The German Labour Market

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INTRODUCTION AND BACKGROUND

It is indisputable that there are problems in the German economy. This is particularly evident in the labour market, where unemployment has been an ever-increasing burden since the 1970s, cf. Chart 1. During periods of recession unemployment has risen, and subsequent upswings have not brought it down to former levels. This is a clear indication that the German labour market is not functioning well. This article presents some of the major problems in relation to the German labour-market structure.

The difficulties are to some extent attributable to the reunification of Germany. Merging East and West has proved to be a lengthy process. After reunification, West German rules, welfare benefits and structures were by and large extended to all of the new Germany. Competitiveness in the East did not catch up, which is still reflected in substantially higher

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UNEMPLOYMENT IN GERMANY

Chart 1

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<th>Percentage of labour force</th>
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- West Germany
- East Germany
- Germany, total

Note: Registered unemployment. National definition. The most recent observation is from April 2005. The increase at the turn of the year 2004-05 is primarily of a technical nature resulting from amended rules and definitions in the unemployment statistics (Hartz IV).

Source: EcoWin.
DIFFERENCES BETWEEN WEST AND EAST GERMANY

Box 1

The economy in the former East Germany is still not on a level with that of the West, although more than 4 per cent of West German GDP is transferred to East Germany every year (OECD, 2001). However, the gap has narrowed since the final reunification in 1991. In 2003, GDP per East German was around 2/3 of the West German level, compared to half in 1991, cf. Chart 2. This heterogeneity should be borne in mind when performing an economic analysis of the structural problems in Germany.

MACROECONOMIC KEY RATIOS FOR WEST AND EAST GERMANY

Chart 2

Note: East Germany includes Berlin. Unit labour costs in the right-hand chart are not calculated on the basis of the productivity and gross income figures shown.


The difference between East and West is most significant in the labour market, cf. Chart 1 in the main article. Unemployment is substantially higher in the former East Germany than in the former West Germany. This is particularly true of long-term unemployment, which points to major adjustment problems in the East German labour market (German Council of Economic Experts, 2004). The challenges in reorienting the labour force from planned economy to market economy have been considerable. The question is whether the East German labour force, which has good qualifications on paper, actually has the skills required in a modern market economy.

Another reason for the excess unemployment in the East is that productivity is lower. Absolute East German unit labour costs, which take account of developments in both productivity and wages, were 34 per cent above the level in West Germany in 1991, cf. Chart 2, and in the period just after reunification massive wage increases in East Germany squeezed competitiveness further. By 2003, the gap had narrowed to just over 8 per cent, so competitiveness is still weaker in the East – particularly in the construction sector. Since 1991, total employment in East and West Germany has, respectively, declined and risen.

In recent years the convergence process between East and West has slowed down. The economic gap narrowed primarily in the years 1991-97, when large government subsidies led to massive investments in infrastructure, buildings and machinery in East Germany. The subsidies contributed to distorting economic decisions and consequently some of the investments led to highly capital-intensive production, but limited employment. Since then subsidies have been phased out, and the economy has increasingly had to compete on market terms. This led to a substantial decrease in investments. Another problem has been the decline in construction activity, which has resulted in substantial overcapacity in the building and construction sector and requires a high degree of adaptability. In 1995 the building and construction sector accounted for 17 per cent of employment in East Germany. This figure had declined to 13 per cent in 2000, but was only 6 per cent in the West in the same year.
unemployment, cf. Chart 1. The differences between East and West are briefly outlined in Box 1.

The labour market is by no means solely a reunification issue, however, as the steadily rising unemployment in the West shows, see Chart 1. It is widely accepted that the structures of the labour market generally impact on unemployment, cf. the Danish Ministry of Finance (2004), Nickell et al. (2005) and the Danish Welfare Commission (2005a). The present article points to a number of factors that have contributed to the high level of unemployment in Germany. These include generous unemployment benefits, extensive employment protection, the limited success of the active labour-market policies and a high level of wage costs.

However, the German problems should be viewed against the background of the extensive structural reforms of the last couple of years, the full impact of which has not been seen yet. A number of measures have been implemented in the labour market, notably the "Hartz reforms". In particular, the unemployment benefit system has been tightened, and employment service routines simplified. The key elements of the Hartz reforms are outlined in Appendix 1.

Overall, the current situation is a result of the lack of reforms in e.g. the 1990s when the economy was booming in the wake of reunification. These reforms must now be implemented in a weak economy. It is hazardous to refrain from introducing reforms for sustained periods, even though the economy appears to be sound.

The rest of the article is structured as follows: the relevant German labour-market structures are reviewed item by item and then put into perspective. The review is based on a comparison with conditions in the OECD countries in general and in Denmark in the period since around 1990. Denmark serves as a yardstick since the increasing unemployment in Denmark in the 1970s and 1980s was reversed in the 1990s when the economy was flourishing and a number of labour-market reforms were introduced. For other analyses of the German labour market, see Deutsche Bundesbank (2004), IMF (2004a) and OECD (2004a).

**GERMAN LABOUR-MARKET STRUCTURES**

**Unemployment benefits**
Comparing unemployment benefit structures in different countries is a complex task. The compensation received by an unemployed German in relation to his or her previous income depends on a number of factors, including family type, entitlement to other social benefits and duration of the period of unemployment. In addition, this comparison is compli-
cated by the significant changes implemented in Germany as from 1 January 2005, known as Hartz IV. As a consequence, the compensation for the long-term unemployed has been reduced substantially, while it remains unchanged for the short-term unemployed.

Prior to this amendment, German unemployment compensation is seen to have been high, cf. Table 1. For the short-term unemployed it

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<tr>
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<th>Low income</th>
<th>Average income</th>
<th>High income</th>
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<tbody>
<tr>
<td><strong>Short-term unemployed:</strong></td>
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<tr>
<td>Germany</td>
<td>81</td>
<td>76</td>
<td>72</td>
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<tr>
<td>Denmark</td>
<td>92</td>
<td>72</td>
<td>58</td>
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<tr>
<td>OECD</td>
<td>75</td>
<td>67</td>
<td>57</td>
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<table>
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<tr>
<th></th>
<th>Low income</th>
<th>Average income</th>
<th>High income</th>
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<tbody>
<tr>
<td><strong>Long-term unemployed:</strong></td>
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<tr>
<td>Germany</td>
<td>83</td>
<td>70</td>
<td>62</td>
</tr>
<tr>
<td>Denmark</td>
<td>75</td>
<td>65</td>
<td>52</td>
</tr>
<tr>
<td>OECD</td>
<td>64</td>
<td>51</td>
<td>39</td>
</tr>
</tbody>
</table>

Note: Net compensation rates. The figures are averages for 6 different family types. “Short-term unemployed” is the initial unemployment compensation after any waiting period. “Long-term unemployed” is unemployment compensation and welfare benefits, etc. after 60 months’ unemployment. “Average income” is equivalent to the average income of a worker in manufacturing industry; “Low income” and “High income” are, respectively, 67 and 150 per cent of the “Average income”. “OECD” includes all 30 OECD countries except Mexico and Turkey.

Source: OECD (2004b) and own calculations.
has been particularly favourable for those in the high income brackets, while e.g. the Danish system is relatively generous to the low income brackets. For the long-term unemployed, German unemployment benefits have so far been relatively generous across income brackets.

Viewed in isolation, a generous unemployment benefit system increases unemployment since the gap between earned income and unemployment benefits is small. The response is usually to set a number of requirements for entitlement to unemployment benefits, in particular availability for work. In practice it is difficult to measure whether the conditions are lenient or not. However, the figures available indicate that the formal German availability requirements – including any sanctions – have been fairly mild, cf. Chart 3. The German rules were tightened slightly from 1997 to 2004, but the gap to the OECD has widened marginally. The opposite is the case in Denmark, where unemployment benefits are also generous, but there has been a firmer attitude towards the availability of the unemployed.

The combination of high unemployment benefits and relatively low availability requirements has undoubtedly contributed to a sustained high level of unemployment in Germany. The Hartz reforms aim to counter this, partly by reducing unemployment benefits for the long-term unemployed, and partly by tightening the formal availability requirements, which has already been reflected in far more stringent enforcement (OECD, 2004a).

**Employment protection**

Compared to other countries, it is difficult for German business enterprises to lay off staff. Employment protection is extensive, although the rules have been diluted somewhat in the last 10-15 years, cf. Chart 4. This relaxation solely concerns the rules applying to temporary employees, while those for permanent employees have remained unchanged at a relatively high level. Presumably business enterprises have indirectly sought to increase flexibility by taking on additional temporary employees. In the early 1990s, temporary employees accounted for approximately 10 per cent of the labour force; by 2002 this figure had risen to approximately 12 per cent.

It has proved to be difficult to establish a clear linkage between employment protection and unemployment (OECD, 2004c). There are two opposite effects. On the one hand, restrictive rules protect existing jobs, but on the other hand business enterprises are more cautious towards taking on new (permanent) employees, and investigations reach different conclusions. However, the OECD believes that more restrictive employment protection lengthens the spells of unemployment. As Chart 5
EMPLOYMENT PROTECTION

Chart 4

Note: The employment protection measure can assume values from 0 to 6. The higher the value, the more restrictive the provisions. "Total" comprises rules for both permanent and temporary employees. "OECD" is calculated as a simple average of the 20 OECD countries for which database values are available for all three years: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Greece, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Germany, UK and USA.

Source: OECD, Labour Market Indicators, database.

LONG-TERM UNEMPLOYMENT

Chart 5

Note: Percentage of the unemployed who have been out of a job for more than 1 year. Calculated on the basis of standardised ILO rates of unemployment. "OECD" includes all OECD countries.

Source: OECD, Labour Market Data, database.
shows, long-term unemployment in Germany is substantially higher than in e.g. Denmark, where business enterprises can relatively easily adjust their workforce, cf. Chart 4. Job turnover is also lower in Germany. For certain groups in Germany, the degree of employment protection is determined by age and seniority, which lowers the incentive to change jobs, and thereby the adaptability of the workforce.

Several factors indicate that the restrictive German rules may have had a negative impact on the labour market in recent years.

Firstly, the labour market may have split into two parts, with the *insiders* (permanently employed) using the high degree of job security to push wages, etc. upwards at the expense of the *outsiders* (the unemployed and temporarily employed). Secondly, surveys indicate that stringent employment protection has an impact on the rate at which unemployment can decline (Nickell et al., 2005). The reason is presumably that in a situation with high unemployment business enterprises are cautious towards taking on new staff even if the economy is picking up, since they may later find it difficult to reduce their workforce again. Finally, the costs of employment protection may have increased. Adaptability has presumably become more important in step with globalisation and the general need for structural adjustment of the German economy in response to e.g. reunification.

**Active labour-market policies**

Labour-market policies can be divided into active and passive measures. Active measures include activation programmes to get the unemployed back into jobs via upgrading of qualifications, education, job training, etc. Passive measures are typically unemployment and cash benefits, paid out on the condition that the recipient is available for work.

Active labour-market measures may have both a positive and a negative impact on unemployment. In addition to the positive direct impact of upgrading qualifications, etc., the prospect – or threat – of an activation offer may also motivate some of the unemployed to search for a job sooner than they would otherwise do. It is also tested whether the unemployed person is in fact available for work. This is an objective in itself when the unemployment benefit system is so generous that there could be people who receive unemployment benefits without actually wanting a job. On the negative side, activation may contribute to sustaining unemployment if those being activated are away from the labour market for too long and the quality of the activation schemes is poor.

Germany spends less on active labour-market policies than Denmark, but more than the OECD average, cf. Chart 6. However, the difference is accentuated by the fact that there are far more unemployed in
Germany. Expenditure per unemployed person is considerably lower than in Denmark, where active measures were given higher priority in the 1990s, cf. Chart 6.¹ High expenditure on activation is not necessarily a target in itself since output quality should match input, but it is seen that increased emphasis on this area coincided with a decline in unemployment in Denmark.

Apparently the quality of some of the German activation measures is doubtful. Much of the effort has been concentrated in the former East Germany, where unemployment and the need for retraining have been particularly evident. However, surveys indicate that the measures have primarily kept the unemployed out of work, thereby aggravating the situation (OECD, 2001). On the other hand, there are indications of positive effects in the former West Germany (Lechner et al., 2005).

**Wage costs**

The level of German wage costs is high. Total hourly wage costs in the manufacturing industry were in the range of kr. 200 in 2004, compared

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to approximately kr. 130 in the OECD overall. One reason for the high level in Germany is that a number of welfare programmes, e.g. pensions and health insurance, are partly financed via social contributions split equally between the business enterprise and the employee. If the social contributions are deducted, direct German wage costs are still relatively high, but somewhat closer to the OECD average.

In step with the growing demand for welfare benefits, the social contributions have generally gone up over time and currently amount to almost 42 per cent of wages. Viewed in isolation, this development undermines business competitiveness. As part of its reform plans the German government has now set a target to reduce this contribution, but so far almost no progress has been made in this area, and the demand for welfare benefits is not likely to fall in the future.

Overall, there seems to be a need for adjustment of costs in Germany. This is also indicated by the wage drift, which has mainly been negative in recent years, cf. Chart 7. This reflects that enterprises have agreed

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1 Based on data from the US Department of Labor. At present, however, there is uncertainty concerning the exact figures since the latest publication includes substantial revisions of the historical figures that are not accounted for.

2 The social contribution of 41.9 per cent of wages comprises retirement insurance (19.5 per cent), health insurance (14.2 per cent), unemployment insurance (6.5 per cent) and long-term care insurance (1.7 per cent).

3 So far German industrial exports have fared well, however, due to an attractive product mix, among other factors.
lower wage increases at local level than agreed in the collective bargaining. In addition, enterprises are increasingly hiring staff in subsidised jobs (mini and midi jobs) that entail lower social contributions.

**Wage formation**

During the last few years wage formation has become less centralised. The social partners have permitted opt-out clauses in collective agreements, which allows for the introduction of enterprise-specific supplementary agreements. In 2004, a number of large, export-oriented enterprises concluded agreements entailing longer working hours without equivalent wage increases. Historically, wage formation in Germany has been more centralised than in the OECD countries on average, cf. Chart 8. In view of the relatively high level of costs in Germany, it seems that for a number of years the centralised negotiation framework has not resulted in wage increases that reflect the sluggish labour market and the underlying productivity trends. The trade unions may possibly have focused excessively on the interests of the permanently employed (insiders) rather than those of the unemployed or temporarily employed (outsiders).

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1 The average working hours per employee in Germany are considerably below the OECD average, but at the same level as in Denmark.
The greater decentralisation of wage negotiations in the last few years reflects a high level of costs and increased need to diversify wages, cf. Chart 7, to match levels that the individual enterprises can afford. The need for wage differentiation is also reflected in a declining coverage level for collective agreements. In eastern Germany, which has a less favourable ratio between productivity and wages than western Germany, the coverage is particularly low (Deutsche Bundesbank, 2004).

Unemployment among older people
The German labour market appears to be functioning particularly poorly for the older people in the labour force. Not only is unemployment higher than in a number of other countries, but the participation rate is also considerably lower, cf. Chart 9. The main explanations are the unemployment benefit system and the opportunity to take early retirement.

Unemployment benefits are far more generous for the 55-64-year-olds, who are eligible for the highest rate for 32 months, compared to e.g. 12 months for the unemployed below the age of 45. In addition, the job-search requirements are less stringent for older people. Like Denmark, Germany also offers a number of early retirement options. For instance, the unemployed can retire at the age of 60. The low rate of

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Note: Standardised ILO rates of unemployment, which are not immediately comparable with the rates of unemployment in Chart 1. "OECD" includes all OECD countries except France, Iceland and Luxembourg.
Source: OECD (2004c).

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1 Increasing decentralisation is also seen in Denmark, where the wage level is also high. For a sustained period of time wage increases have been higher than in Germany, reflecting a tighter labour market. See Beier and Pedersen (2005) for an analysis of wages and competitiveness in Denmark.
employment and high rate of unemployment among the over 55s illustrate that the problems cannot be solved by reducing the labour supply via retirement schemes.

The conditions for the older unemployed are one target area of the current reforms. From 2006, the rules will be tightened so that the highest unemployment benefits are only available for 18 months. In addition, more stringent job-search requirements will be introduced, as well as a gradual increase in the early retirement age to 63 by 2008.

**Education and training**

There are indications that education and training contribute to a mismatch between the demand for and supply of different types of labour. Unemployment is generally higher for the less educated. This is particularly true in Germany, cf. Chart 10, and should be linked to the fact that Germany does not perform too well in international educational surveys, e.g. the PISA Survey. Relatively few people go on to higher education, and the completion time is among the longest in the OECD (OECD, 2004a). In addition, the number of people completing higher education declined in the mid-1990s. At the same time, the demand for highly educated labour rose.\(^1\) This discrepancy between the supply of and the

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\(^1\) In Denmark a similar increase in the demand for educated labour was seen in the 1990s, but unlike in Germany the supply also rose, cf. the Danish Welfare Commission (2005b).
demand for labour should be viewed against the background of a relatively rigid wage structure across qualification levels (Prasad, 2004). This means that the excess demand for highly educated employees did not entail any noticeable rise in their relative wages, and vice versa for those with less education. The challenges of matching supply and demand are also reflected in the fact that for a given level of unemployment the number of vacancies has risen in Germany.

CONCLUSION AND PERSPECTIVE

The problems in the German labour market are complex and can only be solved by considering the interaction between a number of conditions. The article points to e.g. reunification, low job flexibility, the use of labour-market policies, a high level of wage costs and a generous unemployment benefit system, which was previously coupled with very lenient availability requirements.

With the "Hartz reforms" the German government has introduced a number of necessary labour-market reforms, the full impact of which has not been seen yet. Against the background of sustained low growth and high unemployment the government presented a 20-point action plan in March 2005, involving e.g. new initiatives relating to better earnings opportunities for the long-term unemployed, lower corporate tax, less bureaucracy and special measures for the marginal age groups among the unemployed. The opposition has commended the plan, but also argues for measures to counteract the limited job flexibility and the high level of wage costs. Previously, the lack of broad political agreement has obstructed the introduction of structural reforms. This is partly attributable to the two-chamber system, under which economic policy decisions must often be passed by both chambers (see e.g. IMF, 2004b).

Overall, the high unemployment rate is the result of inadequate measures in the labour market for a number of years, which has contributed to the current low growth. Because the reform process was not initiated in due time, Germany has been compelled to introduce radical changes in the labour market within the last couple of years. This illustrates the importance of ongoing structural adjustments – even if the short-term economic prospects are favourable.

It is essential to emphasise that the challenges faced by the German economy are not limited to the labour market. For instance, a number of welfare programmes are under pressure, and reforms of the health and pension sectors, among others, have been launched in parallel with the Hartz reforms. The necessary modernisation of the German economy has thus begun in a wide range of areas.
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APPENDIX 1: LABOUR-MARKET LEGISLATION, NOTABLY HARTZ I-IV

During the 1990s and up to 2002 limited amendments were made to German labour-market legislation, including a minor relaxation of the employment protection rules, enhanced measures to combat long-term unemployment and tightening of the availability and unemployment benefit rules. On taking office in 1998, the Schröder government repealed several of the acts introduced by the previous government, e.g. the relaxation of the employment protection rules and some of the measures to tighten availability rules.

In March 2002, the German government set up the "Hartz Commission", headed by Dr. Peter Hartz, Director of Personnel at VW. In August 2002 the Commission presented its report with recommendations for improvement of labour-market policies. Many of these recommendations have subsequently been transposed into legislation, called the Hartz reforms. The highlights of the most recent labour-market reforms are presented below.

Hartz I (2002)
- Creation of special agencies to provide the unemployed with temporary jobs as stepping stones to the primary labour market.
- Increased focus on speed and quality in job placement services.

Hartz II (2002)
- Lower taxes and social contributions for subsidised jobs (mini and midi jobs) – in order to create a flexible low-wage market.
- Support for unemployed setting up their own enterprise (Ich-AGs).

Hartz III (2003)
- Organisational reform of job centres.

Hartz IV (2004)
- Merging of social welfare and unemployment benefits into one means tested benefit, unemployment benefit II, payable after 12 months' unemployment – aimed at reducing long-term unemployment.
- Tightening of the availability rules and possible sanctions.

In addition, a reduction of the maximum period in which older people are eligible for unemployment benefits has been adopted, as well as a minor relaxation of the employment protection rules, creation of "1-euro jobs", tightening of the older unemployed's right to reject jobs, and a raising of the minimum age for early retirement.