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Germany's Labor Market Turnaround

Time to build on recent improvements and boost demand for workers in Europe's largest economy.

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A recent German Constitutional Court decision to tweak some of the Schröder government's 2003 labor market reforms has led to a renewed debate about the overall direction of those reforms. But while some fine-tuning may be in order, a reversal of Chancellor Gerhard Schröder's overhauls would be misguided. His Agenda 2010 successfully addressed the German labor supply problem, mainly by incentivizing older workers to return to work. It also abolished ineffective instruments such as "job-creation schemes," reorganized long-term unemployment aid, and requires that people prove they're looking for work before they can receive aid.

Now is the moment to build on these achievements and to think about an "Agenda 2020" that would spur labor demand to aim for full employment. Some may find this overly ambitious. But let's be inspired by Germany's recent accomplishments on its classic Achilles heel, the labor market, during the economic crisis. For instance, Germany's short-time working scheme helped significantly to cushion layoffs by extending subsidies for a temporary reduction in working hours. As a result, despite the crisis, the size of the total German working population remained at a record level of more than 40 million people through both 2008 and 2009.

Even more impressive, the labor force participation ratio of older workers, aged 55-64, has risen by a remarkable 15 percentage points over five short years, and is now at almost 59%. How did this happen? Simple: The government removed its funding for early retirement schemes. As a result, many older workers decided to stay economically active.

Likewise, for all the talk about a job malaise among young people, the labor force participation ratio of 15-24-year-olds in Germany also rose by more than five percentage points between 2003 and 2008. That's thanks to early intervention with monitoring and placement activities.

For the first time in three decades, the German labor market has achieved a previously unimaginable milestone: a reduction in the base jobless level. The total number of unemployed in the last boom in 2008 was about 600,000 people less than at the lowest point in the previous boom in 2000. And the number of people receiving long-term unemployment support is now 20% less than in early 2006.

Key to these improvements were stricter monitoring that raised the standards for collecting unemployment aid, and more effective placement and support services for job-seekers. As a result, the unemployed were much more willing to consider lower pay or a longer commute to work. That has helped reduce the duration of unemployment, and cut in half the number of people receiving unemployment aid for up to a year after their layoff.

All of this demonstrates that setting the right kind of incentives can help improve the labor market. There was a time in Europe when the pursuit of such policies, emphasizing personal responsibility and enterprise, would have been rejected as "American." No longer. Today, this concept is accepted and cheered on much of the Continent.

What then should German policymakers put on their future agenda? In social terms, three challenges stand out: The first is combating long-term unemployment; the second creating gainful employment opportunities for low-skilled workers; and the third is to educate and attract skilled labor from abroad. This talent is not only needed to modernize the economy, but also to provide employment opportunities for low-skilled labor.

Those challenges will be at the center of debate not just in Germany, but on both sides of the Atlantic. Regarding low-skilled labor, Germany's basic problem is not that there is not enough work to be had. Everybody knows that Germany has an underdeveloped service sector, parts of which are hidden in a shadow economy that is estimated to account for up to one-sixth of GDP. The key challenge is to reorganize the cost side of the equation. A powerful solution would be to impose the workfare principle on those receiving public benefits - i.e., no financial support without work or engagement for further education. This one measure would make it costly not to take up a regular job in the formal economy. That may sound harsh, but even Scandinavian welfare states have taken similar steps.

Improving Germany's apprenticeship system to ensure that it includes, rather than excludes, young people with low qualifications would also help. Shortening apprenticeship programs to two years from three and de-emphasizing theoretical knowledge would especially help young people from immigrant families to get on the track to gainful employment.

The ageing of Germany's population and the declining size of the workforce pose huge additional challenges. Germany may well have to contend for at least a couple of generations with a rising shortage of skilled labor. Given the already high level of social security contributions, that shrinking labor pool cannot be "milked" much harder to maintain tax revenues, as they would lose the incentive to work.

All of that calls for further adjustments in the future. But the lesson from the past several years of Germany's labor market reforms is clear enough: They worked.

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