



The Hartz Reforms

...and their lessons for the UK

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Acknowledgements

I would like to thank John Winter for his generous support for this paper, Tim Knox for his comments on the text and Tamara Chehayeb Makarem Gaskarth and Susan Gaskarth for their support during the compilation of this report.

Support towards the publication of this study was given by the Institute for Policy Research.

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ISBN No. 978-1-906996-31-4

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Printed by 4 Print, 138 Molesey Avenue, Surrey

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STYLISTIC NOTE

The full title of the body set up to propose reform of the German labour market was the Committee for Modern Services in the Labour Market. This body is commonly referred to as the Hartz Commission after its chair Peter Hartz. The reforms became known as the Hartz Reforms. Consequently this paper refers to the Hartz Commission and the Hartz Reforms throughout rather than using the official bureaucratic terms.

SUMMARY

- Only a few years after German reunification, the German economy began to stagnate. Between 1994 and 2002, it grew by less than the EU average. The GDP growth rate was only 1.6% between 1995 and 2001.
- One of the key problems with the stagnating economy was the high unemployment rate. 13.4% of the German population (including those in labour schemes) were unemployed in 2002.
- Additionally, the German welfare system was seen to be notably over-generous to claimants. This resulted in employers shifting work abroad to find cheaper labour and unemployed persons having no incentive to find work. Ultimately, this led to a reduction in the demand for labour in Germany.
- In 2002, German Chancellor Schröder convened a Commission under his friend Peter Hartz (the Personnel Director of Volkswagen) established to reform the labour market, and address the high unemployment rate.

- Following the Hartz Commission's recommendations, four reforms called the "*Laws for Reform of the Job Market*," (or Hartz Reforms) were enacted in stages between January 2003 and January 2005. These new laws included:
 - the creation of Personal-Service-Agentur to act as temp agencies to place unemployed people with employers;
 - a grant for entrepreneurs, known as the "Ich-AG" (Me, Inc.), to encourage new businesses;
 - benefit cuts of up to 30% if a person on unemployment benefits refused to take up a reasonable offer of work;
 - merging social welfare benefits with long-term unemployment benefits.
- Though the reforms were largely unpopular, they are credited with creating 2.5 million jobs for the German economy and helping the German labour market remain strong through the recession.
- Currently, in the UK, both Conservative and Labour Parties are discussing reforms to wages and benefits. Reforms are necessary, but politically unpopular. The Hartz Reforms can serve as a lesson for the UK by showing how this policy needs to be carefully designed and slowly implemented.

1. INTRODUCTION

“The biggest economy in the euro area, Germany’s, is in a bad way. And its ills are a main cause of the euro’s own weakness.”

The Economist, 3 June 1999

In the 1998 German Federal Election, Social Democrat Party (SPD) Chancellor Gerhard Schröder was elected in coalition with the Green Party. In his election campaign, he had promised to reduce the number of Germans registered as unemployed from 4.2 million to 3.5 million within four years.

Three years later little had changed. The Chancellor’s own Council of Economic Advisors (CoEA) issued a scathing assessment of the state of the German economy in their 2002 Annual Report. A member of the CoEA, Horst Siebert, declared: *“Germany is no longer the economic locomotive that it used to be. The economic engine seems to be stalling... weakness of*

economic growth is one of the characteristics of today's Germany.”¹

The German economy had indeed been in the doldrums for some time. With a GDP growth rate of 1.6% a year between 1995 and 2001, it had grown by less than the EU average and two percentage points a year less than the US.²

The headline rate of German unemployment was 8.7% in 2002.³ And if the 1.7 million in labour schemes were included, the real unemployment rate was 13.4%.⁴ This compared to a rate of 8.3% in France, 8.5% in Italy and 5.1% in the UK.⁵ In 1970 the unemployment rate in West Germany had been just 0.7%.⁶

German reunification: intensifying, not causing, the problem

German reunification was often cited as a cause of the German problems. The substantial fiscal transfers necessary to repair the damage imposed by East German Communism did impair economic growth but the European Commission estimates that German reunification was responsible for only one third of the differential rate of growth compared to the EU average.

¹ Kiel Institute for the World Economy, *Germany – The stalling economic engine*, 9 December 2002.
<http://www.ifw-kiel.de/das-ifw/organisation/siebert/siebert-pdf/stalling.pdf>

² Kiel Institute for the World Economy, op. cit.

³ European Commission, Eurostat, *Unemployment Rate 2001-2012*.

⁴ Kiel Institute for the World Economy, op. cit.

⁵ European Commission, Eurostat, *Unemployment Rate 2001-2012*.
[http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Unemployment_rate_2001-2012_\(%25\).png&filetimestamp=20130627102805](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Unemployment_rate_2001-2012_(%25).png&filetimestamp=20130627102805)

⁶ Kiel Institute for the World Economy, op. cit.

Some mistakes were made. For example, converting East German Marks with the West German Mark at a rate of 1:1 inflated the value of the East German Mark by 400%. Controlled for productivity, wages in East Germany were equivalent to 130% of West German wage rates. However, reunification initially gave the German economy a significant boost. German GDP grew by 5.7% in 1990 and 5.0% in 1991.⁷

The level of structural unemployment in West Germany had been growing since the 1970s. Horst Siebert, a member of the CoEA, explained how: *“In each recession, roughly one million were added to the unemployed in Western Germany, and the high unemployment was not reduced during the boom years in a noteworthy way so that the next recession started from a higher level of unemployment. With unification, the structural unemployment problems in Eastern Germany were added.”*⁸

Welfare: a hammock more than a safety net

The previous welfare system was notably generous to claimants. It had been designed to maintain the unemployed in their current social station until they could find a job they desired, and which matched their qualifications and experience.

Benefit levels were high and were of long duration (see Table 1). The Federal Labour Office (FLO) gave a low priority to job search assistance and monitoring. Sanctions for failing to meet job search requirements were rarely applied. Linking unemployment benefits to the former salary set a high *de facto*

⁷ Kiel Institute for the World Economy, op. cit.

⁸ Ibid.

minimum wage, meaning there was little incentive for the unemployed to find work.

A newly unemployed person who had made contributions to the social security system would receive unemployment benefits for the period for which they had earned an entitlement. To qualify for unemployment benefits (until the 2005 changes) the claimant had to have worked 12 months in the previous three years. Once this ran out they would go on unemployment assistance. This was also linked to their former wage but paid for out of general taxation. This could be supplemented by welfare benefits to ensure an adequate income. Sickness benefits were also linked to former salary and paid at a high percentage for an extended duration.

Social insurance that shortened individuals' working lives

Because unemployment benefits were linked to contributions, there was little stigma attached to claiming them. One think-tank commented that: *"the German unemployment benefit system guaranteed constant and high compensation streams (up to 32 months) for elderly workers."*⁹

⁹ Ralf Wilke, Stephan Dlugosz and Gesine Stephan, *Fixing the Leak: Unemployment Incidence Before and After the 2006 Reform of Unemployment Benefits in Germany*, Centre for European Economic Research December 2009.
<http://econstor.eu/bitstream/10419/29636/1/61581140X.pdf>

Table 1: Benefits in Germany before the Hartz Reforms

	Description	Duration	Amount
Unemployment benefits	Linked to worker contributions and paid to the unemployed.	Varied with age but went up to 32 months.	67% of the previous income for unemployed with one child; 60% for the childless.
Unemployment assistance	Began when unemployment benefits run out. This was means-tested and financed from the federal budget.	Indefinite.	57% of previous wage in cases of a worker with one child; 53% for the childless.
Welfare benefits	Means-tested benefits to ensure decent condition of life. For a married worker with one child.		70% of the lowest wage in the industry sector. 100% of the lowest wage professional in low-paid sectors e.g. service industries.
Sickness benefits	Limited to 78 weeks in a three-year period for the same illness.	First six months: After six months:	100% of previous gross wage. 80% of previous gross wage.

The minimum age to receive 32 months of unemployment benefit – the maximum duration of unemployment benefits – was raised to 57 years old in 1997.¹⁰ However, unemployed citizens over the age of 57 continued to be able to stop their job search and withdraw from official unemployment status and still receive unemployment benefits. The elderly used these benefits as a *“popular bridge between the exit out of regular employment and the entry into old age pension. Unemployment incidence was high among older workers with long tenure, and their labour force participation rate was also exceptionally low.”*¹¹ Unemployment rates for the elderly rose to between 20% and 25% in the mid-1990s.¹²

High social security taxes sapped the desire to work

The welfare system was financed through social security contributions. Half were made by the employer and half by the employee. This reduced the incentive to work by creating a sizeable tax wedge between the gross wage financed by the company and the net wage received by the worker. When combined with income tax, workers on an average income faced a tax and social security charge of 58% if they were married and 67% if they were single.¹³ Of the 58 percentage points of income paid by married workers, 34 percentage points were due to social security.¹⁴

¹⁰ Ralf Wilke, Stephan Dlugosz and Gesine Stephan, op. cit.

¹¹ Ibid.

¹² Ibid.

¹³ Kiel Institute for the World Economy, op. cit.

¹⁴ Ibid.

Employers responded by shifting lower-value roles abroad and using cheap capital to invest in technology. Both these responses contributed to a reduction in the demand for labour in Germany. The decline in the working age population also began to put stress on the social security reserve fund. It was reduced in 2001 from one month to 0.8 months; and in 2002 to 0.5 months.¹⁵ With low immigration levels and a low birth rate, the German system of social security looked unsustainable in the long term.

Marginal work was severely regulated

The German labour market was inflexible as well as expensive. German labour law stipulated that a worker could only diverge from a union-agreed contract if this was favourable to the worker (for example, increased pay or shorter hours). The German courts did not include job security or economic competitiveness as a legitimate reason to alter contracts. Alterations were also not allowed if the original union-agreed contract did not allow for deviations in such circumstances, even if the majority of workers accepted them. Temporary work contracts were limited to two years and employers were prohibited from offering a second temporary contract to the worker after the two years if they did not also offer them the option of a full-time contract.

Hiring individuals for start-ups in new sectors or work in cyclical industries was particularly difficult as workers had come to expect the prospect of secure employment.

Corruption in government discredited previous approach

In addition to the onerous employment regulations, the OECD also explained how corruption and incompetence in the FLO

¹⁵ Kiel Institute for the World Economy, op. cit.

created an urgent need for that body to be reformed. The FLO had been found guilty of falsifying its success rate at finding the unemployed work. This body, employing 90,000 people, had claimed it had found work for around 51% of the unemployed cases it dealt with. In fact, it had only found work for around 18%.¹⁶ An investigation in February 2002 found that 70% of employment cases were being mishandled.¹⁷ German Socio-Economic Panel data indicated that in the early 2000s, 60% of the changes in the unemployment rate were due to increases in the “inflow rate” (i.e. the number of people in the workforce) rather than changes in the “outflow rate” (i.e. more unemployed people finding work).¹⁸ The OECD suggested that: *“The parties running the system arguably had little interest in reforming it, since most of these training and other programmes were run by the social partners themselves, who controlled around 60% of the further education sector.”*¹⁹

¹⁶ Deutsche Welle, Schröder Plans to Revamp Labour Office, 24 February 2002.

<http://www.dw.de/schr%C3%B6der-plans-to-revamp-labour-office/a-448171>

¹⁷ Verena Di Pasquale, *Federal Employment Service to be reformed*, European industrial relations observatory on-line, 4 April 2002.

<http://www.eurofound.europa.eu/eiro/2002/03/feature/de0203204f.htm>

¹⁸ Matthias S. Hertweck and Oliver Sigrist, *The Aggregate Effects of the Hartz Reforms in Germany*, SOEP papers on Multidisciplinary Panel Data Research at DIW Berlin, 21 December 2012.

http://www.diw.de/documents/publikationen/73/diw_01.c.414559.de/diw_sp0532.pdf

¹⁹ William Tompson, *The Political Economy of Reform: Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*, OECD, 2009.

<http://www.oecd.org/site/sgemrh/46190166.pdf>

Klaus Zimmerman of the Institute for Labour explained how “assignment to programs [was] based on the caseworkers’ discretion” with “no systematic individual profiling” or “systematic evaluation.”²⁰ This provided the impetus to establish an ad hoc body outside the traditional corporatist structures – the Hartz Commission – to investigate the problem of high unemployment.

What did the SPD do about unemployment in its first term?

Between 1998 and 2002, the SPD/Green Party Coalition reversed some of the minor labour market reforms implemented by the previous administration of CDU Chancellor Helmut Kohl: job search requirements for the unemployed were relaxed and employment protections for staff of small firms were strengthened. Labour Minister Walter Riester in 1999 drew up plans to end an exemption that reduced the tax and social security contributions due for employing those 6 million workers in low paid jobs which were known as ‘DM360 jobs’. The German Chamber of Commerce estimated these plans could cost 500,000 jobs.²¹ Subsequently these plans were dropped.

A corporatist solution?

Chancellor Schröder reconvened an “Alliance for Jobs”. Its first meeting was in December 1998 and included representatives from trade unions, employer organisations and the Government. It was designed to achieve consensus-based reform.

²⁰ Klaus F Zimmerman, *Structural reforms and the functioning of the Functioning of the Labour Market*, Institute for the Study of Labour (IZA) and University of Bonn, LAC-EU Economic Forum 2013, 22 January 2013.

²¹ *The Economist*, “The Sick Man of the Euro”, 3 June 1999.

However it failed to accomplish this. Trade Unions wanted large companies' boards to be included in the talks to make agreements comprehensive and binding. Agreements made to increase vocational apprenticeships and reduce overtime were non-binding. Employers' associations wanted wage policy guidelines to be agreed in the meetings but trade unions wanted to continue collective bargaining between trade unions and companies on an industry basis. In the run-up to the 2002 Federal Election, it even stopped meeting (there was no meeting between January 2002 and December 2002).²² The SPD included a call for a continuation of the Alliance meetings in its manifesto but side-lined the body after their re-election.²³

A new supply-side approach

The left of the SPD and the trade unions argued that the root cause of high unemployment was insufficient demand. In August 2002 there were 1.4 million unemployed in East Germany but only 76,000 job vacancies.²⁴ The proposed solution was to increase public spending to create demand. German public spending as proportion of GDP increased to 48.6% in 2002 (it had been 39.1% in 1970).²⁵

²² Martin Behrens, Torsten Niechoj, *Future of national Alliance for Jobs under debate*, European Industrial Relations Observatory On-Line, 7 January 2003.

<http://www.eurofound.europa.eu/eiro/2002/12/feature/de0212205f.htm>

²³ Thorsten Shulten, *Tripartite Agreement Establishes National Alliance for Jobs*, European Industrial Relations Observatory On-Line, 28 December 1998.

<http://www.eurofound.europa.eu/eiro/1998/12/inbrief/de9812286n.ht>

²⁴ Lutz Kaiser, *Sweeping Modernisation of Labor Market Policy Proposed*, European Industrial Relations Observatory On-Line, 23 September 2002.

<http://www.eurofound.europa.eu/eiro/2002/09/feature/de0209205f.htm>

²⁵ Kiel Institute for the World Economy, op. cit.

This solution was surprising, not least as the case for more government spending had been somewhat discredited as both spending and unemployment increased in the 1990s. The OECD had criticised the Active Labour Market Policies, in particular the *“extensive public subsidies for short-term work, public job creation and further training.”*²⁶ These combined to create *“a secondary labour market characterised by lock-in effects, zero (or even negative) post-participation effects and substantial dead-weight losses.”*²⁷

There was no shortage in demand for labour – there were one million vacancies unfilled and two thirds of employers said they could not get the staff they needed.²⁸ A black market in labour existed and was estimated at 15% of GDP and generated around €300 billion a year.²⁹

The search for an alternative

Meanwhile, economic growth stagnated, state expenditure on welfare grew and the unemployment rate, having initially fallen, began to resume its long-term upward trend. This suggested that the problem was structural (the product of labour market policy) and not cyclical (the product of a temporary lack of demand). Faced with discredited labour market reforms, and probable imminent defeat in the 2002 Federal Elections, Chancellor Schröder convened a committee (the Hartz Commission) under his friend Peter Hartz, the Personnel Director of Volkswagen, to propose reforms to the labour

²⁶ William Tompson, op. cit.

²⁷ Ibid.

²⁸ Thorsten Shulten, op. cit.

²⁹ *The Economist*, “A plan to put Germans back into jobs”, 22 August 2002.

market. Created in February 2002, its remit was to tackle the single issue of high unemployment, in particular:

- how to reduce the average unemployment period from 33 weeks to the British level of 22 weeks, and thereby save around €20 billion in benefit payments;
- how to reduce unemployment by half (from 4 million to 2 million) within three years.

The Commission delivered its proposals six months later just before the September 2002 elections. The OECD later argued that the Federal Elections helped build the case for the Hartz Reforms. The Government had been elected on a promise to cut unemployment, but unemployment had been rising sharply from 2001. They described how: “...*with elections approaching, the government had to be seen to act decisively to stem the rise in joblessness, particularly since it had been elected on a promise to cut unemployment.*”³⁰

This strengthened the arguments of “modernisers” in the governing SPD who favoured labour-market reform. The Chancellor fully endorsed the Hartz Commission proposals in the 2002 Federal Election. The left of SPD and the trade unions opposition was muted so as not to damage the SPD chances of victory. Once elected, Chancellor Schröder claimed an electoral mandate for the reforms.

³⁰ William Tompson, op. cit.

2. GERMANY STRIKES BACK: THE HARTZ REFORMS

The Hartz Commission was composed of 15 experts: two academics (a law professor and a political scientist), two trade unionists, one representative of an employers' organisation, representatives from management consultancies, company boards and the Government.

Unusually in German politics, the composition of the Commission was not about inclusion and consensus. The two most important employers' organisations – the German Confederation of Employers' Associations and the Federation of German Industry – were not included, nor were the German Confederation of Trade Unions nor the representatives of opposition parties, nor the more traditionalist wing of the SPD, nor the Labour ministry. The OECD commented that the composition “*marked a striking – and deliberate – departure from the tripartism of the Alliance.*”³¹

The Commission made recommendations in 13 areas which are summarised below.

³¹ Ibid.

Table 2: Hartz Commission Recommendations

Job Creation	Improved Placement	Reform of the BA (Federal Labour Office)
Introduction of 'Personal Service Agencies' in each employment district.	Creation of job centres throughout the country.	Simplification of instruments for promoting employment.
Promotion of part-time employment in domestic services (Minijobs).	Simplification of labour law, use of advisory teams, and introduction of notification requirement for dismissal and resignations.	Merger of unemployment benefits and welfare benefits.
Introduction of self-employment or family employment as a new form of labour supported by tax incentives and grants for up to three years.	Expansion of availability of child day-care facilities.	More effective organisation of workflows and control activities at the BA.
Introduction of 'Job Floater' low-interest loans to encourage SMEs to employ previously unemployed individuals.	Tightening the conditions under which individuals could refuse job offers and the institution of flexible sanctions.	
Introduction of company employment 'balance sheets' and payment of bonuses from the unemployment insurance system to those with positive employment development.	Promotion of training and employment for young people, and development of a "bridge" system of employment for older persons involving grants to older workers who accept lower paid jobs or take early retirement.	

These reforms were implemented in stages between December 2002 and January 2005 through the “Laws for Reform of the Job Market” (known as Hartz I to IV).

Hartz I-II

Both Hartz I and Hartz II were introduced in December 2002 and the main provisions are summarised below.

Table 3: Hartz I and II Reforms

Summary of Hartz I reforms
"Staff Services agencies" (Personal-Service-Agentur or PSAs) were established all over Germany and these operated as temp agencies to place unemployed people with employers.
A voucher programme for vocational education was introduced to replace the previous contracting out scheme. This allowed those selected to choose within an area of training decided by their caseworker.
Subsistence payments began to vary according to an individual's ability to work as well as their previous contribution record.
Requirement for companies to register when they make a worker unemployed or for the employee when they resign to give them notice so job search can begin.
Requirement to take up 'reasonable' offers of employment or provide a valid excuse – burden of proof transferred to the unemployed to state why the offer is not reasonable and not the caseworker to explain why it is attractive.
Reform of the law on Temporary Employment and Labour Leasing to end the ban on renewing temporary work contracts with new temporary work contracts.

Summary of Hartz II reforms

New types of employment, "Minijob" and "Midijob" were created. These were short-term and part-time roles with higher thresholds for taxes and social insurance payments for employees and less worker protection to encourage employers to hire.

A grant for entrepreneurs, known as the "Ich-AG" (Me, Inc.) was introduced, to encourage them to start a business and tackle the existence of undeclared employment.

A rise in the number of job centres (their name was changed from labour offices) and an emphasis on them becoming one stop shops combining job search and welfare roles – aim to replicate aspects of the UK job centres.

A more accountable Federal Labour Office

Training vouchers were introduced to help undermine the close relationship between the FLO and the providers of training. This was combined with a commitment to independent evaluation of the impact of these reforms by independent research institutes.

Unemployed clients received a voucher which they could use to pay for the training they sought. All programmes had to be accredited and the scheme was assessed by independent agencies to judge its success and suggest improvements. The OECD believes this combination led to a *"marked shift in training patterns and outcomes."*³²

These reforms also sought to create a nationwide network of temporary work agencies, the Personal Service Agencies (PSAs). These took over the role of the FLO with regard to

³² William Tompson, op. cit.

placing the unemployed who found it hardest to find work, e.g. the young who lacked work experience or the long-term unemployed who may have fallen out of the habits of work.

The PSAs were created by the state, but could be spun out to become private entities undertaking contract work for the state. Their responsibility was to place individuals referred by the FLO in work. The PSA tender specified which hard-to-place target groups it would specialise in and their fee would differ according to prevailing local market conditions and the characteristics of the unemployed individuals targeted. A PSA initially received nine- to twelve-month contracts with a declining monthly fee per case, paid by the FLO. In 2005 this changed to six-month contracts with a set fee for the duration (€500).³³ A success bonus was paid when the individual was placed in a job. In periods when the worker was not placed, the PSA had to demonstrate they were increasing their employability through training.

Among people assigned to the PSAs, the under 25s were significantly over-represented compared to their share of the unemployed population. The next most numerous user groups were women and those in vocational education, though both these groups were lower than their respective share of the unemployed population as shown in Table 4, which also includes the totals for the temporary work agencies.

³³ Janine Leschke, Günther Schmid, Dorit Griga, *On the Marriage of Flexibility and Security: Lessons from the Hartz-reforms in Germany*, WZB Social Science Research Center Berlin, April 2006.
<http://skylla.wz-berlin.de/pdf/2006/i06-108.pdf>

Table 4: Selected socio-economic groups in labour schemes

	TWA-average in 2002	PSA-average from April to October 2003	Share of all unemployed in 2003
<i>Socio-economic group</i>			
Women	27%	34%	44%
Foreigners	14%	10%	13%
Aged under 25	22%	33%	12%
Aged 50 or older	12%	11%	24%
Without vocational education	46%	30%	34%
(Formerly) long-term unemployed	8%	14%	34%
Health-related constraints	Unknown	13%	28%

Source: WZB Social Science Research Centre Berlin

The PSAs were not considered to be a great success: between April 2003 and December 2005 only 130,000 individuals entered a PSA.³⁴ The Social Science Research Centre, in its report *The Marriage of Flexibility and Security: Lessons from the Hartz Reforms in Germany*, suggested that the PSA element of the Hartz Reforms suffered poor publicity, as it failed to achieve inflated targets set by the Hartz Report and one of the major contractors went bankrupt.³⁵ In February 2006 the evaluation report released to parliament on Hartz I–Hartz III recommended the abolition of the PSA.³⁶

³⁴ Janine Leschke, Günther Schmid, Dorit Griga, op. cit.

³⁵ Janine Leschke, Günther Schmid, Dorit Griga, op. cit.

³⁶ Directorate General of the Treasury (France), *How have the Hartz Reforms shaped the German labour market?*, No 110, March 2013. <http://www.tresor.economie.gouv.fr/File/386657>

Legitimising the place of marginal work in the labour market

The trade unions viewed the creation of PSAs and the expansion of temporary work as a threat to their membership. Few temporary workers were members of trade unions. They represented a reserve labour force that the unions feared could be utilised to undercut unionised workers. To ease these fears, the Government allowed the German Trade Union Federation to engage in collective bargaining with the two main employers' associations to form a separate legal arrangement for temporary workers. Without this agreement, the existing law would have required equal treatment for agency workers from their first day. Between 2003 and 2006 the OECD observed a 70% increase in the share of temporary work as a percentage of German employment – from a small base.³⁷

Minijobs – A ladder to permanent work

At the insistence of the opposition-controlled Bundesrat (Germany's upper house and seat of Lander), Hartz II was modified so that the earnings threshold for the "Minijobs" was increased and the range of occupations that could be Minijobs was expanded compared with the original Hartz Commission proposals. Previously it was to be confined to domestic services. Minijobs paid a rate of 10% social security contribution compared to the 22% average.³⁸ The 15-hour limit on marginal employment was abolished.³⁹ From 2003 to 2004 the number of Minijobs increased to 6.64 million.⁴⁰ The Social Science Research Centre

³⁷ William Tompson, op cit.

³⁸ *The Economist*, op. cit., 22 August 2002.

³⁹ Janine Leschke, Günther Schmid, Dorit Griga, op. cit.

⁴⁰ Ibid.

estimates that around half of these people were either young workers under 20, individuals over 64 usually supplementing another income or people with a second job.⁴¹ The maximum earnings for a Minijob were raised from €325 to €400.⁴² Up to this maximum, the employer paid social security contributions and employees still earned an entitlement to retirement insurance.

Midijobs – preventing a disincentive to work

To prevent a huge increase in taxes at the €400 mark Midijobs were created. Past €400, the employee paid a reduced rate of 4% of earnings as social security increasing to 21% for a weekly wage of €800.⁴³ By December 2003, 670,000 workers were registered as Midijobbers.⁴⁴

It has been suggested by the Social Science Research Centre that, as German tax law allows couples to submit joint tax returns, many married couples did not see the benefit of the lower-paid person registering as a Midijobber, even if they were earning within the Midijob earnings range of €400 to €800 per week.⁴⁵ Private households were allowed to claim 10% of the Minijobs cost against their taxable income and paid a reduced rate of 12% in social insurance contributions.⁴⁶ This encouraged families to formalise domestic jobs such as cleaning and childcare, etc. Declared marginal employment in private households doubled

⁴¹ Ibid.

⁴² Ibid.

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ Janine Leschke, Günther Schmid, Dorit Griga, op. cit.

⁴⁶ Ibid.

between 2005 and 2006.⁴⁷ The Social Science Research Centre found that three quarters of Minijobbers and 84% of Midijobbers were women, two thirds of their spouses were employed and the majority were middle-aged.⁴⁸ Surveys of the reasons for individuals entering Mini- and Midijobs showed that a third did so to improve their work-life balance.⁴⁹

Table 5: Demographics: the Midi- and Mini-job

	Woman	Married	Spouse employed	Receiving transfers	Average age
MiniJob (n = 2,445)	73%	72%	66%	27%	47 years
MidiJob (n = 576)	84%	64%	67%	16%	42 years

Source: WZB Social Science Research Centre Berlin

Encouraging self-employment and small start ups

The unemployed were encouraged to set up their own companies under the Ich-AG legislation (“Me Inc.” in English). They could earn up to €25,000 a year taxed at a 10% rate plus a requirement to pay welfare contributions.⁵⁰ Ich-AGs were mostly formed in the services, construction, trade, craft and IT sectors.⁵¹ The Ich-AG allowance was paid as an annual lump sum decreasing to zero over three years.⁵² From the second year of operation, this allowance just covered social security contributions. Those that stopped receiving the allowance could

⁴⁷ Ibid.

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ *The Economist*, op. cit., 22 August 2002.

⁵¹ Janine Leschke, Günther Schmid, Dorit Griga, op. cit.

⁵² Ibid.

still receive unemployment assistance and benefits because they had continued making welfare contributions. This reduced the disincentive to engage in self-employment. This became a type of part-time work particularly favoured by women supplementing existing family income. By September 2005, 236,000 citizens were in receipt of an Ich-AG allowance.⁵³ Until 2005 Ich-AGs were not required to create a business plan. This was later seen as a mistake, as some businesses were created without adequate preparation.⁵⁴

The Hartz III Reforms

The Hartz III came into effect on January 1, 2004. These proposals aimed to cut unemployment benefit for those who turned down a job; and reformed the FLO.

Table 6: Hartz III Reforms - summary of proposals

FLO renamed the Federal Employment Agency (FEA). Ratio of case managers to beneficiaries was lowered, FEA embraced internet and renamed an 'agency' with 'clients.'
Provision to allow a 30% benefit cut if a person on unemployment benefits refused to take up a reasonable offer of work.
Merged job creation and structural adjustment measures into one scheme and reduced the maximum duration.
Access to unemployment insurance benefit was tightened, with the minimum prior contribution period changed to 12 months in the previous two years compared with 12 months in the previous three years formerly.

⁵³ Ibid.

⁵⁴ Ibid.

Sanctions for those unwilling to work

Cuts to social security were controversial not least as Chancellor Schröder had opposed cuts in his 2002 Federal Election campaign. His unpopularity grew and Chancellor Schröder resigned as SPD Party Chairman in February 2004.

The new reforms also meant that single people would be expected to take a job anywhere within Germany. If a job offered 20% less than their former wage, they would still have to accept it. The job applicant would have to convince the labour office that the job was not suitable. It was not the task of the labour office to convince the job seeker the role was worthwhile. Those under 25 could have their employment benefit stopped entirely. Those who refused jobs could lose up to 30% of their benefits.⁵⁵

How did these reforms link in with Agenda 2010?

Chancellor Schröder announced an “Agenda 2010” programme of tough supply-side reform in March 2003. He declared that, *“in the future, no-one will be allowed to rest at the expense of society. Anyone who refuses reasonable work, can expect to face sanctions.”*⁵⁶ Social security contributions were cut as were the basic rate and top rate of income tax (the former by almost 25%, from 19.9% to 15%; the latter by 48.5% to 42%).⁵⁷ Income tax receipts fell by almost €22 billion.⁵⁸

⁵⁵ CESifo Group Munich – Center for Economic Studies, *DICE Report* 2/2005.

http://www.facoltaspes.unimi.it/files/ITA/EPS/ochel_2005.pdf

⁵⁶ *Deutsche Welle*, op. cit., 9 February 2010.

⁵⁷ *Deutsche Welle*, A Quick Guide to ‘Agenda 2010’, 17 October 2003
<http://www.dw.de/a-quick-guide-to-agenda-2010/a-988374-1>

⁵⁸ Ibid.

The Government financed these measures by selling government properties and reducing federal subsidies. The rules requiring mandatory apprenticeships and master craftsman diplomas were also relaxed to allow tailors and goldsmiths without these qualifications to enter the marketplace and compete. Health Insurance Premiums paid by employers from their gross wage were also reduced in stages from 14.3% in 2003 to 12.15% in 2006.⁵⁹ At the same time, the Rürup Commission, looking at the viability of the social insurance system, advised increasing the age of pension eligibility from 65 to 67, and reducing the percentage of the recipients' former income from 48% to 40.1%.⁶⁰ A rival commission set up by the Christian Democrats backed increasing the retirement age to 67 and also advocated a flat healthcare premium.⁶¹

The Hartz IV Reforms

Hartz IV merged social welfare benefits, which guaranteed a minimum income, and the long-term unemployment benefit that began when unemployment I contributory-based benefits expired, into a new unemployment benefit II. This meant lower payments for recipients. Instead of receiving 57% of their former income, benefits were capped at €345 in West Germany and €331 in East Germany.⁶²

⁵⁹ Deutsche Welle, op. cit., 17 October 2003.

⁶⁰ Ibid.

⁶¹ Ibid.

⁶² CESifo Group Munich, op. cit.

Table 7: Hartz IV Reforms - summary of proposals

Unemployment benefits and welfare benefits were combined into one single lower payment entitled Unemployment Benefit II. Previously unemployed German workers could get half their previous salary in benefits while they were out of work indefinitely, could turn down jobs that did not match their specifications or that required a change of location.

Those never employed immediately went on to this scheme; those previously employed receive benefits linked to their previous wage for a period up to two years and then went on Hartz IV. Individuals with savings in excess of €13,000 had to exhaust the excess before they could receive Hartz IV benefits. To receive payment the claimant must sign a contract. This outlined what they were obliged to do to improve their job situation and the help the state agreed to provide.

The claimant could be required to take any type of legal job or face reduction or elimination of benefits. The Labour Office authorised to conduct unannounced inspections to check for the presence of other adults at the claimant's abode or other signs of unreported earnings to ensure correct welfare benefits payments.

The administrative work of the Federal unemployment office and local welfare offices were combined. The Federal Labour Agency had responsibility for the new Unemployment Benefit II.

A new programme for getting the unemployed into non-private work sector was introduced. Known as one-euro jobs, they paid €1 an hour for work in the public interest and the recipient kept their Unemployment Benefit II.

Individuals with a working spouse and/or assets over €13,000 euro had their eligibility for this benefit reduced or eliminated respectively.⁶³ These reforms had unfortunate unintended consequences: they effectively encouraged families to split up and claim as separate households, they punished families where one spouse worked and they disincentivised saving among the working poor.

A new benefit was introduced of €359 a month (not including rent). This combined a series of benefits that previously had to be applied for separately into one single flat-rate benefit. Allowances for the children of the unemployed were also reduced, with children between 7 and 13 years of age being given 60% of the adults' allowance; and those between 14 and 17 years of age receiving 80%.⁶⁴ In October 2009, 1.7 million children were receiving Hartz IV allowances.⁶⁵

The job centre also considered the recipient of Hartz IV benefits 'need community' which included parents, spouses or any recipient sharing a fridge with the benefit claimant.⁶⁶ They did this to detect those whose basic needs might be being met by another. The Labour Office was able to conduct surprise visits to check for undeclared earnings or undeclared residents in the recipients' home. The regulation even meant that recipients of the benefit could have to go through a bureaucratic procedure

⁶³ Paul Roderick Gregory, *Why Obama Cannot Match Germany's Jobs Miracle*, Forbes, 5 May 2013.
<http://www.forbes.com/sites/paulroderickgregory/2013/05/05/why-obama-cannot-match-germanys-jobs-miracle/>

⁶⁴ Ibid.

⁶⁵ Ibid.

⁶⁶ Ibid.

to replace a TV or refrigerator, as the benefits were means-tested and not meant to provide more than the minimum.⁶⁷

Shared responsibilities of Federal and Local Governments

Local welfare offices continued to administer housing and heating benefits. Granting social assistance to those unfit to work remained with the municipalities. The local employment office was responsible for ensuring that the recipient was medically able to work.

The contract between the unemployed and the Federal Labour Agency marked a change in their relationship. It clearly set out the different parties' responsibilities. The motto of the reforms was the "*right and duty principle*."⁶⁸ It included sanctions in the event of a failure to meet these aims. Eligibility for Unemployment II benefits was dependent on signing such an agreement. A March 2013 report for the French Ministry of the Economy and Finance found that individuals with a four to six month contract were 70% more likely to find work compared to a 30% rate for job seekers with similar characteristics not in the programme.⁶⁹

The lowering of the ratio of case managers to unemployment benefit recipients enabled the counsellors to double the amount of time they spent on individual cases and develop more effective plans that were, in turn, more efficiently enforced.

⁶⁷ Paul Roderick Gregory, op. cit.

⁶⁸ CESifo, op. cit.

⁶⁹ Directorate General of the Treasury, op. cit.

The creation of public interest employment

In 2005, “one-euro” jobs were created as part of the Hartz IV reforms. There were 200,000 in the first year and this rose to 320,000 in 2009, before declining sharply in 2011 to 188,000.⁷⁰

The aim of these jobs was to create a pathway to a permanent job for those that were unemployed and on Hartz IV benefits. They enabled individuals to become reacquainted with the habits of work. Those who filled these roles continued to receive their housing, health, heating and social security benefits. The jobs paid between €1 and €2 an hour.⁷¹ The maximum working time was 30 hours.⁷² Those employed for more than 15 hours a week did not appear as unemployed in the FEO statistics.⁷³ These roles were paid tax-free and were mostly charitable and temporary work which had to have a public interest element to prevent them undermining or substituting for ordinary paid work.

The FEO offered the euro jobs to the unemployed and could reduce their benefits if claimants refused to do them. There was no contract of employment. A job-related plan detailed what was expected of the individual. These roles usually lasted between six and nine months. Employees were covered by their employers' insurance for workplace injuries.

⁷⁰ Directorate General of the Treasury, op. cit.

⁷¹ Working-in-Germany, *The One Euro Job*.
<http://www.working-in-germany.com/ein-euro-job-0132.html>

⁷² Ibid.

⁷³ Ibid.

Increased income inequality

These roles, along with reduced benefits and sanctions, have significantly increased income inequality in Germany, even though they reduced unemployment. An OECD report in April 2012 found that: *“Germany is the only [EU] country that has seen an increase in labour earnings inequality from the mid-1990s to the end 2000s driven by increasing inequality in the bottom half of the distribution.”*⁷⁴

They attributed the “*wage moderation*” to a weakening in trade unions and “*a set of reforms in 2003 meant to increase the flexibility of the labour market.*”⁷⁵ A more profound reason for the increase in income inequality is that individuals formerly paid a high level of benefit linked to their former wage for being unemployed, now received means-tested, low-value benefits and were expected to work in low-remunerated roles to maintain their right to these benefits.

The reforms and EU policy/EU law

The Hartz reforms were part of a wider reform policy called the Agenda 2010 programme. This was an attempt by the German Government to implement the EU Lisbon Strategy set out in 2000, which promised, by 2010, to make the EU: *“the most dynamic and competitive knowledge-based economy in the world, capable of sustainable economic growth with more and*

⁷⁴ Kaja Bonesmo Fredriksen, *Income Inequality in the European Union Economics Department Working Papers No. 952*, OECD, 16 April 2012. [http://search.oecd.org/officialdocuments/displaydocumentpdf/?cote=EC/OWKP\(2012\)29&docLanguage=En](http://search.oecd.org/officialdocuments/displaydocumentpdf/?cote=EC/OWKP(2012)29&docLanguage=En)

⁷⁵ Ibid.

better jobs and greater social cohesion, and respect for the environment."⁷⁶

A draft labour law produced by the Ministry of Labour in 2003 stated: *"This labour market reform contributes to the long-term goal of achieving full employment... according to the objectives of the EU employment guidelines... both the Job Activ Law and the Hartz reforms (including Hartz IV) strongly resembled (and referred to) EES [European Employment Service] guidelines"*⁷⁷

It also proposed merging insurance social assistance and unemployment assistance. The European Courts did confirm the legality of aspects of the reforms such as the ability of the German Federal Minister of Economics and Labour to declare a minimum wage in the public interest in particular sectors (2005).⁷⁸

Thus, it might be expected that the reforms would not have had trouble with the European Courts and the European Commission. However, the European Courts and Commission did request some alterations to the Hartz legislation. For example, the Hartz reforms included a regulation specifying that workers older than 52 (before, the age-limit had been 58) could

⁷⁶ Deutsche Welle, op cit., 9 February 2010.

⁷⁷ Sabina Stiller and Minna Van Gerven, *The European Employment Strategy and National Core Executives: Impacts on activation reforms in the Netherlands and Germany*, Journal of European Social Policy, 2012.
<http://www.utwente.nl/mb/csd/research/Stiller%20en%20Van%20Gerven%202012.pdf>

⁷⁸ Kurt Vogler-Ludwig (in cooperation with Simone Leitzke), Discussion Paper: *European Employment Observatory Germany, Job Summit Promoting the Hartz Reforms Quarterly review of labour market trends and policies*, ECONOMIX Research & Consulting, 2005.
<http://www.economix.org/EconomixQuarterlyReviewGermany1.pdf>

be employed on the basis of a fixed-term contract without time limit. It was declared void by the European Court of Justice (ECJ) in 2005. The German Government was required to explore the introduction of other flexible mechanisms to encourage employment for those over 52 years of age.⁷⁹

The Hartz reforms began to move German welfare from a generous and contribution-based system to a basic and taxpayer-financed system. This created the issue of what benefits non-German unemployed EU citizens would receive under Hartz IV. The European Commission is currently seeking to clarify the rights of intra-EU migrants. The Christian Social Union (CSU) Chairman has declared it “*heartbreaking how little the EU Commission takes note of the reality of human life in Europe,*” fearing an influx of welfare tourists.⁸⁰ The CDU/CSU have sought to operate a three-month ban on such EU unemployed migrants receiving social benefits. The issue of immigrants’ access to Hartz benefits has been referred to the ECJ by the Federal Social Court and this issue is awaiting their judgement.⁸¹

⁷⁹ Janine Leschke, Günther Schmid, Dorit Griga, op. cit.

⁸⁰ Daniel Brossler, *EU Commission presents guidelines*, Sueddeutsche.de, 13 January 2014.
<http://www.sueddeutsche.de/politik/sozialleistungen-fuer-zuwanderer-eu-kommission-legt-leitfaden-vor-1.1862254>

⁸¹ Roland Preuss, *Brussels calls Hartz IV exam for unemployed migrants*, Sueddeutsche.de, 10 January 2014.
<http://www.sueddeutsche.de/politik/eu-kommission-bruessel-fordert-hartz-iv-fuer-arbeitslose-auslaender-1.1859619>

The challenging creation of a government database

The OECD criticised the Government for the way the Hartz IV law was introduced. It believed that *“little was done to explain the controversial Hartz IV reform either to the public at large or to those who would be directly affected by it.”*⁸²

Demonstrations were muted until the government sent out a questionnaire to 3.8 million benefit recipients to check their eligibility to the new rules.⁸³ These questionnaires asked about claimants’ personal savings, dietary requirements, health insurance and the income of other family members. The OECD suggests that the form *“frightened and confused many, and gave rise to rumours and misconceptions about what the reform would entail.”*⁸⁴ Combining the benefits required the development of a large single database and expensive software. The system kept crashing initially. However, a week before the Hartz IV reform was to take effect, 94% of questionnaires had been returned and 2.2 million households had received their benefit statements.⁸⁵

Merging unemployment and social benefits

The OECD explained how: *“Rates of long-term unemployment will generally be higher in countries where unemployment benefits are relatively generous and are available for long periods of unemployment. In countries where benefits are low*

⁸² William Tompson, op. cit.

⁸³ *The Economist*, “German Labour Market Reform: Hartz and Minds”, 29 December 2004.
<http://www.economist.com/node/3522141>

⁸⁴ William Tompson, op. cit.

⁸⁵ *The Economist*, op. cit., 29 December 2004.

and of limited duration, unemployed persons will more quickly lower their wage expectations or consider taking jobs that are in other ways less attractive than those which they formerly held.”⁸⁶

To increase the incentives to find work, the Government merged the tax-financed second stage of Unemployment I Benefits with social assistance benefits. This reduced the payments for many recipients. This merger also boosted the number registered as unemployed to above 5 million in February 2005,⁸⁷ creating a false impression that unemployment was going up.

The totemic figure of 5 million unemployed is credited with inflicting some state election losses on the SPD in 2005. IMF research indicates that the change to the official measurement of unemployment added around 500,000 workers to the unemployment rolls between January and March 2005.⁸⁸

150,000 citizens attended marches to protest against the passage of the reforms in 2004, but planned demonstrations for 3 January 2005, the day the reforms became operational, drew only 700 protestors nationwide.⁸⁹ A clear communications campaign could have reassured those benefits recipients

⁸⁶ *OECD Factbook 2013*, Economic, Environmental and Social Statistics.

⁸⁷ William Tompson, op. cit. The increase in unemployment occurred because many of the recipients of social assistance had not previously been registered as unemployed.

⁸⁸ Tom Krebs and Martin Scheffel, *Macroeconomic Evaluation of Labor Market Reform in Germany*, International Monetary Fund 13th Jacques Polak Annual Research Conference, 8-9 November 2012.

⁸⁹ BBC News Online, *German Benefit Protesters Contained*, 3 January 2005.
<http://news.bbc.co.uk/1/hi/world/europe/4142441.stm>

affected and explained that the boost to unemployment numbers was a statistical rearrangement and not an increase in the number of real unemployed.

The impact of the new Grand Coalition

The Government that introduced Hartz I-IV was a Coalition Government of the SPD and the Green Party, two parties of the left. The main opposition parties were both aligned with the right: the Free Democrats (FDP) and the Christian Democrats. The CDU/CSU and the Liberal FDP controlled the upper house – the Bundesrat – for much of the 2003-2005 period, and this gave them an effective veto over the reforms. The Social Democrat-led coalition had a small majority in the lower house – the Bundestag.

In the 2005 Federal Election, a Grand Coalition of the CDU and SPD was formed. In February 2006, the new Coalition introduced a separate Labour Market Reform Act; this cut the maximum period for claiming Unemployment Benefit I to 18 months.⁹⁰ This represented a reduction of 14 months for those aged over 56, an 8 month reduction for those between aged 55-56, a 14 month reduction for those aged 52-54, a 10 month reduction for those aged 47-51 and a 6 month reduction for those aged 45-46. They did not affect individuals under the age of 45. The new rules were effective for all those individuals that lost their job after 31 January 2006.

This reform effectively reinstated a Hartz interim proposal aired in June 2002, but dropped from the final report released in August 2002 after substantial opposition.⁹¹ The effects of these

⁹⁰ Ralf Wilke, Stephan Dlugosz and Gesine Stephan, *op. cit.*

⁹¹ William Tompson, *op. cit.*

changes to Unemployment Benefit I are listed by age group below.

Table 8: Maximum Entitlement Length for Benefits, in months

<i>age group</i>	Until 1/2006	2/2006 to 12/2007	Reduction
< 45	12	12	0
45-46	18	12	6
47-51	22	12	10
52-54	26	12	14
55-56	26	18	8
> 56	32	18	14

Source: Centre for European Economic Research

The impact of the February 2006 reforms on older people entering employment

In February 2006, the maximum entitlement period for unemployment benefits was reduced. One report found: “A considerable anticipation effect just before the reform that led to a peak in the inflow to unemployment during the winter 2005/2006. The size of this effect is surprising, as legal regulations were designed to prevent exactly this anticipation effect. Thus, our results suggest that legislation was not able to fully absorb economic incentives to exploit the old system as far as possible.”⁹²

The authors of this paper examined the impact of the cut in the eligibility period for benefits of up to 14 months, depending on the age of the recipient.⁹³ Between November 2005 and January 2006 the report identified an anticipation effect from the

⁹² Ralf Wilke, Stephan Dlugosz and Gesine Stephan, op. cit.

⁹³ Ibid.

reforms. For the average employee between age 57 and age 64, the probability of transition to unemployment before the full implementation of the reforms was 120% higher.⁹⁴ Following the reforms implementation, individuals between 57 and 64 were 20% less likely to enter unemployment than without the reform.⁹⁵ Due to “*the highly disputed reform*” there was “*a considerable decline in unemployment incidence among older workers.*”⁹⁶ Their study involved a random sample of 2% of employees born before 1970 aged between 40 and 64. It covered the period between 2000 and 2007.

These reforms to unemployment insurance benefit were accompanied by the abolition of a tax-free allowance up to €11,000 for severance pay. As severance payments are linked to tenure this was particularly costly for older workers.

These reforms rapidly encouraged older workers to remain in employment. At the beginning of 2006, the 55 to 64 year old age group represented nearly 15% of all unemployed. By the end 2007, this had fallen to 9%.⁹⁷

How were the reforms implemented so quickly?

The interim conclusions of the Commission were released by Peter Hartz in June 2002 to test the public reaction, and the final report was released in August, just six weeks before the election in September. The OECD suggested that the report: “*...bore little resemblance to the prototype of a government*

⁹⁴ Ibid.

⁹⁵ Ibid.

⁹⁶ Ibid.

⁹⁷ Centre for European Economic Research, op. cit.

report, in style, layout or structure: the summary read more like a manifesto, ending as it did with an appeal to the 'professionals of the nation' to bring forward proposals to reduce unemployment, and it appeared to be aimed at the media and the public rather than at policy élites."⁹⁸

Chancellor Schröder approved the Hartz Reform proposals before the election. The election provided a mandate to implement the reforms. Once elected, the Government did not delay. A top-level steering group including Chancellor Schröder, Peter Hartz and Wolfgang Clement was formed to force the reforms through.⁹⁹

Post-election, the Ministry of Labour and Social Affairs was merged with the Ministry of Economics and Technology under a single minister, Wolfgang Clement.¹⁰⁰ This neutered the opposition from the Labour Ministry, which was seen as more keen on the existing social policy. No representatives of the Labour Ministry were on the Hartz Commission. The preparation of the legislation to change the Social Assistance and Unemployment Assistance was undertaken by a working group of the Commission on the Reform of Municipal Finances.¹⁰¹ This included representatives of the Lander, counties and municipalities, etc. In response to the scandal affecting the FLO, the OECD recounted how: *"The Government turned the volunteer administrative board of the BA, dominated by the social partners, into a supervisory board with no executive*

⁹⁸ William Thompson, op. cit.

⁹⁹ Ibid.

¹⁰⁰ Ibid.

¹⁰¹ Ibid.

functions and installed a new BA management board, made up of professionals and operating under the same rules on the separation of executive authority and oversight that applied to listed companies.”¹⁰²

This neutered their potential opposition to reform.

Concessions to ensure rapid passage of the bills

The reforms were also carefully sequenced to ensure those that were politically and technically easiest to implement were adopted first. The reforms did not tackle the issues of collective bargaining or unemployment protection; nor did they constitute a large-scale attack on restrictive practices that frustrated market entry in various highly regulated sectors, such as the handicrafts industry.

The reforms concentrated on a sector without trade union representation – the unemployed. The Final Report of the Hartz Commission omitted its proposal to limit the duration of income-related Unemployment Benefits I. It had provoked strong trade-union opposition when announced as an interim conclusion; although, as seen above, the post-Schröder Grand Coalition of the CDU and SPD subsequently oversaw the introduction of a reduction in the duration of Unemployment Benefits I effective as of 2006.¹⁰³

Divided control of the federal parliament helped supporters of the reforms by reducing the scope for concessions to the SPD left and the trade unions. Divisions in the administrative control of the benefits system was more of a hindrance. The FLO

¹⁰² Ibid.

¹⁰³ Ralf Wilke, Stephan Dlugosz and Gesine Stephan, op. cit.

administered unemployment benefit, while the municipalities administered social assistance. Combining these two was difficult. The SPD wanted Unemployment Benefit II to be controlled by the Federal Employment Office. The Conservative majority Bundesrat (Upper House of the Federal Parliament) wanted a municipal-run system.¹⁰⁴ A compromise was reached where 69 municipalities were exempted from the agreed system and allowed to opt out.¹⁰⁵ A Municipal Option Act was introduced which codified the division of responsibilities between the Federal Employment Office and the local welfare offices.¹⁰⁶

Did the reforms reduce unemployment?

The Hartz Reforms aimed to reduce unemployment by half by 2005 and to reduce the average length of unemployment by a third.¹⁰⁷

Unemployment continued to increase between 2003 and 2005 while the reforms were introduced.¹⁰⁸ It peaked in 2005 at 11.3% before declining in each subsequent year to 10.3% in 2006, 8.7% in 2007 and 7.5% in 2008.¹⁰⁹ In 2009 unemployment increased by 0.3% from 7.5% per cent to 7.8%. It then resumed its downward course, declining to 7.1% in 2010, then 5.9% in 2011, to 5.5% in 2012.¹¹⁰ An IMF Research Paper estimated that: “*the reform leads*

¹⁰⁴ William Tompson, op. cit.

¹⁰⁵ Ibid.

¹⁰⁶ Ibid.

¹⁰⁷ *The Economist*, op. cit., August 22, 2002.

¹⁰⁸ European Commission, Eurostat, *Unemployment Rate 2001-2012*.

¹⁰⁹ Ibid.

¹¹⁰ Ibid.

to a substantial reduction in the unemployment rate – from 9% before the reform to 7.78% after the reform.”¹¹¹ The German Socio-Economic Panel found that: “Since the implementation of the Hartz reforms in the mid-2000s, the importance of the outflow rate has been steadily increasing. The rising importance of the outflow rate, in conjunction with the falling cyclical volatility of the inflow rate, indicates a substantial increase in matching efficiency.”¹¹²

To simplify – fewer people were entering unemployment and more of the unemployed were finding work. An IMF Research Paper found that unemployment decreased until 2008 and then “barely moved during the Great Recession.”¹¹³

By 2011, the unemployment rate dropped below 3 million, the lowest it had been since 1992.¹¹⁴ The following graph clearly shows the decisive break in the long-run uptrend in unemployment that occurred in 2005.

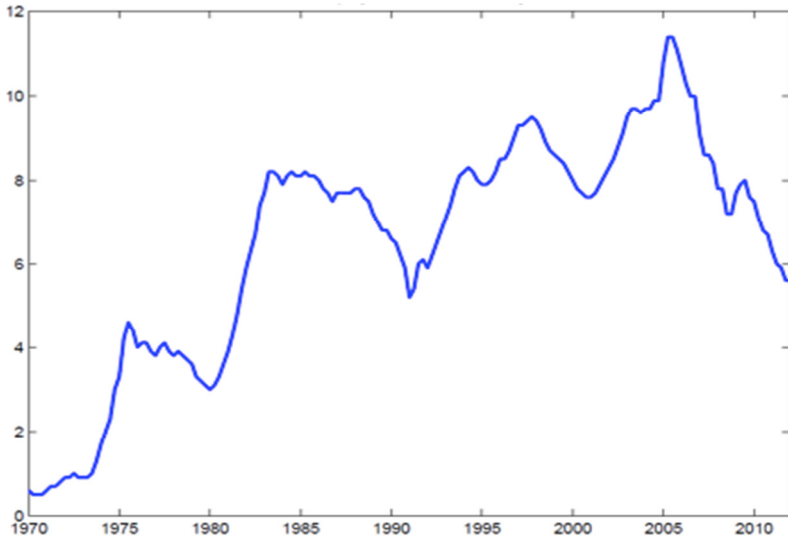
¹¹¹ Tom Krebs and Martin Scheffel, op. cit.

¹¹² Matthias S. Hertweck and Oliver Sigris, op. cit.

¹¹³ Tom Krebs and Martin Scheffel, op. cit.

¹¹⁴ Directorate General of the Treasury (France), op. cit.

Chart 1: The Unemployment Rate in Germany 1970-2011



Source: OECD

Did the reforms increase the size of the active labour force?

A study for the French Ministry of the Economy and Finance in March 2013 found that:

- the German economy created 2.5 million jobs in the period following the Hartz reforms;
- the economically-active population in Germany increased by 4.9% between 2004 and 2011;
- the employment rate increased from 64.9% to 72.4% between 2004 and 2012;
- the labour force participation rate among older workers increased by 16.2%;
- the numbers in part-time work increased by a third.¹¹⁵

¹¹⁵ Directorate General of the Treasury (France), op. cit.

The Reforms and the Social Democratic Party

The labour market reforms split the SPD. In 2005, under the leadership of Oskar Lafontaine, a former SPD Minister of Finance, the left of the party formed a new party entitled Labour and Social Justice – The Electoral Alternative (WASG).

WASG contested the 2005 regional elections in North Rhine-Westphalia. The SPD had ruled this state alone or in coalition since 1966. The WASG gained less than 3% of the vote and then merged with the Left Party in June 2007. However, the Christian Democrat Union won in North Rhine-Westphalia with a 7.9% swing to the party and a 5.7% swing away from the SPD. This gave the CDU/CSU and the FDP an enhanced ability to block SPD reforms when these measures reached the Bundesrat.

In response, the SPD party leader Franz Muntefering and German Chancellor Gerhard Schröder orchestrated the loss of a motion of confidence by urging SPD members to abstain. This was the only way they could procedurally ask the German President to call an early Federal Election. This was called for September 2005. There was a 4.3% swing away from the SPD and a 4.7% swing to the Left Party who increased their number of seats from 2 to 52.

All of the three major parties, the SPD, the CDU and the Green Party, lost votes and seats in the election. The Greens lost their position as the third largest party (held since 1994) dropping to fifth place. The CDU/CSU gained 35% of the vote. The SPD achieved 34% but the personal hostility between Gerhard Schröder and Oskar Lafontaine made an SPD/Left Party/Green party coalition difficult to achieve. Angela Merkel then formed a Coalition Government including the SPD, in which she became Chancellor.

3. TROUBLE AHEAD: THREATS TO THE REFORMS

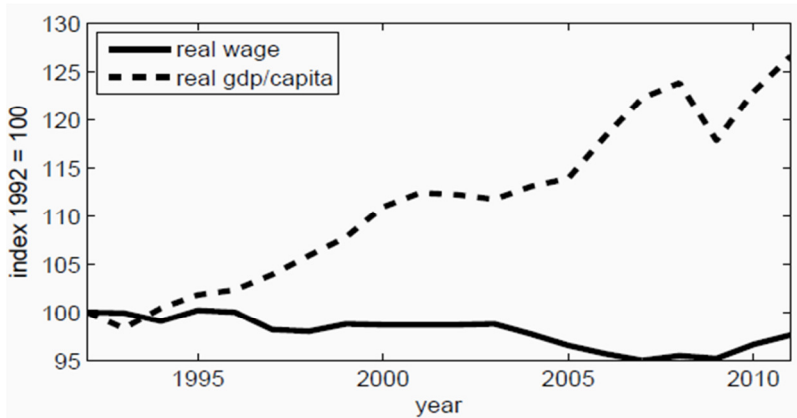
How did German labour costs grow post-Hartz Reforms?

The following graphs demonstrate the impact of the Hartz Reforms on German economic competitiveness.

Chart 2 shows that German wage growth was below growth in GDP throughout the period. This conforms to the German Council of Economic Advisors' advice in 2002 to grow wages below the level of GDP growth to bring the unemployed into employment.¹¹⁶

¹¹⁶ Kiel Institute for the World Economy, op. cit.

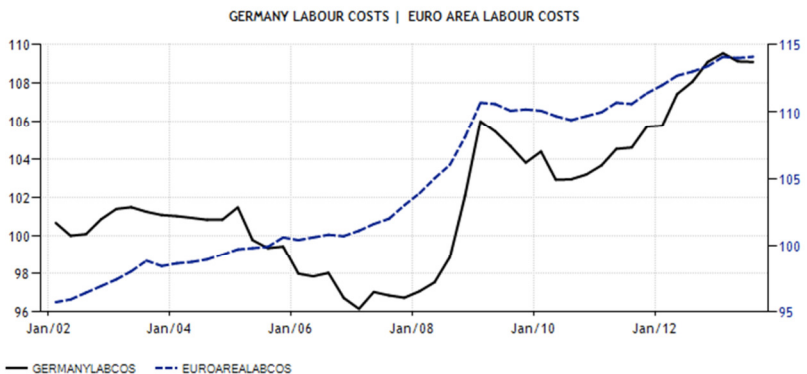
Chart 2: Germany: Real Wage and Real GDP per capita



Source: Statistisches Bundesamt: annual real wage index (series: Reallohnindex) and annual real GDP per capita (series: Bruttoinlandsprodukt) normalised to 1992.

Chart 3 shows German labour cost increases relative to the Eurozone average and reveals that German wages have been growing below the average since late 2005 (the time Hartz IV was introduced).

Chart 3: German Labour Costs compared to the Eurozone

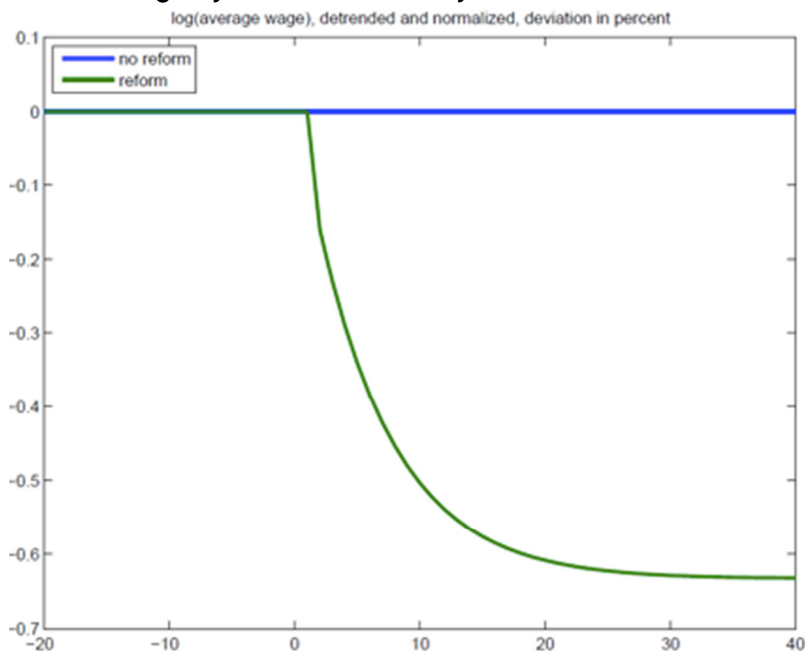


Source: Compiled using Trading Economics tool

Chart 4 shows the impact of the Hartz Reforms on wage growth compared with the alternative steady state model and it shows a clear reduction in wages as a result of the reform. This

answers the question “what would have happened to wages without the Hartz Reforms” – they would not necessarily have increased, but the drop seems to be induced by the Hartz Reforms.

Chart 4: Wage dynamics in Germany

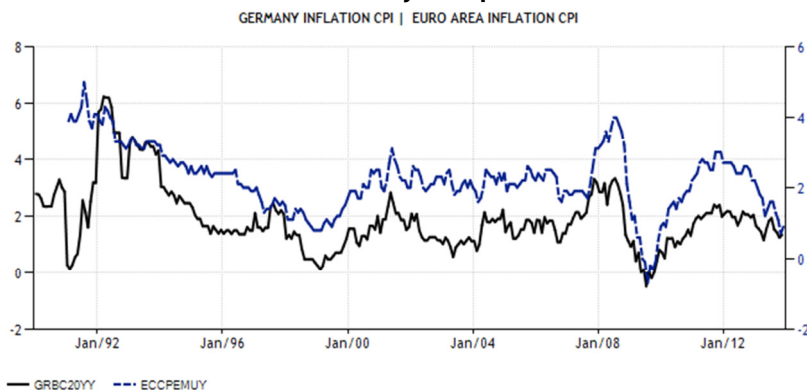


Source: International Monetary Fund, 13th Jacques Polak Annual Research Conference

Chart 5 shows that the reduction in real wages in Germany was not achieved through high inflation: the German inflation rate was consistently below the euro average rate and barely exceeded 2% throughout the period. One commentator has claimed that this wage restraint caused low inflation, which meant that: “Germany’s so-called *real effective exchange rate* within the eurozone fell by 17 per cent between the beginning of 1999 and the third quarter of 2011, making its exports much more price competitive. Over the same period, France’s real

*effective exchange rate rose by 4.4 per cent. Germany's internal devaluation contributed to a big divergence in the two countries' relative trade positions. Whereas ten years ago France and Germany both had small current account surpluses, France is now running a deficit of around 3 per cent of GDP, while Germany is running a surplus of 6 per cent [as of 2011].*¹¹⁷

Chart 5: Inflation rate in Germany compared with the Eurozone



Source: Compiled using Trading Economics tool

The German labour market and the Recession

Despite a decline of 4.7% in German GDP in 2009 and an output decline of over 18% in manufacturing, the German labour market remained strong:

- the German employment level remained at 40 million in both 2008 and 2009, and subsequently rose to 41.5 million,¹¹⁸

¹¹⁷ Simon Tilford, *Why the self-flagellation?*, Centre For European Reform, France: , 10 February 2012.

¹¹⁸ Klaus F Zimmerman, op. cit.

- unemployment increased only marginally and was lower than its pre-crisis value by 2010;
- in October 2013, Germany had the second lowest unemployment rate in the EU at 5.2% (in comparison the UK had a rate of 7.5% and the EU-28 had a rate of 10.9%);¹¹⁹
- the youth unemployment rate (those under 25 years) in Germany was the lowest youth in the EU at 8.1% in 2012 compared to an EU-28 wide rate of 22.8%.¹²⁰

Chart 6 shows how the composition of the German labour market had changed dramatically: the number of inactive citizens decreased, as did the proportion of permanent full-time roles. These had been balanced by increases in the number of self-employed, permanent part-time, marginal/irregular, temporary and agency work.

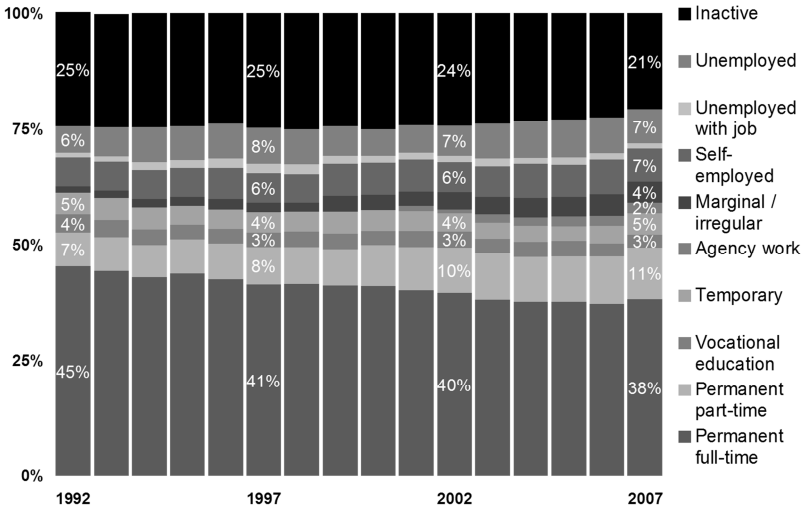
The new flexibility of the employment market limited the effect of the economic downturn of 2008. As the Institute for the Study of Labor commented: *“Without the extensive use of short-time work, unemployment would have risen by approximately twice as much as it actually did.”*¹²¹

¹¹⁹ European Commission, eurostat, *unemployment rates, seasonally adjusted*, October 2013.
http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Unemployment_rates_seasonally_adjusted_October_2013.png&filetimestamp=20131129085903

¹²⁰ European Commission, Eurostat, Themes, Youth Unemployment
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¹²¹ Karl Brenk, Ulf Rinne, Klaus F. Zimmermann, Discussion Paper No. 5780, *Short-Time Work: The German Answer to the Great Recession*, Institute for the Study of Labor, June 2011. <http://ftp.iza.org/dp5780.pdf>

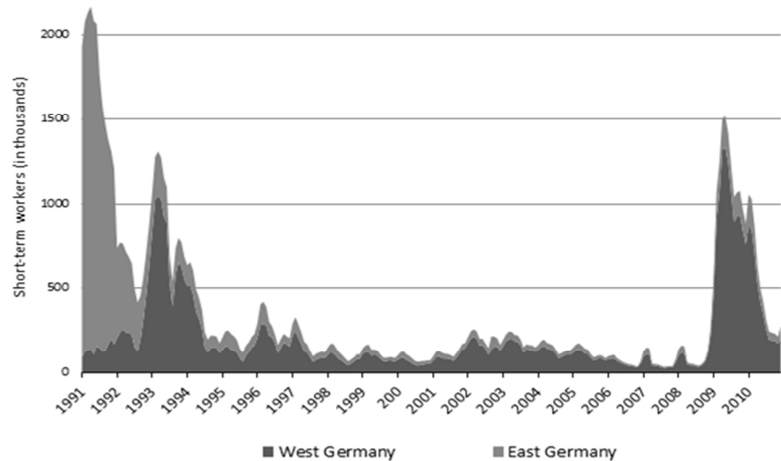
Chart 6: Evolution of the German Labour Force 1992-2007



Source: Institute for the Study of Labour (IZA)

This trend to a more flexible labour force is highlighted in Chart 7 where the proportion of short-term workers peaked in 2009 before dropping sharply.

Chart 7: Stock of short-term workers 1991-2010



Source: Federal Employment Agency

Will the reforms endure?

The SPD has recently been keen to distance itself from the Hartz reforms, which despite their success, have not been popular. As some leading academics have noted: *“The Hartz reforms have always been very unpopular among the German public. This unpopularity has been documented in surveys, but the best evidence comes from the upcoming National Election in Germany to be held on 22 September 2013. There is no major party that dares to run on a platform that openly endorses the Hartz reforms. Indeed, several parties are trying to win votes by promising to roll back the Hartz reforms, including the Social Democrats who initiated the reforms in 2003-2005...”*¹²²

The unpopularity of the reforms has led to some reverses in policy: for example, in 2008, the Grand Coalition partially reversed the 2006 reform by increasing the maximum period of unemployment benefits for both those currently unemployed and the newly unemployed back up to 24 months.¹²³

OECD research has also suggested that Germany’s continuing economic success may endanger the reforms. It has argued that the backlash against Hartz IV: *“...was partly a product of improved labour-market performance, which resulted in part from the reforms: as the situation improved, the sense of urgency about reform declined and politicians were more willing to restore benefits and relax some of the more rigorous elements of the reform.”*¹²⁴

¹²² Tom Kreb and Martin Scheffel, op. cit.

¹²³ Ibid.

¹²⁴ William Tompson, op. cit.

Evidence of this can be found in the recent Grand Coalition negotiations. In the 2013 post-Federal Elections, the SPD have secured a minimum wage of €8.50 euros per hour and a reduction in the retirement age from 67 to 63 for those who have worked for 45 years.¹²⁵ This follows the introduction of a statutory minimum wage in the postal sector in 2007.¹²⁶

Who won and who lost from the reforms?

IMF analysis of the Hartz IV reforms found that:

- employed households gained as the output gains outweighed the welfare loss due to the reduction in unemployment insurance. This gain was equal to “an increase of around 0.3 % of lifetime consumption.”;
- the long-term unemployed suffered a loss equivalent to 1% of their lifetime consumption;
- the short-term unemployed also suffered a welfare loss but “their welfare loss is significantly smaller than the welfare loss of the long-term unemployed.”;
- the reforms lead “to an expansion in output and a decline in real wages”, but the wage effect were “relatively mild.”;
- the rate at which the unemployed found jobs, which had been stable before the Hartz Reforms, afterwards “began to increase steadily until the year 2007, at which stage they remained relatively stable at a significantly higher level.”¹²⁷

¹²⁵ BBC News Online, *Deal reached on new government for Germany under Merkel*, 27 November 2013, <http://www.bbc.co.uk/news/world-europe-25116115>

¹²⁶ William Tompson, op. cit.

¹²⁷ Tom Krebs and Martin Scheffel, op. cit.

Similarly, the OECD has found that:

- the incidence of long-term unemployment dropped from 56.4% in 2006 to 45.5% in 2009;
- around half of benefit recipients experienced a decline in benefits, but one-third had their level of benefits increased.¹²⁸

¹²⁸ OECD Factbook 2013: *Economic, Environmental and Social Statistics*.

4. WHAT CAN BE LEARNT FROM THE GERMAN EXPERIENCE?

Why can't France be Germany?

Research by Societ  Generale showed that, despite there being only a 0.3% gap in employment rates between France and Germany in 2003, this expanded to 10% by 2010.¹²⁹

The unemployment rate rose in France during that period from 8.3% to 9.3%, while it fell in Germany from 9.2% to 6.7%.¹³⁰ Alain Minc, an advisor to President Sarkozy, explained that France's increase in the minimum wage and its introduction of the 35-hour week, combined with the Hartz reforms in Germany, sacrificed the 10% competitive advantage France had over Germany in 1995. By 2007 they had lost 20%.¹³¹ Private

¹²⁹ Gregory White, Why Nicholas Sarkozy Is More Than Happy To Turn The Economic Reigns Over To Angela Merkel, *Business Insider*, 1 February 2011.
<http://www.businessinsider.com/france-economic-reforms-2011-2>

¹³⁰ Gregory White, op. cit.

consumption in Germany had grown by only 4% between 2002 and 2011 but by 17% in France.¹³²

This competitiveness gap led President Sarkozy to announce his support for imitating the German labour market reforms during his 2012 Presidential election campaign, saying “*if it worked for them, why wouldn’t it work for us?*”¹³³ Reuters also reported him saying that “*Germany has had huge success. That doesn’t make us jealous, that inspires us.*”¹³⁴

Sarkozy pledged to cut €13 billion of social charges paid by employers. This would be financed by an increase in the VAT rate from 19.6% to 21.2%.¹³⁵ He also argued for companies to be able to negotiate at the firm level for increases in working hours, provided the workers’ jobs were protected. He did not, however, pledge to abolish the 35-hour week legislation installed by his predecessors.

¹³¹ Spiegel Online International, Part One: *Inside the Elysee: ‘Sarkozy Has Learned To like Angela Merkel’* and Part Two: *Inside the Elysee: The Crisis Has Helped Sarkozy To Become An Adult*, 24 January 2012. <http://www.spiegel.de/international/europe/inside-the-elysee-sarkozy-has-learned-to-like-angela-merkel-a-810868.html>

¹³² Simon Tilford, op. cit.

¹³³ *The Economist*, “France’s Presidential Campaign”, 30 January 2012. <http://www.economist.com/blogs/newsbook/2012/01/frances-presidential-campaign>

¹³⁴ Daniel Flynn, “German boom casts shadow over French election”, *Reuters*, 15 February 2012. <http://uk.reuters.com/article/2012/02/15/uk-france-election-germany-idUKTRE81E01420120215>

¹³⁵ *The Economist*, op. cit., 30 January 2012.

Sarkozy's opponents accused him of "*capitulation to Germany*". Francois Hollande's Campaign Chief Pierre Moscovici believed "*not everything in Germany's economic model deserves to be copied.*"¹³⁶ Opinion polls suggested 62% of French voters thought their nation should take the German approach as an example. But, of course, President Sarkozy nevertheless lost the 2012 election.

Was Germany just lucky?

Some have claimed that the German recovery of the 2000s was due more to other economic factors, such as the sharp increase in demand from emerging nations (such as China) for capital goods. This underestimates the number of nations – in particular, Japan, South Korea and Taiwan – competing to supply capital goods.

Other reasons cited for Germany's economic success were the social market economy with its stress on co-operation and consensus, collective bargaining, strong trade unions and the *Mittelstand* of SMEs. However, this ignores the fact that all of these features were part of the failing German economy of the early 1990s, yet they are part of the successful economy today. They cannot explain the change in fortunes.

Business figures sometimes credit a long-standing German outperformance in exporting.

Are the recent problems with the German economy connected to the Hartz reforms?

In the first quarter of 2014 the German economy grew by 0.7%. In the second quarter of 2014 the German economy declined by

¹³⁶ Daniel Flynn, op. cit.

0.2%. Why the reversal? The Ifo Institute has recorded monthly declines in German business confidence since May 2014. The pro-Russian rebellion in Eastern Ukraine had begun in April 2014, following the annexation of the Crimea. The impact of the economic sanctions over Russian involvement in Ukraine is difficult to quantify but this could be a factor.

Klaus Wohlrabe, an Ifo economist said firms with Russian links were more pessimistic in their survey responses (to the Ifo business confidence survey). Ifo President Hans-Werner Sinn had predicted German economic growth would need to be revised down in the second quarter, partly due to the Ukraine crisis. Germany is a large exporter of agricultural products and Russia's largest European trading partner. Russia has imposed a ban on the importation of some western products. The warm winter in Germany may also have shifted some production to early 2014 e.g. in construction. This may have made the contrast between the two economic quarters appear starker than it was.

Nevertheless the unemployment level remains the second lowest in the EU and the number of people employed in Germany at 42 million in 2013 was the highest level since 1990. Inflation is low, both wages and domestic consumption are increasing. It is too early to tell what the causes of the recent drop in German economic growth are but there is nothing to suggest this is linked to the Hartz reforms.

The relevance to the UK

UK labour costs have recently increased in relative terms compared to our German competitors. The Institute for Fiscal Studies has estimated that during the Labour period in office

the rate rose “*faster than average earnings overall.*”¹³⁷ The UK opt-out from the Social Chapter with its employment and social rights was ended and these rights were incorporated in The Treaty of Amsterdam. Now in opposition, the Labour party, correctly, aims to ensure that working people benefit more from the UK’s economic growth. Higher welfare benefits are politically toxic and public finances are constrained, thus the party is devising means to increase the wages of the working poor to help them out of poverty.

The Labour opposition have developed a concept called ‘Predistribution.’¹³⁸ This is a simple concept – low wage work should pay enough so these workers do not have to rely on supplementary benefits. This is a worthy aim. It is also an electorally-popular one. They want to achieve this through a variety of mechanisms. First, is to pressure companies to adopt the ‘living wage.’ This is a level of remuneration currently determined by the Resolution Foundation to be: “*the purchasing power deemed necessary (albeit still in conjunction with full take-up of tax credits and other means-tested benefits) to provide workers and their families with a basic but acceptable standard of living rather than to estimates of what the market can bear without impacting on employment.*”¹³⁹

¹³⁷ Mike Brewer and Robert Joyce, *Welfare Reform and the Minimum Wage*, Institute for Fiscal Studies 2010 Election Briefing Note Number 8. <http://www.ifs.org.uk/bns/bn95.pdf>

¹³⁸ BBC News Online, *Ed Miliband unveils ‘Predistribution’ plan to fix economy*, 6 September 2012. <http://www.bbc.co.uk/news/uk-politics-19503451>

¹³⁹ Matthew Pennycook, *What Price A Living Wage? Understanding the impact of a living wage on firm level wage bills*, Resolution Foundation, May 2012.

The second is to raise the minimum wage at an accelerated rate (as yet unspecified). The Conservatives have also embraced this movement, with David Cameron declaring in 2010 that the living wage was “*an idea whose time has come*.”¹⁴⁰ Wage remuneration looks set to be a key issue in the next election.

Wage stagnation and politics

Whether the growing recovery is leaving the working poor behind is also a defining issue of the time. Worldwide, the labour share of corporate profits has declined since the mid 1970's. The National Bureau of Economic Research (NBER) in ‘*Declining Labor Shares and the Global Rise of Corporate Saving*’ identified: “*a five percentage point decline in the share of global corporate gross value added paid to labor over the last 30 years*.”¹⁴¹ They found: “*of the 51 countries with more than 10 years of data between 1975 and 2007, 36 exhibited downward trends in their corporate labor share*.”¹⁴²

In ‘*The Global Decline of the Labor Share*’, the NBER explain how “*the lower price of investment goods explains roughly half of the observed decline in the labor share*.”¹⁴³ Research from America also highlights how most economic recoveries begin with an increase in low wage jobs. Research by Dave Altig of the

¹⁴⁰ Ibid.

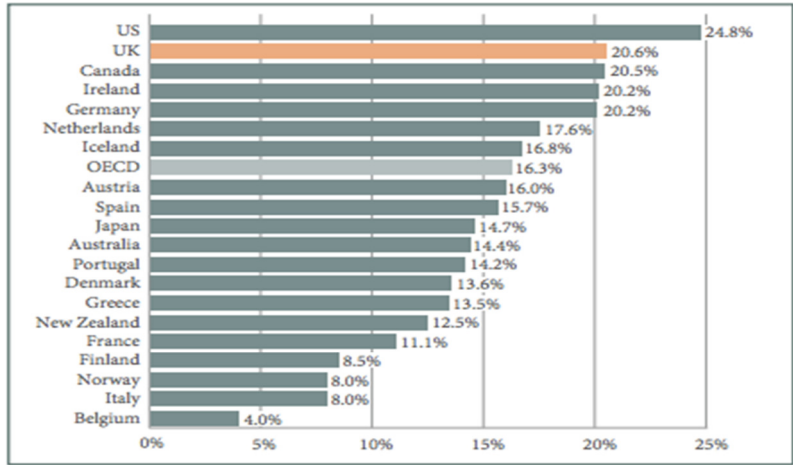
¹⁴¹ Loukas Karabarbounis and Brent Neiman, *Shares and the Global Rise of Corporate Saving Declining*, National Bureau of Economic Research and the University of Chicago, October 2012.
<http://faculty.chicagobooth.edu/brent.neiman/research/LabShare.pdf>

¹⁴² Loukas Karabarbounis and Brent Neiman, op. cit.

¹⁴³ Ibid.

Atlanta Federal Reserve Bank, shows that the lowest wage sectors have provided 40 to 50% of the job gains in the economic recoveries since 1970.¹⁴⁴ The UK has the second highest level of low paid workers among its total workforce, as shown in the Chart below. The Hartz Reforms show that low paid work is an essential part of the economy. What preceded the Hartz Reforms shows what happens when social legislation prices low paid work out of an economy, however well-intentioned that legislation is, the result is higher levels of unemployment.

Chart 8: Share of employees in low paid work



Source: Resolution Foundation

The Labour Party has also proposed a link between the level of unemployment benefits a recipient receives and the tax contributions they have made. Although it is not clear if the total

¹⁴⁴ Federal Reserve Bank of Atlanta, *Myth and Reality: The Low-Wage Job Machine*, 9 August 2013.
<http://macroblog.typepad.com/macroblog/2013/08/myth-and-reality-the-low-wage-job-machine.html>

benefits bill would increase, or if the rises for some will be made up by cuts in the benefits received by those without a contributions record/less of a contributions record. The situation in pre-Hartz Reforms Germany shows how this policy needs to be carefully designed. Otherwise it can lead individuals to take longer periods of unemployment to shorten their working life using contribution-based welfare entitlement to supplement their income until they reach pensionable age.

What are the lessons for the UK?

First, sanctions were introduced to reduce welfare payments to increase the incentive to find work. Second, social protections for low wage jobs were reduced. The responsibility for meeting these social protections was largely transferred from the employer to the state. Third, employment agencies were redesigned; they became more focused on finding individuals work and less on distributing welfare. Fourth, implementation will not be smooth – Germany experienced a temporary increase in unemployment as individuals were laid off under the more generous previous social security terms and experienced problems with the release of a new Government database. Fifth, major reforms cannot be sprung on a people. The failure to win the argument for Hartz VI reforms is one of the reasons it is now being undone. Sixth, rebalancing the economy means becoming price competitive in terms of exports. Germany did this not by devaluing its currency, but by not increasing wages in line with economic growth. This increased employment and exports but reduced domestic demand. Following the German model means the UK population would need to be willing to not increase, and possibly reduce, their spending and accept zero wage growth for an extended period. There is a trade-off between benefit levels, employment protection and employment levels and politicians need to be honest in setting

priorities and accepting the consequences of their policies. The Trades Union Congress in their study *German Lessons: Developing industrial policy in the UK* acknowledges that “Germany’s trade surplus has been achieved at least in part on the back of wage depression to subdue domestic demand, which is not a model we advocate that the UK should follow.”¹⁴⁵

¹⁴⁵ *German Lessons: developing industrial policy in the UK*, Trades Union Congress.

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