise in order to analyse the possibilities of a further growth of labour participation quantitatively. It is based on an update of trend extrapolations in labour supply made by the Netherlands Bureau for Economic Policy Analysis and the Dutch Central Bureau of Statistics in 1997 (see CPB/CBS 1997). We emphasise that this further participation growth scenario should not be regarded as a forecast nor as a policy goal. It is a scenario that indicates which participation growth is possible when a favourable economic growth continues. It is used as a frame of reference for possible restrictions and obstacles, and to foresee the policy options which are needed to relieve these restrictions and facilitate the further growth of labour participation.

The further growth scenario shows that in the years to come the trend of increased female labour participation will have to continue. In figure 2 the realised increase in female labour participation in various age classes in the past is confronted with the necessary future increases according to the further growth scenario. The figure illustrates that such continued female participation growth is by no means self-evident, since future growth should come from other age classes than in the past. In the past female labour participation mainly grew because of the additional participation of young women; in order to realise the further growth scenario, however, it will be mainly older women who will have to participate additionally. In terms of labour market dynamics this implies that women, much more than in the past, will have to remain active in the labour market also at higher age. It also means that women should aim at only a short interruption in their professional career in case they give birth to children.

The need for continued labour participation at an older age is even much stronger for men. In contrast to women a trend reversal is essential when the male participation rate is to comply with the rate in the further growth scenario. This is illustrated in figure 3. As a matter of fact men did not contribute at all to the increase in labour participation in the past twenty years in the Netherlands. There was a small increase in the participation rate of younger men, but that effect has completely been undone by the considerable decrease in participation of older men. The main policy for the future task lies with men between 55 and 65 years of age. The baby boom generation should continue to participate. Fiscal stimuli and institutional reform of the pension system should contribute to this trend reversal (Hazeu 1999).

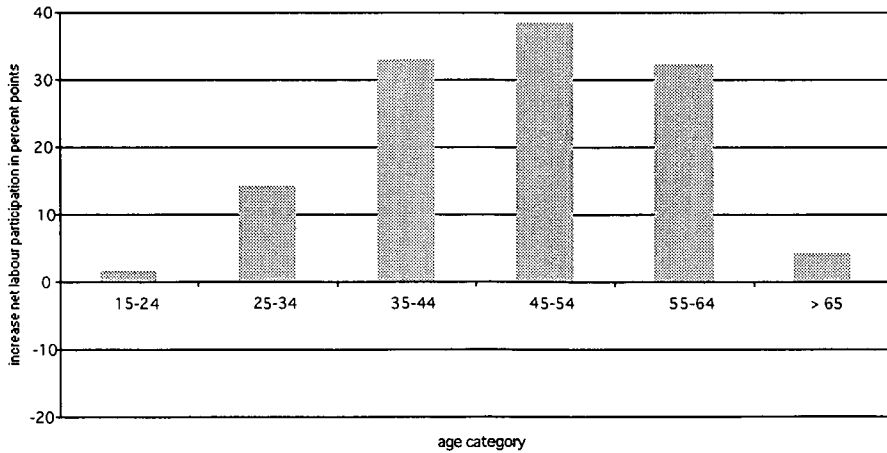
Besides policy options to keep women and baby boomers working there is also another group, namely the unskilled people, amongst which many (descendants of) immigrants, that requires specific policy attention. Now that demand is booming in other parts of the labour market, the labour participation of this group is also rising, although it is relatively low still.

**Figure 3.2a Increase in female labour participation (1999 compared to 1981)**



Sources: CBS-Statline and CPB

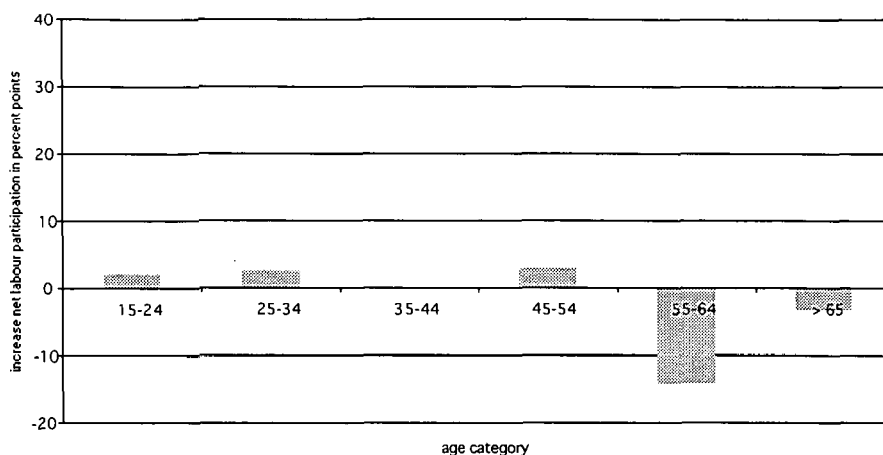
**Figure 3.2b Increase in female labour participation according to the further participation growth scenario (2020 compared to 2000)**



Sources: Own calculations (see WRR 2000) on the basis of CBS/CPB (1997)

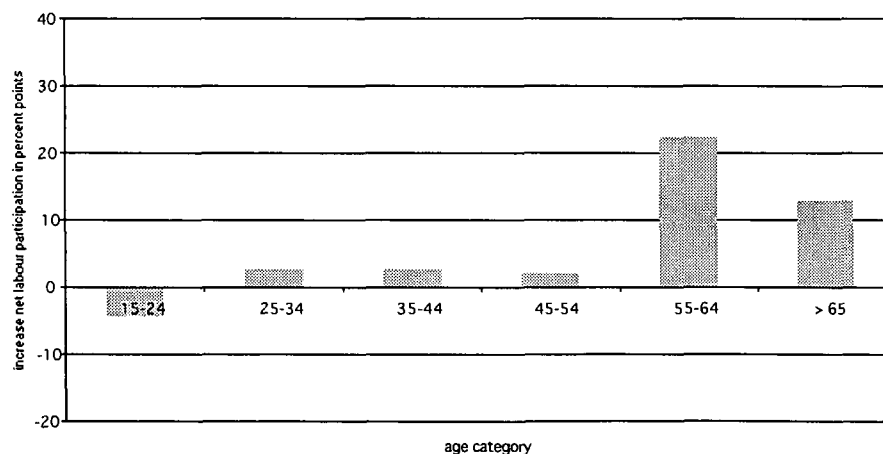


**Figure 3.3a Increase in male labour participation (1999 compared to 1981)**



Sources: CBS-Statline and CPB

**Figure 3.3b Increase in male labour participation according to the further participation growth scenario (2020 compared to 2000)**



Sources: Own calculations (see WRR 2000) on the basis of CBS/CPB (1997)

### 3.5 RESTRICTIONS TO FURTHER PARTICIPATION GROWTH AND POLICY OPTIONS TO ALLEVIATE THESE RESTRICTIONS

This section summarises our analysis of possible restrictions that may hinder the realisation of the further growth participation scenario. It furthermore gives suggestions for policy options that may alleviate or even avoid these restrictions. Before doing so, however, a more fundamental question should be answered, namely what exactly is meant with restrictions in this analysis and why such restrictions may occur. In other words, the question is what kinds of market fail-

ures result from the malfunctioning of markets and thus provide a reason for policy intervention. Apparently, if the economic allocation mechanisms functioned well, there should be no reason why, in the long run, restrictions occur that will not be automatically removed by these equilibrating allocation mechanisms. In that case, in the end demand and supply will match both qualitatively and quantitatively, so that discrepancies will disappear in the long run. It is therefore noticeable that calculating the size of (possible) discrepancies and market failures by computing the differences between trend extrapolations of supply and demand – as is sometimes done – proves to be too pessimistic since it does not reckon with equilibrating mechanisms and changes in behaviour in reaction to these mismatches between demand and supply.

Equilibrating mechanisms may, however, have the effect that participation growth will proceed at a lower rate than according to our further growth scenario for 2020, just because participation reacts on the restrictions revealed by our analysis. As a matter of fact this argument gives a specific interpretation to what we call a restriction, namely that because of adaptation to the restriction a lower participation equilibrium is reached than is considered desirable from the macro perspective of social welfare. Besides this specific interpretation of restriction as a situation where the economy reaches too low an equilibrium, one can think of other reasons why under the assumption of rational behaviour restrictions are not automatically resolved by the working of equilibrating mechanisms in the economy. These are the proper forms of market failure that require policy intervention in the economy. In our analysis of possible restrictions in the further participation growth scenario the following three forms of market failure come to the fore:

- negative externalities,
- incomplete information and bounded rationality,
- rigidities.

Negative externalities occur when individual activities are harmful and reduce the welfare of others. Policy intervention should correct these external effects. In order to do so, the government should have formulated preferences at the macro level, e.g. with respect to enhanced labour participation, which are democratically legitimated, but which will differ from the aggregate of individual preferences. In this case social preferences may partly be in conflict with individual preferences and policy intervention should be cast in such a way that it causes the least possible disturbance of economic allocation so that at least second best solutions are chosen.

Incomplete information and bounded rationality may be due to high information costs. It implies that at the micro level wrong individual decisions are taken. In general such misallocation can be solved by lowering the information costs, e.g. when the government facilitates the work of labour offices, but also by the irrigation function of social security so that transition from a less productive to a more productive job can take place without large and expensive frictions.

In case of rigidities the return to the existing equilibrium or the transition to a new equilibrium after an unexpected shock will take too long from the perspective of social welfare. However, policy intervention will not be very effective and too expensive when adaptation costs are high. On the other hand, an institutional change may be beneficial when such change is not very costly and when it can speed up adjustment.

This taxonomy of restrictions indicates that for policy analysis it is important to have insight in the underlying courses of the restrictions. That is because the policy measures to alleviate the restrictions or even prevent them to occur, should be directed at these underlying courses.

### ***Congestion and mobility***

Traffic congestion due to increased mobility constitutes the first concern in the public debate on the question whether a further growth of labour participation is realistic. A study by Rietveld c.s. (2000) that takes our scenario as a basis, shows that mobility and more specifically mobility of road traffic, will indeed increase in future. However, to a large extent this increase has a structural character and it is the result of enhanced welfare and the growing population. Of course, the relatively fast growth of labour participation according to our scenario will contribute to this increase in mobility and more so to traffic congestion during rush hours. At this moment not more than 4 percent of the working population is structurally confronted with traffic jams during rush hours. Given road capacity, road congestion more than proportionally increases with mobility, namely with an elasticity of 2.2. The consequence is that further growth of labour participation will more than proportionally contribute to the problem of road congestion. It has been calculated that our further growth scenario will enhance the times spent in cars by drivers with an average of 2 percent, which is four hours per person per year. Yet, as a matter of fact, the additional contribution of enhanced labour participation to road congestion is rather small as compared to the other causes of increases in road congestion. Moreover, the calculations show that this additional increase in congestion does not constitute a big impediment for possible future participants to refrain from participation. The second order effect is very small. From the perspective of market failure the congestion can be considered a negative externality of mobility. The main policy options to internalise these externalities are: (some) growth of capacity, road pricing, a strict policy with respect to car parking in urban areas, and incentives for employers to restrict the mobility of their personnel.

### ***Informal care***

Secondly there has been some public debate whether further growth of labour participation will leave sufficient time for informal care for children and elderly relatives. Yet, our quantitative analysis, which is partly based on survey data measuring time use of individuals, indicates that an increase in labour participation will, in principle, not lead to time restrictions for informal care. Time available for informal care is on average likely to increase rather than to decrease

because the reduction of contractual working time did, in the past, exceed the increases in average working time of individuals due to enhanced labour participation. The lack of time which is often associated with modern times, seems to be caused by the increased spending possibilities that the higher level of welfare has brought about, rather than by an actual absolute lack of leisure time due to long working hours. Obviously increased wealth creates additional leisure time, but it consumes even more. In modern lifestyle a lot of time consuming activities are planned. This gives the impression of a lack of time.

The increased labour participation still may cause some problems with respect to supervision of children. Because of the higher welfare and productivity increases in household production, time spend at home decreases. Yet professional child care and arrangements for temporarily leave can provide the possibilities to facilitate a combination of labour and care. Partly this combining of labour and care is a matter of private concern, but it is also partly in the public interest as a high rate of labour participation brings about positive externalities. That is why the government should, by institutional arrangements and by subsidies, facilitate provisions for care and education of children.

The informal care for the elderly may become a more serious problem in the next decades. However, this hardly can be regarded as a direct consequence of a further increase in labour participation. It is especially the greying of the population that will cause this problem. Here we have a possible restriction for further labour participation, which will, by the way, become most serious after 2020, when the baby boomers with little children reach the (very) old age on which their demand for care will rise. This lack of supply of informal care for the elderly will probably lead to a shift from the informal to the formal sector. As far as the elderly become wealthier in the future, they will have more own means to pay for this substitute of informal care. However, also more political pressure may be expected that part of this care for the elderly will be paid out of the public budget.

### ***Schooling and productivity***

Mismatches in schooling and insufficient productive capacity of large groups at the lower end of the labour market are other reasons why in the public debate doubts are shed on the possibilities for a further increase of labour participation. With respect to the mismatch in schooling the major reasons for market failure are the long adjustment lags, in combination with a lack of flexibility in some sectors of the labour market. Yet there is no much scope for direct government intervention in this case. Indirectly the government may support institutional reform that makes relevant sectors of the labour market more flexible so that the working of the equilibrating mechanisms is improved. This will lead to more wage differentiation. However, this wage differentiation does not necessarily imply that inequality increases, because the consequent growth of labour participation will have the effect that a substantial amount of non-participants with no income now, become participants with an income in the near future. So the net effect on income inequality may even be favourable.

In our scenario analysis the major obstacle for a further increase in labour participation appears to be the high and increasing number of people that take part in the social security provisions for illness and disability. This analysis and the implications for institutional reform of this part of the social security system is subject of the next section.

### 3.6 INSTITUTIONAL REFORM FOR ILLNESS AND DISABILITY PROVISIONS

A further participation growth in the Netherlands in the next twenty years requires urgent policy efforts with respect to the social security arrangements for sickness and disability. This is evident from the scenario analysis of a further growth of labour participation. Such an increase is desirable to be able to maintain the support base for various collective financial arrangements such as the collective old age provision system.

The problem is not a new one (see e.g. Aarts and De Jong 1992). Since years a remarkable part of the labour force that falls ill in the Netherlands, has ended up in the disability scheme. The WRR analysis provides four arguments why the sickness and disability problem will even become worse if policy reform stays out.

The first argument is the ageing of the labour force that is to come. The participation growth in the recent past has mainly resulted from the influx of young and healthy people. In the next decades, however, further participation growth should come from elderly who *stay* in employment for a longer period. This is shown in figures 3.1 and 3.2.

In the second place labour participation is selective on health conditions. This does not mean that a paid job makes employees more healthy; the causality between labour participation and health status is rather complicated (e.g. Kerkhofs et al. 2000). If, however, labour participation will have to increase, the additional number of participants should come from the potential of people that have a larger statistical chance on sickness and disability.

A third argument is that the character of (much) work is slowly changing. The information technology and the use of computers will further reduce the share of simple jobs (implying repetitive actions, aimed at a beforehand prescribed output). More and more work will consist of handling the 'difficult cases'. On the one hand this is challenging and can thus contribute to the meaning of life. On the other hand, this may enhance tensions and stress in work. Furthermore, in a lot of occupations and professions employers more and more have to deal with customers, pupils, and patients that nowadays have a ready tongue.

The fourth argument has to do with the regime and culture of the social arrangements for sickness and disability in the Netherlands. At the moment we have about 7 mln. working people and almost 1 mln. that is fully or partly in the disability scheme, i.e. one out of eight (Hazeu 2000). Of the disabled one out of three is disabled due to a psychological reason, varying from work tensions, insufficient appraisal, dissension with the management or the wider working environment or a career that has ended in a deadlock, to problems at home. Furthermore, due to the way the social security rules function work-related problems get an early medical stamp. Taking into account the way the nature of work has been changing, this problem will continue to grow if a 'cultural reversal' cannot be achieved. Although the nineties have shown some sharpening of the rules for sickness absence and disability, the sickness and disability arrangements still have a relatively low threshold and provide insufficient incentives.

The future perspective of the further growth scenario shows that the social security arrangements relating to sickness absence and disability require a drastic reform. Due to the intensified importance of knowledge and skills in society and the labour market the life expectation of a clearly defined job will shorten. The dynamics of the labour market and the necessary anticipation on changes in one's career require that people display a greater flexibility and resilience. The relatively easy entrance into the (psychological) disability schemes (after one year of sickness) is an obstruction in this respect.

The above argumentation results in a number of policy suggestions (WRR 2000: 274-278; Hazeu 2000: 217-219).

First of all, solutions for the sickness and disability problem should be focused on *prevention* of sickness absence, by having more attention for labour and organisation conditions. In terms of policy response it is vital to focus on direct intervention in the preliminary stages of sickness absence. And once people have reported sick, they should be *reintegrated* as soon as possible. This means that the Sickness Benefits Act should be reformed into a 'Reintegration Act'. The disability scheme (WAO) should become a last resort rather than something in which people end up after a 'semi-automatic' process of a year under the Sickness Benefit Act.

A faster reintegration can be enhanced if the sickness benefit period is made dependent of a *compulsory track of reintegration*. Part of the functioning of such a track is that both employer and employee have sufficient financial incentives to stimulate recovery and (in some cases) replacement of the sick employee as soon as possible. If the employer cannot himself provide the employee with another job, he should have an incentive to find him a job elsewhere. The employee, in his turn, can claim this right on mediation. Such a reintegration track should take three years at the most and be at the expense of the employer (i.e. *not* of national or industrial social security funds). For the employee the financial incentive should be that the reintegration benefit he receives during the period of sickness,

is susceptible lower than his normal wage. As a contrast: in the present situation in the Netherlands almost all sick employees get a 30 per cent supplement from their employer above the legal 70 per cent sickness pay, so there is no effective financial incentive.

The second policy suggestion is that the examination practices for sickness and disability should become sharper and more objective. Although we have national laws and rules for this, traditions of sickness absence attendance and examination practice differ per sector. This should be brought to national standards and practices..

A third point is that the inflow in the disability scheme shows interesting differences for gender and branch of industry. Women have a disability incidence that is 50 percent higher than that of men. To be more specific: the disability incidence of women under 40 is twice as high of that of man under 40; as people are older this difference becomes smaller. This gender difference partly has to do with the fact that many women are employed in sectors like health care and education, which show an above average influx in the disability scheme. This also points out an 'institutional factor': in these sectors the costs of the disability scheme is budgeted and claimed on the (funding) government. Our policy suggestion is that in these para-statal sectors too a financial incentive should be introduced, to control the amount of sickness and disability claims.

The most recent development in the Netherlands is, that as the number of disability claimants kept on growing, government installed a national advisory committee – a typical Dutch solution – to make an analysis and come with policy suggestions. This committee reported to the government to make a rigorous distinction between fully disabled and partly disabled (*Adviescommissie Arbeidsongeschiktheid 2001*). The first group should keep its disability allowance and should not be re-examined any more. For the second group the committee advised for a strict reintegration scheme, with duties and sanctions for both employers and employees to cooperate. On this advice of the committee government asked for advice of the social partners. But clearly the committee had a juridical and categorical bias in its view of the problem, so that the advise at least can be criticised because it did not recommend to strengthen financial incentives. On the contrary; it neglected the possibility to introduce more incentives for employees in the sickness fase (the preliminary stage of the disability scheme), and further the recommendations of the committee seem even to weaken the financial incentives in the disability scheme for employers.

### **3.7 CONCLUSIONS: INSTITUTIONAL REFORM IN THE DUTCH POLDER MODEL**

The so-called 'polder model' as it has grown in the Netherlands, will not automatically solve all economic and social problems. It would be an illusion to think

that the model is just sanctifying. Labour participation certainly has grown substantially since the middle of the eighties, from a European low of 52 percent to the European average of 65 in 2000. The strong economic growth in this period has stimulated labour demand; the (late) emancipation of women on the labour market has been the main source of additional labour supply. The moderate development of wages since the 'Wassenaar agreement' of 1982 till the end of the nineties, and the policies to make the labour market more flexible, have been the most important policy contributions to the success of the 'Dutch cure' after the period of 'Dutch disease'. The need of a solid tax base in a greying society on the one hand and the contribution of labour participation to social cohesion on the other hand, give two strong arguments to continue policies for a further participation growth in the near future. Our scenario analysis showed that, principally, it is possible to reduce the non-participation rate of the labour force from 35 percent in 2000 to 25 percent in 2020. Taking a closer look at the policy instruments this means that for a further participation growth a policy reorientation is needed. Sensible general macro-economic policies and continuous attention for better and flexible working labour markets cannot be missed, but most of all specific policies are needed for the groups that lag behind (elderly, lower educated, women) and policies for the specific potential restrictions that may hinder participation growth (traffic congestion, informal care, education and productivity, and sickness and disability).

58

Of these four potential restrictions the largest obstacle for a further participation growth are the present arrangements with respect to illness and disability. Concerning the three groups the most urgent policy task is to keep the baby boom generation on the labour market. Off course it is clear that these two problems are related. Although these problems are well known and public debate on them is growing, both in the Netherlands and all over Europe, the institutions of the 'polder model' did not lead to clear solutions yet. So, these central problems not only are the current proof of the problem solving qualities of our institutions, but probably will also lead to reform of our institutions themselves.



## REFERENCES

- Aarts, L.J.M. and Ph.R. de Jong (1992) *Economic aspects of disability behavior*, Amsterdam: North-Holland.
- Adviescommissie Arbeidsongeschiktheid (2001), *Werk maken van arbeidsgeschiktheid*, Den Haag.
- Blanchard, O.J. and P. Diamond (1992) 'The flow approach to labor markets', *American Economic Review*, 82, 354-359.
- Butter, F.A.G. den, and U. Kock (2001), Social security, economic growth and poverty; theoretical considerations and guidelines for institutional arrangements, *VU Research Memorandum 2001-2* (to be published by World Bank).
- Centraal Bureau voor de Statistiek and Centraal Planbureau (1997) *Bevolking en arbeidsaanbod: drie scenario's tot 2020*, Den Haag: Sdu Uitgevers.
- Davis, S.J., J.C. Haltiwanger and S. Schuh (1996) *Job creation and destruction*, Cambridge MA: MIT Press.
- Hartog, J. and J.J.M. Theeuwes (1993), 'Post-war unemployment in the Netherlands', *European Journal of Political Economy*, 9, 73-112.
- Hazeu, C.A. (1998) 'De orde in de polder: van 'Dutch disease' naar 'Dutch cure', in: F.J. Dietz and C.A. Hazeu, eds., *Economie en beleid*, Amsterdam: Boom: 57-67.
- Hazeu, C.A. (1999) 'Is er een toekomst voor ouderen op de arbeidsmarkt?', *Geron. Tijdschrift voor Sociale Gerontologie*, 1: 5-13.
- Hazeu, C.A. (2000) 'ZW en WAO knelpunten voor verdere participatiegroei', *Openbare Uitgaven*, 32/5: 213-220.
- Kapteyn, A. and K. de Vos (1999) 'Social security and retirement in the Netherlands', in: J. Gruber and D.A. Wise, eds., *Social security and retirement around the world*, Chicago: University of Chicago Press: 269-304.
- Kerkhofs, M.J.M, M. Megens, M.J.D. Schalk and F.R.H. Zijlstra (2000) 'Ontwikkelingen in arbeidsparticipatie en gezondheid', in: C.A. Hazeu, J.J.A. Eggelte and F.A.G. den Butter, eds., *Naar een vrijwel volledige arbeidsparticipatie*, WRR Werkdocumenten W113, Den Haag: 219-324.
- Machin, S. and J. Van Reenen (1998) Technology and changes in skill structure: evidence from seven OECD countries, *Quarterly Journal of Economics*, 113/4: 1215-1244.
- Pissarides, C.A. (2000), *Unemployment equilibrium theory*, second edition, Cambridge MA: MIT press.
- Rietveld, P., C. Gorter and A.J. van der Vlist (2000) 'Arbeidsmarktparticipatie en verkeer', in: C.A. Hazeu, J.J.A. Eggelte and F.A.G. den Butter, eds., *Naar een vrijwel volledige arbeidsparticipatie*, WRR Werkdocumenten W113, Den Haag: 71-129.
- Schettkat, R. and J. Reinders (1999) *The disease that became a model. The economics behind the employment trends in the Netherlands*, Report prepared for the Economic Policy Institute, Washington D.C.
- Snower, D.J. (1999) 'The organizational revolution and its labor market implications', Keynote Address to the European Association of Labour Economists (EALE) annual conference 1999, Regensburg, Germany, 24 September 1999.
- Visser, J. and A.C. Hemerijck (1997) 'A Dutch miracle': job growth, welfare reform and corporatism in the Netherlands, Amsterdam: Amsterdam University Press.

Wetenschappelijke Raad voor het Regeringsbeleid (1987) *Activerend arbeidsmarktbeleid (An active labour market policy)*, Rapporten aan de regering nr. 33, Den Haag: Sdu Uitgeverij.

Wetenschappelijke Raad voor het Regeringsbeleid (1990) *Een werkend perspectief. Arbeidsparticipatie in de jaren '90 (Work in perspective)*, Rapporten aan de regering nr. 38, Den Haag: Sdu Uitgeverij.

Wetenschappelijke Raad voor het Regeringsbeleid (1999) *Generatiebewust beleid (Generationally-aware policy)*, Rapporten aan de regering nr. 55, Den Haag: Sdu Uitgeverij.

Wetenschappelijke Raad voor het Regeringsbeleid (2000) *Doorgroei van arbeidsparticipatie (Towards a further growth of labour participation)*, Rapporten aan de regering nr. 57, Den Haag: Sdu Uitgeverij.

## 4 DEVELOPMENT OF EMPLOYMENT AND LABOUR MARKET INSTITUTIONS; THE EMPLOYMENT-POLICY SUCCESS OF THE NETHERLANDS

*Heinz Werner, Ulrich Walwei*

### 4.1 COUNTRIES WITH SUCCESSFUL EMPLOYMENT POLICY

Following the profound labour market crisis in the 1990s Germany's employment situation is improving only slowly. In contrast, the USA and some European countries such as Great Britain, Denmark, Ireland or the Netherlands have already been showing a strong upturn in employment for some time now.<sup>1</sup> Whereas the American way does not seem to be feasible for most of the European countries because of its negative consequences such as an immensely unequal distribution of incomes, the Netherlands have probably found a European answer. The labour market results are remarkable, it was obviously possible to avoid the downside of unrestricted competition capitalism. The reforms were made with the agreement of the social partners and were accepted by broad sections of the population. It is therefore worth taking a look across the borders and investigating what is behind this "employment miracle".

The paper begins with the development and structure of unemployment and employment. This is then followed by a short account of the relationship between economic growth and employment and an overview of the reforms that have contributed to the success of the "Polder Model". Then the significance of the institutional framework for the upturn in employment in the Netherlands is discussed. Finally the paper attempts to draw a conclusion with regard to the institutional aspects of the reform approach and its transferability.

Table 4.1 shows the development of economic growth, employment and the unemployment rate for the Netherlands, Germany and EU -15. Until into the first half of the 1990s the economic indicators for Germany were not poorer than those for the Netherlands. However, the Netherlands have always had a higher level of employment growth. A reverse development between the two countries did not begin until the early 1990s for unemployment and employment. Moreover the outlook for the Netherlands continues to be estimated as considerably better than for Germany, as the table shows.

**Table 4.1 Economic growth, development of employment and unemployment rates**

	1986- 1990	1991- 1995	1996- 2000	2000	2001*	2002*	2003*
<b>Netherlands</b>							
GPD growth (in real terms)	3.3	2.1	3.7	3.5	1.1	1.5	2.7
Employment growth	2.3	1.1	2.6	2.4	2.1	0.6	0.9
Unemployment rate	7.4	6.1	4.1	2.8	2.4	3.0	3.5
<b>Germany**</b>							
GPD growth (in real terms)	3.4	2.0	1.8	3.0	0.6	0.8	2.7
Employment growth	1.5	-0.1	0.7	1.6	0.2	-0.3	0.8
Unemployment rate	5.9	6.6	8.9	7.9	7.9	8.3	7.9
<b>EU-15</b>							
GPD growth (in real terms)	3.3	1.6	2.6	3.3	1.7	1.5	2.9
Employment growth	1.4	-0.4	1.3	1.8	1.2	0.3	1.0
Unemployment rate	8.9	9.7	9.6	8.1	7.6	7.8	7.5

\* 2001-2003 estimates

\*\* Until 1991/92 Western Germany only

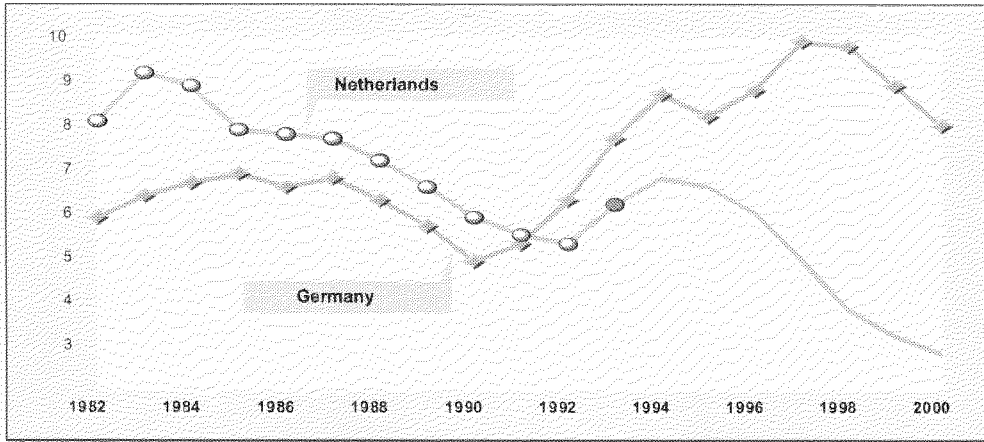
Source: European Commission (2002): Spring forecast

## 4.2 UNEMPLOYMENT

At the beginning of the 1980s the Netherlands had one of the highest unemployment rates of the European industrial nations. It was considerably higher than that of the Federal Republic of Germany (figure 4.1). Afterwards the Dutch rate dropped steadily until the early 1990s, and after a brief increase in 1994 has been continuing its fall ever since. At the current rate of below 3 percent, full employment has almost been achieved. A rather low unemployment rate is forecast to continue. In contrast with this the German unemployment rate has been rising since 1990 – also as a consequence of reunification – has overtaken the Dutch rate and last stood at about 8 percent (the whole of Germany from 1991).

As regards the structure of unemployment it is still necessary to point out that the unemployment rates of Dutch women – as in most of the EU countries – are higher than those of men. Although youth unemployment in the Netherlands fell with the general decline in unemployment, it is almost twice the level of average unemployment. In contrast – unlike in Germany – the unemployment rate of older workers has improved.<sup>2</sup> It must also be mentioned that the low-skilled and people belonging to ethnic minorities are affected by unemployment to a disproportionate extent. As here in Germany, it can also be observed in the Netherlands that with increasing duration the unemployment is concentrated on certain groups of people who can only be placed in employment again with difficulty. In spite of the labour market situation being better in the economy as a whole, the proportion of long-term unemployment in the stock (unemployed for a year or longer) among the overall figure has remained high at about 50 percent.

**Figure 4.1 Unemployment rates in the Netherlands and in Germany\* - 1982 until 2000 as percentages**



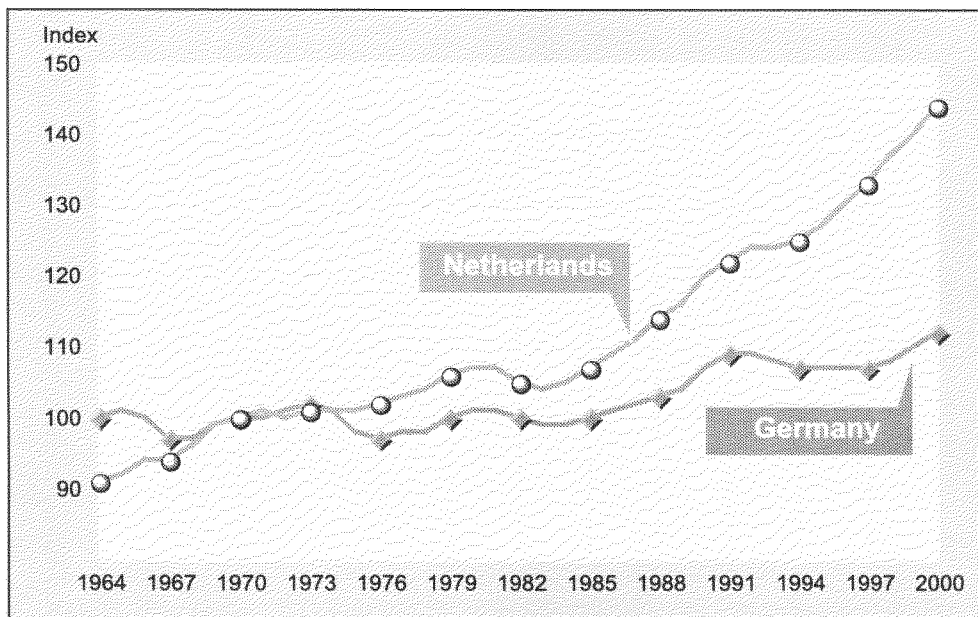
from 1991 including Eastern Germany

Source: EUROSTAT, labour force survey, various years; OECD, Quarterly Labour Force Statistics 1/2002

### 4.3 EMPLOYMENT

Between 1983 and 1993 the Netherlands showed the highest employment growth in the Netherlands recorded exactly the same growth rate as the USA for this peri-

**Figure 4.2 Employment in the Netherlands and in Western Germany 1964 until 2000 - index values (1970 = 100)**

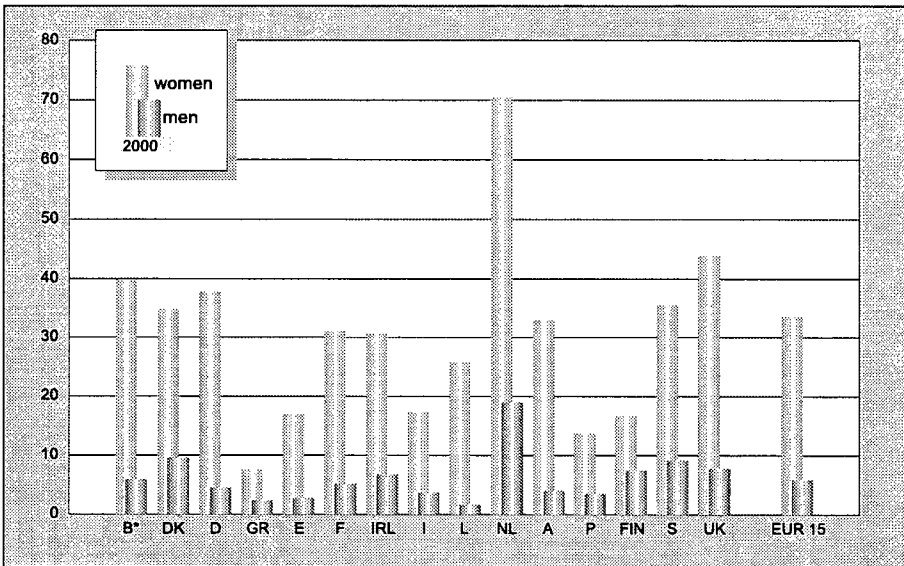


Source: OECD, Labour Force Statistics, various years; Centraal Bureau voor de Statistiek; own estimates for western Germany

od. After a slight dip in 1993 (-0.1 %) the Netherlands have since once again achieved employment gains of more than 2 percent. The development of employment for the Netherlands and (western) Germany can be seen in figure 4.2.

With a 41 percent share of the labour force in 2000 the Netherlands show by far the highest rate of part-time work in the western world. Figure 4.3 shows the part-time rates for the 15 EU states. Almost 70 percent of all working women and nearly a fifth of all men are in part-time employment. Since 1973 there has been an almost astronomical rise in the proportion of part-time work, increasing by more than 35 percentage points. This development was encouraged by the dynamic development in the services sector (with an employment share of 74%) and by the need to catch up as regards female employment. Analyses by the IAB have revealed that changes in the behaviour and preferences of the players on the labour market were even more decisive than changes concerning the structural composition of the labour force (e.g. by gender or sectors) for explaining the dynamics of part-time employment in the Netherlands.<sup>3</sup> The example of the Netherlands shows that what matters in the promotion of part-time work is not so much special support from the state (however: exclusion of discrimination)<sup>4</sup>, but more a change in the attitude to part-time work on the part of everyone, employers, trade unions and society alike.

**Figure 4.3 Part-time rates in the EU states by gender, 2000, as percentages**



\* Belgium: only employees

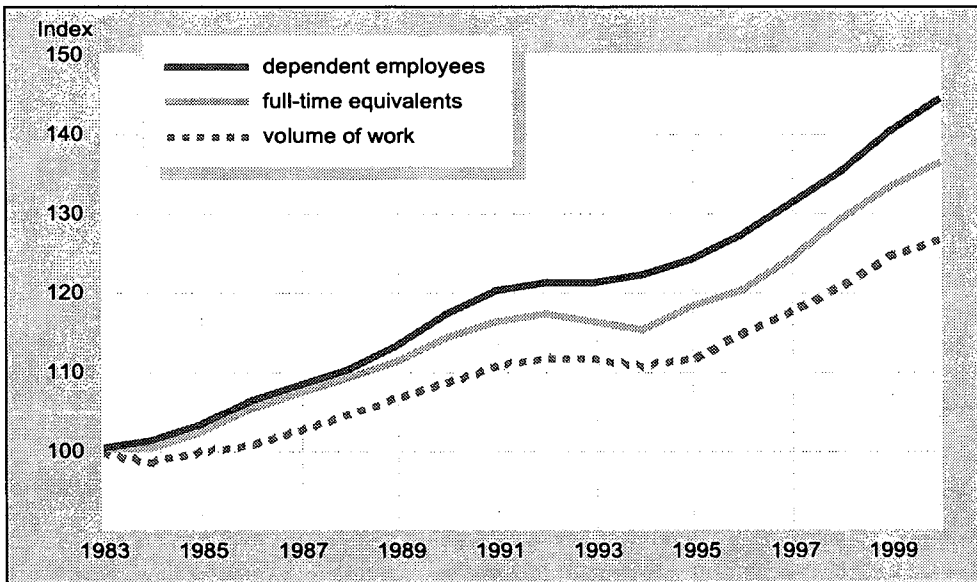
Source: EUROSTAT: labour force survey 2000

It is also necessary to add that the part-time work is mainly performed voluntarily, in other words a full-time job is not being sought. In 2000 only 3.5 percent of all part-timers were working part-time involuntarily. This is the lowest percent-

age of all the EU countries.<sup>5</sup> In the Netherlands it is not rare for well qualified workers, too, to work part-time. What is striking, however, is that the proportion of “marginal” part-time workers (fewer than 10 hours per week) is particularly high at one quarter.<sup>6</sup> These workers are therefore probably already safeguarded elsewhere as regards subsistence or social insurance (via study/vocational training, through spouse or receipt of social benefits).<sup>7</sup>

Against the background of the considerable increase in part-time employment it is interesting to examine the volume of work. After all it could be argued that the employment growth – which is usually counted by the number of persons – is based above all on the expansion of part-time work and less on the creation of more employment. Then the employment success of the Netherlands would have to be relativised considerably. Figure 4.4 shows, however, that also the volume of work in the economy as a whole has increased constantly.

**Figure 4.4** Dependent employment in the Netherlands employees, full-time equivalents and volume of work - index values (1983 = 100)

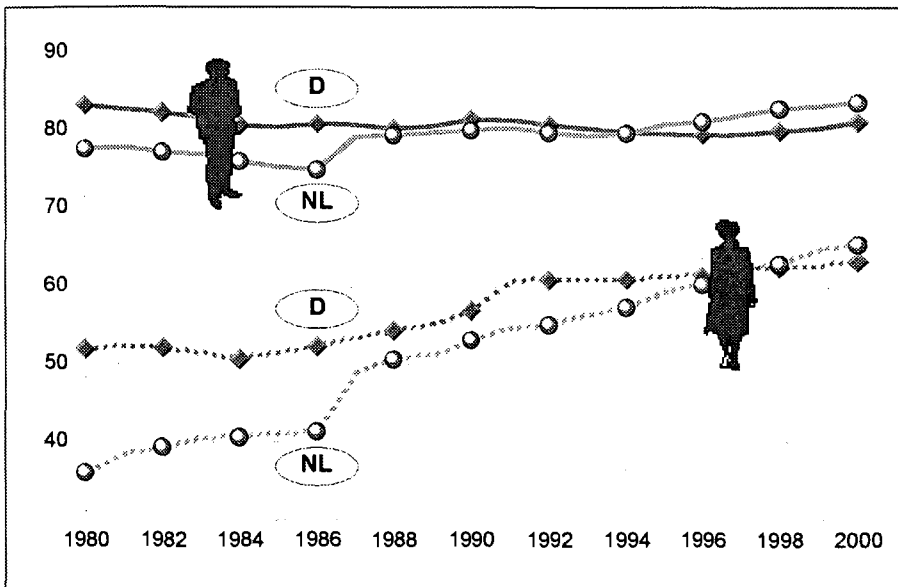


Source: Centraal Bureau voor de Statistiek

What is also revealing is a comparison of the labour force participation rates. The development of the Dutch male participation rates ran almost parallel to the German rate, having started out from a level that was about 4 percent lower (figure 4.5). However, the downwards trend in the Netherlands stopped in the 1990s, in fact it even reversed, with the result that in the meantime the Netherlands show a higher labour force participation of men than Germany does. In comparison the labour force participation rates of women in the Netherlands were far behind those in Germany at the beginning of the 1980s, though it must be noted that Germany's rates are to be found more in mid-table when compared internationally. As is evident from figure 4.5, Dutch women have caught up with

their German counterparts in the meantime. The immense increase in employment can therefore be explained above all by the increasing economic activity of women – especially in part-time employment. If one compares the labour force participation rates by age groups (figure 4.6), then it becomes clear that in the Netherlands older people show a decidedly low participation rate. This is certainly associated with the various programmes aimed at older people’s withdrawal from the labour market (for example due to early retirement or invalidity). The reverse is true for the conditions among young people. Here the labour force participation rate is considerably higher. This indicates that young people also work in addition to their training to a greater extent.

**Figure 4.5 Labour force participation rates in the Netherlands and in Germany Men and women, 1980 to 2000 – as percentages**



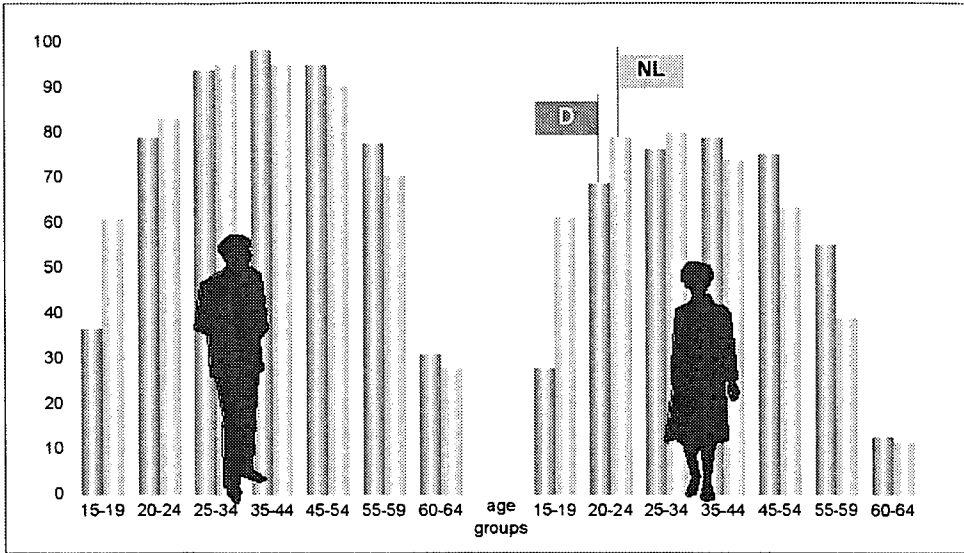
Source: OECD (2001): Labour Force Statistics 1980 - 2000

#### 4.4 ECONOMIC GROWTH AND EMPLOYMENT

One of the reasons for the good economic results is that *private consumption and investment* remained high. The high level of consumption can be explained by the improved employment situation and the reductions in tax and social insurance contributions.<sup>8</sup> In this way both domestic demand was supported and labour costs were lowered, which encouraged the policy of wage restraint pursued by the Netherlands since 1982. The moderate wage development also had a positive effect on foreign trade. As the Netherlands had had their guilder linked to the German mark since 1983, this resulted in a cost advantage in the form of a “devaluation in real terms” compared with the German mark.<sup>9</sup> Investment, too, was a growth factor in the 1990s. It was always above the EU average until 1999, whereas in Germany it was below the EU average.<sup>10</sup>



**Figure 4.6 Labour force participation rates in the Netherlands and in Germany Men and women by age groups in 2000 – rates as percentages**



Source: OECD (2001): Labour Force Statistics 1980 - 2000

If economic growth (GDP) and employment are compared over time, then it can be seen that in the Netherlands employment follows the development of GDP more closely than it does in Germany (figures 4.7 and 4.8).<sup>11</sup> What is particularly noticeable for recent years in the case of (Western) Germany is that a gap has opened up between economic growth and the development of employment. One could also say that more was produced per employee here in Germany.

This has an effect on the so-called employment threshold, in other words the percentage of economic growth from which employment increases. The employment threshold can be portrayed in the form of a graph by comparing the changes in employment and the changes in the national product as is done in figures 4.9 and 4.10. The intersection of the regression lines with the abscissa (economic growth as a percentage) depicts the employment threshold during the period under observation. In the Netherlands this level of economic growth from which employment begins to increase is close to zero: employment already grows with a slight increase in the national product. In Germany this threshold averages 1.5 percent to 2 percent for the years 1983-2000 and has risen in recent years.

Similarly to the case of the, USA the high level of employment growth in the Netherlands can not be explained solely by a more favourable economic development than in other West European countries. For instance although the average economic growth in the Netherlands was above the EU average of 2.3 percent between 1983 and 1993, at 2.6 percent, it was below Germany's average growth rate of 2.8 percent and the us's 2.9 percent rate.<sup>12</sup> Since 1995 the Dutch growth rates have been fluctuating above the EU average, however, and are considerably higher than the German average.

As there is little difference between Germany and the Netherlands as regards the gdp growth rates until the mid-1990s, the positive employment trend must be attributable to other factors.

As in the USA, more jobs are created in the Netherlands at a given economic growth than for example in Germany. In other words the employment intensity of the economic growth was higher there than it was here.<sup>13</sup> Explanations for this can be found for example in the development of working time and wages, as is explained below.

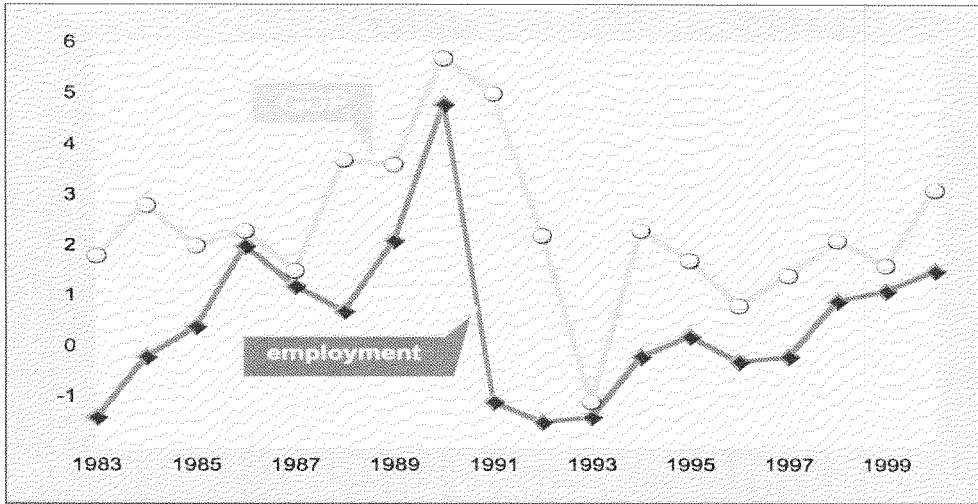
**Figure 4.7 GDP\* and employment in the Netherlands; annual rates of change 1983 to 2000 – as percentages**



\* Gross domestic product in prices and purchasing power standards of 1995

Source: Centraal Bureau voor de Statistiek, OECD (2002): National Accounts 1989 - 2000, Vol. I; own calculations

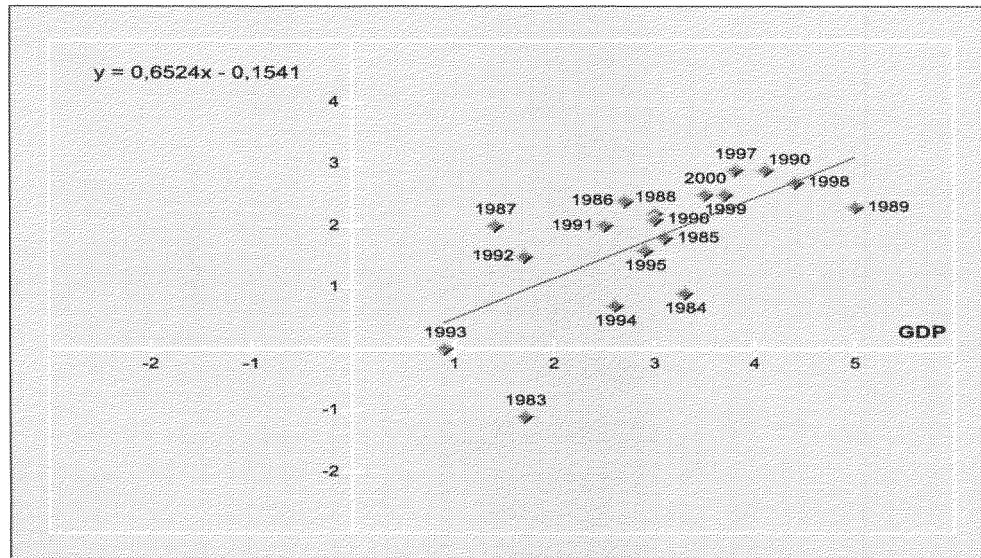
**Figure 4.8 GDP\* and employment in Germany; annual rates of change 1983 to 2000 – as percentages**



\* Gross domestic product in prices of 1995  
\*\* until 1991 Western Germany only

Source: OECD: Labour Force Statistics, various years; Federal Statistical Office from 1991 (revised employment figures); European Commission (2000): Statistical Annex to European Economy, Spring 2002

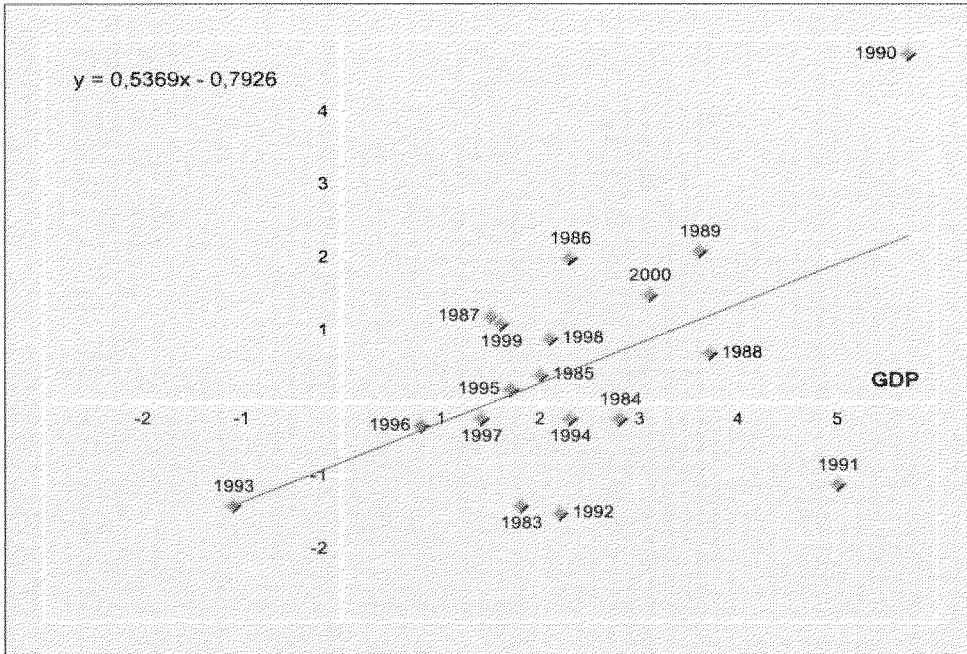
**Figure 4.9 GDP\* and employment in the Netherlands; growth rates 1983 to 2000 – as percentages**



\* Gross domestic product in prices and purchasing power standards of 1995

Source: Centraal Bureau voor de Statistiek;  
OECD (2002): National Accounts 1989 - 2000, Vol. I; own calculations

**Figure 4.10** GDP\* and employment in Germany\*\*; annual rates of change 1983 to 2000 – as percentages



\* Gross domestic product in prices of 1995

\*\* until 1991 western Germany only

Source: OECD: Labour Force Statistics, various years;  
 Federal Statistical Office from 1991 (revised employment figures);  
 European Commission (2002): Statistical Annex to European Economy, Spring 2002

### 4.1.1 WORKING TIME

Working time has shown a similarly decreasing trend in the two countries. However in the Netherlands this is due above all to the greater spread of part-time employment – another explanation for the Dutch “employment miracle” (see table 4.2). But part-time work is only one pillar of the Dutch model of working time policy. The second pillar has always been the reduction of labour supply by means of the early retirement of older workers or those with a reduced earning capacity. That is why – as mentioned earlier – the labour force participation rates of older workers in the Netherlands are so extraordinarily low in an international comparison.

**Table 4.2 Part-time rates\* for Germany and the Netherlands 1985-2000**

	Germany			The Netherlands		
	Total	Men	Women	Total	Men	Women
1985	12.4	1.6	29.3	22.3	7.3	51.0
1990	14.9	2.3	33.6	31.3	14.3	59.1
1995	16.0	3.2	33.6	37.0	16.1	67.2
2000	19.1	4.5	37.7	41.0	18.9	70.5

\*\* people aged 15-64

Source: EUROSTAT, Labour Force Survey

If all forms of exclusion from the labour market as well as participation in labour market schemes and highly subsidised forms of employment are added up then according to the OECD we get a so-called “broad” unemployment rate. This is made up of the unemployed, recipients of social transfers following unemployment (early retirement, social assistance, invalidity benefit) and participants in employment and training schemes. This “broad” unemployment rate comes to 27 percent for 1996 and has been falling only very slowly since then.<sup>14</sup> In comparison with this, the rate in Germany at that time stood at 22 percent, though the special situation in eastern Germany has already been taken into account.<sup>15</sup> The considerable level of the so-called broad unemployment rate thus relativises the Dutch “success story”. Nevertheless the labour-market-policy performance of the Netherlands occupies a top position in Europe because it was possible to get a continuous employment creation going with employment growth rates like in the USA.

#### 4.4.2 WAGE DEVELOPMENT AND WAGE STRUCTURES

The more favourable employment trend compared with other EU countries can also be partly explained by the moderate wage development. Since the mid-1980s the government has supported a policy of wage restraint which also received the support of the social partners. According to information from the OECD the unit labour costs have grown far less in the Netherlands since 1983 than they have in the neighbouring European countries.<sup>16</sup>

Are there differences between the wage structures that could explain the greater employment growth in the Netherlands? Whilst for example in the USA the wage disparities increased considerably, they remained largely stable in the Netherlands.<sup>17</sup> A change in the wage disparity therefore has to be ruled out as a possible explanation. The ratio of the middle wage decile (D<sub>5</sub>) to the lowest decile (D<sub>1</sub>) remained constant at 1.6, whilst it fell from 1.6 to 1.4 in western Germany between 1983 and 1993, as OECD studies have proven. This means that in (western) Germany there was an above-average increase in the real income of workers in the lower wage groups.<sup>18</sup> This involves a danger of the corresponding jobs being cut as a part of streamlining efforts.

Owing to the labour shortage it is possible to observe a considerable wage increase in the Netherlands from 2000 onwards, which is pushing up the unit labour costs. This goes against the wage restraint that was pursued until the late 1990s. However, it can also be regarded as a "normal" adjustment process in a monetary union with different economic cycles.<sup>19</sup>

When searching for the reasons for the Dutch employment miracle it is necessary to start out from the question as to what factors could have encouraged the lower employment threshold. What is to be considered here are not least changes in the institutional framework, in other words the labour market system. This is dealt with in the following chapter.

## **4.5 THE SIGNIFICANCE OF THE INSTITUTIONAL FRAMEWORK**

Institutional changes have an impact on employment if they have a wage-moderating effect (such as a longer-term restraint in the collectively agreed wages or measures aimed at activating the unemployed), if they help to reduce the average annual working time per worker (such as flexible and individual forms of reduction in working time) and if they raise the willingness of firms to hire new workers in an employment upswing (such as factors easing the agreement of flexible employment relationships). These aspects are to be looked into in the following sections.

### **4.5.1 MORE DECENTRAL WAGE DETERMINATION AND WAGE RESTRAINT**

In the Netherlands there is a long tradition of negotiations between employers' associations, trade unions and the government. However, the state has a particularly strong position in the process of wage formation because it can intervene directly in the wage negotiations and can even suspend them. However, no use has been made of this possibility since the beginning of the 1980s. As regards the organisation of wage determination there is an interesting mixture of centrality and decentrality. The platform for the annual wage negotiations is the bilateral dialogue between the employers' associations and the trade unions in the "Foundation for Labour". The orientation for wage policy found here (the so-called "Centraal Akkoord") then forms the basis for the actual collective negotiations that take place at industry and firm level. These negotiations are orientated towards the Centraal Akkoord, but nonetheless take into account regional and sectoral differences.

Wage policy has been oriented towards wage restraint for more than 15 years now and has slowed down the increase in productivity as a result of its longer-term orientation. The increased flexibility of collective agreements has probably contributed towards the wage restraint. This can be seen for example from the fact that the wage agreements of the individual industries increasingly contain more

general outline provisions, thus leaving more freedom for the negotiations in the firms. In this way the concrete wage agreements are linked more and more to the market development of individual-firms. As already mentioned, a considerable wage increase can be ascertained as of 2000 which could impair the competitiveness of the Dutch economy. The EU and OECD forecasts assume, however, that the economic development and labour market situation will continue to be favourable.

#### 4.5.2 ACTIVATION OF THE UNEMPLOYED

For a long time the Netherlands pushed ahead on a grand scale the early retirement of older people and people who were unable to work. Thus the number of assisted people who were unable to work rose to 800,000 at the beginning of the 1990s. This method was frequently offered in the case of dismissals as a way to reduce unemployment. The early retirements provided relief on the supply side which was greatly reduced by the activity rate of older people. However, in the past decade the public has been becoming increasingly aware of the high level of inactivity of the unemployed and the resulting burden of social benefits.

In the course of the upswing in employment the course was set for activation and prevention. The condition of incapacity for work is now checked at regular intervals. The method of financing invalidity benefits has also changed. In the meantime also the employers pay the contributions due for this. It should be ensured that the case of invalidity does not arise if at all possible. Two other moves in this direction are the firms taking on the continued payment of remuneration in the event of sickness and the entrusting of the private economy with the administration of the health insurance funds. After this law came into force in 1994 the number of benefit recipients fell somewhat but then stagnated at a high level of approx. 800,000.

With social assistance, too, more emphasis has been placed on a return to working life. The employment office and the local social services work closely together to reintegrate social assistance recipients into the labour market. The attitude of society has changed: whereas occupational inactivity used to be tolerated and the payment of benefits used to be accepted, social assistance recipients are now urged to look for work, to retrain if necessary or to take part in further training. Otherwise those concerned will be threatened with sanctions. However, an improved labour market situation is ultimately the requirement for such a procedure. It must also be mentioned that since 2001 unemployed people have received a one-off payment of 1,815 euros if they cease to draw benefit early.

Other measures aimed at activation which should be mentioned are the moderate reduction in the (still generous) transfer payments in the event of unemployment and the tightening of the requirements of acceptability in placing the unemployed in new jobs. Reforms of active labour market policy are also connected with this.

According to OECD information<sup>20</sup> the Netherlands have always spent a relatively large amount on labour market policy measures. In 1998 it was more than 4 percent of their national product (as a comparison Germany in 1998: 3.6%). The proportion used to be even higher. As unemployment fell, the expenditure on labour market policy measures also dropped to 3.7 percent in 2000. However, three fifths (= 2.1%) of the expenditure on labour market policy are allotted to the payment of unemployment benefit.<sup>21</sup> A third of the remaining 1.6 percent is needed for benefits paid in the event of incapacity to work.<sup>22</sup> The rest of the expenditure is spread over training measures (0.30%) and wage subsidies (0.41%). 0.25 percent is used for the public labour administration (Germany: 0.23%).

Dutch labour market policy is increasingly focusing on certain target groups, such as jobseekers who are hard-to-place (especially the long-term unemployed), young people or ethnic minorities.<sup>23</sup> A further focus can be found in the intensification of placement and advisory services via the public employment service and local or non-profit agencies. For this, placement pools or interim jobs are set up for the long-term unemployed. This is accompanied by a considerable decentralisation, a strict monitoring and a budgeting that is related to results, in order to improve the effectiveness of the measures. An example of this is the payment to agencies of a flat-rate payment per placement. Moreover efforts are being made to facilitate the early recognition of the risks of long-term unemployment (so-called profiling), in order to start appropriate measures as soon as possible after the beginning of unemployment which are intended to prevent the individual from sliding into long-term unemployment. At a registration meeting unemployed people are classified according to their capacity to work and are accordingly looked after more or less intensively, and they are "activated" to look for work, to take up a subsidised job or to participate in a training measure. It must also be pointed out that a radical reform of the employment service has taken place – with considerable trends towards decentralisation and privatisation.

#### **4.5.3 WAGE SUBSIDIES FOR LOW-WAGE EARNERS**

In order to facilitate access to the labour market for low-skilled and long-term unemployed jobseekers, firstly the gap between the lower collectively agreed wage groups and the statutory minimum wage (2002: 1,207 euros) has been steadily reduced by means of exemption clauses in collective agreements. The lowest collectively agreed wage groups are only 5 percent above the minimum wage in the meantime.<sup>24</sup> Secondly, in the case of low-wage earners, subsidies are paid towards the employer contributions to social insurance. In this way the effective labour costs can even be pushed below the minimum wage.

This support has two target groups. Firstly people who earn no more than 115 percent of the statutory minimum wage in a 36-hour week. The permanent



annual subsidy to the employer amounts to 1,806 euros (1999). Secondly, employers can receive a subsidy for long-term unemployed and hard-to-place individuals (1999: 2,156 euros) for a maximum of 4 years as long as the newly hired worker does not earn more than 130 percent of the minimum wage. The different subsidies can be cumulated, thus reducing the wage costs by up to 23 percent. In addition to this it is being considered to exempt employers temporarily from the statutory minimum wage if they take on a long-term unemployed person.

These still relatively new measures could push ahead the wage differentiation (by qualifications) in the Netherlands, thus contributing to wage restraint in the economy as a whole.<sup>25</sup> The tax credit for low-earners that was introduced with the 2001 income tax reform is along the same lines.

#### **4.5.4 INDIVIDUAL AND FLEXIBLE FORMS OF WORKING TIME REDUCTION**

The reduction in the average annual working time per worker can be put down, as already mentioned, in particular to the increasing significance of part-time employment. The majority of part-time employment relationships are voluntary, i.e. a full-time job is not desired. Many part-time workers have a higher level of education or training, which says something for superior working conditions. In addition there is an astonishingly large number of men in part-time employment. The large proportion of marginal part-time employment is also worth mentioning. This characterises part-time work as a possibility of a secondary activity (e.g. for housewives or recipients of transfer benefits) and as an instrument to make gainful employment compatible with other activities (e.g. family work, training, further training).

The basic state retirement pension is seen as one reason for the large increase in part-time employment and flexible employment. This pension is independent of contribution payments and – depending on the family context – is only just higher than social assistance. The advantage of the basic pension is that it ensures the subsistence level in old age even for people with low incomes or unstable phases of employment. Further reasons for the boom in part-time work are the increasing tendency for married women to work, the traditional acceptance of part-time employment by the trade unions, and the active role played by the state as a part-time employer.

#### **4.5.5 MORE POSSIBILITIES FOR FLEXIBLE EMPLOYMENT RELATIONSHIPS**

Whilst dismissal protection in the Netherlands continues, according to the OECD, to be relatively restrictive,<sup>26</sup> there was a noticeable deregulation in the 1990s with regard to temporary forms of employment (hiring-out of labour, fixed-term employment). What must be named here in particular are greater possibilities for

extending fixed-term employment and an extension of the duration of temporary work in the case of temporary workers.

The data from the European labour force survey emphasise that temporary forms of employment have gained clearly in significance. According to the results of the European labour force survey this form of employment has increased sharply in the Netherlands (as well as in France) and in 2002 stands at the upper end of the scale of the EU countries with almost 14 percent of all workers.<sup>27</sup> Above all temporary work plays a comparatively large role in the Netherlands (with about 4% of the people in dependent employment). It is used in particular to cover peaks in orders and to tide over temporary staff bottlenecks. OECD analyses on the labour market effects of employment protection legislation show that the effects on the structure of employment, in other words the distribution of employment opportunities and risks of unemployment seem to be considerably more significant than the level effects.<sup>28</sup> Legislation also has an impact on the inflows into and outflows from unemployment or employment in the business cycle.

### **"Flexicurity" as a new approach**

In the Netherlands it is generally accepted that external flexibility (inflows and outflows of staff) is an increasingly important precondition for the ability of the labour markets to function. If flexibility increases, however, deficits in the area of social security can result where occupational histories are less straightforward. In order to alleviate this increasingly clear conflict of aims the Dutch government passed the Law for Flexibility and Security (valid as of 01.01.1999). The aim of this approach, which is known as "flexicurity" for short, is a greater adjustment capacity of the labour market – if possible by dismantling the labour market segmentation into core workforce and peripheral workers. This occurs firstly by atypical employment being facilitated or its legal position being strengthened. Secondly the employment security of the "regular workers" was lowered. In this way the segmentation of the labour markets is reduced and transitions become more possible. The overall flexibility of the labour market improves.

The "Flexicurity" approach in the Netherlands consists of three components:

1. more contractual freedom in the case of fixed-term employment (e.g. by facilitating consecutive short-term contracts) and in the use of temporary workers (e.g. abolishing the obligation to obtain permission and the maximum limit for the length of the period of hiring-out and permitting temporary work also in the construction sector);
2. strengthening of the legal position of people in atypical employment (e.g. for temporary agency workers the right to the same times of employment as for permanent employees and entitlement to continued payment of remuneration in periods when the worker is not being hired out and to dismissal protection after at least 18 months of employment) and
3. fewer protective rights for so-called "regular workers" (e.g. extended probationary periods, shorter notice periods).

In addition to the greater fluctuation, which counteracts the strengthening tendencies on the labour market, there is another advantage of flexible labour markets: they respond far more rapidly and more strongly to changes in the economic basic conditions. This could have encouraged the linking of the upturns in the economy and employment.

#### 4.6 CONCLUSION: WAYS TO GAIN MORE LABOUR MARKET FLEXIBILITY

In the early eighties economic growth in the Netherlands almost came to a standstill, unemployment shot up to about 11 percent, the national debt and deficits reached record levels. Against this background the government and the two sides of industry decided to conclude an alliance for work, the main component of which was wage restraint (Wassenaar Agreement of 1983). The government took this to heart and cut the salaries of civil servants and pensions by 3 percent. Furthermore the national deficit was stemmed by means of economising. Subsidies for endangered industries ceased to be the guiding principle of structural policy, they were replaced in this aspect by the strengthening of technological change and of research and teaching. Since then the Netherlands have shown considerable success in growth policy. Besides the consistent supply policy (e.g. moderate wage policy, budgetary consolidation) the real devaluation of the guilder and the resulting activation of the foreign trade and payments balance have had a positive effect on development.<sup>29</sup> However, the finally strong economic growth alone does not explain the spectacular increase in employment, which had already begun earlier.

Internationally comparative analyses suggest that strict employment protection is negatively correlated with labour mobility. However, for everyone involved fluctuation at industry and macroeconomic level is associated with effort (e.g. frictions owing to search and settling into a new job) and return (e.g. new ideas and better allocation). It is clear here that an evaluation of the fors and againsts (in the sense of a cost-benefit analysis) of labour mobility can not be done solely with the aid of scientific analyses. Therefore in conclusion there should be some employment-policy arguments. In view of increasingly persistent unemployment, any revisions of labour legislation would have to take in particular the interests of outsiders (the unemployed and peripheral workers) more into account.<sup>30</sup> More mobility due to labour-law reforms would not only open up more entry possibilities to outsiders, however, but would also direct public interest away from the preservation of existing employment and towards the creation of new employment, thus promoting structural change.

In order firstly to take into account the growing need for scope for action in personnel policy and secondly to be able to avoid social rejections there are two conceivable ways to arrange the labour market order: in the first one it would only be necessary to change little in the substance of employment security *de jure* – apart from a partial modernisation of the legal norms – if the existing freedom

for flexibility in wages and working time were consistently made full use of or were expanded, e.g. by means of exemption clauses in collective agreements. If the second method were chosen, the effective level of employment security *de jure* would be in question. More freedom in the termination of employment relationships and thus more market on the labour market seem to be possible if – like in our Dutch neighbour’s “Flexicurity” concept – there were acceptable exchange deals: if the workers are expected to accept less employment stability, their social security should not be neglected in the reforms of the tax and transfer systems that are also on the agenda.

What must also be mentioned in this context is the fact that the IAB, with their set of strategies, formulated a catalogue of measures on the basis of simulation calculations, which could bring about an employment-intensifying growth path for Germany too.<sup>31</sup> This policy-mix consists of three components that are to be implemented simultaneously: (1) reductions in working time, which should be arranged in such a way that it would not incur any additional expense and would be individual, flexible and reversible - e.g. more part-time work and less overtime; (2) moderate increases in nominal wages at macroeconomic level, which would have to be below the progress in productivity initially and (3) fiscal-policy impulses – e.g. delayed consolidation, restructuring in the public budgets in favour of investments and the reduction of direct taxes. Furthermore, an international comparison of countries with successful employment policy come to similar results.<sup>32</sup>

The years between the development of the IAB set of strategies (1996) and today have shown, however, that model calculations and reality are two very different things. The implementation of the set of strategies in this country could be facilitated further, however, if, as in the Netherlands, the institutional framework also left more scope for labour market flexibility and if the course were set consistently for more employment. The precondition for the reversal of the employment trend in the Netherlands was the wish to act together and the view that labour market flexibility plus security is the order of the day. With the alliance for work, training and competitiveness there would at least be a forum at which a process of rethinking – similar to the Dutch “Stichting van de Arbeid” could be introduced and stepped up.

## NOTES

- <sup>1</sup> On this issue see *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung* No. 2/1998, subject focus "Strategien für mehr Beschäftigung - Internationale Erfahrungen" [Strategies for more employment - international experiences] and a series of country reports on the respective labour market situations under [www.IAB.de](http://www.IAB.de), in the series "IAB-Kurzberichte" (full text for downloading).
- <sup>2</sup> This can be put down among other things to early withdrawal from working life as a result of incapacity to work and early retirement. Both of these methods were practised on a large scale in the Netherlands. See the remarks on the concept of the "broad unemployment rate" in Chapter 4 "Working time".
- <sup>3</sup> On this subject see Walwei/Werner 1995: 365 ff.
- <sup>4</sup> Dutch labour legislation has always been as neutral as possible with regard to working time. Part-time and full-time workers are treated as equal in legal terms. See Act on Part-time Employment in: European Commission 1996: 21.
- <sup>5</sup> EUROSTAT 2001: 140-141
- <sup>6</sup> In Germany this proportion for 1998 was 15 percent. However, surveys such as the Socio-Economic Panel or the studies conducted by the Institut für Sozialforschung und Gesellschaftspolitik (Institute for Social Research and Social Policy) or also the IAB establishment panel find considerably higher values for so-called "marginal" part-time employment than the EUROSTAT microcensus used here. On this subject see: Kohler/Rudolph/Spitznagel 1996.
- <sup>7</sup> What is certain to contribute to the large spread of these jobs with short working hours is the possibility to work a certain number of hours per week while continuing to receive social benefits in full (invalidity benefit, retirement pension).
- <sup>8</sup> OECD 1996: 11 and OECD 2000: 19 ff.
- <sup>9</sup> Günther Schmid 1997: 27.
- <sup>10</sup> European Commission 1997: 264 ff. and European Commission 2002: 113.
- <sup>11</sup> The employment figures for the Netherlands come from the Statistical Office there. No information about the civilian labour force is available from this source.
- <sup>12</sup> According to information from the OECD. From 1992 onwards the growth rate also takes into account the economic development in eastern Germany.
- <sup>13</sup> The employment intensity indicates the percentage by which employment increases (decreases) when economic growth rises (falls) by 1 percent.

- <sup>14</sup> OECD 2000: 25. Meanwhile the “broad” unemployment rate still stands at almost 20 percent. See OECD 2002: 27.
- <sup>15</sup> Günther Schmid 1997: 30.
- <sup>16</sup> OECD 1999: Annex Table 13 and Günther Schmid 1997: 27.
- <sup>17</sup> It must be taken into account that this comparison refers to full-time employees. See OECD 1996a: 60 ff.
- <sup>18</sup> OECD 1997a: 7 and Günther Schmid 1997: 27.
- <sup>19</sup> OECD 2002: 30 and OECD 2002a: 146.
- <sup>20</sup> See the information in the OECD’s Employment Outlook.
- <sup>21</sup> In an international comparison the wage-replacement benefits in the event of unemployment have remained high in the Netherlands.
- <sup>22</sup> In the Netherlands early withdrawal from working life owing to incapacity to work is extraordinarily high compared with other countries.
- <sup>23</sup> The non-profit-making temporary employment business “Start” has served as a model for a number of European industrial countries. Start hires out hard-to-place unemployed people to firms on a trial basis. Start funds itself from the income achieved from hiring out workers to employers. In 1994 Start made 130,000 placements in more or less short-term jobs. In addition to this it is necessary to mention non-profit-making agencies which place social assistance recipients in work above all on behalf of the local authorities (e.g. “Maatwerk”). Agencies in the context of Maatwerk, which means “tailor-made work”, receive a flat-rate payment from the employment office for every successful placement.
- <sup>24</sup> However, they appear to have been little used by the firms so far. In contrast 300,000 or 5 percent of employees already draw the minimum wage. See OECD 2000: 57.
- <sup>25</sup> On this subject see the model calculations in OECD 2000: 56.
- <sup>26</sup> OECD 1999a: 66.
- <sup>27</sup> Germany, too, is in the upper group of countries with large proportions of fixed-term employment, with a good 13 percent. However, the change was far less dramatic than it was in the Netherlands.
- <sup>28</sup> OECD 1999a: 49 ff.

- <sup>29</sup> Cf. on this subject Pohl/Volz 1997.
- <sup>30</sup> Cf. Ichino 1998.
- <sup>31</sup> Klauder/Schnur/Zika 1996; Schnur/Walwei/Zika 1998: 3.2; Schnur/Walwei/Zika 2000: 24. 3.
- <sup>32</sup> Werner 1998: 324 ff., Walwei 1998: 334 ff. and Walwei/Werner/König 2001.

## REFERENCES

- Auer, Peter; International Labour Office (Ed.) (2000): *Employment revival in Europe. Labour market success in Austria, Denmark, Ireland and the Netherlands*. Geneva.
- Berthold, Norbert/Fehn, Rainer (1996): The positive economic of unemployment and labour market inflexibility. In: *Kyklos* Vol. 49, No. 4.
- Europäische Kommission (1996): *Beschäftigungsobservatorium - Basisinformationsbericht - Niederlande*, Berlin.
- Europäische Kommission (1997): Europäische Wirtschaft Nr. 68: *Grundzüge der Wirtschaftspolitik 1999*, Berlin.
- European Commission (various years): *Employment in Europe*. Luxembourg.
- European Commission (1999): *Netherlands. Institutions, Procedures and Measures*; MISEP Basic Information Report. Berlin.
- European Commission (2002): *European Economy* No. 2, Economic Forecasts - Spring 2002.
- EUROSTAT (2001): *Erhebung über Arbeitskräfte - Ergebnisse der Arbeitskräfteerhebung 2000*, Luxemburg.
- Fagan, Colette/O'Reilly, Jaqueline/Rubery, Jill (1999): Teilzeitarbeit in den Niederlanden, Deutschland und dem Vereinigten Königreich: Eine Herausforderung für den Geschlechtervertrag? In: *WSI Mitteilungen* 1, S. 58-69.
- Hartog, Joop by (1999): So what's so special about the Dutch model? *Country Employment Policy Reviews: The Netherlands; Social Dialogue and Employment Success*. At ILO Symposium, March, Geneva.
- Heijden van der, Paul (1998): *Wege aus der Beschäftigungskrise. Das holländische Beispiel*; Schriftenreihe der Otto Brenner Stiftung 70, Bund-Verlag Frankfurt.
- Heister, Michael (1999): Ein holländisches Wunder? In: *Arbeit und Sozialpolitik. Europäische Beschäftigungspolitik*, Heft 5/6.
- Ichino, Pietro (1998): The labour market: A lawyer's view of economic arguments, In: *International Labour Review*, Vol. 137, No. 3, S. 299-311
- Klauder, Wolfgang/Schnur, Peter/Zika, Gerd. (1996): *Wege zu mehr Beschäftigung. Simulationsrechnungen bis zum Jahr 2005 am Beispiel Westdeutschland*. IAB-Werkstattbericht Nr. 5.
- Kohler, Hans/Rudolph, Helmut/Spitznagel, Eugen (1996): *Umfang, Struktur und Entwicklung der geringfügigen Beschäftigung*. Eine Bestandsaufnahme. IAB - Kurzbericht Nr. 2.
- Konle-Seidl, Regina/Walwei, Ulrich (2001): *Job placement regimes in Europe*, IAB-topics No. 46
- Kötter, Ute (1998): Soziale Sicherheit in den Niederlanden. Ein Kaleidoskop öffentlicher und privater Sicherungsformen. In: *Soziale Sicherheit* Nr. 10, S. 339-348.
- OECD (1999): *OECD Economic Outlook*, Paris.
- OECD (1996a): *OECD Employment Outlook*, Paris.
- OECD (1997a): *OECD Employment Outlook*, Paris.
- OECD (1999a): *OECD Employment Outlook*, Paris.
- OECD (1996): *OECD Economic Surveys - Netherlands*, Paris.
- OECD (2000): *OECD Economic Surveys - Netherlands*, Paris.
- OECD (2002): *OECD Economic Surveys - Netherlands*, Paris.



- OECD (1999b): OECD Regulatory Reform in the Netherlands; Reviews of Regulatory Reform, Paris.
- OECD (2002a): OECD Wirtschaftsausblick; Paris.
- Oorschot, van Wim (2000): Soziale Sicherheit, Arbeitsmarkt und Flexibilität in den Niederlanden 1980-2000. In: *WSI-Mitteilungen* Nr. 5, S. 330-334.
- Paridon, Kees van (1997): Das Modell Holland - Ein neues Wirtschaftswunder. In: *Wirtschaftsdienst* Nr. 4, S. 200 ff.
- Pennings, Frans (1999): Flexibilität und Sicherheit: neue Entwicklungen im niederländischen Arbeitsrecht. In: *Zeitschrift für ausländisches und internationales Arbeits- und Sozialrecht (ZIAS)*, Heft 2, S. 153-218.
- Peters, Marjolein, Gesellschaft für Angewandte Sozial- und Wirtschaftswissenschaften (Hrsg.) (1998): Unterbeschäftigung in der Europäischen Union - jüngste Trends. Niederlande. In: *Zeitschrift des Europäischen Systems für Dokumentation, Evaluation und Begleitungspolitiken (SYSDÉM)* Nr. 30, S. 65-71, Berlin.
- Pohl, Reinhard/Volz, Joachim. Deutsches Institut für Wirtschaftsforschung (Hrsg.) (1997): Die Niederlande: Beschäftigungspolitische Vorbild? In: *Wochenbericht* Nr. 16, S. 259-264, Berlin.
- Schettkat, Ronald/Reijnders, Jan (1999): *The Disease that became a Model. The Economics behind the Employment Trends in the Netherlands*; Report prepared for the Economic Policy Institute, Washington D.C., January.
- Schmid, Günter (1997): Das niederländische Beschäftigungswunder? Ein Vergleich der Beschäftigungssysteme in den Niederlanden und Deutschland. In: *Infor MISEP* Nr. 59.
- Schnur, Peter/Walwei, Ulrich/Zika, Gerd (1998): *Wege zu mehr Beschäftigung. Strategiebündel immer noch tragfähig. Was ist aus den Vorschlägen des IAB vom Sommer 1996 geworden?* IAB-Kurzbericht Nr. 4.
- Schnur, Peter/Walwei, Ulrich/Zika, Gerd (2000): *Strategiebündel des IAB auf dem Prüfstand*, IAB-Kurzbericht Nr. 2.
- Schrader, Klaus (2000): Das "niederländische Modell": Ein Patentrezept für Vollbeschäftigung? In: *Die Weltwirtschaft*, Heft 1, Tübingen.
- Stille, Frank (1998): Der niederländische Weg: Durch Konsens zum Erfolg. In: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, Heft 2.
- Visser, Jelle/Hemerijck, Anton (1997): 'A Dutch Miracle'. *Job Growth, Welfare Reform and Corporatism in the Netherlands*; Amsterdam University Press, Amsterdam.
- Visser, Jelle/Hemerijck, Anton (1998): *Ein holländisches Wunder? Reform des Sozialstaates und Beschäftigungswachstum in den Niederlanden*. (Schriften des Max-Planck-Instituts für Gesellschaftsforschung Köln), Campus-Verlag Frankfurt/New York.
- Voss-Dahm, Dorothea (1998): Die Niederländer und ihr Modell. In: *Blätter für deutsche und internationale Politik*, Heft 1, Januar, S. 77-84, Bonn.
- Walwei, Ulrich/Werner, Heinz/König, Ingeborg (2001): *Was und wie man von anderen lernen kann*, IAB-Werkstattbericht Nr. 2
- Walwei, Ulrich (1998): Beschäftigungspolitisch erfolgreiche Länder - Konsequenzen für Deutschland. In: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, Heft 2.

- Walwei, Ulrich (2000): Die Beendigung von Arbeitsverhältnissen: Rechtlicher Reformbedarf und Kompensationsmöglichkeiten. In: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, Heft 1, S. 101 ff.
- Walwei, Ulrich/Werner, Heinz/König, Inge (2001): *Was und wie man von anderen lernen kann*, IAB-Werkstattbericht Nr. 2.
- Walwei, Ulrich/Werner, Heinz (1995): Entwicklung der Teilzeitbeschäftigung im internationalen Vergleich. Ursachen, Arbeitsmarkteffekte und Konsequenzen. In: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, Heft 3, S. 365.
- Werner, Heinz (1997): *Beschäftigungswunder USA - Viel Licht und viel Schatten*. IAB-Kurzbericht Nr. 1.
- Werner, Heinz (1997): *Kann Deutschland von den Niederlanden lernen?* IAB-Kurzbericht Nr. 12.
- Werner, Heinz (1998): Beschäftigungspolitisch erfolgreiche Länder - Was steckt dahinter? In: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, Heft 2, S. 324-333.
- Wilthagen, Ton; Wissenschaftszentrum Berlin für Sozialforschung (Hrsg.) (1998): *Flexicurity: A New Paradigm for Labour Market Policy Reform?* Discussion Paper FS I 98-202.

## 5 INCREASED LABOUR MARKET FLEXIBILITY AND UNEMPLOYMENT

*Rainer Fehn*

### 5.1 INTRODUCTORY REMARKS

For some time now the highly developed economies have been passing through a phase of radical structural change, which can be recognised by at least four points. Firstly the service sector is expanding, whereas the industrial sector is tending to shrink. One speaks of a tertiarisation of the highly developed economies, though this is clearly further advanced especially in the USA than it is for instance in Germany. Secondly a change towards the so-called "new economy" can be detected; this is an expansion of all the sectors that increasingly back the new information and communication technologies or the use of high-quality EDP. A perfect example of this development is biotechnology, which also already has a far greater status in the USA than it has in Germany, though within the USA it is possible to detect a considerable concentration on certain regions such as for example the catchment areas of Boston and San Francisco. Thirdly in numerous firms a far-reaching change in the organisation of work is taking place, which is facilitated not least by the extensive use of computers. Firms are increasingly giving up the Taylorist-Fordist production methods with a very extensive specialisation of workers and are adopting instead a holistic work organisation in which workers have to perform different tasks which are often complementary to each other and in which they are expected to show a far greater ability to work in a team and to make decisions. Fourthly the extent and frequency of data changes with which the firms find themselves confronted has increased with the result that the economic environment has become more volatile on the whole.<sup>1</sup>

These considerable changes in the economic environment have caused an increase in the adjustment burdens with which the highly developed economies have to cope. Especially in the large Continental European countries of Germany, France, Italy or also Spain, however, the capacity to deal with such considerable adjustment burdens is relatively small. The main reason for this can be seen in relatively rigid labour markets and generously developed welfare states which open up to the players numerous channels to pass the arising adjustment burdens on to third parties such as the taxpayers or future generations.<sup>2</sup> The somewhat unsurprising result is steadily increasing hard-core unemployment which does not disappear even in boom phases. This structural hard-core unemployment, which can not be attributed to a poor demand for goods in the economy as a whole, probably makes up some 85 percent of total unemployment in Germany for example. The counterpart to this increasing hard-core unemployment is a completely insufficient creation of new jobs. Here in Germany it is obviously considerably more difficult to create new jobs especially in the expanding sectors of the economy than it is for instance in the USA.<sup>3</sup>

This serious deficit in the creation of new jobs is also related in particular to the defensive policy strategy which is pursued in Germany of maintaining for as long as possible old jobs in declining sectors such as mining, agriculture or also in the shipyards, and compensating the losers in the structural change on a considerable scale. Consequently it is possible to identify two core elements of this defensive policy strategy. Firstly the attempt to postpone the destruction of old jobs for as long as possible by means of subsidies and labour market rigidities, such as dismissal protection, thus tying down the resources in the appropriations that are no longer profitable. Secondly a generous social cushioning of the workers who are nevertheless made redundant in these declining sectors by means of the welfare state, that is unemployment benefit, unemployment assistance which is unlimited as regards time but nonetheless linked to the last net wage, and as a final safety net, social assistance, which especially for families provides a benefit level that comes close to the level of an average earner's net pay and puts an absolute minimum wage into the spectrum of wages that can be achieved on the market. However, such a generous welfare state runs the risk of largely destroying the incentive to work of the losers in the structural change, so that the people affected do not just live off the general public temporarily but more permanently. The actual aim of the welfare state to help people to help themselves and to act as a kind of trampoline facilitating the way back into the regular labour market is being missed on a grand scale, which can be seen among other things from the long-term unemployment rate of about 50 percent, which is extremely high in an international comparison.<sup>4</sup>

What is without question far more promising in the long run especially in phases of radical structural change is an offensive policy strategy which pursues the central aim of creating the best possible institutional basic conditions for the creation of new jobs in the expanding sectors and which actively promotes the process of redirecting resources away from the declining sectors and into the expanding sectors. To be consistent, however, such an offensive policy strategy must then also be prepared to accept a larger degree of social hardships in the process of structural change. Consequently the core element of such an offensive policy strategy must be the comprehensive reform of the institutional basic conditions on the labour market and in the field of the welfare state. The entire jungle of regulations in these two areas must be put under the microscope to see whether it has a negative or positive effect on the creation of new jobs. In view of constant mass unemployment it is more than doubtful whether regulations that have a negative effect can be justified as a result of other "considerations of justice". If a system permanently contributes to responsible citizens not standing on their own feet and makes them dependent on the drip of the welfare state, then this is probably one of the greatest possible "injustices" and wrong controls in a state whose constitution is based on the principle of liberty. However, the rate at which new jobs are created also depends decisively on other institutional factors besides the labour market and the welfare state, namely in particular on the openness and competition intensity on the goods markets, the ability of the capital markets to function – they must be suitable in particular for financing busi-

ness start-ups and high-risk, innovative projects – and also on the arrangement of the tax system, which must above all provide strong incentives for entrepreneurial activities. On the whole dealing successfully with structural change thus depends on the institutional basic conditions promoting outsider competition in all areas and not hindering it. The more successfully the established players on the different markets succeed, with the state's help, in protecting themselves from the unpleasant competition from new arrivals and outsiders with potentially innovative ideas, the less an economy is in the position on the whole to cope successfully with a phase of radical structural change.<sup>5</sup>

This paper is intended first and foremost to deal with how rigid labour markets help to explain the persistent employment problems here in Germany, although it seems reasonable to suppose that other areas, such as the institutional basic conditions in the field of the welfare state, on the capital and goods markets and the arrangement of the tax system, also play an important role. The paper continues as follows. First it is explained that wage policy is a central determinant of labour market performance and that in particular wage moderation and wage differentiation are important in order to reach better employment results permanently. After this some central labour market institutions are examined more closely with regard to their employment effects, namely unemployment benefit, social assistance, dismissal protection and the degree of centralisation of wage negotiations.

## **5.2 WAGE POLICY AND LABOUR MARKET PERFORMANCE**

### **5.2.1 WAGE MODERATION**

A wage policy that is orientated towards employment is the key requirement for a permanently good labour market performance. From the point of view of employment the institutional basic conditions on the labour market are therefore to be arranged in such a way that the wage policy makes the largest possible contribution towards avoiding persistent mass unemployment or reducing it if it already exists, as for example in Germany. At aggregate level this means first of all that the so-called macroeconomic leeway of wage policy must on no account be fully exhausted if a contribution is to be made towards reducing unemployment. Only then will scope be left for employment gains and a wage differentiation conforming to market conditions, which can be realised for example by means of voluntary surcharges of firms that are developing better than average or by introducing plans for profit-sharing at firm level. This macroeconomic leeway results from the level of aggregate growth in the trend development of labour productivity plus the inflation rate that is considered acceptable by the central bank.<sup>6</sup> Progress in labour productivity which was only made possible by previous job cuts does not justify any higher wage increases because this would otherwise trigger a vicious circle of falling employment and constantly increasing wage demands. The same is true of data changes and policy measures that lower

the consumption real wage but which do not face an equivalent increase in labour productivity. Typical examples of this are deteriorations in the "terms of trade", for example due to a large increase in the price of crude oil or owing to a clear devaluation of the domestic currency, increases in social insurance contributions or in value-added tax or income tax. If the two sides of industry respond to such data changes with higher wage agreements in order to keep the consumption real wage constant, then in this way they inevitably contribute to the further reduction of employment.

The current round of wage negotiations in Germany in 2002 shows that trade unions still do not want to admit the negative relationship between wage increases and the development of employment. The most prominent example is the current demand by the trade union IG-metall for a 6.5 percent wage rise, which exceeds by far the macroeconomic leeway even though, in view of persistent mass unemployment, wage restraint would clearly be necessary in order to leave room for employment gains. If as a result of their strike power, which is as considerable as ever, IG-metall manages to enforce these demands even only approximately then the result will inevitably be an intensified reduction in the number of jobs and pressure to rationalise in the metalworking industry. The current 3.3 percent wage rise in the chemical industry, too, is not in any way suitable for facilitating employment gains. Obviously once again far greater importance was attached to the employees' interests in income rises than was attached to the interest of the unemployed in improved chances of being hired. As a result of the pilot function of the first wage agreement in a round of wage negotiations, which can usually be observed in Germany, it is additionally to be feared that the wage agreement in the chemical industry will influence the other sectors and even be regarded by the trade unions as a lower limit, resulting in further negative employment effects. As a longer-term response, the firms will produce even more capital-intensively than they did before and will continue to transfer their manufacturing plants abroad. Above all less-skilled workers will be affected by the growing pressure to lay off workers, which will push up the already high unemployment among this problem group on the labour market.

The trade unions try to justify their aggressive wage policy with its supposedly positive effect on demand in the economy as a whole, which would then supposedly result in a positive employment effect. However, this is nothing but eye-wash. The argument about the purchasing power of the wage has long since been disproved.<sup>7</sup> If it were even only approximately true, then the employment situation in eastern Germany should be magnificent, since the wage policy there in the nineties was anything but restrained. But the opposite is true. In view of the employment crisis here in Germany, whose primary causes are structural, a deficit of demand for goods is not an urgent problem anyway. Even if Keynes' demand-related component of unemployment gains importance, however, an expansionary wage policy is not the right policy instrument for responding to it. The positive demand effect on the home market of an expansionary wage policy is highly uncertain, but the cost increases and thus the deterioration of the sup-

ply side occurs in any case and thus predominates in terms of weight. What is more important in the case of a collapse in the demand for goods in the economy as a whole is monetary and fiscal policy, the latter in particular in the form of the automatic stabilisers, in order to stabilise macroeconomic demand.<sup>8</sup>

In this context it is also necessary to point out that the calculations of unit labour costs, which one can frequently find and which make Germany not look all that bad in international comparisons, especially in the manufacturing sector, are highly problematical. It can not come as a surprise that the development of unit labour costs proceeds relatively moderately if wage and social policies are pursued which systematically promote the increase of real capital and human capital intensity in the production process and contribute for example to low-skilled or older workers no longer having a chance on the labour market and becoming a burden on the welfare state. The measured increases in labour productivity have then not been obtained genuinely by the firms' careful management, but are to a considerable part the result of a personnel policy responding to increases in wage costs, the burden of which falls on the general public. Moreover, such a situation is highly unstable in as far as firms can generally choose their production location for new establishments or for expansion investments. Unit labour costs which seem to be fairly moderate as a result of an artificially excessive use of capital are then, however, not exactly an argument for establishing firms in such an institutional environment. From the viewpoint of the firms when making such a longer-term decision it depends far more crucially in the planning period on the expected ratio of the burden from wages, taxes and insurance contributions relative to the public infrastructure in the broadest sense and relative to the workers' qualification level and work input. The institutional basic conditions with regard to the firms' freedom of disposition, which especially in Germany has been further restricted for larger firms by the recently extended works councils' share in decision-making, also plays a considerable role. The development of the direct investments made in Germany by foreign firms, which continues to be rather modest, suggests that, irrespective of all comparisons of unit labour costs, Germany does not appear to be particularly attractive as a production location from the point of view of firms. In summary therefore the institutional basic conditions on the labour market should be arranged in such a way that they promote a permanently restrained wage policy and thus create scope for the urgently needed employment gains.

### 5.2.2 WAGE DIFFERENTIATION

What is at least as important as a permanent policy of wage moderation, however, is that the wages are adequately differentiated with regard to qualification, sector and region in accordance with the requirements of the labour market. If on the other hand the wage structure in these three dimensions is very narrow and is more egalitarian in nature, then workers must demonstrate a very high level of mobility in order to avoid considerable problems with mismatch unemploy-

ment. Especially in a welfare-state environment in which the state transfer payments via unemployment assistance are linked to the last net wage and are unlimited as regards time and where the unemployed are not expected to move to a different town or region, one can not expect the unemployed to be particularly mobile. Labour demand and supply then have difficulty coming together, however, and the combination of the low level of mobility among the unemployed, resulting from the welfare state, and wage structures that are only slightly differentiated inevitably leads to huge mismatch problems on the labour market.<sup>9</sup>

The situation intensifies even further when, as has been the case for some time now, radical structural change can be detected in particular with regard to sectors and qualifications. The outstanding trend in the structure of labour demand away from standardised industrial production and towards services and the so-called "new economy", and away from low-skilled workers and towards highly qualified workers who demonstrate extensive abilities and can perform a broad spectrum of tasks, demands a clearly growing wage differentiation in order to avoid an increase in structural unemployment.<sup>10</sup> However, contrary to the international trend, this has not occurred in Germany. It is more the case that, contrary to the needs of the market, the wage structure in Germany has been further levelled out in particular with regard to qualifications.<sup>11</sup> Against this background it should not come as a surprise that especially low-skilled workers and former workers from the industrial sector are affected by persistent unemployment.

90

This policy of little differentiation in wages is once again largely the result of the institutional basic conditions that can be observed here in Germany on the labour market and in the area of the welfare state. A wage policy which systematically tries to level out the income differences that actually arise from the market process can only be kept up if the resulting unemployment is socially cushioned on a grand scale via insurance and transfer payments from the welfare state. If, however, the social net is only very wide-meshed, as is the case for example in the USA, then the social fall of laid-off workers who fail to find a new job quickly is so great that a considerable political and social pressure arises to give up such a wage policy which is not in accordance with the demands of the labour market. The people affected then simply can not afford to be unemployed permanently, so that ultimately it can not come as a surprise that the rate of long-term unemployment here in Germany is roughly eight times higher than that in the USA.<sup>12</sup> The wage negotiations in Germany, which continue to be relatively centralised compared with other countries, and the leitmotiv of German wage policy of "equal pay for equal work", which already proved fatal in the process of reunification, result in steadily growing losses of efficiency and employment. The situation is thus becoming more and more unstable and sooner or later serious changes will have to be made in both respects in Germany too.

It will, however, be a major challenge for the model of the "social market economy" to organise this process of change in such a way that it is accompanied by



less social hardship than is the case for instance in the USA. This should be possible if one considers that other European countries such as Switzerland or the Netherlands have for a long time been far more successful in their employment policy than Germany has, without demonstrating the same extent of income differences and social hardship as the USA. However, these countries are rather small, comparable in size with German *Länder* such as Bavaria, Baden-Württemberg or North-Rhine-Westphalia. Therefore two central questions arise in this context. Firstly, to what extent the experiences of such countries can be applied to larger countries such as Germany, France or Italy. Secondly whether it is necessary in Germany, too, to transfer far more competences to the more decentralised *Länder* level in the field of labour market and social policy, though this might have to be accompanied at least by cooperations of smaller *Länder* if not even by the task of reorganising the *Länder*, a task that would be politically extremely difficult.

### 5.3 REFORM OF THE INSURANCE AND TRANSFER PAYMENTS TO THE UNEMPLOYED

An employment policy can ultimately only be described as successful if it manages to reintegrate a great many of the unemployed and especially many long-term unemployed into the regular labour market. In order to achieve this aim both positive and negative incentive mechanisms, in other words the carrot and the stick, are basically suitable. However, it is also necessary for the firms to be willing and able to hire job-seekers at a real wage in accordance with their marginal productivity. It would make most sense to pursue all three methods, making it essential first of all to increase the competitiveness of the unemployed on the regular labour market by means of targeted measures to promote reintegration, second to arrange far more restrictively the transfer payments to unemployed people who do not use the opportunities offered to them in spite of an objective ability to work, and finally to raise firms' interest in hiring new workers. As this paper deals with the influence of labour market rigidities on labour market performance, the extensive first area of a sensible arrangement of active labour market policy is not discussed here.<sup>13</sup> Therefore in the following paragraphs the arrangement of the insurance and transfer payments to the unemployed is first discussed before going into the influence that dismissal protection and the degree of centralisation of wage negotiations have on firms' willingness to hire and on the macroeconomic labour market performance.

In internationally comparative studies it is shown again and again that the generosity of unemployment benefit is a key determinant for the extent of unemployment in a country.<sup>14</sup> The longer that benefits are paid, the higher these benefits are and the more lax the criteria are that govern what is expected of an unemployed person in order to be granted these benefits, the higher the level of unemployment and particularly long-term unemployment is. Several chains of effect are responsible for this rather unsurprising result. First of all it simply

leads to a reduction in the search intensity of the unemployed and subsequently to a drop in their probability of being hired. In addition to that the wedge of taxes and insurance contributions that lies between the gross wage costs for the firms and the net wage that the workers receive broadens with the subsequent higher costs of the welfare state. The incentives shift towards non-employment or clandestine employment. The inevitable consequence is a more aggressive wage bargaining behaviour on the part of the trade unions, which of course focus on the net wage that their members actually receive, with corresponding employment losses. Another reason for this result is, however, that trade unions and firms know that excessive wage increases and rash dismissals entail less serious consequences for those workers who are made redundant as a result. After all they fall into a generously structured welfare-state net that guarantees them a considerable part of the net income they last earned in Germany even for an unlimited time. The existence and the arrangement of the state unemployment insurance thus induces a number of changes in behaviour which are detrimental to employment, it causes so-called "moral hazard" problems.

Germany does badly in international comparisons with regard to the arrangement of unemployment benefit. The benefits are not only relatively high, but they are above all paid for a very long time, basically for an unlimited period, and what is more the criteria of what an unemployed person is expected to accept in a job can be described as rather lax, with the result that the incentives to work are low. These criteria were made slightly stricter during the last phase of the Kohl government with the reform that came into effect in 1997. In that reform in particular the time that a worker can be expected to have to travel for a working day of more than six hours was extended from 150 to 180 minutes. The Schröder government, however, immediately cancelled this slight tightening of the criteria again and even abolished entirely the obligation to report regularly to the employment office. Even workers who are seeking full-time employment are still not expected to accept a move to a different town even if they have been unemployed for a longer time. It can therefore not come as a surprise that the mobility of German workers can only be described as low compared for example with that of their American colleagues. What has also not yet been touched upon despite the recent discussions is the duration of benefits for the unemployed. The payment of unemployment benefits, lasting for up to 32 months, is already very long in an international comparison. But in Germany this is also followed by the unlimited payment of unemployment assistance, which is also orientated towards the previous net wage.<sup>15</sup>

### **5.3.1 INDIVIDUAL UNEMPLOYMENT INSURANCE ACCOUNT**

There are two key elements for getting the serious "moral hazard" problems associated with unemployment benefit better under control. They are a far stronger emphasis of the actuarial principle of equivalence and the property rights in the context of the state unemployment insurance. The thought which

actually seems to suggest itself, that of privatising unemployment insurance in order to achieve these aims is, however, not implementable so easily. As long as the state guarantees a socio-cultural subsistence level, workers will not voluntarily insure themselves adequately against the risk of becoming unemployed. Since especially a state that is bound to the concept of the "social market economy" does not allow the individual in case of doubt to fall into a bottomless abyss, there is not enough personal interest in making one's own insurance provisions. Furthermore it is also doubtful whether a private unemployment insurance would have the necessary stability at all during macroeconomic disturbances. Unemployment constitutes a risk that is not insurable or only insurable with difficulty because in the case of macroeconomic disturbances the material consequences of risk do not occur independently of each other and they can not therefore be diversified or at least only partly. Therefore as long as private insurances do not manage to pool the risk of unemployment with other risks which are statistically independent of unemployment a private insurance solution always runs the danger of collapsing. In any case it is not sufficient if private unemployment insurances act internationally because macro-shocks such as oil price shocks or turbulences on the financial markets often affect numerous countries simultaneously and the cyclical swings these days seem to be passed on between the highly developed industrial countries rather more markedly than they used to be, as is suggested by the recent recession. Finally, private insurers would also try to pursue a strategy of taking the pick of the bunch and would only insure the good risks, with the result that bad risks would have to pay prohibitively high contribution rates.

What is quite conceivable, however, is the setting up of individual unemployment insurance accounts (individuale Arbeitslosenversicherungskonten – IAK) within the framework of the state unemployment insurance, that is under state charge.<sup>16</sup> Employed workers could then leave the state unemployment insurance on a voluntary basis as soon as they have paid into this account at least the amount which is equal to the worker's socio-cultural subsistence level multiplied by the duration of the unemployment benefits that he or she would be entitled to on becoming unemployed. After losing a job the worker should therefore not become a burden on social assistance during an otherwise existing entitlement to unemployment benefit. Whenever the balance on the unemployment insurance account fell below this amount the workers would have to pay contributions to the unemployment insurance. The workers would only have access to the account in the event of unemployment. If the balance of the account were positive at the time of retirement, the workers would also be entitled to this, and the state would have to pay interest equivalent to Federal loans on positive balances. The current state pseudo-insurance would therefore become an insurance with considerably reinforced property rights and a savings function. Such a construction would have the decisive advantage that workers would fall back on their own money in the event of becoming unemployed, so that the "moral hazard" problems described would be reduced. The unemployed would look more intensively for a job because every further day of unemployment would have to

be paid out of their own pocket. Moreover, for the same reason trade unions with excessive wage demands and firms making rash redundancies would have to expect substantially more resistance from the workers. Finally, administrative costs would be saved because owing to the improved incentive structures unemployed people who support themselves from their unemployment insurance accounts would automatically seek work intensively. The supervision and spoon-feeding of all unemployed people which is necessary in today's system could be stopped at least for some of the unemployed.

Furthermore, however, the question arises as to how the compulsory state part of the unemployment insurance should be arranged so that the negative repercussions on the employment situation are as small as possible. It makes particular sense to reduce the maximum period of unemployment benefit receipt, to make the criteria of what must reasonably be accepted more strict and to link the amount of earnings replacement benefit to the duration of the spell of unemployment. Only in this way is it possible to avoid a growing sediment of long-term unemployed in an economic environment that is becoming increasingly volatile and is marked by a tremendously rapid structural change. It must be taken into consideration here that above all the maximum duration of receipt of earnings replacement benefit helps to explain empirically the very different level of persistence of unemployment in individual countries, so the prime concern in reforms has to start here.<sup>17</sup> A general rearrangement of the unemployment insurance systems in this direction would clearly raise the incentive of the unemployed to look for a job more intensively so that they are successfully reintegrated into the labour market sooner.<sup>18</sup>

### **5.3.2 SHORTER DURATION OF RECEIPT OF BENEFITS FROM THE UNEMPLOYMENT INSURANCE**

In addition to setting up individual unemployment insurance accounts, the maximum duration of receipt of unemployment benefit should at any rate be clearly reduced, for instance to one year, so that entitlement to unemployment benefit ceases with the transition into long-term unemployment. The USA which has been far more successful in employment policy in the last decades, even limit entitlement to unemployment benefit to a maximum receipt duration of only six months.<sup>19</sup> This is a key reason for the far lower rate of long-term unemployed in the USA. In addition to the long duration of receipt, constantly high earnings replacement benefits, too, aggravate the "moral hazard" problem of unemployment benefit. Here, too, the incentives should be set in such a way that unemployment is avoided as far as possible without losing sight of the insurance aspect. Terminating an employment contract should be clearly punished financially, whilst finding a new job should be rewarded financially.<sup>20</sup> These considerations suggest that unemployment benefits should not be constant throughout the duration of receipt. What would be preferable is if they were especially low in the first month of unemployment, then increased up to a maximum for exam-

ple after six months of unemployment, in order then to be reduced again gradually until the benefits ran out after a maximum of one year. Furthermore the criteria of what must be accepted in a job should be intensified to the effect that an unemployed person must also be prepared to move home after a certain duration of unemployment, for example after six months. This would mean an unemployed person losing his or her entitlement to unemployment benefit after drawing it for six months if he or she only turns down jobs offered because of the need to commute more than 180 minutes per day to reach the place of work.

### 5.3.3 ABOLITION OF UNEMPLOYMENT ASSISTANCE

It must be stated furthermore that the institution of unemployment assistance is a bad design.<sup>21</sup> It is not financed from insurance contributions but via taxes. Its benefits lead one to believe, however, that one has an entitlement to insurance by their nonetheless being linked to the last earned net income with the result that in spite of a means test it is possible to receive more than the social assistance rate.<sup>22</sup> In addition to this, unemployment assistance is paid for an unlimited time. If one assumes that the local authorities share with the employment offices the responsibility for reintegrating long-term unemployed people, then it is in addition extremely problematic that unemployment assistance is financed from the national tax coffers. The funding of the benefits and the responsibility for reintegration should be in the same hands in order to avoid false incentives. A high rate of success in the reintegration efforts must also be reflected in an immediate financial advantage for the relevant institution. Taken together all these arguments are in favour of abolishing unemployment assistance altogether. Anyone who has still not found a job when his or her unemployment benefit has expired is not an insurance case but a hardship case. Those affected should also definitely be made aware of this in order to urge them to increase their job-search efforts. Of course, if they are needy the people concerned should also receive social assistance like anyone else.

### 5.3.4 SOCIAL ASSISTANCE ONLY WHEN WILLING TO WORK

If unemployment assistance is abolished and the duration of receipt of unemployment benefit is reduced clearly at the same time, then of course the question immediately arises as to what should happen to the unemployed people who still have not found a new job even after their unemployment benefit entitlement has expired. First of all it is clear that in a "social market economy" needy people are then entitled to social assistance. But this results once again in "moral hazard" problems. Above all unemployed people have the advantage over people in employment of having far more free time at their disposal. The better also long-term unemployed people are integrated into society, the greater the influence this time advantage has, because the free time can be used in particular for clandestine work. For this reason long-term unemployed people should only

receive the full social assistance rate if one of the two following conditions is met. Firstly that the person concerned is objectively not able to work, either because he or she has to care for small children and there are no adequate child-care facilities available, or because the person concerned shows too serious physical limitations whereby the burden of proof is always to be left to the potential recipient of transfer payments. Secondly, that the social assistance recipient does not decline to participate in integration or job-creation measures offered by the particular local authority. These can by all means also be ancillary activities and the actual income of the long-term unemployed individual should be equivalent to the previous social assistance rate.

Such a rigorous policy of service and service in return also in the area of the welfare state would have the inestimable advantage that it would increase once again the general acceptance of the principle of the welfare state. For some time now the wage-gap principle for families in the lower income bracket has no longer been given. Families in which only one parent is working in the lower income segment are only slightly better off financially than similar families which are financed by social assistance and in which nobody goes to a regular job that is generally rather arduous; if the family receiving social assistance does clandestine work then the genuine working families are even worse off.<sup>23</sup> This distorted situation and the subsequent envy effects could at least be reduced with this approach, once again without disregarding the elementary principles of the welfare state. Furthermore this reduces the problem that the way social assistance is currently arranged it constitutes an absolute lower limit for the net wage at which unemployed social assistance recipients are prepared to accept a regular job, if it is more pleasant for the people concerned and is associated with better opportunities for advancement to perform a low-paid regular job instead of the work offered by the local authority. A reform of social assistance is particularly promising above all if, in contrast to the current institutional arrangement, a constant transition is created with regard to the net wage from the receipt of state transfer payments to the performance of a regular job. This could be achieved in particular by permitting people who have been unemployed for a longer time to earn their own income from regular employment for a limited period in addition to receiving social assistance without them losing in tax 100 percent of every extra euro earned.<sup>24</sup>

### **5.3.5 INSTITUTIONAL COMPETITION IN THE TRANSFER PAYMENTS TO UNEMPLOYED PEOPLE**

It is obvious that the outlined far-reaching reforms in unemployment insurance will meet with considerable resistance in view of the general scepticism concerning market-economy solutions. It will hardly be possible to introduce them in one large step. The support depends above all on the extent to which the general public also hopes to obtain positive employment effects from passing reforms. This dangerous obstacle can be negotiated successfully, however, by firstly opening up to institutional competition within Germany the arrangement of the

transfer payments to the unemployed, that is unemployment benefit, unemployment assistance and social assistance. Regions, for instance Federal *Länder*, should have considerably more freedom to arrange their benefit package for the unemployed than they have had so far. Here it is also quite desirable for the regions to offer the unemployed differently generous benefit packages which then also differ in price. In order to set the incentives correctly, however, the worker concerned would have to have the full benefit of any savings in the contributions, not giving part of it to the employer.<sup>25</sup>

In the context of such institutional competition in the area of the transfer payments to the unemployed, some pacemaker regions would then develop considerably more polished and also stricter systems than has so far been the case. The consequent gains in efficiency in the form of lower unemployment and lower contributions would of course have to benefit the particular region in full so that financing, too, would have to be regionalised. Only then do workers and firms in a certain region benefit directly from regionally more efficient solutions. The insurance principle however suggests once again that regions must not be too small to be able to organise a reasonably efficient protection against the risk of unemployment. In the case of larger *Länder* such as Bavaria, Baden-Württemberg or North-Rhine-Westphalia, this should not be an all too serious problem, but in the case of smaller ones such as the city *Länder* or Saarland it would be. Thus several small *Länder* would have to get together with regard to the matter of protection against the risk of unemployment, or one dares to tackle the large and very controversial project of reorganising the *Länder*. However, one must not expect any employment-policy miracles just from an arrangement of the insurance and transfer payments to the unemployed, no matter how restrictive it is. Only if it is possible at the same time to make the wage negotiation behaviour of those in possession of jobs more restrained and more flexible can a breakthrough in the reintegration of the (long-term) unemployed into the regular labour market really succeed.

#### 5.4 HOW CAN THE WAGE SETTING BEHAVIOUR BE DISCIPLINED?

The actual crux of the problem of structural unemployment is that the people with jobs have the market force, not only on partial labour markets but even at macroeconomic level, to push through real wages that are not in agreement with full employment. They manage to monopolise productivity gains for themselves largely in the form of wage increases. For an employment-orientated wage policy, however, it would be necessary in the situation of large-scale underemployment, which has now prevailed for many years, for wage increases to lag behind the productivity increases clearly and for a longer period of time so that the productivity gains can benefit the unemployed in the form of improved employment opportunities.<sup>26</sup>

The job-holders' strong position is based to a considerable extent on statutory labour market regulations which undermine its ability to function. It is therefore necessary to reform the institutional arrangement of the labour market in such a way that the market forces on the labour market once again are strengthened. This means that a surplus of labour supply must result in a clearly more marked restraint in wage agreements than has so far been the case. It must not be the case in particular that an "end of modesty" is already pronounced when open unemployment falls modestly, if mass unemployment continues to prevail and at least five million jobs are missing.<sup>27</sup>

The wage setting behaviour could be moderated easily if radical interventions were undertaken in the present institutional arrangement on the labour market. A first possibility in this direction would be to suspend the collective bargaining autonomy as long as the unemployment rate is above a certain critical value. Secondly it would be possible to grant by law to representatives of the unemployed a right to be heard in wage negotiations. Thirdly it is conceivable in the event of the employers and the trade unions not reaching agreement, that a state compulsory arbitration could come into effect so as to avoid a situation such as that currently occurring in the wage negotiations in the metalworking industry, where extensive strike measures are already being prepared although no attempt at arbitration has yet been made. Fourthly the market force of the trade unions could also be reduced decisively by restricting their right to strike, for example by giving each worker the right to relinquish his or her right to strike by means of an individually negotiated contract with his or her firm. However, at least in Germany all these measures constitute infringements of employee rights which are guaranteed by Basic Constitutional Law and also intrusions on the collective bargaining autonomy.<sup>28</sup> Especially in the case of the first three suggestions it is also doubtful whether they are compatible with a liberal economic order. It is not necessarily appropriate to replace the current cartel solution on the labour market with the iron hand of the state. Instead the state should first of all eliminate all the legislative obstacles to competition on the labour market and mind that market entry and offers from outsiders as well as alternative wage determination systems are possible without any restriction and are not hindered by laws. This would already moderate wage setting behaviour lastingly and would make it more flexible.

#### **5.4.1 REDUCTION OF STATUTORY DISMISSAL COSTS**

In principle the employment effect of high statutory dismissal costs is controversial. They have the effect firstly that firms are more restrained in times of crisis when it is a matter of laying off employees. The other side of the coin, however, is that firms are also more restrictive about hiring new employees during upturns. That is why it is only possible to ascertain clearly first of all the fact that high statutory dismissal costs reduce the fluctuation on the labour market and intensify long-term unemployment, which from a political viewpoint is particu-



larly problematic, in other words fostering a more marked segmentation on the labour market between insiders and outsiders. Such an ambivalent point of view is only appropriate, however, when economic fluctuations prevail. In a long-term perspective and above all in times of radical structural change the declining industries and firms will have to lay off at least a great many of their employees in any case in the end, irrespective of the level of statutory dismissal costs. In contrast to cyclical fluctuations, lay-offs can only be delayed but not prevented. Thus the more intensive the structural change is, the more clearly high statutory dismissal costs result in a long-term negative employment effect, because fewer new jobs are created and a considerable number of the old jobs are nonetheless lost through the process of creative destruction irrespective of the high statutory dismissal costs. In the extreme case the declining firms simply go bankrupt.

The level of statutory dismissal costs in Germany, which is high in international comparison and which primarily takes the form of dismissal protection regulations and obligations to draw up a "social plan", has a negative effect on the realisable employment volume in the longer term in two respects. Firstly high dismissal costs increase the market force of the people with jobs in wage negotiations. Therefore the wage setting behaviour is generally more aggressive.<sup>29</sup> In crisis situations, too, the necessary change of course in wage policy is delayed because those with jobs are protected from actually being made redundant. The extension of the statutory dismissal costs which took place in Germany in the late sixties and early seventies is therefore partly responsible for wage policy on the whole following a too aggressive course, and for it failing to respond flexibly enough, in particular in the event of negative shocks, to avoid a permanent rise in unemployment.<sup>30</sup> An extensive reduction of statutory dismissal costs can thus help decisively to moderate wage setting behaviour and to make it more flexible. The job-holders' risk of being laid off grows if they enforce excessive wage agreements. As a result of the wage policy which is then oriented more towards employment the firms are in a better position to take on unemployed people again.

Secondly, as high statutory dismissal costs reduce the demand for labour in the longer-term, even the realisable employment volume falls as a result of the response of both sides of the market. High statutory dismissal costs increase the costs associated with the utilisation of the factor of production of labour. Before a worker is hired all the costs are variable like in an investment decision. A hiring therefore only takes place if the expected present value of this decision is positive. Consequently, as a result of high dismissal costs fewer new hirings occur. The firms try to make themselves more independent from the now almost fixed production factor of labour and, as is the case in Germany for instance, opt for a production technology that is very intensive in terms of real capital and human capital. The dismissal costs have a greater negative impact on new hirings the greater the probability is assessed that a firm will have to lay off workers owing to poor business development sometime in the future. This probability has grown as a result of the accelerated structural change and because of the general-

ly more volatile economic environment. High dismissal costs therefore have a more marked negative effect on the extent of new hirings nowadays than they did in times of a constant upward economic trend such as that in the fifties and sixties. They also lead to an economy tending to specialise in the production of safe goods which are already further advanced in their product cycle, because the demand for these goods is less volatile and therefore the necessity for future dismissals is smaller. However, in a dynamic perspective these safer goods generally show a lower growth potential than high-risk innovative products. Therefore in the long run this results in a further serious negative effect on the demand for labour in the economy as a whole because economies with high statutory dismissal costs have lower growth potential.<sup>31</sup> High dismissal costs also make it more difficult to take over or rehabilitate ailing firms. Therefore they contribute to an unnecessarily large number of bankruptcies, which also has a negative effect on the demand for labour in the economy as a whole. An excessive devaluation of real capital and human capital is the inevitable consequence.

Seen in the longer-term these negative effects of high statutory dismissal costs are of greater significance, especially in the case of a high stock of unemployment, than the positive stabilisation effect that high dismissal costs have on labour demand, which results from firms waiting longer before making employees redundant during a crisis. This applies in particular because high dismissal costs help to avoid lay-offs primarily in the case of cyclical fluctuations but not in the massive structural changes that can currently be observed. The result is the stagnation in employment growth that is visible here in Germany and the huge increase in particular of long-term unemployment and unemployment among low-skilled workers.<sup>32</sup>

Against this background there is highly controversial debate in Germany about how in particular the excessive regulations in the area of general dismissal protection and the obligation to draw up a social plan can be relaxed.<sup>33</sup> Both the dismissal protection and the obligation to draw up a social plan were originally designed to prevent employers from abusing their market power, but the current extent of these regulations grants privileges to those with jobs at the expense of the employment opportunities of the unemployed. It is particularly problematic that the labour-law judicial decisions in dismissal processes give strict priority to the individual protection of the worker concerned and that these labour-law judicial decisions which focus on the individual case leave no scope for macro-economic considerations. As a result of the dominance of case law, a considerable legal uncertainty is also created in this area, which is why now and then a real trade in severance payments arises. The legislator is therefore at least required to clarify exactly when dismissals are legal. If in addition he puts into concrete terms and reduces the criteria to be observed in the event of lay-offs for operational reasons then this would constitute a major step towards more importance once again being attached to the macroeconomic interest in a high level of employment.

What opposes a complete elimination of statutory dismissal protection is the fact that protection against arbitrary dismissals obviously has an efficiency-enhancing effect. Furthermore it should be in accordance with the ideas of social values to weigh up company-related aspects against social aspects when carrying out redundancies.<sup>34</sup> However in times of crisis very small firms hardly have any alternative adjustment instruments other than redundancies, which larger firms do have for example in the form of transferring workers within the firm. For this reason it would make sense from an employment point of view at any rate to cancel the extension of the statutory dismissal protection to cover small firms with six to ten full-time employees, which was carried out by the Schröder government at the start of its period of office. Especially such smaller firms are often more innovative than average and promising with regard to future employment growth. However, they have to rely especially on being able to respond to data changes rapidly and flexibly so that they do not disappear from the market again due to problematic regulations, without this being necessary from a longer-term economic perspective.

In addition to statutory dismissal protection, the obligation to draw up a social plan in the event of mass redundancies for operational reasons also causes considerable dismissal costs. In economic terms the social plan is justified by the fact that it is intended to force the firms in the event of dismissals to include in their calculations the mobility costs incurred by the employee. These mobility costs consist primarily of the costs for searching for a new job, costs for moving house and the devaluation of the firm-specific human capital. However, laid-off workers generally suffer considerable income losses due to the general imbalance on the labour market because it is relatively rare for them to find a new job immediately. But this does not belong to the responsibility of the individual firm. Therefore from an economic viewpoint the costs arising due to the worker concerned losing his or her privileged status as a job-holder do not belong in the firms' social plan obligations. The current legal regulation and above all the actual implementation of the social plan obligation in Germany is thus not only too far-reaching, it also has a discriminating effect, and this in two respects. Firstly the obligation to draw up a social plan only applies to firms with more than twenty employees. Secondly only victims of mass dismissals have the benefit of social plans.<sup>35</sup>

In principle it is essential to ensure a more employment-friendly arrangement of dismissal protection and the social plan obligation. In order to achieve these aims but also to protect against arbitrary dismissals, it would be possible to prescribe by law flat-rate indemnity payments for lay-offs for operational reasons in general, i.e. irrespective of the size of the firm and of the number of redundancies. So far, however, both Germany and also numerous other European welfare states have tried to rope in the firms for compensating to a large extent for the social hardships associated with redundancies. But if redundancies are unavoidable owing to the increasingly rapid structural change and the more volatile economic environment, then this attempt has fatal consequences for employment in the long run, as can be recognised without difficulty in the meantime.

#### 5.4.2 MORE DECENTRALISED WAGE NEGOTIATIONS

Another important point of departure for moderating the wage negotiation behaviour of those with jobs is the arrangement of the collective negotiations. Especially the optimum degree of centralisation of wage negotiations has been discussed intensively in literature during the last decade. Three quite different hypotheses compete about what effect the degree of centralisation of wage negotiations has on the employment results:<sup>36</sup>

- 1) *The corporatist hypothesis:*<sup>37</sup> corporatist countries are always characterised by wage negotiations being conducted at a very centralised level. The more extensive an interest group is, however, the less success it can have in obtaining special advantages at the expense of other social groups. Central social partners therefore take more into consideration the macroeconomic consequences of the wage increases that they agree upon and thus act more or less in the sense of an actor maximising the common good? Centralised wage negotiations consequently also have a positive effect on consensus-orientated behaviour based on partnership between the social partners, which is also reflected in a lower strike rate and a constructive co-operation between the state and the two sides of industry.
- 2) *The liberal-pluralist hypothesis:*<sup>38</sup> based upon considerations of political economics, in particular the danger of policy failure is emphasised here and the problems are brought out which are associated with systematically cancelling the market forces on the labour market by means of a central organisation of wage negotiations. A close involvement of powerful interest groups with integration of the state can at best reduce the negative effects of data changes in the short term. But in the longer-term this leads to decrepitude and inflexibilities that hinder growth and employment.
- 3) *The hump shape hypothesis:*<sup>39</sup> this hypothesis brings together the two previous explanatory approaches. According to this, both wage negotiations organised at a very centralised level and those organised at a very decentralised level have a positive effect on the employment results. What do considerably less well on the other hand are intermediate forms in which the disciplining force of the market has been lost to a large extent but on the other hand the wage negotiations are not yet organised so comprehensively that the two sides of industry orientate themselves towards the good of the economy as a whole.

The three hypotheses must be judged by which degree of centralisation of wage negotiations is more likely to fulfil the two main criteria – micro-flexibility and macro-flexibility – that a wage negotiation system must fulfil in order to obtain positive employment results. A wage negotiation system should firstly have a positive effect on the growth of a country's productivity and economy, because taken together these two factors facilitate employment gains (micro-flexibility).

This can occur in particular by means of a wage structure that fosters economic incentives. Secondly a wage negotiation system should help to orientate wage increases towards the development of productivity (macro-flexibility). If at the starting time there is full employment, then the wage increases should not exceed the progress in productivity, whereas if there is mass unemployment initially, as has been the case in Germany for some time now, it is necessary to make a clear deduction from the trend growth of labour productivity. Aggressive general wage increases which are not justified by productivity progress, on the other hand, inevitably lead to employment losses. From the point of view of macro-flexibility, the preferable degree of centralisation of wage negotiations is therefore the one that keeps at a low level the macroeconomic pressure to raise wages and responds flexibly to macroeconomic shocks.<sup>40</sup>

### ***Degree of centralisation of wage negotiations and micro-flexibility***

The question as to the effect that centralised wage negotiations have on a country's micro-flexibility is a controversial one. On the one hand it is argued that centralised wage negotiations have a positive effect on the speed of structural change and the formation of real capital and thus on economic growth. On the other hand more and more economists have recently been of the opinion that the more inflexible wage structures and lower wage dispersion that are associated with centralised wage negotiations have a negative impact on micro-flexibility.<sup>41</sup> If wages are fixed bindingly at central level then every firm pays roughly the same wage for the same work irrespective of their particular profit position. This is why with centralised wage negotiations the wage structure is more inflexible and the wage dispersion is smaller than with decentralised wage negotiations. This is frequently regarded as an advantage and not as a disadvantage, however, because it supposedly results in an acceleration of structural change and investment activity.<sup>42</sup> Less dynamic and inefficient industries and firms are forced to rationalise more intensively or to withdraw from the market more quickly. In this area employment will thus decline. This is opposed, however, by a possibly greater positive employment effect which arises as a result of the more dynamic and above-average productive firms paying lower wages than they would in the case of decentralised wage negotiations because the wages do not follow the profits. For this reason these firms have at their disposal more available funds for financing investments from their own resources. In the case of the often lamented imperfect capital markets especially in the area of innovative and higher-risk investments this has a positive impact on economic and employment growth. In conclusion, according to this idea, centralised wage negotiations can manage to speed up the process of creative destruction.<sup>43</sup>

If these ideas are examined more closely, however, they turn out to be too simple and misleading. Cause and effect become confused if the more flexible wage structures associated with more decentralised wage negotiations are held responsible for an inadequate structural change. A flexible wage structure is only necessary at all if the production factor of labour is not sufficiently mobile. If, however, in the case of immobile production factors one prevents any occurring

structural shocks from being dealt with by means of flexible wage structures, then unemployment among the less mobile workers will necessarily rise. Wage structures which are artificially lashed down by means of centralised wage negotiations increase the pressure on these unemployed workers to move to the expanding industries and regions against their actual wishes. A considerable proportion of the laid-off workers is unable to gain the qualifications required in the expanding industries, however, which means that especially when transfer payments to the unemployed are generous it is not possible to avoid a permanent increase in unemployment.<sup>44</sup>

It is often claimed for other reasons, however, that centralised wage negotiations have positive repercussions on investment in real capital and thus on the employment situation.<sup>45</sup> Whereas with centralised wage negotiations the development of wages is orientated more towards macroeconomic factors, with decentralised wage negotiations the profitability situation of the individual firm is also a decisive influential factor. In this respect decentralised wage negotiations are closely related to profit-sharing systems as regards their consequences.<sup>46</sup> Since in the case of decentralised wage negotiations the workers are able to skim off at least part of the profits arising from the production process, the firms' incentives to make new investments decrease according to this thesis.<sup>47</sup>

104

---

This is opposed, however, by a number of positive effects of decentralised wage negotiations on investment behaviour. Investments are always decisions made under uncertainty, in which the optimum division of risk plays a considerable role. With functioning capital markets and a low level of discretionary freedom in the management's decision-making it makes sense for the capital owners to bear the entire firm-specific risk because they are able to diversify it by means of a broadly spread investment on the capital market. In reality, however, neither of the requirements are quite met. Especially in the area of innovative and high-risk investments the capital market shows considerable imperfections, especially in Germany. In Germany it is extremely difficult for young and innovative firms to acquire sufficient venture capital without providing appropriate material securities.<sup>48</sup> Owing to the inadequate supervision by the financial backers the management also has considerable discretionary freedom in decision-making so that its behaviour which is averse to risk has an effect on investment decisions. Managers behave averse to risk because they generally have to accept income losses if they change their job involuntarily. Both arguments, imperfections on the capital market and management behaviour that is averse to risk, support having to take into account what effect a more volatile economic environment has on investment behaviour. Only if the firms behaved neutrally as regards risk would more frequent shocks have no significance in decisions regarding investment. In the case of centralised wage negotiations the wages are not orientated towards the particular firm's profits. Thus the risk of investments in real capital is higher and the investment activity in the economy as a whole is more likely to be lower with centralised than with decentralised wage negotiations as a result of

the risk aspect. The empirical significance of this argument can be substantiated by the fact that especially in young and innovative firms the pay is frequently linked to the business profit, so that a considerable part of the firm-specific risk is passed on to the employees.

In addition to this, the argument that with a centralised organisation of wage negotiations there is a greater possibility of an agreement to go without wage rises today in order to facilitate higher investment in real capital and consequently even greater wage increases tomorrow seems dubious.<sup>49</sup> Firstly such "standstill agreements" suffer from the classical problem of externalities. The positive returns are concentrated on the employees in whose firms the wage restraint leads to greater investments, whilst the rest of the workers come away largely empty-handed. Secondly it is more difficult to check at central level whether the profits made are really invested in real capital within the country. Thirdly such centrally organised "standstill agreements" usually only come into existence as a result of intervention by the state. The state then generally guarantees efficiency-reducing special advantages to both of the groups involved. The costs of these advantages often only come to light with a delay and are usually passed on to taxpayers, consumers and above all the future generations without the individual noticing much. All three of these problems only occur to a lesser extent however with decentralised wage negotiations so that "standstill agreements" are more likely to come into being at firm level without efficiency-reducing state involvement. On the whole the argument which is frequently presented that decentralised wage negotiations or also the introduction of a profit-sharing component in the wages have a negative effect on the real investment activity must be called into question in the light of the above arguments. The reverse relationship seems more likely to apply.

Finally, minimum wages fixed bindingly at central level also reduce individual performance incentives as well as the willingness to invest increasingly above all in firm-specific human capital. As a result of this the gains in labour productivity and in economic growth decline. Individual performance incentives and the formation of firm-specific human capital are of little importance for the level of national income only when the economy produces primarily standardised, so-called Fordist products and is in a technological catching-up process. However this situation hardly exists any longer in Germany. It is more the case that the production structure is developing away from largely standardised, Fordist mass goods and towards more sophisticated and higher-quality "high-tech" products which can be used more flexibly. This post-Fordist production method stands out for a flexible specialisation in production technology. As the individual products are only produced in small numbers, returns to scale can not be taken advantage of so well.<sup>50</sup>

The more this technological catching-up process is completed and the more markedly the focus of production shifts towards "high-tech" goods, the more the economy is forced to create technological knowledge itself. In such an envi-

ronment highly qualified activities gain importance and thus also the firm-specific human capital, so that the question increasingly arises as to how workers can be motivated and trained also by means of appropriately arranged wage contracts. It is therefore becoming more and more important to use flexible qualification-related and sectoral wage structures and a high wage dispersion as incentive instruments. It must be borne in mind here, though, that firms' most important parameter of response to increased international competitive pressure in a post-Fordist environment is the introduction of innovative technologies and products. But this necessarily demands more decentral decision-making powers in order in this way to gain information and response advantages over the competitors. Not least for these reasons workers' pay must also be increasingly orientated towards success. Thus the firms require great leeway in the wage structure and wage level, which is ultimately only possible with decentralised wage negotiations.<sup>51</sup>

106

With a rapidly accelerating technological change in which the activities of the individual workers and firms are constantly becoming more heterogeneous, it is also more and more problematic to fix at central level wage groups into which the individual workers are pressed. The information problem increases so that central solutions become more inefficient. After all the information problem is known to have been partly responsible for the failure of the central administrative economies of Eastern Europe. It is almost inevitable that regulations made at central level overly restrict the management's freedom to use wage incentives to promote the workers' productivity.<sup>52</sup> As centralised wage negotiations weaken the workers' incentive to form human capital, however, this then also causes a reduction in investment in real capital. This is immediately clear if it is borne in mind that human capital is a complementary production factor to real capital. Therefore in a world that is characterised meanwhile by post-Fordist production methods in which the generation of rents at firm level by building up information and response advantages over the competitors is gaining in importance, these aspects support the idea of giving preference to decentralised wage negotiations with regard to micro-flexibility.<sup>53</sup>

#### ***Degree of centralisation of wage negotiations and macro-flexibility***

The next task is to check the thesis which is frequently stated that centralised wage negotiations result in a lower wage pressure than decentralised ones do, so they have a positive effect on a country's macro-flexibility. In order to discuss the problem of macro-flexibility, in the following the central idea of the hump shape hypothesis mentioned earlier is presented. Then it is shown that decentralised wage negotiations are ultimately superior with regard to macro-flexibility, too.<sup>54</sup>

The hump shape hypothesis claims that both centralised and decentralised wage negotiations lead to wage restraint and thus to favourable employment results, whilst wage negotiations at middle level such as at industry level foster aggressive wage increases, therefore causing employment losses.<sup>55</sup> This theoretical



result arises as follows. With decentralised wage negotiations at firm level those with jobs have no freedom in wage setting. As an individual firm is virtually unable to pass aggressive wage rises on to the prices, the immediate result is lay-offs. If the wage negotiations are conducted at industry level, on the other hand, then the firms have a certain scope for price setting because those with demand for the goods can not easily switch over to products from other industries. The temptation to enforce excessive wage agreements is therefore far higher at industry level because the related employment losses are smaller. The costs of excessive wages can largely be passed on to the rest of the economy in the form of higher prices for goods. As all industry-wide trade unions behave in this way, though, the wage rise pressure is too great on the whole so that macroeconomic employment losses are the inevitable consequence. The situation with wage negotiations at central level is different again. On the one hand the trade union's negotiating power is very great in this case because it is ultimately able to bring the whole economy to a standstill. On the other hand, however, at least in a closed economy no more costs can be passed on because an increase in unemployment and inflation must ultimately always be borne by the members of the centrally organised trade union. In this respect there is no longer any incentive to enforce excessive wage agreements. Therefore both centralised wage negotiations trusting in social consensus and decentralised wage negotiations orientated towards competition lead to wage restraint and thus to similarly good employment results, whereas wage negotiations at middle industry level lead to poorer employment results.

However, there is a number of weighty arguments in favour of ultimately preferring decentralised wage negotiations also with respect to macro-flexibility. Increased international trade and an accelerating structural change increase the probability of data changes arising which concern specific sectors, regions and worker groups. Such specific data changes can, however, be dealt with far better by decentralised wage negotiations because they permit greater flexibility in the wage structures and a greater wage dispersion. In addition to that, with centralised wage negotiations there are generally partially informal subsequent negotiations at firm level, also in order to defuse the problem of micro-inflexibility. The central wage agreements are therefore only binding at the lower end and not at the upper end so that the conflict between unemployed people and those with jobs is not really alleviated. These subsequent negotiations generally take place under a duty to refrain from industrial action, which means that the employees are not allowed to strike and the employers have to pay at least the wage agreed at central level.<sup>56</sup> Nonetheless the employees are able to exert considerable pressure on the firms by threatening to work to rule or by using code-termination rights that they are entitled to. Such wage agreements at several levels tend to lead to greater wage pressure than when negotiations are conducted at one level only, which can only realistically be the case with decentralised wage negotiations. Furthermore, relatively high wage agreements at central level also reduce the firms' possibilities to fan out the wage structure by means of voluntary supplements in order to alleviate incentive problems. Thus wage negotia-

tions at several levels intensify both the problem of macro-inflexibility and that of micro-inflexibility.<sup>57</sup>

This can also be shown if the case of Sweden is examined more closely, a country which was for a long time a perfect example of centralised wage agreements and allegedly of moderation in real wages. In Sweden restraint in real wages was achieved not by concessions in the nominal wages but by the acceptance of considerable, discretionary devaluations of the nominal exchange rate and, in the wake of this, acceptance of high inflation rates compared with the average of the OECD states. High inflation rates are, however, probably a necessary condition for central wage negotiations to function. If nominal wages are downwardly rigid both at central level and at the subsequent negotiation levels, then real wage restraint connected with an adequate wage differentiation with a relatively low trend growth of labour productivity requires the acceptance of higher inflation rates. If great importance is attached to the aim of price stability then this is a serious disadvantage of centralised wage negotiation systems.<sup>58</sup>

The moderation in real wages in Sweden caused by the relatively high inflation rates was, however, by no means so marked that it could explain satisfactorily the considerably better employment trend that prevailed for a long time. This is easier to do if one takes into account the enormous over-expansion of state employment and of active labour market policy as well as the increasing tax burden and national debt which inevitably accompany this. However, this is not a specifically Swedish phenomenon; it can be observed generally that countries with a high degree of centralisation in wage negotiations put a lot of money into active labour market policy. In such countries the state therefore easily degenerates to a repair firm for a wage policy that is not orientated sufficiently towards employment.<sup>59</sup> In these countries the two sides of industry are more likely to manage to take the state hostage with regard to employment policy and to blur the economic-policy distribution of tasks that is actually sensible in economic terms.

In conclusion it can thus be stated that decentralised wage negotiations have a positive effect these days not only on micro-flexibility but also on macro-flexibility. Alliances for work should therefore be established at firm level and not for instance at the national level with intervention from the government. It is important, however, to arrange decentralised wage negotiations in such a way that the people in employment are not in a position to block new hirings. The legislator should therefore exercise great restraint in the case of statutory dismissal costs and legally imposed co-determination rights for the staff in company decisions, so at least from this point of view the expansion of employees' co-determination rights which was initiated under the Schröder-government was counter-productive.<sup>60</sup>

Besides the reduction of statutory dismissal costs, the transition to more decentralised wage negotiations thus constitutes the most important point of depar-

ture to make the wage setting behaviour not only more restrained but above all also more flexible and more differentiated with regard to qualifications, sectors and regions. In today's economic environment, which is characterised by a high degree of volatility and a rapid structural change, firms require greater freedom in decision-making in order to be able to respond more rapidly in particular to crisis situations. It is therefore indispensable to shift the wage negotiation competences, too, as quickly as possible from sectoral level to firm level.

### ***The transition to more decentralised wage negotiations***

It is not surprising therefore that a development towards more decentralised wage negotiations can be observed in numerous OECD countries. In these OECD countries economic rule already seems to be asserting itself against political force. What is problematic, however, is that Germany is clearly lagging behind in this decentralisation process.<sup>61</sup> Therefore the question arises as to how the transition to a more decentralised collective bargaining policy can take place in Germany, too, and how it might be speeded up. The rigorous solution is to cancel entirely § 77 paragraph 3 of the Law on Labour Relations at the Workplace ("Betriebliche Regelungssperre/Betriebsverfassungsgesetz") so that wage negotiations at firm level would be admissible without restriction. The huge resistance against this path which can still be observed today makes it seem rather unlikely however that this logical solution can be reached within the foreseeable future. The radical alternative is that no statutory and/or collectively agreed flexibilisation steps are undertaken and the corporatist state disintegrates gradually or even eruptively under the pressure of economic constraints. This process can take a very long time, however, and is in this respect associated with substantial efficiency losses. If, furthermore, one wishes to avoid the eruptive and thus also largely uncontrolled collapse of the corporatist state, the thing to do would be to delegate decision-making competences to the firms rapidly and in a controlled way in order to create scope for flexibility and to reinforce the capacity to adapt to shocks. Such a way is in all probability not associated with a complete loss of competence on the part of the unions, so it should also be in their interest.

In the meantime there are numerous suggestions in literature as to what shape this could take with an institutional arrangement of wage negotiations that is in principle unchanged to begin with.<sup>62</sup> A first suggestion is that the collectively agreed wages effective at sectoral or regional level continue to provide the collectively agreed framework for the working time and the level of pay, but that this can be deviated from at firm level. The employees both in firms bound by collective agreements and in firms which are not can then in principle decide with a qualified majority about whether they wish to deviate from the sectoral or regional wage agreement. In addition to the works council, all other coalitions of workers are also able to be a party to a collective agreement. In general, sectoral or regional wage agreements should in future include the option that with regard to the wage level the individual firms can deviate in a downward direction if the firm and the works council simultaneously agree on a certain level of employ-

ment or if the firm introduces in return an adequate profit-sharing component in the pay.<sup>63</sup> In addition to this it would also be possible simply to fix at union level a corridor within which the wage rises have to move. Furthermore the collective agreements should increasingly include hardship clauses and exemption clauses permitting the firms to pay less than the centrally agreed wage rises during times of crisis. Finally lower entry wages should be created for problem groups such as the long-term unemployed, new entrants to the labour market and older workers.

It is the responsibility of the legislator to accompany positively such a policy of shifting decision-making competences to firm level. The legislator will do this task justice if he firstly changes the Law on Labour Relations at the Workplace to the effect that remuneration and other conditions of employment may in future also be regulated unequivocally by means of a works agreement. Secondly the principle of favourability ("Günstigkeitsprinzip") in the Collective Bargaining Act should be arranged in such a way that it can also be to the employee's advantage if he or she is paid below the agreed wage rate but in return keeps his job or is employed at all. Thirdly the legislator should make more precise at least the criteria regarding when a declaration of general application of collectively agreed wages ("Allgemeinverbindlichkeitserklärung") is in the interest of the general public.<sup>64</sup> What would be even better, though, is to abolish the institution of the declaration of general application entirely straight away.

110

## 5.2 CONCLUDING REMARKS

To summarize it can be stated that a therapy for the persisting employment crisis in Europe which is adequate for the causes must amount mainly to a permanent strengthening of the market forces above all on the labour market. It is frequently pointed out that there are numerous causes of unemployment and that therefore a mono-causal explanatory approach does not do justice to the complexity of the problem. However, even if this is without doubt right, it must still be emphasised from an economic point of view that wage moderation and flexible wage structures as well as the unemployed showing a high level of willingness to work are crucial requirements for permanently good employment results. Countries such as the USA, which put their trust in this market-economy principle of a flexible price to balance supply and demand also on the labour market, prove to be superior to the more corporatist countries of Europe with regard to economic and employment growth in the longer term. Of course even on a competitive labour market the wage level and the wage structures are not perfectly flexible. The pronounced rigidity of these two factors in Germany, however, can be attributed decisively to state interventions. It is essential to reduce these rigidities which have political causes if one is interested in a longer-term improvement in the employment results. As the market forces on the labour market have been largely restricted by the government it is not possible to hope that together with a start of economic growth they will suffice to reduce unemployment deci-

sively. What is necessary is more an offensive in favor of giving market forces greater leeway on all markets, but especially on the labour market.

Such an offensive focussing must revive the price mechanism on the labour market and thus contribute to a more moderate and more flexible wage setting behaviour. A reduction of all statutory regulations which grant privileges to the people with jobs at the expense of those without helps towards this aim. An extensive reduction of statutory dismissal costs is an important step in this direction. In addition to this the trend that can be observed internationally towards more decentralised wage negotiations helps to make wage setting behaviour become more restrained and above all more flexible. In this respect it must be classified as a disadvantage from a German viewpoint that Germany is lagging behind other countries in the development towards more decentralised wage negotiations. All the statutory regulations that help to stabilise the current wage bargaining cartel should be put under the microscope.

However, it will hardly be possible even in the medium term to reduce the existing mass unemployment extensively solely by means of a change in the course of wage policy. What is also required are additional measures which specifically help to reintegrate the (long-term) unemployed into the labour market. A first key point of departure for this is the arrangement of the transfer payments to the unemployed, that is unemployment benefit, unemployment assistance and social assistance. In their present form all of these systems foster the emergence of long-term unemployment. From an economic point of view unemployment assistance is absurd and foreign to the system. It should be abolished.

Unemployment benefit should only be paid for a shorter period and should also be gradually reduced. If in addition the criteria of what an unemployed person has to accept in a job are tightened, then the result that can be expected from all these measures together is a lasting increase in the search intensity of the unemployed. Social assistance should finally be paid to unemployed people who are able to work only on condition that they are willing to work.

The state should also help the unemployed to get back into the regular labour market. As a result of the numerous problems associated with this, however, the state should make less use of state training and employment schemes and on no account use general wage subsidies that are unlimited as regards time. It makes more sense to permit the unemployed, depending on the length of their unemployment, to convert some of their entitlement to state benefits into wage subsidies for a limited period. This would reduce the "unemployment trap" which generally exists in Europe's welfare states, and would in addition help the unemployed to build up human capital again "on the job".

Having the right remedies is one thing, implementing them in a democracy is another. It is particularly difficult because although all the measures that seem suitable for permanently improving the situation on the labour market do improve the situation of many people, there are always also some who lose, even

if only temporarily and in relation to the winners. Therefore the question as to how it can be possible to steer clear of these political-economy cliffs and actually to carry through employment-enhancing measures in the political decision-making process is one which is extremely complex and remains largely unanswered. A considerable number of the proposed measures affect without a doubt the vested rights of the people with jobs. As these people exert an especially great influence on political decisions, however, considerable difficulties have to be expected when such painful interventions are translated into policy. State interventions in the labour markets' capacity to function fulfil an important political-economy function. They create a greater political middle class, which is interested in political stability and in maintaining the status quo. In this way they are useful to both politicians and people with jobs. But this is at the expense of the unemployed and at the expense of future generations, because economies with persistently high unemployment suffer growth losses. The dreadful employment situation must therefore be regarded altogether as a political-economy problem.

However, this political-economy problem does not mean that it is permanently impossible to deregulate the labour market politically.<sup>65</sup> The transition from the currently rigid labour market to a considerably more flexible one is probably easiest to pull off if at least the following conditions are met. This requires firstly Schumpeterian political entrepreneurs who credibly make their trademark a market-economy orientation in economic policy. They must resolutely put through an extensive package of measures to strengthen the market forces. The chances of successfully implementing such a programme of reforms increase secondly if it includes a certain amount of compensation for those who lose out as a result of the reforms, and additional demand-policy measures. The latter contribute towards the positive employment effects not taking too long to happen, without the inflation rate rising as a result. In addition to this, thirdly, the right timing is of crucial importance. From a political-economy viewpoint it makes sense to tackle an extensive package of radical reforms immediately after a change of government.

Such an offensive in favor of strengthening market forces is, however, in any case only implementable in political terms when there is an appropriate pressure to make decisions and if the principle of the institutions of a market economy once again meets with a greater agreement in the population. Only a government that pursues the fundamental principles of competition on all markets will have the power and credibility to liberalise a labour market which is particularly explosive politically. For this reason alone a consistent liberalisation of the labour market should be connected with an appropriate policy of deregulation also on the goods and capital markets. This makes additional sense because especially the existence of monopoly rents on the goods and capital markets stirs up distribution conflicts and reinforces the incentive for the job-holders to cartelise the labour market and in this way to skim off part of these monopoly rents. Finally an arrangement of the goods and capital markets that is more competition-

orientated is needed to achieve a higher rate of new business start-ups and the creation of innovative products that are strong in added value. Without the boost in economic dynamics triggered off by this, it will hardly be possible to get the employment problems in Europe under control.<sup>66</sup> On the whole, however, irrespective of all the political-economy difficulties, more market is to be expected in any case on the labour market, too, in the longer-term. The visible rapid technological change, which is increasingly pushing low-skilled workers out of the production process, and the rapid globalisation of the markets will gradually weaken the blockade attitude of the people with jobs, thus smoothing the way for reforms.

If it is therefore possible sooner or later to grant right of way again to a way of “neoliberal” thinking and to push the employment aim into the foreground again in economic and collective bargaining policy, then this is also the best distribution policy in the medium- to longer-term. The unemployed are best helped if they are able to perform a regular job. If appropriate reforms get investment activity going again, then lasting employment gains can be achieved without the workers losing income permanently. As the examples of other successful reform countries such as Holland, Great Britain or New Zealand have impressively shown, when investment activity is started up it opens up to the same extent the scope for employment gains and wage increases in the long run. Therefore it is essential to stand up to pessimism and fatalism in view of the persisting mass unemployment. Unemployment is not an inevitable fate but can be avoided to quite a large extent by improving institutional conditions. However, the exciting question as to how the necessary political majorities can be forged from this knowledge remains largely unanswered.

## NOTES

- <sup>1</sup> Cf. Fehn (2002).
- <sup>2</sup> Cf. Siebert (1997); international comparisons of labour market flexibility have regularly come to the result recently that with regard to labour market flexibility Germany ranks lowest among the group of OECD countries and newly industrialised countries, which persistently underlines the need for action in economic policy; cf. for example Gwartney et al. (2001).
- <sup>3</sup> Cf. Eichhorst et al. (2001) and Fehn (1997).
- <sup>4</sup> Cf. OECD (2001).
- <sup>5</sup> Cf. Fehn (2002).
- <sup>6</sup> Cf. Berthold, Fehn and Thode (2000).
- <sup>7</sup> Cf. Jerger and Landmann (2001) and Berthold, Fehn and Thode (2002).
- <sup>8</sup> Since the attacks of 11 September 2001 in particular the USA has been pursuing such an expansionary monetary and fiscal policy, though there must be some doubt as to whether the USA is overdoing its demand-policy response. Especially the fiscal policy package could ultimately have a pro-cyclical effect because it is only now really being got under way but the cyclical recovery is already beginning to emerge.
- <sup>9</sup> Cf. Berthold and Fehn (1997a).
- <sup>10</sup> Cf. Lindbeck and Snower (2000).
- <sup>11</sup> Cf. Eichhorst et al. (2001).
- <sup>12</sup> Cf. OECD (2001).
- <sup>13</sup> For a comprehensive analysis of active labour market policy, see Steiner and Hagen (2000), Schmidt et al. (2001) and Berthold, Fehn and von Berchem (2001).
- <sup>14</sup> Cf. Hunt (1995), Nickell (1997), Layard et al. (1991) and Bover et al. (1998).
- <sup>15</sup> A more detailed description of the German unemployment benefit system can be found in Steiner (1997).
- <sup>16</sup> Cf. Leef (1998) and Orszag and Snower (1997).
- <sup>17</sup> Cf. Layard et al. (1991).



- <sup>18</sup> Cf. Alogoskoufis et al. (1995, 104-108); for a comprehensive overview of possibilities of reforming the arrangement of unemployment insurance, see Snower (1995, 635-646).
- <sup>19</sup> Cf. Baicker et al. (1997) and Anderson and Meyer (1994).
- <sup>20</sup> Cf. Hopenhayn and Nicolini (1997), Wang and Williamson (1996) and Meyer (1995).
- <sup>21</sup> Cf. Steiner (1997).
- <sup>22</sup> The benefit entitlement is calculated as 57 percent of the benefit assessment basis if the recipient has at least one child in the sense of § 32 paras.1, 3 to 5 of the Income Tax Act, and otherwise 53 percent. The basis used is the remuneration liable to contributions which the unemployed person received on average in the last twelve months before becoming unemployed. The taxes and social insurance contributions that are usually incurred by employees are then deducted from this gross payment or assessment payment. This flat-rate net remuneration then constitutes the benefit assessment basis.
- <sup>23</sup> Cf. Boss (2001).
- <sup>24</sup> The so-called "benefit transfer program" constitutes an important proposal pointing in this direction; cf. among others Snower (1994), Orszag and Snower (2000) and Berthold and Fehn (1997b); Siebert and Klodt (1991) also made a similar suggestion.
- <sup>25</sup> Cf. Berthold, Fehn and von Berchem (2001).
- <sup>26</sup> Cf. Siebert (1996, 3 f.) and Sachverständigenrat (German Council of Economic Experts) (1995, 332 ff.); Lehment (1991) shows empirically that a restrained wage policy in which the wage increases lie below the growth in net added value really leads to a significant growth in employment with a certain time lag. Productivity increases which were obtained only by means of preceding job cuts can not be used as justification for wage increases, however. This is why the frequently used international comparison of unit labour costs is not suitable for determining whether a country has a wage cost problem.
- <sup>27</sup> Cf. Berthold and Fehn (1996a), and Deregulierungskommission (Deregulation Commission) (1991, 253-274).
- <sup>28</sup> Cf. Lindbeck and Snower (1988, 264), Wenger (1988, 468 f.) and Möschel (1996, 46).
- <sup>29</sup> From time to time it is argued that high dismissal costs contribute to wage moderation, which the employees practise in return for their better protection against the injustices of the development on the market. However, this viewpoint is only appropriate if it is a matter of a voluntary agreement at firm level or in the improbable event that the trade unions commit themselves explicitly and credibly to a constant

course of wage restraint in return for an extension of the statutory dismissal protection. However, once the statutory dismissal protection has been tightened, then the insiders' scope for wage setting increases in any case compared with that of the firms, and only a credible threat from the government to reduce it again might discipline the insiders.

<sup>30</sup> Cf. Eichhorst et al. (2001), Fehn (2002) and Berthold, Fehn and Thode (2002).

<sup>31</sup> Cf. Saint-Paul (2002).

<sup>32</sup> Cf. Bentilola and Bertola (1990).

<sup>33</sup> Cf. Deregulierungskommission (1991), Schellhaaß (1996, 61-69).

<sup>34</sup> Cf. Deregulierungskommission (1991, 261).

<sup>35</sup> For a definition of mass dismissals cf. Deregulierungskommission (1991, 212).

<sup>36</sup> Cf. Schnabel (1993, 260 f.) and Pohjola (1992, 44 ff.).

<sup>37</sup> Cf. Bruno and Sachs (1985).

<sup>38</sup> Cf. Lindbeck (1993).

<sup>39</sup> Cf. Calmfors and Driffill (1988).

<sup>40</sup> Cf. Ramaswamy and Rowthorn (1993) and Brown and Walsh (1994, 381).

<sup>41</sup> Cf. Freeman and Gibbons (1993), Ramaswamy and Rowthorn (1993) and Sachverständigenrat (German Council of Economic Experts) (1994, 261).

<sup>42</sup> Cf. Meidner (1974).

<sup>43</sup> Cf. Rowthorn (1992, 512) and Moene et al. (1993, 119).

<sup>44</sup> Cf. Paqué (1994).

<sup>45</sup> Cf. Moene et al. (1993, 113 f.).

<sup>46</sup> Cf. Weitzmann (1987).

<sup>47</sup> Cf. Moene et al. (1993).

<sup>48</sup> Cf. Fehn (2002).

<sup>49</sup> Cf. Eichengreen (1994).

- <sup>50</sup> Cf. Ramaswamy and Rowthorn (1993), Soskice (1990, 52 f.) and Katz (1993).
- <sup>51</sup> Cf. Brown and Walsh (1994, 387 f.), Ramaswamy (1994, 377) and Calmfors (1993).
- <sup>52</sup> Cf. Lindbeck (1993) and Brown and Walsh (1994, 386).
- <sup>53</sup> Cf. Ramaswamy (1994), Ramaswamy and Rowthorn (1993) and Pohjola (1992, 78).
- <sup>54</sup> Cf. Berthold and Fehn (1996a).
- <sup>55</sup> Cf. Calmfors and Driffill (1988).
- <sup>56</sup> Cf. Moene et al. (1993, 100-103), Calmfors (1993).
- <sup>57</sup> Cf. Lindbeck (1993) and Calmfors (1993, 36).
- <sup>58</sup> Cf. Calmfors (1993), Lindbeck (1993) and Ramaswamy (1994, 374).
- <sup>59</sup> Cf. Berthold and Fehn (1997b).
- <sup>60</sup> For a more detailed analysis cf. Berthold and Stettes (2001).
- <sup>61</sup> Cf. Berthold and Fehn (1996a).
- <sup>62</sup> Cf. Sachverständigenrat (German Council of Economic Experts) (1995, 339-346).
- <sup>63</sup> A comprehensive analysis of profit-sharing plans is provided by Schares (1996).
- <sup>64</sup> Cf. Sachverständigenrat (German Council of Economic Experts) (1995, 343).
- <sup>65</sup> Cf. Berthold and Fehn (1996b).
- <sup>66</sup> Cf. in detail on this issue Fehn (2002) and Belke and Fehn (2002).

## REFERENCES

- Alogoskoufis, G. u.a. (1995): *Unemployment: Choices for Europe*, CEPR Report: *Monitoring European Integration 5*, London.
- Anderson, P. and B. Meyer (1994): *The Effects of Unemployment Insurance Taxes and Benefits on Layoffs Using Firm and Individual Data*, NBER Working Paper No. 4960, Cambridge MA.
- Baicker, K. u.a. (1997): *A Distinctive System: Origins and Impact of u.s. Unemployment Compensation*, NBER Working Paper 5889, Cambridge MA.
- Belke, A. and R. Fehn (2002): *Institutions and Structural Unemployment: Do Capital-Market Imperfections Matter?* Published in: *ifo Studien*.
- Bentilola, S. and G. Bertola (1990): *Firing Costs and Labour Demand: How Bad is Eurosclerosis?* in: *Review of Economic Studies*, Vol. 57, S. 381-402.
- Berthold, N. and R. Fehn (1996a): *Evolution von Lohnverhandlungssystemen - Macht oder ökonomisches Gesetz?*, in: Zohlnhöfer, W. (Hrsg.): *Die Tarifautonomie auf dem Prüfstand, Schriften des Vereins für Socialpolitik*, N. F. Band 244, Berlin, S. 57-94.
- Berthold, N. and R. Fehn (1996b): *The Positive Economics of Unemployment and Labor Market Inflexibility*, in: *Kyklos*, Vol. 49, No. 4, S. 583-613.
- Berthold, N. and R. Fehn (1997a): *Das Beschäftigungspotential einer flexibleren qualifikatorischen Lohnstruktur*, in: Sadowski, D. and M. Schneider (Hrsg.): *Vorschläge zu einer neuen Lohnpolitik: Optionen für mehr Beschäftigung I*, Frankfurt am Main/New York, S. 71-99.
- Berthold, N. and R. Fehn (1997b): *Aktive Arbeitsmarktpolitik - wirksames Instrument der Beschäftigungspolitik oder politische Beruhigungsspielle?* in: *Ordo* 48, S. 411-435.
- Berthold, N., Fehn, R. and E. Thode (2000): *Rigider Arbeitsmarkt oder ungleiche Einkommensverteilung - Ein unlösbares Dilemma?* In: *Zeitschrift für Wirtschaftspolitik*, Vol. 49 (2000), Heft 1, S. 3-26.
- Berthold, N., Fehn, R. and E. Thode (2002): *Falling Labor Share and Rising Unemployment: Long-Run Consequences of Institutional Shocks?* Published in: *German Economic Review*, Vol. 3 (4).
- Berthold, N., Fehn, R. and S. von Berchem (2001): *Innovative Beschäftigungspolitik - Wege aus der Strukturkrise*, Studie im Auftrag der Herbert Quandt-Stiftung, Bad Homburg v.d. Höhe.
- Berthold, N. and O. Stettes (2001): *Die betriebliche Mitbestimmung in Deutschland: Gratwanderung zwischen Markt- und Staatsversagen*, WiSt, Bd. 30 (10): 506-512.
- Boss, A. (2001): *Sozialhilfe, Lohnabstand, Leistungsanreize und Mindestlohnarbeitslosigkeit*, Kieler Arbeitspapier Nr. 1075, Institut für Weltwirtschaft, Kiel.
- Bover, O. u.a. (1998): *Unemployment Duration, Benefit Duration and the Business Cycle*, CEPR Discussion Paper No. 1840, London.
- Brown, W. and J. Walsh (1994): *Corporate Pay Policies and the Internationalization of Markets*, in: Niland, J. u.a. (Hrsg.): *The Future of Industrial Relations: Global Change and Challenges*, London u.a., S. 377-388.
- Bruno, M. and J. Sachs (1985): *Economics of Worldwide Stagflation*, Oxford.
- Calmfors, L. (1993): *Centralization of Wage Bargaining and Macroeconomic Performance - A Survey*, Seminar Paper No. 536, Institute for International Economic Studies, Stockholm.

- Calmfors, L. and J. Driffill (1988): Bargaining Structure, Corporatism and Macroeconomic Performance, in: *Economic Policy*, Vol. 6, S. 13-61.
- Deregulierungskommission (1991): *Marktöffnung und Wettbewerb - Zweiter Bericht: Der Arbeitsmarkt*, Bonn.
- Eichengreen, B. (1994): *Institutions and Economic Growth: Europe after World War II*, CEPR Discussion Paper No. 973, London.
- Eichhorst, W., Profit, S. and E. Thode (2001): *Benchmarking Deutschland: Arbeitsmarkt und Beschäftigung*, Bericht der Arbeitsgruppe Benchmarking und der Bertelsmann Stiftung, Berlin u.a.
- Fehn, R. (1997): *Der strukturell bedingte Anstieg der Arbeitslosigkeit in Europa: Ursachen und Lösungsansätze*, Baden-Baden.
- Fehn, R. (2002): *Schöpferische Zerstörung und struktureller Wandel: Wie beeinflussen Kapitalbildung und Kapitalmarktunvollkommenheiten die Beschäftigungsentwicklung*, Habilitationsschrift, Baden-Baden 2002 (erscheint demnächst).
- Freeman, R. and R. Gibbons (1993): *Getting Together and Breaking Apart: The Decline of Centralized Bargaining*, NBER Working Paper No. 4464, Cambridge MA.
- Gwartney, J. u.a. (2001): *Economic Freedom of the World*, Annual Report, The Fraser Institute, Vancouver.
- Hopenhayn, H. and J. Nicolini (1997): Optimal Unemployment Insurance, in: *Journal of Political Economy*, Vol. 105, No. 21, S. 412-438.
- Hunt, J. (1995): The Effect of Unemployment Compensation on Unemployment Duration in Germany, in: *Journal of Labor Economics*, Vol. 13, No. 1, S. 88-120.
- Jerger, J. and O. Landmann (2001): *Güternachfrage und Beschäftigung*, WiSt, Bd. 30 (3): 143-149.
- Katz, L. (1993): The Decentralization of Collective Bargaining: A Literature Review and Comparative Analysis, in: *Industrial and Labor Relations Review*, Vol. 47, No. 1, S. 3-22.
- Layard, R. u.a. (1991): *Unemployment, Macroeconomic Performance and the Labour Market*, Oxford.
- Leef, G. (1998): Unemployment Compensation - The Case for a Free Market Alternative, in: *Regulation* (Winter 1998).
- Lehment, H. (1991): Lohnzurückhaltung, Arbeitszeitverkürzung und Beschäftigung - Eine empirische Untersuchung für die Bundesrepublik Deutschland 1973-1990, in: *Die Weltwirtschaft*, Heft 3, S. 72-85.
- Lindbeck, A. (1993): *Unemployment and Macroeconomics*, Cambridge MA, London.
- Lindbeck, A. and D. Snower (1988): *The Insider-Outsider Theory of Employment and Unemployment*, Cambridge (Mass.), London.
- Lindbeck, A. and D. Snower (2000): *The Division of Labor and the Market for Organizations*, CESifo Working Paper 267, München.
- Meidner, R. (1974): *Coordination and Solidarity: An Approach to Wage Policy*, Stockholm.
- Meyer, B. (1995): Lessons from the u.s. Unemployment Insurance Experiments, in: *Journal of Economic Literature*, Vol. 33, S. 91-131.
- Moene, K.O. u.a. (1993): Bargaining Structure and Economic Performance, in: Flanagan, R. u.a. (Hrsg.): *Trade Union Behaviour, Pay-Bargaining and Economic Behaviour*, FIEF Studies in Labour Markets and Economic Policy, Oxford, S. 63-131.

- Möschel, W. (1996): Ist die Tarifautonomie noch zeitgemäß? in: *Zeitschrift für Wirtschaftspolitik*, 45. Jahrgang, Heft 1, S. 39-48.
- Nickell, S. (1997): Unemployment and Labour Market Rigidities: Europe versus North America, in: *Journal of Economic Perspectives* 11 (3), S. 55-74.
- OECD (2001): *Employment Outlook*, Paris.
- Orszag, M. and D. Snower (1997): *Expanding the Welfare System: A Proposal for Reform*, CEPR Discussion Paper No. 1674, London.
- Orszag, M. and D. Snower (2000): *The Effectiveness of Employment Vouchers: A Simple Approach*, German Economic Review, Vol. 1 (4): 385-419.
- Paqué, K. H. (1994): *Unemployment and the Crisis of the German Model. A Long-Term Interpretation*, Working Paper No. 655, Institut für Weltwirtschaft, Kiel.
- Pohjola, M. (1992): Corporatism and Wage Bargaining, in: Pekkarinen, J. u.a. (Hrsg.), *Social Corporatism: A Superior Economic System*, Oxford, S. 44-81.
- Ramaswamy, R. (1994): *The Structural Crisis in the Swedish Economy: The Role of Labor Markets*, in: IMF Staff Papers, Vol. 41, No. 2, S. 367-379.
- Ramaswamy, R. and R. Rowthorn (1993): *Centralized Bargaining, Efficiency Wages and Flexibility*, IMF Working Paper No. 25, Washington D.C.
- Rowthorn, R. (1992): Centralization, Employment, and Wage Dispersion, in: *The Economic Journal*, Vol. 102, S. 506-523.
- Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (1994): *Jahresgutachten 1994/95: Den Aufschwung sichern - Arbeitsplätze schaffen*, Stuttgart.
- Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (1995): *Jahresgutachten 1995/1996: Im Standortwettbewerb*, Stuttgart.
- Saint-Paul, G. (2002): Employment Protection, International Specialization, and Innovation, *European Economic Review*, Vol. 46 (2): 375-395.
- Schellhaaß, H.M. (1996): *Die Zukunft des Arbeitsmarktes - Wege zu mehr Beschäftigung*, Frankfurter Institut - Kleine Handbibliothek, Band 17, Bad Homburg.
- Schmidt, C. u.a. (2001): *Perspektiven der Arbeitsmarktpolitik - Internationaler Vergleich und Empfehlungen für Deutschland*, Berlin u.a.
- Schnabel, C. (1993): Korporatismus, zentralisierte Tarifverhandlungen und makroökonomische Performance, in: *Zeitschrift für Wirtschaftspolitik*, Jahrgang 42 (1993), Heft 3, S. 259-272.
- Siebert, H. (1996): *Hundert Punkte für mehr Beschäftigung*, Kieler Diskussionsbeiträge Nr. 264, Institut für Weltwirtschaft, Kiel.
- Siebert, H. (1997): Labor Market Rigidities - At the Root of Unemployment in Europe, *Journal of Economic Perspectives*, Vol. 11 (3): 37-54.
- Siebert, H. and H. Klodt (1991): *Qualifizierungsgutscheine: Eintrittskarten in den Arbeitsmarkt*, Diskussionpapier Nr. 175, Institut für Weltwirtschaft, Kiel.
- Snower, D. (1994): *The Simple Economics of Benefit Transfers*, CEPR Discussion Paper No. 1086, London.
- Snower, D. (1995): Unemployment Benefits: An Assessment of Proposals for Reform, in: *International Labour Review*, Vol. 134, S. 625-647.
- Soskice, D. (1990): Wage Determination: The Changing Role of Institutions in Advanced Industrialized Countries, in: *Oxford Review of Economic Policy*, Vol. 6, No. 4, S. 36-61.

- Steiner, V. (1997): *Extended Benefit-Entitlement Periods and the Duration of Unemployment in West Germany*, ZEW Discussion Paper No. 97-14, Mannheim.
- Steiner, V. and Hagen, T. (2000), *Von der Finanzierung der Arbeitslosigkeit zur Förderung von Arbeit - Analysen und Handlungsempfehlungen zur Arbeitsmarktpolitik*, ZEW - Wirtschaftsanalysen, Bd. 51, Baden-Baden.
- Wang, C. and S. Williamson (1996): Unemployment Insurance with Moral Hazard in a Dynamic Economy, in: *Carnegie Rochester Conference Series on Public Policy* 44, S. 1-41.
- Weitzman, M. (1987): Steady State Unemployment under Profit Sharing, in: *The Economic Journal*, Vol. 97, S. 86-105.
- Wenger, E. (1988): Der Einfluß von "Schutzrechten" für Arbeitnehmer auf die Allokation nichtsystematischer Risiken, in: Fischer, W. (Hrsg.): *Währungsreform und Soziale Marktwirtschaft, Schriften des Vereins für Socialpolitik*, N.F., Band 190, Berlin, S. 451-470.





## 6 LABOUR MARKET FLEXIBILITY AND UNEMPLOYMENT REGULATION AND FLEXIBILITY OF MARKETS; TAKING THE NETHERLANDS AND THE FEDERAL REPUBLIC OF GERMANY AS AN EXAMPLE

*Ronald Schettkat*

### 6.1 INTRODUCTION

High and persistent unemployment, like that in Germany, is often attributed to a lack of labour market flexibility. The OECD Job Study, the EU Commission, the German Council of Economic Experts (Sachverständigenrat) and the European Central Bank are obviously in agreement on this. Mr Tietmeier, in the days of the German Federal Bank, and today Mr Duisenberg have referred to inflexible labour markets that bind the hands of monetary policy. Europe and Germany can not grow more rapidly because so-called 'rigidities' in the labour market prevent it. Expansionary economic policy measures would produce nothing but more inflation and no additional employment. In other words, this position claims that in the Federal Republic of Germany an unemployment rate of eight or nine percent is equivalent to the equilibrium unemployment rate. This is the non-accelerating inflation rate of unemployment which arises as a result of the institutional conditions (the 'rigidities') in the Federal Republic of Germany. According to this thesis lower unemployment can only be achieved by 'deregulating' the labour market, and this is then usually followed by a long list of welfare-state institutions that are supposedly a spanner in the works of the labour market (cf. for example Siebert 1997).

There is no doubt that inflexible economies and labour markets that do not respond to changes in the basic conditions will not be able to set the tone in economic terms, they will fall behind and will have to let other more flexible economies have the first league. Rigidities reduce the capacity for adjustment and competition. Who can fail to agree with that? But what are rigidities in labour markets, what is a flexible labour market? What does the institutional framework of a flexible, economically fit economy look like, how must the labour market be organised so that the economy can grow as smoothly as possible and so that it achieves as high a level of efficiency as possible? In this paper I would like to restrict myself to the theoretical and empirical evidence for the growth-hampering and employment-damaging effect of welfare-state institutions and regulations, and not touch upon other assessment criteria than a highest possible efficiency – even though these can not be less relevant (Stiglitz 2000, Krueger 2000).

Popular though this thesis of over-regulated European labour markets is, the empirical evidence of the employment-enhancing effect of deregulation or vice versa the employment-damaging effect of welfare-state institutions is amazingly thin. It is at any rate out of all proportion to the absoluteness of the 'deregulation

demands', as even "The Economist" occasionally complains. Whilst unemployment in Europe was increasing steadily, unemployment benefits were by no means increased but were lowered, the criteria for jobs that have to be accepted were not relaxed but made stricter etc. (for a detailed overview cf.: Esping-Andersen/Regini 2000 and for Germany cf. Fuchs/Schettkat 2000). The development of the institutional regulations which potentially cause labour market rigidities is not a suitable reason for the increasing unemployment and employment weakness in Europe. "Timing is wrong" says Professor Solow (2001) briefly and succinctly commenting on attempts to attribute Europe's unemployment to an increasingly generous welfare state.

The deregulation argument also gets its strength above all from the model of perfect markets (markets with complete information, infinite speed of adjustment etc), which is based on numerous assumptions. The 'perfect market' is used as a yardstick for assessing welfare-state institutions, and deviations from this reference model are classified as 'rigidities' which only disturb the tendency for equilibrium. It is assumed that markets without 'artificial' institutional interventions would function in the way that the idealised theoretical model intends, though 'natural' rigidities are usually left out of account here. Of course no serious economist claims that the ideal market model is an adequate description of reality, which is of course far more complex and less 'perfect', but – it is argued – it is an appropriate reference model. It is inferred from the conclusiveness of the ideal model, which is based on numerous assumptions, that countries which come closer to the theoretical ideal model show a better economic and/or employment-policy development.

Indeed numerous welfare-state regulations seem to be unnecessary or inefficient when they are compared with the model of perfect markets. Reality must always do badly compared with this model. In real markets, however, there are 'real rigidities', which is why the negative employment effects of regulation, which are derived with the model of perfect markets, are also by no means so clear theoretically. "Some of the so-called rigidities may represent rough institutional corrections for other distortion of the labor market" (Blanchard/Wolfers 1999: 12). It is even possible that without institutional embedding, asymmetric information would cause the market to 'die', as Professor George Akerlof (1970) showed in his 'markets for lemons'. Josef Stiglitz (1994) argues that if the assumptions of the ideal market model were correct, then planned economies would be the ideal form of economy, since one would know according to the assumption exactly what was needed where, what could be produced where, what the equilibrium prices were etc. But it is well known that planned economies did not survive and in leading economics the questions are asked as to how markets actually function (Gordon 1989), what consequences incomplete and asymmetric information has on the players' market behaviour, what consequences interactions between the expectations of the market participants have.

What is referred to in economics as flexibility is described in biology as fitness – the ability of organisms to adapt in such a way that their ability to survive is high.<sup>1</sup> The standard statement on Germany's labour market situation assumes that there is only one optimal institutional arrangement, which is equivalent to the 'ideal' of unregulated markets. The closer one gets to this ideal, the better the labour market situation. This idea is portrayed in figure 6.1 in the upper fitness landscape. Economic fitness reaches its maximum when the real institutions correspond to those of the idealised market model. Here there is only one optimal form of the institutions, the landscape of institutions and economic fitness is unimodal. In such a model world, international comparisons and policy recommendations are relatively simple:

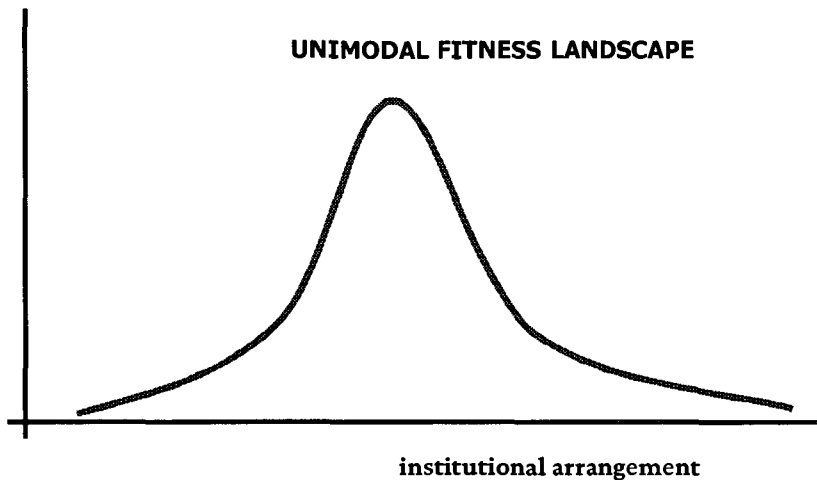
- the fittest economy is identified (the economy with the lowest unemployment rate, the highest rate of economic or employment growth etc.);
- recommendations are given to copy the institutional arrangement of this economy.

As there is only one single optimal constellation, any movement towards these institutions must increase the economic fitness. Neither in identifying the fittest economy nor in analysing the institutional arrangements is it necessary to go into much detail, since above all the theoretical analysis guides the action. The optimal institutional arrangement has been deduced from the model of perfect markets and empirical knowledge is more or less used only as illustration. The USA, as a supposedly deregulated economy, enjoys great popularity in this respect. In the second half of the 1990s the USA was undoubtedly very successful, they reduced unemployment without inflationary pressure (cf. Blinder/Yellen 2001). At the same time the welfare state in the USA is minimal, dismissal protection is virtually unknown, the trade unions are weak and wages are flexible. But the Netherlands, too, are often used to illustrate the correctness of the neo-classical policy recommendations. Have the Netherlands not lowered unemployment benefit payments and experienced an expansion of employment which even surpasses the boom in the USA? That is right, but it is also right that the Netherlands are one of the best countries in the world for social security and its institutional arrangements can certainly not be equated with those of the USA.

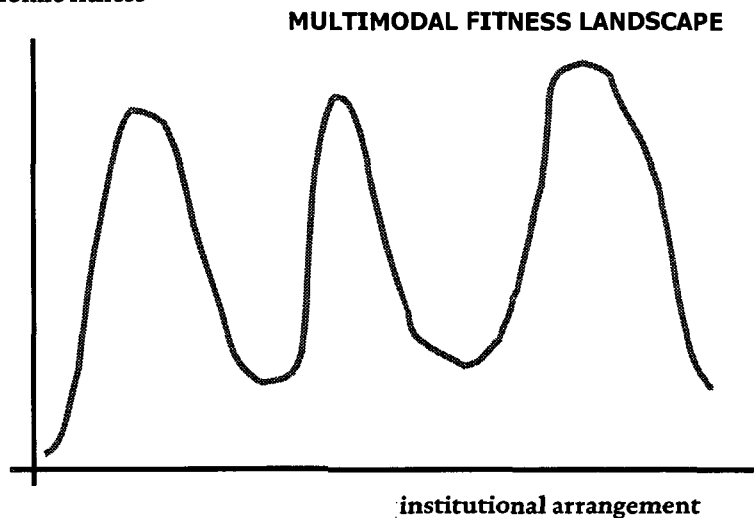
It is therefore not in any way agreed either empirically or theoretically that there is only one optimal arrangement for highly developed economies. It is more likely that several institutional arrangements can achieve similarly good results. In other words it has not been shown theoretically and definitely not empirically that deregulated economies produce the better results. It is more the case that there can be a multitude of institutional arrangements that can all yield equally good results. Capitalist economies can be multimodal (figure 6.1, lower graph).

Figure 6.1 Fitness landscapes: institutional arrangements and economic fitness

economic fitness



economic fitness



In the following, labour-market-related institutional arrangements in the Federal Republic of Germany and the Netherlands are compared with each other and it is examined whether the institutional differences can plausibly explain the remarkably diverging employment development in the Netherlands and Germany. If the hypothesis of the employment-damaging effect of welfare-state institutions is right, the Netherlands should be "more deregulated" than Germany in important aspects, the transfer payments should be lower and the incentives to take up work should be greater. It can be seen, however, that the Dutch welfare state is more generous, dismissal protection is stricter and wage negotiations have

become like those in Germany in institutional terms. Regulations that are frequently criticised in Germany such as the assumption of dependent employment in some contracts for services, a right to part-time work etc. have long been common practice in the Netherlands.

I would like to take up three areas of institutional regulations which are particularly interesting for the Germany-Netherlands comparison and which are frequently blamed for the labour market problems. (1) Dismissal protection, where the Netherlands have stricter regulations than Germany, (2) wage negotiation systems, where the Netherlands have come closer to Germany's regulations, and (3) incentives to take up work associated with transfer payments, tax and social-security contributions.

## 6.2 DISMISSAL PROTECTION

Although dismissal protection occupies a prominent position in political debate, the simplifications in the conclusion of fixed-term employment contracts (Employment Promotion Act of 1986 and its numerous extensions) have only been used to a small extent in Germany (Büchtemann/Höland 1989, Bielenski 1997, Bielenski/Kohler/Schreiber-Kittl 1994). Why do firms not use the possibility of fixed-term employment contracts to a greater extent, why are they found above all in the lower-skilled labour market segment and why are they used above all as an extended probationary period? One answer can be found in the 'natural rigidities' of the labour market. In general the firms have an information deficit about an applicant's actual qualifications, about whether the advised hiring is actually a good 'match' and about whether the new employee will possess the expected productivity.

127

Dismissal protection (or the severance payments association with it) increase the wage costs and thus shift the labour demand function in figure 6.2 from  $L_d'$  to  $L_d''$ . Fewer people are employed at a given wage (in figure 6.2 employment falls from  $E'$  to  $E''$ ). How far downwards will the labour demand function shift? This depends on the extent to which the dismissal protection actually leads to an additional cost burden for the firm, which in turn depends on the exact arrangement of the dismissal protection, on the employment stability in the firm and on the recruitment costs.

Absolute dismissal protection in the sense that dismissals are not possible at all will certainly push the labour demand function down clearly. But there is no absolute dismissal protection either in the Netherlands or in Germany. Terminations of employment relationships are possible in both countries although they require a reason and a notice period of at least four weeks. In both of the countries the statutory regulations can be extended by collective agreements or individual agreements. Unlike in Germany, however, dismissals in the Netherlands still have to be approved by the employment offices, although a

Wage negotiations can take place decentrally at firm or even individual level, or at the other end of the scale they can take place at centralised level between the leading employee and employer associations (cf. Calmfors/Driffill 1988, Appelbaum/Schettkat 1996 and literature listed there). Two different effects are associated with an increasing degree of organisation of the workers. Firstly the power of the organised workers increases along with the degree of centralisation, which corresponds to a monopoly if it is fully centralised, in which case the temptation to misuse power (the price or wage mark-up) is known to be at its greatest. This negative effect is opposed, however, by the internalisation of negative effects, which also increases along with the degree of centralisation. For a trade union that represents all the workers, negative effects of their wage policy will affect their own members, which is why the effects are carefully weighed up. Mancur Olson deduced that organised interests are all the more harmful the more specific they are, because then the negative effects influence the rest of the economy but burden one's own clientele only imperceptibly. The wage agreements for pilots that were concluded between the Cockpit organisation and Lufthansa may illustrate the Olson thesis. Collectively agreed wages are usually declared to be generally applicable in the Netherlands, which is often criticised as opposing an employment-enhancing wage differentiation. But the general application of the collective agreements of course also leads to trade unions internalising the macroeconomic consequences of their wage policy, which can produce positive employment effects.

130

Both in the Netherlands and in Germany most employees work under industry-specific collective agreements (Hartog 1999). Collective bargaining autonomy has actually been in existence in the Netherlands since the late 1970s but has only been established by law since 1986. Previously the government was able to intervene directly in wage negotiations and there was an automatic price compensation (Scala Mobile like in Italy). In the course of time the negotiation level has shifted from central level to industry level, which is known in the Netherlands as decentralisation. In Germany, like in the Netherlands, the collective agreements contain emergency clauses which provide for deviations from the collectively agreed regulations in practice when the survival of the firm is at stake (Hartog 1999, Fuchs/Schettkat 2000). In the Netherlands of the 1990s collective bargaining was organised in roughly the same way as in Germany but, because of the size of the Netherlands, without regionalisation components. The Netherlands have come closer to Germany with regard to the wage negotiation institutions.

The Dutch and the German wage bargaining systems are very similar, however, and also produce very similar wage distributions, which are at the lower end of the scale compared with international values. Thus for instance the relation of the wage of the 10 percent best-paid workers (D<sub>9</sub>) to that of the 10 percent worst-paid workers (D<sub>1</sub>) is 2.3 in Germany, and 2.6 in the Netherlands, but 4.4 in the USA. Interestingly the differences between the two European countries and the USA turn up in other statistics, too, such as the proportion of children living

in poverty, which is some 25 percent in the USA but only about 10 percent in the Netherlands and Germany. Differences between Germany and the Netherlands are found above all in the development of the wage level, which has risen only very slightly over a twenty-year period in the Netherlands and has contributed considerably to the foreign trade success of the Netherlands (cf. Schettkat/Reijnders 2000).

High minimum wages and a small wage spread are often identified as the 'roots of Europe's employment problems' (e.g. Siebert 1997), which is why the 'wage gap principle' occupies an outstanding position in the discussion surrounding employment policy. The Netherlands (like the USA, too) have a statutory minimum wage which fell clearly in the 1980s, but which in the Netherlands still amounts to some 58 percent of the average wage and thus lies clearly above the US minimum wage (approx. 35% of the average wage). In Germany, social security establishes a minimum wage demand (Sinn 1998) which is comparable in its labour market effects with those of the minimum wage. If social assistance including housing benefit payments for a single person is taken as a basis, then the minimum wage demand that can be derived from this is 32 percent in Germany and thus lies approximately at the level of the American minimum wage (Freeman/Schettkat 1998).

Freeman and Schettkat (2000) also find on the basis of the Comparative German-American Structural Database (CGAS, cf. Freeman/Schettkat 1998) that the wage structure in the upper qualification sector in Germany is clearly more condensed than in the USA, but that in the lower qualification segment there are more 'returns to education' in Germany than in the USA. Undoubtedly the individual wages vary less in Europe than in the USA but the raw wage variation is of course irrelevant, since any economist will agree that wages should be differentiated according to qualifications. A broader spread of the qualifications also leads to a greater variation of wages. In the USA the spread of qualifications is clearly greater than that in Germany and the Netherlands, which is concealed by the customary indicator for qualifications – periods of formal education. In the USA formal education periods have a higher mean value and a lower variation than in Germany (Freeman/Schettkat 2000). The use of formal education periods as an indicator for qualifications assumes, however, that an academic year in the USA generates the same qualifications as in Holland or Germany. But the education systems are actually very different with regard to intensity of learning, length of schooling, teaching qualifications, motivation of the pupils etc. Before the PISA study, the OECD together with Statistics Canada conducted an internationally comparative survey of job-relevant qualifications among the population of working age (aged 15 and above), which shows in standardised form on a scale of 0 to 500 for example the capacity to process written and quantitative information (OECD 1995, 1997). This was the first comparable survey of qualifications among the adult population, and it shows clearly differing distributions between the USA and the European countries, but very similar distributions in Germany and the Netherlands. It is not so much the mean values as the variation, which differs clearly

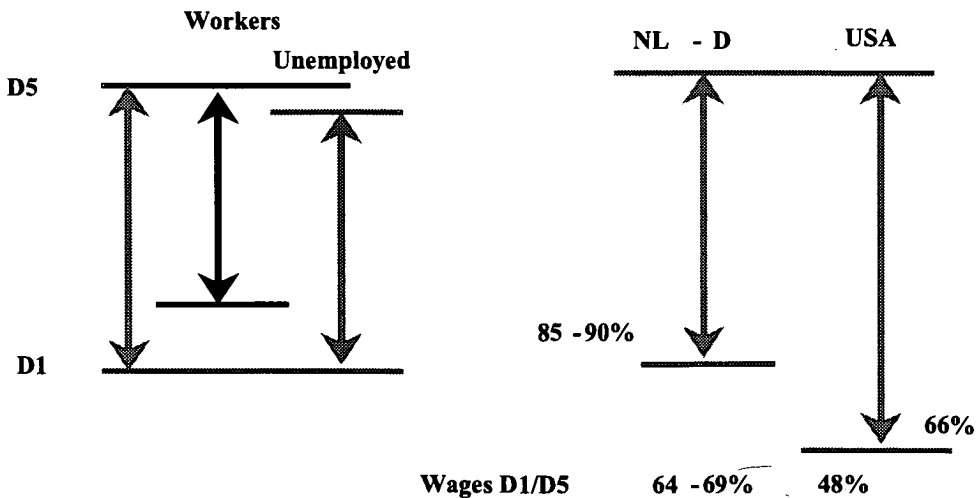
from that in Germany and the Netherlands especially at the lower end of the qualification scale.<sup>3</sup> Figure 6.3 illustrates the qualification differentials among workers and unemployed people in the Netherlands, Germany and the USA.

If the claim that a higher wage spread can integrate the low-skilled unemployed into the employment system is right then in the USA the qualification decile of the workers in employment should be roughly equal to that of the unemployed, since the unemployed should not be selected negatively according to the integration thesis. In the two European countries, however, clear qualification differences between the unemployed and those in work should open up. The large discrepancy between the qualifications of workers and those of the unemployed is found in the USA, however, and not in Europe. In other words the American unemployed have clearly lower qualifications than the Americans in work, whilst the Dutch and German unemployed have roughly the same qualification levels as the people in employment.

This finding completely contradicts the wage compression hypothesis and confirms the results of Steve Nickell and Brian Bell (1996) as well as those of Freeman and Schettkat (2000), which find that the relative unemployment of people with a low qualification level is approximately as high in countries with a 'flexible' wage structure as in countries with a 'rigid' wage structure. It is possible that the effect of relative wages on the relative employment chances of low-skilled workers is overrated. The differences between the USA and Germany regarding labour force participation are then also not qualification-specific but can be determined in general in all qualification levels (Freeman/Schettkat 2000).

132

**Figure 6.3 Differences in qualification levels in the Netherlands, Germany and the USA**



Source: calculations are based on the International Adult Literacy Survey



## 6.4 TRANSFER PAYMENTS, TAXES, SOCIAL-SECURITY CONTRIBUTIONS

Are the incentives to take up work sufficient? The answer to this question depends of course on the achievable wage and on the family status because when an unemployed person takes up a job, housing benefit and other transfers may be reduced or cancelled altogether. The relation between net wages and net transfers determines the incentives to take up employment and if net transfers exceed the net wages, then employment is only likely to be taken up in exceptions. As earned income often reduces transfer payments almost proportionately, the marginal tax rates for low incomes can be very high, which is rightly of great importance in the debate surrounding the incentive effects of transfers and taxes. Transfer payments, taxes and social-security contributions are very difficult to compare internationally and average values are frequently used, which can be very misleading, however, if the individual conditions (for instance the family status, number of children etc) have an influence on these quantities. In some countries transfers are subject to taxation (in the Netherlands) whereas in other countries they are largely excluded from taxation (like in Germany). The Dutch 'Central Plan Bureau' (CPB, 1995) has worked out data that take into consideration the family allowances and housing benefits etc. As these benefits generally depend on the income and family status, values for single people and single-earner households with two children are presented here.

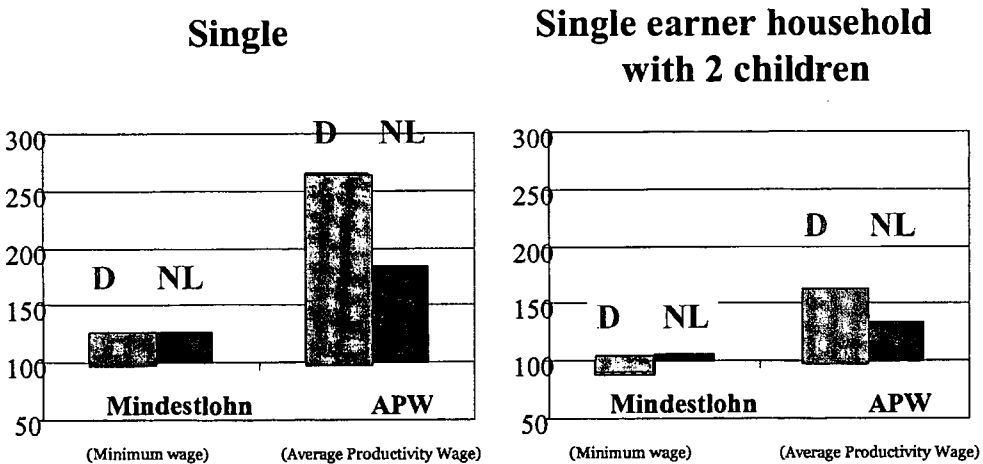
In unemployment benefit (and unemployment assistance) the net wage replacement rates are higher in Holland for all lengths of unemployment than they are in Germany. Only in the case of a single-earner couple with two children does an unemployed person in the Netherlands receive lower wage replacement benefits than in Germany. In all other cases Dutch unemployment benefit is more generous than the German equivalent. Although the wage replacement benefits in the event of unemployment have been reduced in the Netherlands, they are still higher than those in Germany even if a spell of unemployment lasts 60 months, apart from the exception mentioned above. In other words the monetary incentives for taking up work which are derived from unemployment benefit are higher in Germany than in Holland.<sup>4</sup>

In both of the countries the transfer payments may be reduced or cancelled if job offers are turned down. The definition of acceptable jobs has been made more strict both in Holland and in Germany in the course of time. Losses of income amounting to 20 to 30 percent have to be accepted in Germany during the first six months of unemployment and after that any job that provides an income at least equivalent to the level of unemployment benefit is regarded as reasonable (Emmerich 2001). In the Netherlands the acceptance is defined depending on the qualification level. In the first six months of unemployment the original qualification level is taken as a basis, after that time the acceptance definition is reduced by one qualification level every six months (Emmerich 2001).

Is it worth working? Figure 6.4 shows net wages as a percentage of transfer payments. Even in the case of the minimum wage (collectively agreed minimum wage) it is worthwhile in both countries for a single person to take up a job. Only in the case of a single-earner couple with two children and minimum wage is the transfer income in Germany higher than the earned income, and in the Netherlands the earned income is only just above the transfers in this case. If factors of need play a role, such as in the case of single-earner couples with children, the reduction of transfer payments can even overcompensate for the achievable earned income. This is a real poverty trap which urgently requires correction and for which numerous credit models have been suggested that would make it financially attractive to take up work. In the Netherlands this 'need effect' has been moderated by taxation and transfer income being orientated above all towards the individual and being largely independent of the household context (Schettkat/Yocarini 2001).

In summary it can be stated that, with the exception of single-earner couples with children, in the Netherlands the taxes and social-security contributions are higher and unemployment benefits more generous than in Germany.<sup>5</sup> Explaining the Dutch employment miracle solely with microeconomic 'push factors' is therefore not very plausible. It is more the case that 'pull factors' must be included for the explanation of the Dutch-German employment differences.

Figure 6.4 Net wages as a percentage of the net transfers



Source: calculations are based on CPB 1995

## 6.5 CONCLUSIONS

The institutional arrangement of the Dutch labour market is very similar to the German institutional arrangement. In many areas, such as collective bargaining or unemployment benefit, the Dutch institutions have moved towards the German ones. As a rule the Dutch regulations are more restrictive than the German ones, however, and the Dutch transfer system is more generous than its German counterpart. Nonetheless in the Netherlands employment has grown even more strongly than in the USA. The Netherlands show that employment expansion is indeed possible with an arrangement of the welfare state that is typical for Continental Europe. Employment expansion does not require the dismantling of all social achievements whose supposed negative effect on employment is often theoretically ambivalent and can not be proven empirically.

If the differences in the welfare-state regulations can not explain the diverging employment trends of the Netherlands and Germany, the macroeconomic constellation in the Netherlands must play a special role. Interestingly the employment success was achieved under the monetary policy of the German Federal Bank, since the Netherlands had a kind of monetary union with the Deutschmark since 1983, which was in turn the requirement for the success of the restrained wage policy, which was supported in fiscal policy terms by reductions in taxes and social-security contributions. The macroeconomic connections can not be picked up here, however, and interested readers are referred to Schettkat (2001).

Flexible labour markets are essential in a dynamic economy but the classification of regulations as rigidities, which is derived from the model of perfect markets, need not necessarily be correct. Labour market institutions can be a spanner in the works of the labour market but they can also be a lubricant and be the pre-condition for flexibility.

## NOTES

- <sup>1</sup> Cf. Bak 1997. To my knowledge the metaphor of fitness landscapes was first introduced into economics by Richard Freeman (2000).
- <sup>2</sup> It is frequently argued that the large proportion of part-time employment results from the strict dismissal protection. Part-time employment is certainly a flexible working time buffer, but all labour-law regulations apply to part-time workers just as much as they do to full-time employees.
- <sup>3</sup> The comparison of the PISA study with the International Adult Literacy Survey (IALS) must be alarming both for Germany and for the Netherlands, since it makes clear the rapid decline of the general education standard.
- <sup>4</sup> The data of the CPB agree with the more recent net wage replacement rates of the OECD (1999). Sie sind auch in der OECD Publikation in Deutschland niedriger als in den Niederlanden (OECD 1999: 34).
- <sup>5</sup> Contrary to all prophecies of doom the taxes and social-security contributions for low-earners differ surprisingly little between some US states and Germany. The social-security contributions in New York are comparable with the values in Germany (cf. Schettkat 2001).

## REFERENCES

- Akerlof, G. (1970) The Market for 'Lemons', *Quarterly Journal of Economics* 84: 488-500.
- Appelbaum, E. and R. Schettkat (1996), "The Increasing Importance of Institutions for Employment Performance", in: Schmid, G. et al., *International Handbook of Labor Market Policy and Policy Evaluation*, London 1996: Edward Elgar, 791-810.
- Bak, P (1997), *How Nature works: The Science of Self-Organized Criticality*, Oxford University Press
- Bentolila, S., Bertola, G. (1990). "Firing Costs and Labour Demand: How Bad is Euroclerosis?", *Review of Economic Studies*, 57: 381-402.
- Bertola, G. (1992), "Labor Turnover Costs and Average Labor Demand", *Journal of Labor Economics*, 4.
- Bielenski, H. 1997: Deregulierung des Rechts befristeter Arbeitsverträge. Enttäuschte Hoffnungen, unbegründete Befürchtungen, in: *WSI-Mitteilungen*. 50, 8. pp. 532-537.
- Bielenski, H./Kohler, B./Schreiber-Kittl, M. 1994: *Befristete Beschäftigung und Arbeitsmarkt. Empirische Untersuchung über befristete Arbeitsverträge nach dem BeschFG*. Forschungsbericht 242 des Bundesministeriums für Arbeit und Sozialordnung.
- Blanchard, O./Wolfers, J, 1999, *The Role for Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence*, NBER Working Paper 7282, NBER, Cambridge Mass.
- Blinder, A., Yellen, J. (2001), The Fabulous Decade: Macroeconomic Lessons from the 1990s, in: Krueger, A., Solow, R. (eds.) *The Roaring Nineties*, New York: Russel Sage.
- Büchtemann, C.F., Höland, A. (1989), "Befristete Arbeitsverträge nach dem Beschäftigungsförderungsgesetz 1985", Forschungsberichte Band 183, Bonn: Bundesminister für Arbeit und Sozialordnung.
- CPB (1995). *Replacement rates*. The Hague, Central Plan Bureau: 135.
- Emmerich, K. (2001) *Innovative Ansätze aktivierender Arbeitsmarktpolitik in den Niederlanden und Dänemark*, Nürnberg: Institut für Arbeitsmarkt- und Berufsforschung, mimeo.
- Esping-Andersen, G., Regini, M. (eds.), *Why Deregulate Labour Markets?*, Oxford: Oxford University Press.
- Freeman, R. (2000) Single Peaked vs. Diversified Capitalism: *The Relation Between Economic Institutions and Outcomes*, NBER Working Paper no. 7556, Cambridge, Mass., National Bureau of Economic Research.
- Freeman, R.B., Schettkat, R. (1998), *From McDonald's to McKinsey: Comparing German and US Employment and Wage Structures*, Leverhulme II conference, Labour Market: Stocks and Flows, 28-29 September 1998, Institute of Economics and Statistics Oxford.
- Freeman, R.B., Schettkat, R. (2001) *Skill Compression, Wage Differentials and Employment: Germany vs. the US*, Oxford Economic Papers, 582-603.
- Fuchs, S. Schettkat, R. (2000) Germany: A Regulated Flexibility, in: Esping-Andersen, G., Regini, M. (eds.), *Why Deregulate Labour Markets?*, Oxford: Oxford University Press, 211-244.
- Gordon, R.J. (1990) What is New-Keynesian Economics?, *Journal of Economic Literature* 28: 1115-1171.

- Hartog, J. (1999) *So what's so special about the Dutch model?*, ILO Symposium on Social Dialogue and Employment Success, Geneva, March 2-3.
- Hassink, W. (1999) De rol van de leeftijd bij de ontslagbeslissing, *Economisch Statistische Berichten*, Vol 84, December, 947-949.
- Kraft, K. (1994), *A comparison of employment adjustment in France, Germany, Great Britain and Italy*, Wissenschaftszentrum Berlin, FS I 94-207, Berlin.
- Krueger, A. (2000). From Bismarck to Maastricht. *Labour Economics*, Vol. 7, 1-21.
- Krueger, A. B.; Summers, L. H., 1988: Efficiency Wages and the Interindustry Wage Structure. In: *Econometrica* 56, 2: 259-93.
- Nickell, S. J., Bell, B. (1996) Changes in the Distribution of Wages and Unemployment in the OECD countries, *American Economic Review*, 86 (5), Papers and Proceedings, 302-308.
- OECD (1997), *Implementing the OECD Jobs Strategy: Lessons from Member Countries' Experience*, Paris, Council at Ministerial Level, 26-27 May.
- OECD (1997), *Literacy Skills for the Knowledge Society*, International Adult Literacy Survey, Paris.
- OECD (1998) *Employment Outlook*, Paris.
- OECD (1999) *Employment Outlook*, Paris.
- Schellhaass, H. (1989), "Sozialpläne aus ökonomischer Sicht", *Zeitschrift für Arbeitsrecht*, 167-207.
- Schettkat, R., 1997: Employment Protection and Labor Mobility in Europe: An Empirical Analysis using the EU's Labor Force Survey. In: *International Review of Applied Economics* 11, 1: 105-118.
- Schettkat, R., 2001a: How bad are welfare state institutions for economic development? The amazing vitality of the European Tigers. In: *Challenge* January/February: 1-21.
- Schettkat, R., Reijnders, J. (2000). *The disease that became a model*. Washington, D.C., Economic Policy Institute.
- Schettkat, R./Yocarini, L. (2001) *Some Institutional Arrangements and their Potential Labor Market Effects in the Netherlands*, IZA Discussion Paper, IZA, Bonn.
- Schettkat, R. (1999) Small Economy Macroeconomics; The Economic Success of Ireland, Denmark, Austria, and the Netherlands Compared, in: *Intereconomics*, Vol. 34, No.4, 1999: 159-169.
- Siebert, H. (1997) Labor Market Rigidities: At the Root of Unemployment in Europe, *Journal of Economic Perspectives*, Vol. 11, 3, 37-54.
- Sinn, H-W. (1998) *Der Sozialstaat in der Zwickmühle*, Handelsblatt November 24, 1998, page 53.
- Solow, R. (2000) The European Unemployment Problem, in *CES ifo Forum*, Spring 2000, 3-5.
- Stiglitz, J. (2000) *Democratic Development as the Fruits of Labor*, Keynote Address Industrial Relations Research Association, Boston, January 2000, mimeo.
- Stiglitz, J. E. (1994). *Whither Socialism?* Cambridge, Massachusetts, MIT press
- Summers, L.H. (1989), Some Simple Economics of Mandated Benefits, *The American Economic Review*, vol. 79, issue 2, 177-183

## **7 SCOPE FOR FUTURE EMPLOYMENT POLICY AND INSTITUTIONAL REFORM IN GERMANY AND THE NETHERLANDS; A REJOINDER**

*Uwe Blien, Frank den Butter<sup>1</sup>*

### **7.1 INTRODUCTION**

What can we learn from the contributions in this volume? What are the major determinants and institutional characteristics which made the working of the labour market in the Netherlands and that in the Federal Republic of Germany differ so much? A number of important results from these contributions are discussed below in order to provide some answers to these questions.

The articles of this volume highlight both from the theoretical and from the empirical perspective some striking differences in labour market developments and policies in the last decades in these industrialised countries whose economies are much intertwined. As yet, the articles illustrate that there is no unanimity amongst the authors about what differences in policy and institutional set ups can be held responsible for the differences in labour market developments. So, we will, in this rejoinder, not try to derive lessons from policies which seem to have been successful in one country in order to recommend that this policy should also be conducted in the other country. As a matter of fact, as Freeman (1998, 2000) and Schettkat (this volume) have noted, there is no true and unique institutional model that can be applied with success in each country.

139

The remainder of this rejoinder is as follows. The next section discusses by way of summary the major arguments in the policy assessments of the contributions to this volume. Section 3 reviews, with reference to the political situation, some recent developments in both countries. Here, the perspective is the turn to right wing policies in general elections in Europe in recent years. The results of the general elections in May 2002, in the Netherlands, have been in accordance with this trend. However, the trend was not continued in Germany as the Social Democratic and Green coalition of the Schröder government was re-elected in September 2002 (albeit by a small margin). In a final section we draw conclusions and give some prospects for future developments and policies.

### **7.2 SOME MAIN FINDINGS OF THE ARTICLES FROM THIS VOLUME**

Den Butter and Hazeu focus, in their analysis of the situation in the Netherlands, on the enhanced labour participation rate which increased from an European low of 52 percent in 1985 to the European average of 65 percent now. Enhancing labour participation has been one of the major policy goals of the previous Dutch coalition governments – the first cabinet or prime minister Kok even had “work, work, work” as its slogan (see e.g. Klauder, 1999, for similar arguments for

Germany). This participation policy has been rather successful. The way the social dialogue is organised in the Netherlands can be regarded as a major source of success of this transition from the Dutch disease of the early 1980's to the Dutch miracle of the late 1990's. In this social dialogue, with a major role for the Social Economic Council (Sociaal Economische Raad: SER), consensus and compromises are formed on labour market policies. This way of organising the dialogue enhances social acceptance of the policy proposals, and therefore their effectiveness. Wage moderation has played a prominent part in enhancing labour participation and promoting employment equilibrium. Yet it should be noted that some observers in the Netherlands attribute this success merely to the working of the Phillips curve effect after a period of high unemployment in the late 1970's and early 1980's. From that perspective the labour market in the Netherlands has proven to be rather flexible. As a matter of fact, as also Walwei and Werner mention in their article in this volume, there was an early need for such flexibility of the labour market in the Netherlands as this small open economy already had, for a long period, its currency fixed to the German Mark. In doing so it gave up the possibility of using the exchange rate for adapting asymmetric shocks much earlier than other (and larger) European countries where the need for more flexible labour markets became more urgent only when entering the EMS.

Den Butter and Hazeu also stress the importance of considering labour market dynamics in the analysis of policy measures which aim to improve the working of the labour market. Using a scenario analysis they consider the possibilities of further enhancing labour market participation in the Netherlands in the next two decades. Because of the ageing of the working-age population a major policy goal in enhancing labour participation in the future is to keep the elderly people, especially the baby boom generation, at work. It is noticeable that, although ageing of the population is a problem in Germany as well, none of the other articles in this volume discuss the need for policy options in this respect. Finally it appears that the social dialogue, up to now, was unable to solve a major problem which is typical for the Dutch labour market, namely the very high amount of people receiving benefits from arrangements with respect to illness and disability. Den Butter and Hazeu state that these arrangements are still too generous with too little financial incentives for prevention and early reintegration.

The German authors in this volume put much emphasis the huge amount of part time jobs when discussing labour market developments in the Netherlands (see e.g. the articles by Walwei and Werner, and Kromphardt). Indeed, a major part of additional labour participation in the Netherlands in the past two decades comes from part time jobs. Yet, surveys conducted in the Netherlands indicate that these part time jobs are much in accordance to preferences and that they do not only consist of bad jobs at the lower end of the labour market. Admittedly it were mostly women who were responsible for the enhanced labour participation in the Netherlands in the last decades, and, of course, many of them have taken part time jobs.



Some contributions to this volume discuss whether the policy of wage restraint can be beneficial to employment. Here there are two conflicting mechanisms, namely the Keynesian demand effect and the neo-classical supply effect. The policy consensus in the Netherlands on the need of wage restraint, which was confirmed by the Wassenaar agreement, emanated from the believe in the policy models of the Central Planning Bureau (nowadays called Netherlands Bureau for Economic Policy Analysis) which showed that the neo-classical supply effect is much larger than the Keynesian demand effect (see e.g Den Hartog and Tjan, 1974, 1976; Den Butter, 1991). However, a policy of wage restraint will be less effective in enhancing labour participation in the years to come than it was in the past. On the other hand, when real wage increases will exceed the growth rate of labour productivity, it will depress economic activity and hence labour demand. In the present situation of substantial differences between and within sectoral and regional labour markets, more emphasis should be on wage differentiation than on wage restraint.

It is, anyhow, an almost unanimous conclusion from the various contributions to this volume that the Dutch labour market has benefited much from the policy of wage restraint after the Wassenaar agreement. Kromphardt is the only author who has doubts about this policy. Yet it should be noticed that fixing the Guilder to the D-Mark contributed considerably to the effectiveness of such policy. The strong links of the Dutch economy with the German economy gave rise to a direct cost advantage over the German economy, which resulted in higher employment growth in The Netherlands.

The other factor that is consistently emphasised in the contributions to this volume (e.g. that by Van Paridon) as being behind the positive evolution of the Dutch economy is the close degree of coordination between the various interest groups. This is at the heart of the "polder model". Of course, it is not the coordination itself that has direct effects on the labour market, but it is the general agreement and consensus about measures which seem most beneficial to the labour market. It is the contents of the agreements which is the crucial factor.

Such a measure is that of wage restraint, as Fehn emphasises in his contribution. He proposes that the German economy should follow this example. More generally he also calls for the strengthening of market structures, for which he puts forward a number of important arguments. Fehn notes that smaller countries, in particular, have successful employment policies in Europe and proposes that the *Länder* in the Federal Republic should be given wide-ranging powers to shape labour market policy, for example in relation to the level and calculation of unemployment benefits, so as to open up institutional competition in Germany as well and to switch to smaller political decision-making units. The regionalisation of labour market policy and unemployment insurance would also extend to the financing arrangements.

The allocation of wider regional powers in labour market policy could certainly contribute towards an improved and, in particular, more appropriate response to labour market problems in the Federal Republic, in that asymmetrical regional shocks could be absorbed more effectively. Unfortunately the far-reaching regionalisation of benefits and the financing of unemployment insurance as described would inevitably have problematical consequences for regional development. Prosperous regions would be able to demand lower contributions than crisis regions, in turn easing the cost burden for employers in the better-off *Länder*, while employers in *Länder* that were faring less well would find themselves at an additional disadvantage. The regionalisation of unemployment insurance would have the effect of entrenching an additional trend towards the regional divergence of labour markets. Fehn's proposal would only be feasible if the institutional organisation of unemployment insurance were the central determinant not just of developments in the labour market but indeed of the economy in general. In these circumstances it would then be possible to have effective competition among the *Länder*.

Another striking element in Fehn's contribution is that he calls for "the incorporation of a greater measure of social rigour in the process of social change". Fehn advocates cuts in various social benefits and seeks greater wage differentiation and lower wage increases in circumstances of mass unemployment. Fehn regards institutional changes as a necessary element in improving the labour market situation. The currently restricted market forces should be set free in order to combat unemployment.

The heavy emphasis on market forces sought by Fehn would not appear compatible with basic continental European political viewpoints and social values. Even if the desired labour market effects were to be achieved they would need to be balanced against the consequences of a marked polarisation in society. These might include substantially higher crime rates, as has been the experience in other countries. A further argument in this connection is that social competition among the countries of Europe which results in a race to the bottom should be prevented. If a country is in a position to attract more international capital because it sets lower social standards than its neighbours, this position could be lost again when the other countries make downward adjustments as well.

Independently of Fehn's position, a number of arguments in Schettkat's contribution could be used against a line of reasoning that would place the labour market itself at the centre in explaining unemployment. He makes it clear that in many respects the Dutch economy does not measure up to the image of the liberal labour market but that many institutional regulations are shaped along much the same lines as those in Germany. If the level of unemployment were in fact primarily determined by the institutional structure of the labour market, the way in which the major differences between Germany and the Netherlands had arisen could then be hardly explained.

## 7.3 RECENT DEVELOPMENTS AND POLITICAL SITUATION

### 7.3.1 THE NETHERLANDS

In the Netherlands the general elections for the 150 seats in the second chamber of the parliament in May 2002 mark the end of eight years of government by the purple coalition. The purple coalition was exceptional in the political landscape in the Netherlands as it combined the left wing Labour party (PVDA, coloured red) with the rather right wing and conservative Liberals (VVD, coloured blue). The third party in this coalition was the Social Liberals of D66 which, in a way took, the role of instigator and binding factor in this coalition government. The coalition was exceptional in the sense that it excluded the Christian Democrats (CDA) which are in the middle of the political scene and which, up to 1994, had always been part of the government either in a centre-left or a centre-right coalition. However, as the table 7.1 shows, they suffered a large defeat in the elections of 1994 when Lubbers, who had been prime minister in three consecutive governments, stepped back as political leader of the Christian Democrats.

From a macroeconomic point of view, the two consecutive purple governments of prime minister Kok, have been rather successful. Employment increased with over 100,000 jobs a year which resulted in a considerable rise in labour participation. Unemployment decreased to a very low level relative to other European countries. In public finance government deficit was reduced drastically and even turned into a surplus in order to make provisions for the future increase in government spending due to the ageing of the population. This reduction of the government deficit was accompanied by a reduction of the tax burden. As yet, the favourable economic situation still allowed considerable increases in public expenditure in fields of concern of the public opinion. During the period of government of the second purple cabinet, the volume of expenditure for public health and care, and for security increased respectively with 4 percent and 7.25 percent yearly, whereas average growth of real GDP was "only" 2.5 percent.

**Table 7.1 Election results in the Netherlands; number of seats in 'second chamber' of parliament (total = 150 seats)**

Year of election	1989	1994	1998	2002	2003
<b>Political party</b>					
Labour (PVDA)	49	37	45	23	42
Liberal (VVD)	24	31	38	24	28
Christian democrats (CDA)	52	34	29	43	44
Social liberals (D66)	12	24	14	7	6
Green left	6	5	11	10	8
Pim Fortuyn (LPF)	-	-	-	26	8
Other Christian	6	7	8	6	5
Other Left wing	0	2	5	9	9
Other	1	10	0	2	0
<b>Total</b>	150	150	150	150	150

In spite of these achievements the purple coalition suffered a dramatic loss in the elections of May 2002. Table 7.1 shows that, from the majority of 95 seats in the parliament of 150 seats, only 54 seats remained after the elections. All three parties in the coalition lost about half of their seats in the elections. This was especially hard for the Labour party of prime minister Kok who had just regained in the elections of 1998 some of the considerable loss from the elections of 1994. Yet, apparently Kok's successor as party leader (and alleged prime minister) Melkert, conducted a very unsuccessful election campaign.

A major issue in the election campaigns of all three parties of the purple coalition was that they emphasised the economic success in their past periods of government. The message was that when only the problem of the high demand for disability provisions were to be solved, – and the Social Economic Council had already reached an agreement on that matter – glorious prospects glimmered for economic welfare in the Netherlands. However, it appeared that the coalition partners in their election campaign, disregarded public discontent on issues which were not captured by the admirable macroeconomic indicators, namely security and crime, immigration and integration policy, bureaucracy and malfunctioning of the public health and care system.

This discontent was articulated and made explicit in an unusual political campaign of a single person, namely Pim Fortuyn. Only a few months before the elections he founded a new political party, and although Fortuyn was assassinated just before the elections – the first political murder in the Netherlands after more than 300 years – , his party gained 26 seats and became, after the Christian Democrats, the second largest party in the country. The Christian Democrats, which were in the opposition for 8 years now, conducted a very cautious election campaign, unlike the coalition parties who heavily attacked Fortuyn's ideas. By emphasising in their campaign the need to a return to individual responsibility and the importance of keeping up with values and norms, they regained a considerable number of their seats lost after the end of the Lubbers government in 1994. Their new leader, Jan Peter Balkenende (a professor of economics at the Vrije Universiteit Amsterdam and former financial spokesman) became the next prime minister of a right wing coalition with the Liberals and Pim Fortuyn's party. Yet, as we will see, this government was not born under a lucky star!

It must be admitted that the public discontent with the achievements of the purple government were by no means evident from the surveys conducted by the Social Cultural Planning Bureau. As table 7.2 shows, according to the answers in the surveys, "to combat crime" and "maintaining public security" did not gain much importance as political issues amongst the population since the mid 1990's. So sociologists and political scientists that supported the purple coalition have disregarded these as the main issues for the election campaign. It was finally Pim Fortuyn's focus on these issues, and on the issue of immigration policy, that articulated the discontent. May be the fact, that according to the survey data, "to combat unemployment" and "facilitating a high economic growth" lost consider-

able importance as policy issues, could have been a warning for the parties of the purple government to put less emphasis on their economic successes in the election campaign. However, this is an interpretation with the benefit of hindsight.

Although the purple government, in combination with the working of the polder model, has brought structural economic success to the Netherlands, it is noticeable, that not so much the parties of the purple coalition but much more so the Christian Democrats are advocates of consensus formation in the polder model. Pim Fortuyn (2002:17) was even a strong opponent of the endless discussions in the polder model in order to reach consensus agreement and compared it with the moesjawara system, the discussions between the local chiefs on the Isle of Java (former Netherlands' Indies) which sometimes lasted a year or more. In the end nobody took final responsibility for the decisions which were taken. Therefore, expectations were that the new coalition of the Christian Democrats, the Liberals and the late Pim Fortuyn's LPF would not form a stable government, the more so as members of parliament and the Ministers of the LPF were recruited in a somewhat hasty and unusual way. It was already in November 2002, after only 87 days of government, that the Balkenende cabinet had to resign. Remarkably, the reason was not disagreement in the cabinet, or in parliament, on policy matters, but it was a conflict between two Ministers of the LPF and continuous rows between the LPF members of parliament, which led to the fall of the cabinet. New general elections were held in January 2003. The outcome of these elections is that Pim Fortuyn's party suffered a huge loss and only retained 8 of its 26 seats (see table 7.1). The Christian Democrats, led by prime minister Balkenende, remained the largest party and even gained one more seat in parliament. However, there was a remarkable recovery of the Labour party, with Wouter Bos as the new and charismatic leader. They obtained 42 seats, which is only 2 seats less than the Christian Democrats.

**Table 7.2 Political issues of major importance in the Netherlands (in % amongst 5 highly ranked issues)**

Year	1996	1998	1999	2000
To combat crime	55	57	64	63
Maintaining public security	44	50	59	58
Keeping social security at level	46	50	53	55
Maintaining stability of the economy	51	49	50	50
Protect freedom of speech	31	33	44	44
To combat unemployment	53	41	32	33
Facilitate high economic growth	52	50	35	25
To combat inflation	29	26	21	21

Source: surveys conducted by SCP

A further problem for the Balkenende government was that, after the economic successes of the purple government, the economic situation in the Netherlands worsened quite drastically as the country was hit by the world wide economic

cyclical downturn and, to a lesser extent, by the bursting of the ICT bubble. The picture of the present cyclical situation (december 2002) in the Netherlands is somewhat mixed. At the end of 2002 GPD growth has been almost nil for 5 consecutive quarters and total GPD growth in 2002 is expected to be 0.2 percent only. Growth of consumer expenditures was very high at the end of the nineties (above 4.5% in 1998 and 1999) but dropped considerably afterwards and is now around 1 percent (but still positive!). After a steady decrease from 1994 onwards to the lowest level of 134,000 registered unemployed in November 2001, unemployment started to rise slightly from that month onwards. Up to very recently, the number of persons receiving benefits because of disability was still rising further, and the indicator also did rise when it is expressed as a percentage of total employment. It is remarkable that the latest data on new entrants to disability show a reversal of this trend. This may be caused by the fact that finally measures to foster reintegration during the period of illness before entering the disability scheme become effective (see the article by Den Butter and Hazeu in this volume). Consumer confidence dropped again further after a short rise in the period around the start of 2002. Inflation in the Netherlands was high as compared to other EMU-countries, which was partly due to a rise in labour costs and to a change in the tax system from direct to indirect taxes. However, in the years to come inflation is expected to come down to the European average.

On the basis of calculations using the MORKMON-model, at the end of 2002 the Netherlands Bank foresees a slight increase in GPD growth in 2003, namely to 1,1 percent and a further increase in 2004 to 2,1 percent (De Nederlandsche Bank, 2002). Hence the recession will come to an end in the next year, albeit very slowly. However, according to these projections the growth of labour supply will exceed that of labour demand, so that for the years 2003 and 2004, the Netherlands Bank predicts a further increase in unemployment. For 2003, even a decrease in employment is foreseen, which is a lagged reaction to the slack and fall in investments in the previous years. May be, unemployment can be expected to rise even more than in the projections of the MORKMON model when demand for disability provisions will indeed continue to fall, because part of those in the disability scheme are unemployed in disguise.

### 7.3.2 FEDERAL REPUBLIC OF GERMANY

The collapse of the world economy affecting the Netherlands had an equally adverse effect on the German economy. Unemployment once again broke through the 4 million barrier in July 2002, the highest level in four years, where the average of 2001 was 3.85 million persons. In that year the rate of unemployment (in relation to the labour force, including self-employment) in West Germany was 7.4 percent but in East Germany it was 17.5 percent, producing a rate of unemployment for the country as a whole of 9.4 percent. In 2002 the average annual rate was 9.8 percent. The growth rate of the economy came to a 10 year low in 2002 with a figure of 0.2 percent according to estimates by the

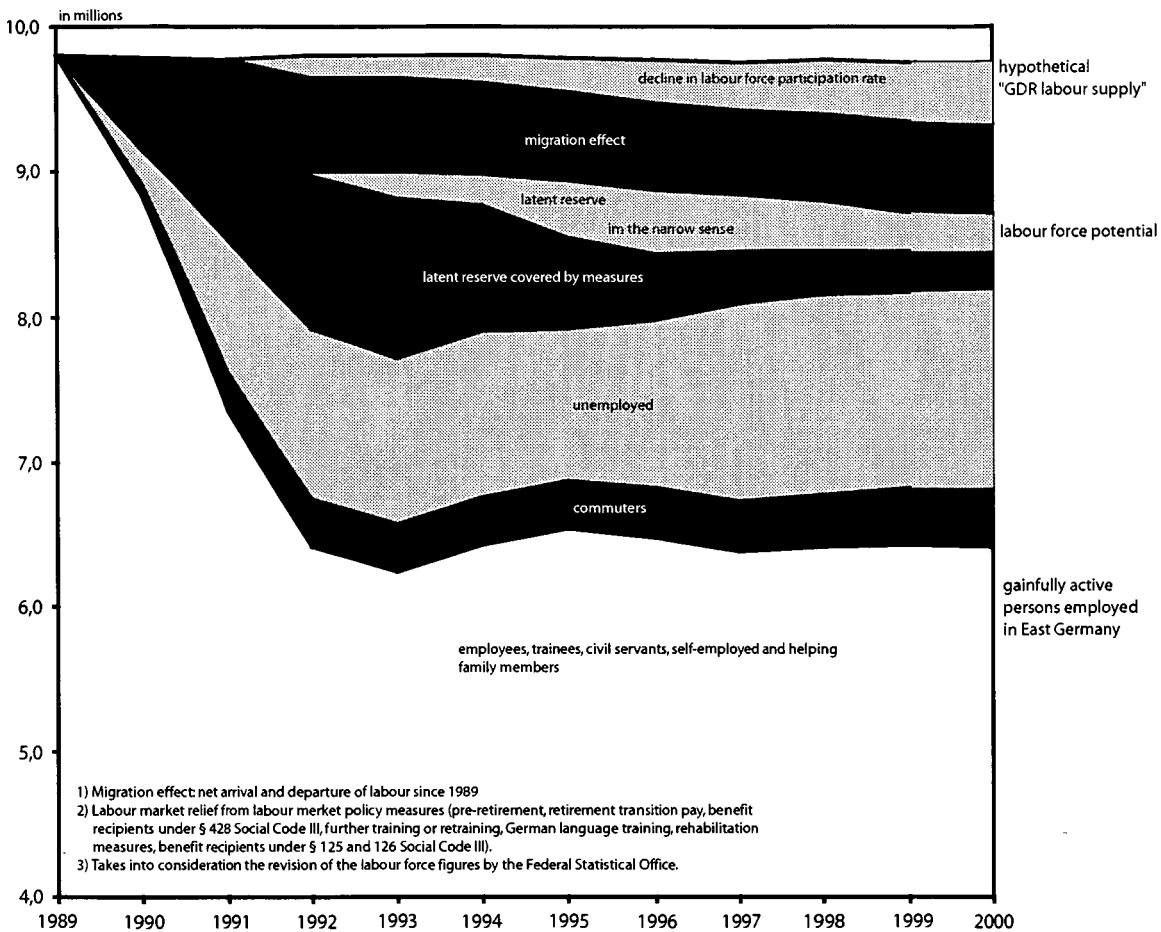
Federal Statistical Office. Due to the strong orientation of the German economy towards the world market the downswing of business is stronger than in other European countries. It is interesting that especially in two election years (1998, 2002) the German economy performed especially bad, showing that there is no obvious political business cycle in this country.

The marked divergence of labour market trends in East and West Germany partly “explains” the relatively high rate of unemployment in Germany as a whole. Productivity in significant parts of the East German economy remains too low for that part of the country to compete in world markets, while conversely the competitive segments remain too small (cf. Blien et al. 2001 and Ragnitz et al. 2001). Taking just the western part of the country, the rate of unemployment remains below the EU average (cf. the contribution by Walwei and Werner, cf. Blien/Walwei/Werner).

The situation in East Germany is in fact even worse than it looks, since there is a substantial net commuter outflow to West Germany (437,000 people in 2001) and many employees remain covered by employment-generating measures. In East Germany in 2001 an annual average of 190,000 persons were covered by employment-generating (ABM) and related measures, while 134,000 persons were in full-time further education courses. A comparison of these figures with the annual average level of registered unemployment of 1,374,000 in the eastern part of the country provides an indication of the scale on which the labour market is being directly relieved by such measures. The actual employment shortfall is clearly higher than that represented by the rate of unemployment. The “collapse” of employment in East Germany after reunification may be seen in detail from figure 7.1.

The Schröder-led coalition government consisting of the Social Democrats and the Green Party set itself the target of achieving a substantial reduction in unemployment in East and West Germany, which could not be achieved. In order to get closer to the target a package of changes to the Social Code was introduced in early 2002, known as the *Job-AQTIV* Law, the basic conception of which was developed in the expectation of a sustained upswing in the labour market. The law contains a wealth of detailed changes based on the principle of an active labour market policy, while also providing incentives to return the long-term unemployed and other people with poor placement prospects to employment. In this connection many traditional labour market policy instruments were made more flexible and efforts were made to bring them more closely into line with business practice.

**Figure 7.1 Development of the labour market in East Germany, 1989-2000 (annual averages)**



\* Source: IAB-Kurzbericht 10/98 (updated)

During 2002 the number of placement officers at the local units of the Federal Employment Services was increased from approximately 5,000 to approximately 8,000. Even after this change each placement officer remained responsible for some 500 unemployed persons, meaning that the measures provided for in the law for the individual support and guidance of the unemployed could be implemented on a limited scale only. Newly introduced measures for profiling and the conclusion of integration agreements (involving compulsory integration steps for both the unemployed and the labour exchange) could be realised on a limited scale only.

In a situation of economic downturn, the law was unable to throw up any barriers to the rise in unemployment resulting from the collapse of the economy and failed to have the desired effect. Its overall orientation was consistent with the



mainstream economic theory of the 1990s which, as explained by Layard/Nickell/Jackman (1991), centred not on the goods market, as in Keynesianism, or on the money/capital market, as in monetarism, in explaining the problem of unemployment, but on the labour market itself. Under this approach more flexibility of the labour market should lead to equilibrium between the two sides of the market. Reference has already been made to the significance of Schettkat's argumentation in his contribution to this volume in the discussion of positions such as that of Layard et al.

Several years ago the Institute for Employment Research (IAB) simulated a package of measures that represented a special approach, as it combined various political areas and market approaches (cf. Klauder/Schnur/Zika 1996 and the contribution by Walwei & Werner in the present volume, section 6). This package of measures for Germany was designed to bring about an employment-boosting growth path and was worked up into an all-embracing concept in time for the 1998 Federal elections (Autorengemeinschaft 1998).

Apart from measures to promote flexibility in the labour market, the package provides for a reduction in the social insurance burden bearing on the factor of labour and greater funding of the welfare state through indirect taxation. In addition it calls for reductions in working hours that would not serve to increase costs and additional fiscal policy impulses, together with moderate wage policies to help ease costs. Although the IAB strategic package attracted widespread attention among the German public, it was never seriously tested in practice. In particular, the temporary increase in public borrowing which the package involved was not politically acceptable in the light of the Maastricht stability criteria.

An event took place in February 2002 the consequences of which have since had a major impact on the debate about labour market policy and the development of practical strategies. Following an audit by the Federal Audit Office it was disclosed that the number of job placements in the labour market that the Federal Employment Services (BA) had ascribed to their own activities had been exaggerated. This state of affairs became the occasion for subjecting the entire organisation of passive and active labour market policies in Germany to thorough examination. A Commission was set up under the chairmanship of Peter Hartz, a member of the vw Board of Management, which was asked to come up with recommendations as to how the BA should be reformed. The "Hartz Kommission" (see Kommission 2002) developed plans for the restructuring of the Federal Employment Services job-placement activities, but interpreted its terms of reference very broadly and accordingly came up with proposals for reforming the entire institutional structure of the labour market and also other aspects, up to and including a new system for the generation of capital in East Germany. "The goal of full employment can only be achieved by means of an overarching labour policy approach" (Kommission 2002: 37). Some of the propositions of the commission gain by the example given by The Netherlands. It is planned to increase the number of people working in flexible working arrangements by creating spe-

cial Personal Service Agencies (PSA).

The IAB assessed the propositions of the commission and came to the conclusion that they are steps in a direction effective to reduce unemployment. The hopes of halving the unemployment problem are, however, not feasible by these measures alone. A recovery of the whole economy is needed. At the moment the re-elected red-green government of chancellor Schröder is busy in taking steps to translate the propositions of the Hartz Kommission in political actions. The first law has passed the Parliament, three more will come during the year 2003.

Even before the publication of the Hartz Commission's proposals the leadership of the Federal Employment Services was reshaped. Instead of a president (formerly B. Jagoda) it is now led by a full-time three-person executive chaired by Florian Gerster. For its part the executive of the BA had already submitted ideas for the transformation of the BA, providing inter alia for greater customer focus and more internal flexibility. In particular a higher level of service was to be provided to firms in the private sector. The individual employment exchanges have been given greater independence, as well as more responsibility.

## 7.4 PROSPECTS

The discussion examined so far indicates that a reduction in unemployment cannot readily be achieved by transferring the institutional structures of the one country to another. Once again we may refer by way of substantiation for this argument to Schettkat's contribution. Institutions that have proven their effectiveness in the context of one country for particular (e.g. state) goals will not function in the context of a different country as they are not consistent with the institutional arrangements, state regulations and cultural traditions in that country.

The new institutionalism in economic theory (which now has its counterpart in sociological theory, cf. Mense-Petermann 2002) holds the view that institutions need to be regarded as an interrelated whole and are not just shaped by formal rules (referred to by Engerer/Voigt 2002 as "external institutions"), laid down for example by the State. Also important are normative expectations ("internal institutions" subset) of economic subjects and members of society. An economy can only function effectively if its formal institutions and cultural expectations are in accordance.

As the example of most transformation economies indicates, this demand for consistency is not readily fulfilled. Positive economic developments have taken place much later (if at all) after the usual crisis of transformation than most economists had expected. East Germany is a by no means unimportant example of this, a fact that also serves to explain a substantial part of the German labour market imbalance. East Germany exemplifies the strategy of the rushed introduction of market economy capitalist institutions that had formerly "proven"

themselves in a large country. Even so this institutional transformation failed to have the positive effects that had been expected upon German reunification.

One reason for this unsatisfactory state of affairs was that the West German institutional structure is not consistent with the experience and expectations of the East German population. In retrospect it is a matter for some astonishment from an economic viewpoint that it proved possible immediately after reunification for such a rapid increase in wages to be demanded and indeed pushed through that the wages in the new *Länder* (new federal states) were for a while twice as high as per capita productivity. Since unit wage costs were correspondingly around twice as high as in West Germany (Hoffmann 1993), production only took place in East Germany when the cost disadvantage was eliminated by subsidies. Unemployment spiralled upwards to levels from which they have yet to come down significantly. Right to the present day the productivity/wage ratio in the East is distinctly less favourable than in the West.

The East German population, however, had no experience with the connection between unemployment and remuneration but viewed wage levels from the standpoint of "justice": why should East German workers be paid less than West German workers? Are they worth less? It proved possible for such high wages to be pushed through in wage negotiations because the counterpart to the trade unions – the employer associations – while formally in place were by no means as organised and motivated (Sinn/Sinn 1992). This development indicates that for an economy to change, special arrangements need to be made to assist the process of institutional transition.

Relating this to our current problem of the comparison between the Netherlands and Germany it is obvious that an agreement along the lines of the Dutch Wassenaar agreement could not be reached in Germany as the cultural traditions of the polder model are lacking. While the Netherlands is not such a small country as its area might suggest – it has a population of over 15 million – the number of responsible actors is more manageable than in Germany. This in turn facilitates consensus-building and makes it easier to control the consequences of the decisions that are taken. Furthermore the cultural tradition of the Netherlands is based more on consensus than on conflict. The 2002 election, based as it was on highly polarised political camps, was a typical and the election defeat by the Purple Coalition may in part be explained by the fact that the leaders of the coalition parties were simply not used to such polarisation. Such an election contest is closer to the practice in Germany, with the exception that there is no counterpart in Germany to the LPF of Pim Fortuyn.

The German trade unions are under pressure "to offer something" to their rank and file in return for their membership. Kromphardt notes that the total wage sum related to the national product in the Federal Republic has fallen heavily over the past two decades. How is one to persuade the rank and file that in the future an even worsened distributional position is to be expected? The situation

is especially bad since the tax and social security contribution wedge in Germany is large and increased during the nineties. German unification was financed by the social security system to a large extent. Therefore cost wages are high but consumption wages are not or at least there is an increasing discrepancy.

In the discussion concerning the consequences of institutional change a number of limitations to the theoretical approaches come to light. The concept of institutions as put forward in the new institutionalist approaches (e.g. by North 1991) is misleading in some aspects, as it suggests that institutions are additive, whereas they cannot be combined at will, as has already been seen in the light of the work by Freeman and Schettkat. In order to ensure positive economic development, the basic institutions of a society must have coherent foundations. At the surface level – i.e. where they come into contact with the economic subjects – they must be compatible with the culturally developed expectations and viewpoints of those subjects. A “relational” approach is necessary which places the institutions in their common contexts and secures an analysis for the economy as a whole.

What perspectives can then be developed for the two at once so similar and so different economies in the Netherlands and Germany? We have already seen that the current economic problems are if anything pointing in different directions. In Germany economic growth – especially in the East – is too low and the labour market is consequently not growing as it needs to. The Netherlands if anything has a productivity problem; wage restraint has taken the pressure off individual companies to boost productivity in the way required in order to maintain international competitiveness.

In order to analyse the problems of both countries there it is interesting to consider an approach developed by Appelbaum/Schettkat (1993, 1999, cf. Schettkat 1997, elaborated by Blien 2001), although it is not mentioned by Schettkat in his article in this volume. As the authors demonstrate in a simple formal model, the effectiveness of productivity gains depends, under certain conditions, above all on the elasticity of demand in the product markets. If demand is elastic towards price changes resulting from productivity increases, the demand of goods increases sufficiently for employment to grow. In this case the negative effect exerted by productivity increases on employment is more than offset by the greater volume of sales.

If on the other hand demand is inelastic, employment will shrink. In this case price cuts will do little to increase the volume of goods sold. Instead the productivity gains permit a certain amount of labour to be scrapped. This is not fully counteracted by higher sales of goods resulting from price cuts.

In economic theory the two possible consequences of productivity increases for employment are known as the rationalisation and compensation effects. The sizes of these effects have been systematically derived in the approach put forward by Appelbaum/Schettkat, in that they are related to the elasticity of the

demand for goods. The empirical question then arises as to the branches of the economy in which demand will tend to be either elastic or inelastic.

An understanding of how the processes run their course may be obtained by drawing on the widely held product-cycle theory. Among others this may be traced back to Schumpeter (1939), while modern versions have been based on Utterback/Abernathy (1975). A product cycle describes an empirical regularity, not a necessity of development. In such a cycle a new product first enters the market at a very high price based on small-batch production and the manufacturer has a more or less pronounced monopoly position (the product innovation phase). Continuing experience with manufacture and efforts to improve productivity (the process innovation phase) lead to production in larger batches and clear price reductions which, given unsaturated (elastic) demand, in turn lead to high production increases well above the productivity gains, so that the input of labour grows very strongly. The situation alters over the course of time as demand becomes increasingly saturated, competition in the market grows and the scope for technological innovation is exhausted. In these circumstances productivity gains only lead to small increases in the volume of goods sold and hence to falling turnover and reduced employment.

We may draw certain conclusions for the two economies under comparison when we realise that product cycles can place their stamp on entire industries and that the key question then concerns the extent to which an economy is based on "old industrial" or innovative areas. There are at any event certain empirical indications to suggest that the specialisation of the German economy is unfavourable in so far as the economy's strengths do not lie in the services area, as in the case of the Dutch economy, or in innovative new technologies, but in the classical areas of manufacturing industry. The latter tend however to be characterised by inelastic demand. What is important is that the danger of a reduction in employment will occur even if the economy in question is highly competitive. The high export ratios of the German economy are fully compatible with a structure characterised by inelastic demand.

Recently empirical investigations by J. Möller (2001) have revealed that the demand for the products being produced by the Federal German economy grew increasingly inelastic towards the end of the 1960s, when unemployment rose sharply. This finding confirms the Appelbaum/Schettkat approach. Large-scale regional surveys conducted by the Institute for Employment Research (IAB) (cf. Blien et al. 2001 and 2003) are also consistent with this proposition.

According to this approach, appropriate economic strategies for the Dutch and German economies would – as Fehn would also argue – be based not on subsidising the traditional, superseded parts of the economy but on the promotion of innovative new industries. Subsidies which keep established industries alive only exacerbate economic problems as they are used for rationalisation purposes which, in circumstances of inelastic demand, will only lead to a contraction in

employment. In vain did the IAB recommend its "strategy package" to combat unemployment in Germany (Autorengemeinschaft 1998).

Despite the scepticism about the possibility of simply copying each others' institutions, much can be learned from the discussion on the institutional solutions in the two countries. An important point is the increase in the labour force participation rate (especially among older people) being pushed for in the Netherlands. In Germany the corresponding discussion is confined to the aspects of the social security system, but it is seldom transferred to the design of labour market policy, since the primary problem here is that of high unemployment. Certain proposals being put forward in the current political debate concerning labour market problems in fact provide for the early elimination from the labour market of unemployed persons aged over 55.

They can however be no doubt that a high labour force participation rate is crucial for the long-term preservation of the welfare state, and indeed for the production of goods and social wealth (cf. Kommission 2002: 117 ff.). As the population is rapidly ageing, similar efforts towards the activation and integration of older persons in the labour market are to be expected, at least in the medium term. For this to succeed it is important for the high birth years to remain employed and productive. Only in this way can the funding of the welfare state, pensions and health system be sustained. For this reason further initiatives in the Netherlands deserve to be closely monitored in Germany.

## NOTES

- <sup>1</sup> The authors would like to thank H. Werner (IAB) for comments to a previous version of this paper. Any responsibility for the contents remain with the authors.

## REFERENCES

- Appelbaum, Eileen/Schettkat, Ronald (1993): *Employment Developments in Industrialized Economies: Explaining Common and Diverging Trends*, Discussion Paper FS 1 93- 313, Wissenschaftszentrum Berlin für Sozialforschung.
- Appelbaum, Eileen/Schettkat, Ronald (1999): Are Prices Unimportant?, in: *Journal of Post-Keynesian Economics* 21/3: 387-398.
- Autorengemeinschaft (1998): IAB-Agenda '98. *Wissenschaftliche Befunde und Empfehlungen zur Arbeitsmarkt- und Beschäftigungspolitik*, IAB Werkstattbericht 10, Nürnberg.
- Autorengemeinschaft (2002): Der Arbeitsmarkt in den Jahren 2001 und 2002 mit einem Ausblick auf 2003, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung* 1: 7-36.
- Blien, Uwe (2001): *Arbeitslosigkeit und Entlohnung auf regionalen Arbeitsmärkten*, Heidelberg: Physica.
- Blien, Uwe/Blume, Lorenz/Eickelpasch, Alexander/Geppert, Kurt/Maierhofer, Erich/Vollkommer, Dieter/Wolf, Katja (2001): *Neue Bundesländer: Einflussfaktoren der Regionalentwicklung* ([http://www.kfw.de/DE/Research/PDF/KFW-Studie\\_Neue\\_Bundesl.pdf](http://www.kfw.de/DE/Research/PDF/KFW-Studie_Neue_Bundesl.pdf)), Nürnberg/Berlin.
- Blien, Uwe (ed.) (2003): *Die Entwicklung der ostdeutschen Regionen, Beiträge zur Arbeitsmarkt- und Berufsforschung (forthcoming)*, Nürnberg
- Blien, Uwe/Walwei, Ulrich/Werner, Heinz (2002): Job Placement, Unemployment Insurance and Active Labor Market in Germany, in: Yoo, Kil-Sang/Chang, Jiyeun (eds.): *Active Labour Market Policies and Unemployment Insurance in Selected Countries*, Seoul: Korea Labor Institute: 225-286.
- Butter, Frank A.G. den (1991): Macroeconomic modelling and the policy of restraint in the Netherlands, in: *Economic Modelling*, 8: 16-33.
- De Nederlandsche Bank (2002): De Nederlandse economie in 2002-2004: een voor-spelling met MORKMON (the Dutch economy in 2002-2004: a prediction using the MORKMON - model), *De Nederlandsche Bank, Kwartaalbericht*, December 2002: 63-74.
- Engerer, Hella/Voigt, Stefan (2002): *Institutions and Transformation*, in: Zimmermann (2002).
- Fortuyn, Pim (2002): *De puinhopen van acht jaar Paars* (The ruins of eight years of purple government), Karakter Uitgevers, Uithoorn.
- Freeman, Richard (1998): War of the models: Which labour market institutions for the 21st century?, in: *Labour Economics* 5: 1-24.
- Freeman, Richard B. (2000): *Single peaked vs. diversified capitalism* (National Bureau of Economic Research Working Paper 7556).
- Hartog, Hans. den/Tjan, Jimmy (H.S). (1974): *Investerings, lonen, prijzen en arbeids-plaatsen*, Occasional Paper no. 2, Central Planning Bureau, The Hague.

- Hartog, Hans. den/Tjan, Jimmy (H.S). (1976): Investment, wages, prices and demand for labour (a clay-clay vintage model for the Netherlands), in: *The Economist* 124: 32-55.
- Hoffmann, Lutz (1993): *Warten auf den Aufschwung. Eine ostdeutsche Bilanz*, Regensburg: Transfer.
- Klauder, Wolfgang/Schnur, Peter/Zika, Gerd (1996): IAB-Kurzbericht 7.
- Kommission Moderne Dienstleistungen am Arbeitsmarkt (2002): *Endbericht*, Berlin.
- Layard, Richard/Nickell, Stephen/Jackman, Richard (1991): *Unemployment. Macroeconomic Performance and the Labour Market*, Oxford: Oxford University Press.
- Mense-Petermann, Ursula (2002): Kontinuität und Wandel. Zum Erklärungspotenzial institutionalistischer Ansätze in der Transformationsforschung, in: *Berliner Journal für Soziologie* 2: 227-242.
- Möller, Joachim (2001): *Income and Price Elasticities in Different Sectors of the Economy. An Analysis of Structural Change for Germany, the UK and the US*, in: Ten Raa, Schettkat (2001).
- North, Douglas C. (1991): Institutions, in: *The Journal of Economic Perspectives* 5/1: 97-112.
- Raa, Thijs ten/Schettkat, Ronald (Hrsg.) (2001): *The Growth of Service Industries. The Paradox of Exploding Costs and Persistent Demand*, Cheltenham, Northampton: Edward Elgar.
- Ragnitz, Joachim et al. (2001): *Produktivitätsunterschiede und Konvergenz von Wirtschaftsräumen: Das Beispiel der neuen Länder*, Halle (Saale): IWH.
- Schettkat, Ronald (1997): Die Interdependenz von Produkt- und Arbeitsmärkten. Die Wirtschafts- und Beschäftigungsentwicklung der Industrieländer aus der Produktmarktperspektive, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung* 30/4: 721-731.
- Schumpeter, Joseph A. (1939): *Business Cycles*, New York.
- Sinn, Gerlinde/Sinn, Hans-Werner (1992): *Jumpstart. The Economic Unification of Germany*, MIT Press: Cambridge, Mass. etc.
- Utterback, James M./Abernathy, William J. (1975): A Dynamic Model of Process and Product Innovation, in: *Omega, The International Journal of Management Science* 3/6: 639-656.
- Zimmermann, Klaus (2002) (ed.): *Frontiers in Economics*, Berlin etc.: Springer.