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Lessons for the United States from the German Labor Market Miracle

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Executive Summary

Although many nations were severely affected by the recent worldwide recession, the impact on the labor market of various countries—including unemployment rates—varied considerably. In a notable example, Brookings Governance Studies Fellow Elisabeth Jacobs shows that the recession had much less drastic effects on German workers than on American workers. The prime causes for Germany's success can be traced to the country's coordinated market economy, which emphasizes long-term objectives, and to specific labor market policies intended to reduce the shocks of economic reversals. The traditional U.S. focus on short-term gains and protections may not be a model that continues to serve our economy—and our workers—well in competitive global markets. To help us weather future economic reversals with less pain, our leaders may want to examine some aspects of Germany's approach, including the following:

- ***Recognizing and increasing the cost of employee turnover.*** U.S. employers tend to rely on layoffs when demand for their products or services slackens. The costs of this short-term strategy—in unemployment compensation and in rehiring or retraining workers when demand rises—are substantial. In contrast, German employers tend to put more workers on shorter hours, and public and private programs are available that help them do so (short-time compensation and "working time accounts"). Labor market policies reinforce incentives to hoard human capital because of the country's high-skill workforce, because employers are responsible for worker training and because of high levels of employment protection.

- ***Aligning incentives through coordinated reforms.*** Simply pushing for a short-time compensation program for the United States is unlikely to stabilize the workforce in future recessions. Reforms to any one part of the system must take into consideration the incentives created by other employment policies and must align incentives for employers and workers. In Germany, employers benefit from the availability of a flexible working time toolkit and public policies incentivize labor market participation among individual workers. Unemployment benefits are more generous in both value and duration, employment training and services are far more intense and rigorous, subsidies and incentives for re-employment are far more widespread and generous and employment protection remains far stronger than

in the United States. Taken together, this package of policies stabilizes the workforce and the entire German economy.

- ***Encouraging long-term financing mechanisms.*** The ability of a corporation to form long-term commitments—including long-term employment commitments to its workers—depends on its ability to raise capital from sources that share a long time horizon. New institutions, such as the proposed Infrastructure Bank, may help promote the long view in the face of a U.S. investment culture focused almost exclusively on short-term gains.

- ***Increasing the federal role in the unemployment insurance system to allow for greater coordination and alignment of incentives for employers.*** The United States is an outlier in the developed world with respect to unemployment insurance; most other post-industrial nations have federalized programs run by the national government. Our fragmented, 50-state approach creates administrative complexity and costs for businesses operating across state lines and, more importantly, makes policy coordination and reform virtually impossible.

The evolution of Germany's labor market policies toward a system of aligned incentives that supports workforce participation and a more equal sharing of the economic impact of lean economic times, came about despite intense political obstacles. The same level of opposition would face those seeking reforms in the U.S. labor market. Nevertheless, Germany's success—accomplished by a combination of factors including timing, leadership, and widespread recognition of past inefficiencies—shows that reform can happen despite the strength of entrenched interests.

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The U.S. labor market remains mired in the aftermath of the Great Recession and further burdened by long-term difficulties stemming from decades of uneven and slow wage growth. Yet America was not the only nation to experience a dramatic economic contraction in response to the financial crises of 2007. Examination of the impact of contractions on workers in other countries—notably Germany—may prove instructive in understanding the dynamics of the American experience.

Germany's experience of the Great Recession provides a dramatic foil to that of the United States. While German GDP fell even more sharply than ours, the German labor market was virtually unscathed. Indeed, employment growth remained on a steady, strong upward trajectory. Germany's "labor market miracle" is all the more remarkable in the context of Germany's reputation as one of the "sick men" of Europe, ailing from slow economic growth, high long-term unemployment, and a political system unable to adopt economic reforms.[1] What explains the differences between the two nations' recent economic experiences, and what lessons can we draw from these differences?

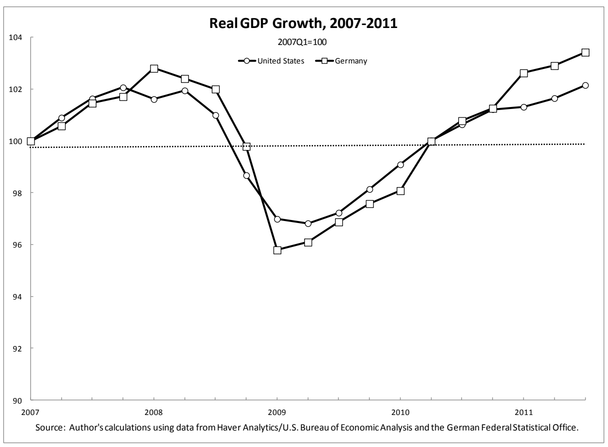
In the pages that follow, I review the factors that distinguish the contemporary German approach to labor market weaknesses, and contrast these policies with the American approach. While specific policies – both public policies and private employment arrangements – help explain Germany's recent success, the underlying reasons for the German "labor market miracle" may have more to do with broad institutional structures and incentives than with specific policies, per se. German labor market and political institutions are structured to encourage coordination, and therefore long-term thinking and a long view regarding economic success,. As a result, I argue, the most important lessons to be learned from the German experience in the American context may have more to do with orienting policy toward shifting the incentive structure in the United States away from short-term thinking and towards a long view more along the lines of the German model.

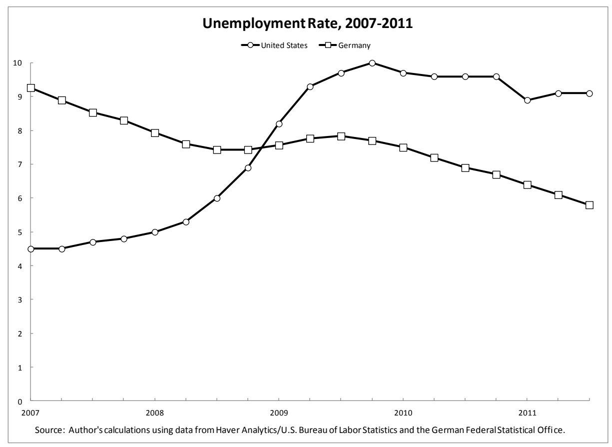
A Tale of Two Recessions

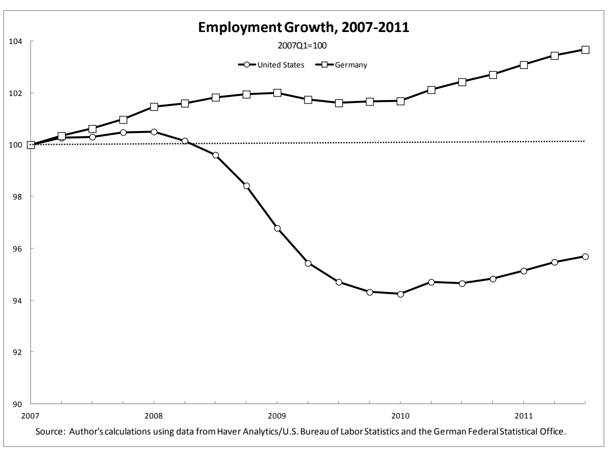
Both Germany and the United States experienced a recent recession of historic proportions. Indeed, the German economic contraction was sharper than the American drop in growth, as shown in the first chart below. German GDP fell by 6.6 percent from its peak in early 2008, compared to the 4.1 percent drop in American GDP.[2] Yet the two countries' labor markets have exhibited dramatically different trajectories. While the U.S. labor market collapsed during the recession and remains remarkably weak during the current recovery, the German labor market was mostly immune to the dramatic drop in economic growth.

The U.S. unemployment rate rose 5.5 percentage points during the Great Recession, soaring from 4.5 percent at the start of 2007 to 10.0 percent at the end of 2009. Two years into the recovery, unemployment in the United States remains close to double its pre-recession levels (see chart). In contrast, the German unemployment rate actually fell during the Great Recession. These contrasting labor market experiences are mirrored in the payroll data. U.S. employment fell by 5.6 percent, and job growth during the recovery remains weak. German employment fell by just 0.5 percent before resuming a steady growth trajectory (see chart). Hours worked declined more sharply than did employment in Germany, but that 3.4 percent decline in person-hours was far smaller than the 7.6 percent decline in person-hours in the United States (see chart).

In short: Germany seems to have weathered the Great Recession with little damage to its labor market, while the United States labor market remains badly beaten by the economic storm.







Changes in Output and the Labor Market in the Great Recession, United States and Germany Percent except where otherwise noted. Data are seasonally adjusted							
	United States				**Germany**		
Measure	*Peak*	*Trough*	*Change*		*Peak*	*Trough*	*Change*
Real GDP	2007Q4	2009Q2	-4.1		2008Q1	2009Q1	-6.6
Unemployment Rate[a]	2007Q1	2009Q4	5.5		2008Q4	2009Q2	-0.5
Employment	2008Q1	2009Q4	-5.6		2008Q4	2009Q2	-0.5
Person-Hours	2007Q4	2009Q4	-7.6		2008Q2	2009Q2	-3.4
a. In percentage points							
Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, German Federal Statistical Office, and Bart Hobijn, Federal Reserve Bank of San Francisco.							
Table reproduced from Burda, Michael C. and Jennifer Hunt. 2011. "What Explains the Miracle in the German Labor Market?" *Brookings Papers on Economic Activity* Spring 2011 (273-335).							

Explanations for the German Labor Market Miracle

Two main explanations have been offered to explain the remarkable performance of the German labor market. The most frequently cited explanation is the German government's short-time compensation program, which allows workers to collect unemployment compensation in exchange for reduced hours at work.[3] Recent empirical work suggests that short-time compensation did have a mitigating impact on employment losses during the recession, but not to the dramatic effect that the popular press would lead us to believe.[4] While German short-time compensation policies were important, so were private employer-employee work arrangements encouraging flexibility in work hours across the business cycle.

Public Policy: Short-Time Compensation (Kurzarbeit)

Short-time compensation (STC) has a long history in Germany, and in the broadest of terms represents a policy incentive encouraging hours' reductions rather than layoffs. In essence, STC programs make labor hoarding cheaper. The German program provides a subsidy for working time reductions, where unemployment insurance partially compensates workers' income losses and the costs to firms for maintaining workers. A firm facing financial difficulties due to a documented demand shortfall can apply to the employment office that administers unemployment insurance program, providing written documentation requesting short-term support. Assuming the application is accepted, the firm then refrains from layoffs but reduces workers' hours and pay, in proportion to the hours' reduction. Workers receive between 60 and 67 percent of the pay they would have received for the hours not demanded. Firms pay workers this "short-time money" and are later reimbursed by the employment agency through the unemployment insurance fund. In order to help protect workers against abuse of the system by management, implementation of short-time work at the firm level must be agreed upon by the works council (establishment-level organizations charged with representing workers' interests).

In past recessions, firms were expected to pay the full burden of social security and other payroll contributions for workers receiving short-time compensation. As a result, average labor costs rose with the reduction of hours. The aggressive expansion of STC during the Great Recession shifted more of this burden onto the state; from February 2009 through July 2009, the government paid 50 percent of all contributions (and 100 percent of all training costs for any training provided to workers on short-time compensation). Currently, the government pays 100 percent of all contributions from the seventh month of short-time work onwards.[5]

During the recession, the German government expanded STC in other ways as well. Firms could claim subsidies for up to 24 months rather than the typical six-month limit. The required minimum number of affected employees was reduced dramatically. Prior to the recession, firms were required to illustrate that at least one-third of their workforce would be affected by slack demand. Currently, firms can access STC if just one employee is at risk. The body of workers eligible for STC was expanded to include temporary workers, who technically work on contract with temporary help agencies rather than under a contract with the firm itself. In addition, the Federal Employment Agency engaged in a marketing campaign aiming to publicize the program as widely as possible, taking out newspaper advertisements encouraging firms to apply for short-time subsidies.[6]

In 2009, approximately 1.1 million German employees worked short-time. This figure represents the highest intensity of use (measured in number and share of all employees) since the beginning of the 1990s, where short-time work was used to dampen the structural consequences of German reunification.[7] The average short-time worker lost about 36 percent of working time, which corresponds to between 340,000-400,000 full-time employees in 2009, or 1 percent of total employment.[8] Deconstructing the sources of declines in hours per worker between 2008 and 2009 suggests that STC accounted for 32 percent of the reduction.[9]

While the government's expansion of Germany's short-time compensation program during the recession almost certainly played an important role in preserving jobs, the policy is not sufficient to explain the remarkable performance of the German labor market. Implemented in the early 20th century and in use since the 1970s, the STC program did not prevent steep increases in the unemployment rate during past recessions (e.g. 1973-1974, and 1993).[10] Anecdotal reports from large German firms suggest that employers were reticent to use STC until recently.[11]

Employee-Employer Arrangements: Working-Time Accounts (Arbeitskeitkonten)

In contrast to short-time work, which is a public policy funded through the federal unemployment insurance coffers, working time accounts are private employer-employee arrangements that require no public dollars but accomplish the similar goal of limiting worker hours during times of slack demand. Working time accounts allow employers the freedom to increase hours above standard work-hours with no immediate remuneration to workers, so long as hours are reduced at some future time with no reduction in take-home pay. Hours are left standard over a set window of time. The number of hours the employer owes the worker are tracked in the employee's working time account; the number of hours owed may be negative or positive. The share of workers with such an account rose dramatically from 33 percent in 1998 to 48 percent in 2005, and the average window for each account was 30 weeks.[12]

Firms do not immediately reduce labor costs by winnowing surpluses in employees' working time accounts, so it is not obvious why firms would do so in a severe downturn in lieu of laying off workers permanently. The key is in the design of the accounts: a worker's account must be paid off in full if he is laid off, either as a severance payment including the overtime premium or in the form of reduced hours at full pay prior to the layoff taking effect.[13] As a result, firms using working time accounts have an incentive to postpone layoffs as long as possible, instead drawing down workers' surplus time banked in working time accounts. A Federal Labor Court ruling at the start of the recession in 2007 strengthened the employers' incentive to use working time accounts by ruling that a firm could not lay off a worker if another employee doing equivalent work had a surplus in his working time account.

Working time accounts were substantially reduced during the recession, particularly between the fourth quarter of 2008 and the first quarter of 2009, when GDP declines were sharpest.[14] Deconstructing the sources of declines in hours per worker between 2008 and 2009 suggests that 17 percent was due to use of working time accounts.[15]

Taken together, the use of public STC and private working time accounts suggest a prominent role for hours' reductions rather than layoffs as German employers' strategy for managing the slack labor demand accompanying the Great Recession. Both public and private policies are structured so that the economic pain of the downturn is minimized through burden-sharing. Rather than place the full burden upon a relatively small share of workers through layoffs, the German model asks more workers to share in the costs. The result is a relatively small sacrifice for a wide swath of the population. Between 2008-2009, the average German worker lost just 3 percent of total annual hours, with the bulk of those hours lost through STC, working time accounts, and foregone overtime.[16]

The Private and Public Roots of Germany's Flexible Working Time Toolkit

The combination of Germany's public short-time compensation program and the private employer-employee arrangements are salient examples of the successful evolution of German industrial relations over the course of the last decade. In addition to decades of iterative adaptation by employers and unions, a series of politically difficult reforms in the early 2000s introduced a new set of flexible labor market instruments into the German economy, which are credited with injecting the "sick man of Europe" with an economic booster shot that restored the competitiveness of German firms. The result is a labor market policy that affords German firms a "flexible working-time toolkit" that allowed them to weather the deep recession with minimal impact on workers.[17]

Germany is a classic "coordinated market economy," characterized by formal and informal linkages between firms and other economic actors (including unions and banks), all of which support a supply of collective goods involved in industrial production (e.g., supply of transferable skills, the provision of long-term financing, technological innovation and labor peace).[18] Business and labor negotiate sectoral or regional collective agreements in accordance with German labor law, and firms subject to the collective agreement cannot undercut its provisions unless they do so in ways that benefit employees. These three main pillars – coordinated business, organized labor and the state – made up the *Modell Deutschland* of the 1960s, and allowed for near full-employment and relatively high, egalitarian wages through the 1970s.[19] While economic pressures in the 1980s and, in particular, in the 1990s post-unification period, put a great deal of strain on the German system, the three main pillars remain intact and continue to play a critical role in shaping the labor market.

Declining union coverage over the last two decades and sweeping reforms to German labor market policies in the 2000s have not altered the basic foundations of the German system. The availability of the supply-side goods stemming from coordination between employers and organized labor encourages firms to develop production strategies that exploit their use. Employers are keen to cultivate long-term skilled employees, so German firms are generally supportive of strong employee protection laws. Union coverage remains relatively high, with 63 percent of the labor force covered by collective bargaining agreements (as compared to just 13 percent of the United States).[20] German unions are a key bargaining partner for employers; their desire to coordinate across as much of the economy as possible means that employers are generally supportive of strong collective bargaining rights and a strong labor movement.

Contrary to what the idea of a "coordinated" economy might suggest to the average American, the German economy is a far cry from socialism. Indeed, the high degree of coordination by business interests means that employers are unlikely to turn to the government for solutions to labor market problems. [21] Coordination depends on firms' readiness to share sensitive information about their needs, growth plans and activities. As a result, Germany features a set of authoritative monitoring institutions (e.g., employers' associations, banks, etc.) that ensure compliance with coordinated business strategies, apply pressure to potential outliers and enforce sanctions against those who fail to comply. These self-governance structures mean that the German state generally exerts a relatively light touch on labor market policy matters.

Evolving Employer-Employee Relations

Just as fundamental as the underlying stability in the German way of doing business, however, is the evolution of industrial relations over the last several decades. A decades-long process of decentralization and re-organization of German industrial relations combined with sweeping labor market policy reforms in the early 2000s created a flexible working-time toolkit that employers relied upon with great success in the most recent recession.[22] These reforms have happened within the context of the existing system of coordinated industrial relations, rather than fundamentally overturning them, in no small part because many firms and workers have incentives to protect that system.[23] This has been especially true in the export-oriented large-scale manufacturing sector, where firms sought (and unions accommodated) greater flexibility and wage restraints in order to bolster international competitiveness.[24] Three critical developments were: the introduction of a trade-off between reduced working hours and working time flexibility, the introduction of opening clauses and the introduction of company-level agreements trading employment security for flexibility of working time and/or compensation.

The flexible working-time toolkit originated in the metals and electronics industries. Facing rising unemployment and the fall-out from the 1970s oil crisis, the dominant metalworkers' union (IG Metall) proposed a reduction in working hours from 40 to 35 hours a week as a strategy for countering unemployment. In exchange, employers demanded more flexible working time at the plant level, in order to increase efficiency and competitiveness in the globalizing market for exports. The resulting 1984 Leber Compromise institutionalized both reduced hours and working-time flexibility in the metals and electronics industries.[25] In the ensuing years, more than 10,000 plant-level agreements were negotiated that specified variable working time, seasonal working time, and further introduced working time accounts. Other industries soon adapted similar agreements that balanced working time reductions with working-time flexibility.[26] In addition to introducing flexibility as a basic tool, these agreements represented a move toward a less centralized system of industrial relations, whereby each company negotiated working time independently, rather than at a sectoral level.

The second critical flexible working-time toolkit element is the diffusion of "opening clauses" in collective agreements, which allow for greater firm flexibility in working time. When the West German collective bargaining system was transferred to the East following unification, many East German firms could not pay the collectively agreed-upon wages. Union concessions allowed those firms to introduce hardship clauses permitting deviations from collective agreements. During the 1992-1993 recession, opening hardship clauses spread into collective agreements in West Germany, with temporary working time reductions and wage reductions serving as employment protection measures. In subsequent years, opening clauses became normalized, even in non-recessionary times. By 2004, 75 percent of firms made use of an opening clause.[27] Perhaps most notably, the 2004 Pfzorheim Accord in the German metal industry sought to "secure competitiveness" by allowing firms to deviate from collectively agreed-upon working time, pay and bonuses; the unions agreed to the accord largely due to pressure from then-Chancellor Gerhard Schröder, who threatened to enact formal legislation standardizing opening clauses if the unions failed to accommodate employer demands for increased flexibility.[28]

The third key toolkit element is the rising prevalence of company-level pacts between employee representatives ("works councils") and management, which grant workers employment security in exchange for concessions on working time and/or compensation. The goal, shared by both employees and employers, is to maintain competitiveness by reducing costs and increasing productivity.[29] In negotiating the Volkswagen agreements of 1994, management, the firm-level works council and the industry-wide IG Metall union produced a company-level pact that reduced weekly hours, cut compensation, and preserved 30,000 jobs. Management viewed reduced working time as an attractive alternative to the government-sponsored short-time work compensation program, which was expensive due to the requirement that employers continue to pay workers' full social benefits contributions. Firing workers was an unacceptable alternative, reflecting the German commitment to long-term employment.[30] The proportion of firms with company-level pacts rose from 30 percent in 1999 to 58.5 percent in 2010, and most measures negotiated in these pacts concern working time.[31]

Evolving Public Labor Market Policies

In addition to these three critical developments in private sector working-time management, the German coalition government under Chancellor Schröder successfully implemented a series of labor market policy reforms that reinforced enhanced flexibility. Commonly known as Hartz I-IV, the reforms stemmed from a politically-appointed commission headed by Volkswagen CEO Peter Hartz and became part of Schröder's Agenda 2010 initiative aimed at tackling rising unemployment and moribund growth. The reforms were phased in from 2003 and 2005, and reflect a three-part strategy: 1) improving employment services for the unemployed, 2) encouraging labor force participation by the long-term unemployed and 3) fostering labor demand by relaxing labor market regulations. The reforms fundamentally changed the legal framework determining the rights and responsibilities of the unemployed and relaxed employment protections in some segments of the labor market.

Prior to reform, unemployment insurance in Germany was designed to maintain a worker's socio-economic status, rather than serving as a safety net of last resort. All payments made to the individual over the entire period of unemployment were linked to prior earnings. "Unemployment benefits" of 67 percent of the last net income (60 percent for childless workers) were paid for the first 6 to 32 months of unemployment, the time period depending on previous employment duration and age. “Unemployment assistance” of 57 percent (53 percent for childless workers) of the last net income was paid for an indefinite period following the exhaustion of unemployment benefits. Unemployment benefits were financed by contributions from employers and workers, while unemployment assistance was financed by general taxes. Unemployment assistance was, in theory, annually means-tested, and it could be combined with additional tax-financed social benefits. Incentives to take up a job were quite low, because the system combined generous benefits with high benefit-reduction rates that taxed most of the recipient’s additional earned income.[32] Active labor market policies prior to reform did little to incentivize work effort, with minimal weight given to job search assistance and a very minor role for policies supporting the direct integration of jobless workers into regular employment. Search effort requirements were rarely enforced, and assignment into training programs was largely based on caseworker discretion rather than systematic profiling.

The Hartz reforms overturned the status quo and introduced a new model of labor market policy for Germany. First, they aimed to improve the performance of placement services and training programs. Public employment services agencies were re-organized, with results-based accountability systems implemented at a local level. Caseworkers’ case loads were reduced, with every jobseeker assigned a fixed caseworker. Market forces were introduced into employment services, in an effort to improve the quality and efficiency of services. For example, vouchers for job training services were made available to unemployed workers whom the public agency fails to place within six weeks of unemployment, and public employment services agencies have the option to outsource placement services.

Second, the Hartz reforms aimed to “activate” the unemployed. Under the prior unemployment insurance system, previous contributions were the key criterion for benefit access. Following the reforms, access to benefits is strictly conditioned on a person’s ability to work.[33] Those capable of working are assigned to employment services agencies, and are subject to activation policies based on the principle of “rights and duties.”[34] An unemployed worker receives “Type I” benefits for the first 6 to 12 months of unemployment (determined by length of prior employment). Thereafter, the unemployed worker is entitled to substantially less generous “Type II” benefits, commonly referred to simply as “Hartz IV”; unlike “unemployment assistance” in the prior system, Hartz IV benefits are not earnings-based. Additional means-tested social assistance is not available to those receiving Hartz IV benefits and is now available only to those who are not capable of working due to illness, disability, or care responsibilities. In exchange for a promise of services, the unemployed are now required to take any offer of suitable work (or to forfeit benefits).

In addition to essentially revising the contract between the individual worker and the state, the Hartz reforms also introduced a number of policies aimed at making work pay, and thereby incentivizing labor force participation. Two programs provide generous subsidies for start-up business begun by unemployed workers: “bridging allowances” provide the equivalent of 6 months of unemployment benefits plus a lump sum social security contribution, and *Ich-AG* (“Me, Inc.”) subsidies provide a three-year subsidy to entrepreneurs with incomes at or below 25,000 EUR (about $33,000) annually.[35] In addition, Germany now offers wage insurance to all older workers; when workers age 50 and over accept a job offer that pays less than their previous job, they are eligible for a limited-duration, government-funded wage subsidy equivalent to 50 percent of the difference between their prior wage and their current wage. The Hartz reforms also introduced several new types of employment for low-wage workers, including “minijobs” (jobs with a monthly income below 400 EUR, or about $520) and midijobs (jobs with a monthly income of 400 EUR to 800 EUR, or between $520 and $1040). Both mini- and midijobs require reduced social security contributions, thus effectively increasing employees’ net wages.[36]

The third key element of the Hartz reforms was the relaxation of labor market rigidities through deregulation. Many of these reforms built on the long-term trends in labor-management relations. Regulations on temporary work were formally loosened after decades of gradual liberalization; for instance, the reforms abolished restrictions on fixed-term contracts and the maximum duration of temporary employment, and permitted the use of temporary work in the construction industry provided that a collective bargaining agreement applies. However, the reforms are still very much within the confines of the coordinated system: a temporary work agency must either guarantee equal pay and equal treatment of temporary and regular workers, or they must join a collective bargaining agreement between trade unions and employers. Reforms to fixed-term contract regulations and dismissal regulations were similarly circumspect. Prior to reform, exemptions from fixed-term contracts were permitted only for employees ages 58 and over (i.e., only these older workers could have fixed-term contracts repeatedly renewed without justification). Following reform, these exemptions were permitted for employees ages 52 and over. Prior to reform, exemptions from dismissal protection were granted to firms with five or fewer employees. Following reforms, firms with 10 or fewer employees may dismiss workers for reasons other than conduct, personal capacity or redundancy. Note, however, that employment protection legislation did not change at all, and remains quite stringent. Moreover, the wage-setting process remains highly centralized in collective agreements between unions and employer associations.

The role of the Hartz reforms in the German labor market “miracle” is arguably minimal, because so much of the critical action in terms of increased labor market flexibility occurred in the context of the collective agreements between employers and employees. However, the Hartz reforms highlight two relevant points in comparing U.S. and German labor market performance during recession. First, despite moves toward a neoliberal system, Germany’s labor market policies post-Hartz are still fundamentally different from those in the U.S. system. Unemployment benefits in Germany remain more generous in both value and duration, employment training and services are far more intense and rigorous, subsidies and incentives for re-employment are far more widespread and generous, and employment protection remains far stronger than in the United States. To suggest that Germany’s success stems from emulating the United States is to misunderstand both the German and American systems.

Second, and perhaps even more importantly, the Hartz reforms provide an example of successful sweeping labor market policy reforms despite intense political obstacles. This is a lesson of particular value for U.S. policymakers, who face steep political barriers to change – political gridlock, polarization, and entrenched interests have led many to throw up their hands at the prospect of meaningful reform anytime soon. Germany’s public labor market policies had long been criticized from all sides for their inefficiency and potential contributions to the nation’s labor market problems, while a variety of entrenched interests successfully prohibited meaningful reform. The establishment of the Hartz Commission followed on the heels of a scandal involving the Federal Employment Agency’s falsification of job placement statistics, which provided a rare window of opportunity for change. Rather than bringing together the traditional "social partners" (employers' associations, unions, and government), the Hartz Commission membership drew from a broad spectrum of society – the social partners, the sciences, business consulting companies, large individual enterprises, and politics. Rather than tackling "the unemployment crisis" as a whole, the Hartz Commission was charged with suggesting institutional reforms to active and passive labor market policies. The result was thirteen specific "modules" of reform, which Chancellor Schröder made a top priority for his second term in office, promising to implement the reforms "one to one,"—that is, without major compromises as suggested by the social partners, his own party (the Social Democrats) or the smaller party in his coalition government (the Greens). Following difficult negotiations, including particularly challenging negotiations with the Christian Democrats who controlled the lower chamber of Parliament, two-thirds of the modules were implemented.[37] Both the Commission and the implementation battle are an illustration of the possibility for real reform in the context of significant political challenges.

Germany's success during the most recent recession, then, is likely due to a combination of the evolution of a flexible working-time toolkit for employers, and policy reforms that incentivized labor market participation among individual workers. Both developments reflect an underlying commitment to long-term employment stability for workers, or a "long view" approach. Employers' development of a flexible working-time toolkit evolved to increase competitiveness without a fundamental disruption to employment security; labor traded some control over working time in exchange for continued job security. The overhauling of the unemployment insurance system did little to destabilize this basic arrangement.

Public and Private Responses to Slack Demand in the United States

Contrary to Germany's "long view," American policy and business strategy is oriented around a short-term time horizon, which may explain why short-time work and flexible work-hours accounting remain the exception to the rule in the United States.

American firms relied heavily on layoffs to weather the slack demand conditions during the recession, and hiring has remained weak as consumer demand continues to be frail. Employers were clearly not unaware of the incentive to retain employees, as average hours worked did fall during the recession. However, compared to their German counterparts, American employers were far more likely to eliminate workers rather than reduce worker hours across the board. In the short-run, layoffs make sense for a business looking to trim costs. But in the long-run, they do not – the cost of recruiting and re-training a new worker is substantial. The public cost of layoffs is substantial as well, particularly as compared to the cost of a short-time compensation program. One back-of-the-envelope estimate suggests that short-term work costs about 30 percent of the average unemployment benefit.[38] A more thorough accounting of the costs saved by avoiding layoffs would incorporate the productivity losses that stem from unemployment, lost tax revenues due to prolonged earnings losses following unemployment, increased health care costs due to the long-term health consequences associated with unemployment, and the increased burden on the disability insurance program stemming from the rise in disability receipt predicted by job loss.[39]

The United States does have public short-time compensation programs, but the program structure bears little resemblance to the German model. First, responsibility for unemployment insurance is decentralized to the states.[40] A handful of states (17) had a short-time compensation program (often called "work-sharing" programs) attached to their unemployment systems at the start of the recession, and several more began programs during the recession. Most of these programs date back to the 1970s or early 1980s. Yet work-sharing programs had relatively little impact on unemployment, even though two of the nation's largest states (California and New York) had such programs in place from the recession's start. Participation in short-time compensation programs in the United States peaked in 2009, at about 153,000 workers – just over 0.1 percent of payroll employment. Participation in short-time compensation programs exceeded 1 percent of payroll employment in just two states: Rhode Island and Kansas.

Participation in these programs by U.S. employers may have been weak in part because the programs are unfamiliar and poorly understood. As noted above, most of the existing programs were first implemented in the 1970s or early 1980s, and have changed little since. They are overly bureaucratic and not well publicized. For example, employers are closely held to a very specific plan for short-time work. Most states require that an employer certify that the proposed reduction in hours per worker is an alternative to layoffs, and they then must lay out a specific plan for reduced work hours, usually for specific employees. This allows individual workers to claim unemployment benefits against the scheduled reduction in work time. In contrast, in the German system, the employer must certify that the program is designed due to slack work, but enjoys far more flexibility in the details of implementation. German employers continue to pay employees on short-time and are reimbursed by the federal unemployment fund for the cost.[41]

Moreover, participation in short-time compensation programs has fallen sharply since 2009, because program participants are not eligible for extended unemployment insurance benefits; thus the maximum weeks of short-time compensation available to U.S. workers is 26 weeks.[42] Employee take-up of employer offers of short-time work may have been low, too, because the collection of short-time work compensation reduces future entitlement to unemployment benefits if a worker is ultimately laid off, unlike in Germany where this relationship does not exist.[43] Also, in Germany, the state assumes a share of the burden of fringe benefit contributions (including health insurance), whereas the majority of U.S. programs require employers to continue to provide health insurance and retirement benefits to workers on short-time as if they were working their full schedule, with no state assistance for these costs.[44] Thus, due to their design, U.S. short-time compensation programs typically increase employers' average labor costs.

Nor have U.S. private employment arrangements facilitated reduced-hours strategies. American firms have not developed flexible working-time toolkits as have German firms. While flexible work arrangements (e.g. flexibility in terms of daily starting and quitting times, compressed work-weeks, telecommuting) have become significantly more common in the United States since the early 1990s, working-time accounts play a minor role as a management tool among American firms.[45]

The reasons behind the limited use of reduced-time as a strategy for managing slack demand are rooted in the basic incentive structures created by the American political economy. The United States is a classic "liberal market economy," with very different underpinnings from Germany's coordinated market economy.[46] As a result, capitalism functions quite differently in America, with many incentives aligned toward short-term thinking. Because U.S. employers are only very loosely organized, they have little incentive to invest in collective goods. The state can play a small role in developing collective goods on behalf of employers – for instance, vocational training and education – but governments are not well-suited to make appropriate investments on behalf of firms. In the absence of institutionalized channels for intra-firm coordination, employers are unable to sustain long-view oriented policies. Instead, American firms depend on low-cost, flexible production strategies, and rely heavily on short-term returns to measure progress and success.

Whereas German firms are keen to cultivate and retain long-term, skilled employees and therefore exhibit strong support for statutory employment protection and for unions and collective bargaining arrangements, American firms face a different set of incentives. U.S. firms' competitive advantage comes from low-cost, high-flexibility strategies. This places American business interests strongly at odds with employment protection legislation, market regulations, and organized labor. It also means that American business consistently looks to government for assistance in maintaining low levels of employment protection and other non-wage labor costs, including hostility to collective bargaining.[47]

In short and simple terms: Germany had effective labor market strategies for weathering the Great Recession because of the incentive structures created by its political economy, which encourages long-view strategic thinking and investments by employers, and the resultant strong and diverse coalition of support for active government labor market policies. The United States does precisely the opposite, encouraging short-view thinking and offering little or fragmented support for active labor market policy.

The Sweet Spot?

The "old" German model – highly inflexible labor markets and highly generous social insurance and social welfare policies – was responsible for decades of sclerosis in both the German economy and the German labor market. Yet the American model – extremely flexible labor markets and relatively stingy social insurance and social welfare policies – is arguably responsible for the devastating impact of the economic contraction on the U.S. labor market. Moreover, the American system has generated a highly polarized workforce and remarkably high levels of earnings and income inequality over the last several decades. Based on Germany's recent economic success in the aftermath of a set of sweeping reforms, it is worth considering whether the Germans have hit upon a "sweet spot" along the continuum of labor flexibility/inflexibility, as well as along the continuum between economic security and promoting opportunity. If this is indeed the case, the question then becomes how to best incentivize this behavior in the United States.

The United States is not likely to become a coordinated market economy like Germany's any time soon. Policies – and the institutional trajectories that shape them – are notoriously "sticky," and policy stability is far more likely than policy change over time.[48] America's liberal market economy has long been characterized by a loosely organized business community, with no formal mechanisms for capital coordination. As a result, American labor market policies reflect a commitment to flexibility and low labor costs and offer little stability for workers during recessions. The short-term time horizon over which American employers make decisions and evaluate success translates into a heavy reliance on layoffs during recessions and minimal investment in worker training. Simply advocating short-time compensation programs or pleading with employers and unions to consider working time accounts is unlikely to gain traction. In the absence of reforms that modify incentives for employers (and, perhaps, employees and unions), a shift toward a long-term strategy is unlikely.

Companies adjust their strategies to exploit the comparative advantage of the market economy in which they find themselves. But globalization means that U.S. companies are no longer operating in the same market economy under which existing institutional arrangements developed. Thus, the United States may need to adapt in order to achieve greater levels of coordination if it is to remain competitive in a future characterized by global capitalism. U.S. firms face competition not only within the domestic labor market, but, increasingly, from abroad. We can choose between engaging in a race-to-the-bottom (with China, India, and other nations where the cost of labor is far cheaper and labor is far more flexible) or in a race-to-the-top with nations like Germany, where coordinated efforts have focused on a high-skill, high-wage, export-oriented economy.

The sheer size of the unskilled labor force in the developing world, coupled with weak employment protection, means that the United States is at a comparative disadvantage. Even if we wanted to engage in a race-to-the-bottom strategy, we are unlikely to win. More promising—and more consistent with U.S. values—would be a commitment to engaging in a race-to-the-top, not simply because of the obvious advantages for the population, but also because we are far more likely to succeed. The question, then, is this: How can we tweak the policy incentive structure so that companies – and the government – are oriented toward long-term, coordinated, high-road efforts rather than short-termism? Without this as our focus, we may face economic decline.[49]

By way of conclusion, I offer a handful of thoughts on how we might incentivize a long-term view among employers and government with regards to labor market policy. All are meant as a jumping-off point for further thought, research and discussion, rather than as clear proposals. Changing incentives is hard work – particularly in the context of political and economic institutions that are highly resistant to change, and even more so in the context of a sharply divided and bitterly polarized political environment. Hard thinking about ways to encourage the long view in the United States is a critical first step.

- ***Increase the cost of turnover.*** In the broadest of terms, the cost of labor turnover to German employers is higher than to American employers. This is because of Germany's high-skill workforce, because German employers assume responsibility for worker training (unlike in the United States, where worker training is seen as the government's responsibility), and because of high levels of employment protection. As a result, German companies have incentives to invest in employees' human capital, and labor hoarding becomes an attractive strategy for weathering recession. If labor turnover costs were higher in the United States, layoffs might no longer be an attractive strategy for coping with slack demand. While this framework may be controversial, and certainly is not a political winner, it is worth at least considering whether this basic formulation is at the heart of how to think about realigning incentive structures to encourage a long view amongst American businesses.

- ***Align incentives through coordinated reforms*.** Actors will resist reforms that bring about incoherent incentive structures.[50] This is part of why simply pushing for a short-time compensation program within the context of the current U.S. unemployment insurance system is unlikely to fundamentally change the impact of recessions on the labor market; employers still face multiple incentives to shed labor costs in the short term and have little reason to support such policies. Similarly, this may be why enthusiasm for workforce development policy in the United States is so low. Consider that the Workforce Investment Act, the country's main vehicle for financing workforce development and worker training, has been up for reauthorization, yet unable to secure passage, for years. This is despite a weak labor market, record high levels of long-term unemployment, and fundamental structural shifts in the U.S. economy preceding the Great Recession and echoing into the future. Reforms to any one part of the system are unlikely to gain traction unless they take into consideration the incentives created by other policies operating in the same space. Thus reform to labor market policy should use a "bundle" approach that explicitly aligns incentives for employers and workers.

- ***Encourage long-term financing mechanisms.*** The ability of a corporation to form long-term commitments – including long-term employment commitments to its workers—depends on the ability to raise far-sighted capital. The longer the time horizon of capital suppliers, the greater the autonomy of corporate managers. Indeed, the time horizon of capital is one of the defining determinants of variation between political economies.[51] The involvement of "patient capital" will be key to developing a long view among U.S. employers. While the patient capital approach has garnered some attention as an appropriate mechanism for funding aid to the developing world, it is worth considering as a broader strategy for America business.[52]

- ***Design new institutions explicitly (or implicitly) designed to promote the long view.*** Embedding long-view thinking piecemeal has the potential to create traction and a track-record of success. The Infrastructure Bank proposed most recently by President Obama (originally a bi-partisan proposal from Senators John Kerry and Kay Bailey Hutchinson) is a potential example that could incorporate a "patient capital" approach in its leveraging of public and private dollars.

- ***Increase the federal role in the unemployment insurance system to allow for greater coordination and alignment of incentives for employers.*** Each U.S. state designs and manages its own unemployment compensation program with its own rules and administrative structures, and the federal government plays merely an oversight role (and offers back-up financing). In this way, the United States is an outlier in the developed world; most other post-industrial nations have federalized unemployment insurance run by the national government.[53] Our fragmented system makes coordination virtually impossible and complicates administrative matters for businesses operating across state lines (imposing higher administrative costs as a result). Creating a more-unified national system would provide a policy framework under which coordination would be possible and even desirable. Moreover, a broader federal role would make a short-time compensation program far more attractive to business.

Each of these broad ideas represents an area for potentially fruitful reforms oriented towards realigning incentives for both U.S. employers and workers in the context of global capitalism. From both political and economic perspectives, each of these proposals pose significant challenges. Yet the path forward for the American economy may require a commitment to working through these challenges in order to create future opportunities and increased employment stability. Germany's recent success suggests that such efforts have the potential to yield real results. Given the performance of the U.S. labor market over the last several years and the broader problems of stagnant middle-class wages, increases in economic inequality and insecurity, and declining social mobility over the last several decades, the moment may have arrived for turning crisis into opportunity.

Notes and References

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[8] Dietz, et. al. 2011; Burda and Hunt, 2011.

[9] Burda and Hunt, 2011. However, Burda and Hunt point out that person-hours lost to short-time work was comparable to that of the far-shallower 1973-1975 recession, thus crediting the German labor market's performance to short-time work may be misguided.

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