

# Germany: building a fairer society

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*Germany will elect a new parliament on 24 September 2017. The main contenders are the outgoing CDU Chancellor Angela Merkel and the SPD leader Martin Schulz. Whereas the Chancellor is defending the economic record of her government, her opponent is emphasising the growing inequality in German society. The latter is related to the labour market reaction to globalisation. Nevertheless, in terms of income inequality, Germany compares still very favourably with the other European countries. Given the booming economy, it remains to be seen whether social justice is indeed a major issue for the voters.*

On 24 September, Germany will elect a new parliament (see Box, page 3). The out-going Chancellor, Angela Merkel, will defend the record of her government, a grand coalition between the two largest parties CDU/CSU (Christian Democrats) and the SPD (social democrats). The economic record of the coalition, in place since December 2013, is quite good: GDP is growing well above potential, estimated at 1.3% of GDP, and unemployment has declined to levels not seen since German reunification, in 1991. Moreover, the government finances are in excellent shape. The budget balance is positive and the public sector debt is close to 60% of GDP.

The Chancellor's main contender, SPD leader Martin Schulz, has been emphasizing that these achievements have come at a cost. Many feel that the German society has become more unequal. Some have even called Germany one of the most unequal rich countries in the world.<sup>1</sup> Traditionally, reducing social inequality has always been a major priority for the SPD. For example, during the current coalition period, the party has been the main driving force behind the introduction of a national statutory minimum wage in 2015. During the next government period, Mr. Schulz would like to soften some of the labour market reforms implemented during the early 2000s by SPD Chancellor Schröder.

As the largest party is likely to lead the next government, media attention has mainly focussed on the CDU/CSU and SPD. The CDU/CSU has taken a clear lead in the opinion polls, with voting intentions at just below 40%, followed by the SPD at around 25%. Nevertheless, the smaller parties could also play an important role as junior partner in a coalition led by one of the major blocks, thereby offering an alternative for replacing the grand coalition.

The Linke obtained 8.6% of the votes in the 2013 federal election, making it Germany's third party. It is a radical left wing party, with its major stronghold in the eastern part of the country. In recent years, it attracted many disappointed SPD supporters, which rejected the Hartz labour market reforms. In early 2017, it stood even at around 10% in the polls. However, since the election of Martin Schulz as SPD leader in March, its support has declined. According to the latest opinion polls, it would only obtain 8% of the vote. Given its radical left programme, participation in any coalition is unlikely.

The Greens obtained 8.3% of the votes in the 2013 federal election. The party is split in a dogmatic left wing and a more pragmatic wing. It shares many points with the SPD, in particular on social justice. That explains its weakening support after Mr. Schulz was elected as SPD leader. The party could easily join the SPD in a coalition, but a coalition with the CDU is also possible. In Baden-Württemberg, the Greens already form a coalition with the CDU, headed by a Green Prime Minister.

In the 2013 federal election, the liberal FDP did not win any direct seats and failed to pass the 5% threshold. It is likely to do better in the upcoming one on a programme of tax cuts and reducing red tape. According to the latest polls, the party could obtain 9% of the vote. It could join a coalition headed by either the CDU/CSU or the SPD.

The populist right party Alternative for Germany (AfD) also failed to win any seats in the 2013 federal election. It is expected to do much better in the upcoming election. During the refugee crisis in 2015-16, its support increased to close to 15% as it rejected strongly the Chancellor's "Refugees welcome" policy. However, since end-2016, its support has dropped sharply, as the inflow of asylum seekers diminished partly due to the tightening of admission rules for migrants. Moreover, the party lost support because of infighting about the party's direction. According to the latest opinion polls, the party could gain around 8% of the vote, implying the entrance of an extreme right party in parliament for the first time since the Second World War. However, cooperation with the party is rejected by both the CDU/CSU and the SPD.

According to the polls, a coalition between CDU/CSU, Green, and FDP – called Jamaica coalition after the colours of these parties – would be the only viable alternative to the grand coalition.

## A strong economy

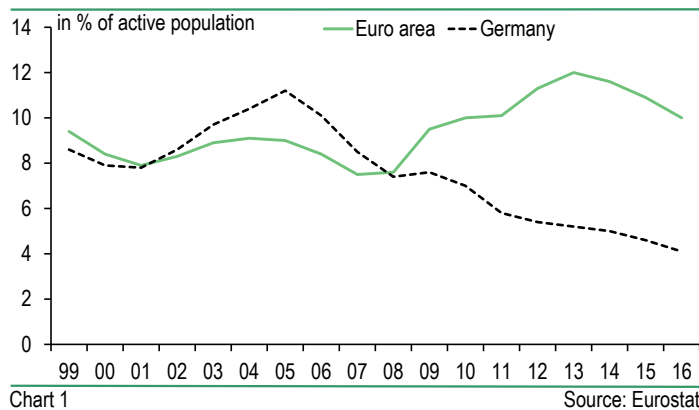
By the end of the 1990s and the early 2000s, Germany was known as the "sick man of Europe". The costs of reunification were weighing heavily on the country's prospects. Germany was growing well below potential and the negative output gap widened to 1.7% of potential GDP by 2004, a record since German reunification. The unemployment rate peaked at 11.2% in 2005 (Chart 1, page 3). In the same year, GDP per capita was only 4% higher than the EU15 average compared with 13% a decade earlier (Chart 2, page 3).

<sup>1</sup> See f.e. Marcel Fratzscher, 2016, "Verteilungskampf", Carl Hanser Verlag, Munich.

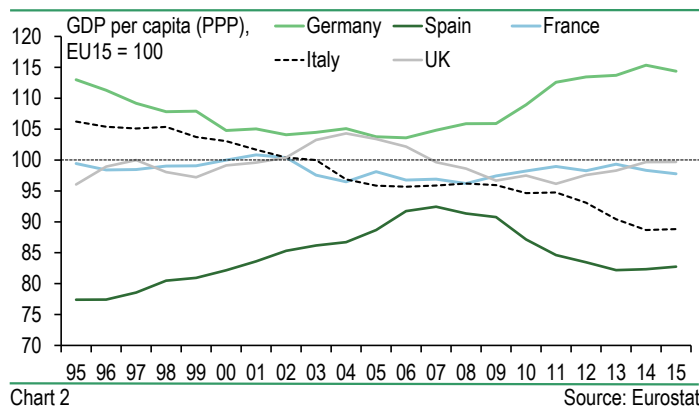


However, in the following decade, the country clearly neighbours. The relative income position gradually improved in particular after the Great Financial Crisis in 2008-09. By 2015, GDP per capita was 14% higher than the EU15 average. At the same time the unemployment rate had fallen to only 4.6%, less than half the EU average.

### German jobless rate on a downward trend



### Germany widens gap with the rest of Europe



An important reason is that German industry resisted better to globalisation and international competition than other European manufacturers. By 2015, the share of manufacturing in value added amounted to 23% in 2015, exactly the same as two decades earlier (Chart 3). During the same period, it had fallen by around five percentage points both in France and Italy. Contrary to its European competitors, German enterprises have been able to improve competitiveness thanks to gains in productivity and wage moderation (chart 4).

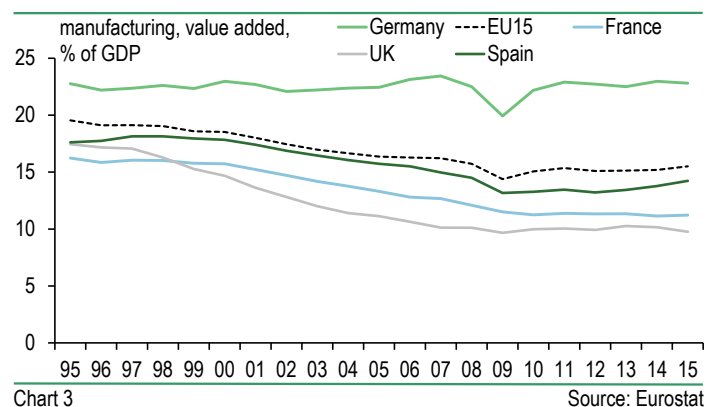
### How does Germany elect its parliament?

The voting system for the German Parliament, the Bundestag, is a mixture of a district system and a proportional representation system. In principle, the parliament has 598 seats, half of which are elected by local constituencies. Each voter gets two votes. The first one (*Erststimme*) is for the local candidates. They are elected according to the first-past-the-post system (*Mehrheitsrecht*). The second vote (*Zweitstimme*) is for a party and determines the party's relative strength in the Bundestag.

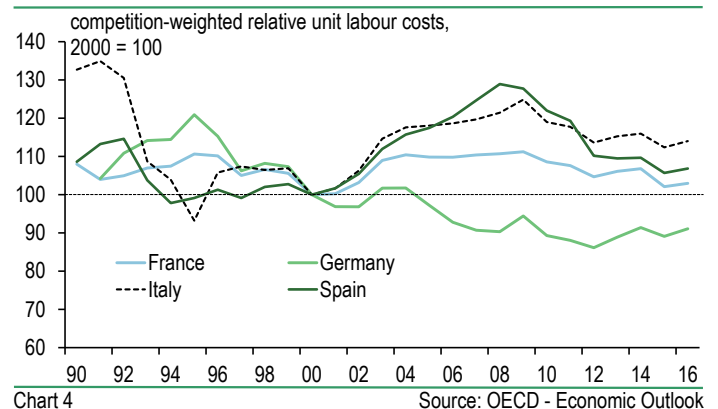
In the first phase, the 598 seats are allocated to the 16 *Länder* on the basis of population data. The local mandates are deducted from the seats allocated to the *Land*. It is possible that in a *Land*, a party wins more direct mandates than seats to which it is entitled according to the second vote (the so-called *Überhangmandate*).

In the second phase, the seats are recalculated at the Federal level. Parties that are disadvantaged compared to the parties with *Überhangmandate* get compensated by more seats (*Ausgleichmandate*) to preserve proportionality. For this reason, the number of seats can exceed 598; the current Bundestag has 630 seats. To be represented in the Bundestag, the party has to pass at least the 5% threshold of the *Zweitstimme* at the federal level. However, the 5%-rule is not applied for parties that gain at least three direct mandates.

### German manufacturers maintain their output share



### Significant gains in competitiveness of German enterprises



## Labour market governance allow for flexibility

Durtmann and Schönberg (2016) attributed the improvement in competitiveness to slowing wage growth after 1995, in particular in western Germany.<sup>2</sup> In this part of the country, wages for full-time workers at the bottom of the distribution declined in real terms from 1995 onwards. By the early 2000s, also real median wages started to decline; only wages at the top of the distribution (85th percentile) continued to grow in real terms.

One would expect that in particular wages in the tradable manufacturing sector would contribute to this pattern. However, in this sector, real wages at the bottom (15th percentile) started to decline only by the mid-2000s, after the non-tradable sector and tradable services. According to the authors, the sector resisted for much longer thanks to stronger productivity gains than in the other two sectors. Moreover, the sector benefited from low wages in the other domestic sectors and cheap imports. The German manufacturers made much more use of imported intermediate goods, in particular coming from Central and Eastern European countries, than their competitors.

Durtmann and Schönberg argue that the German economy resisted better to globalisation because of the typical governance structure of labour market relations. In Germany, relations between the main labour market parties, trade unions, employer associations and work councils<sup>3</sup>, are not regulated by laws but are laid down in contracts and mutual agreements. In practice, this has led to consensus-based decision making in which negotiating parties pursue the common interest.

There exist three basic regimes of wage bargaining. First, wage bargaining may take place at the industry level between employers' associations and labour unions. These contracts are normally negotiated at the regional level rather than the national level. As a result, there are slight variations between regions. The agreements apply to all members of the employers' association and also to all employees in these enterprises irrespective of their union membership. Deviations from collective agreements are only allowed, if these would be more advantageous for the employee (*Gunstigkeitsprinzip*) or when the collective agreement contains opt-out clauses (*Offnungsklausel*). The latter allow management and work councils to reach agreements at the plant level on wages, working time and other working conditions. Second, labour contracts can be negotiated at the company level between the employer and the trade union. This is less common and mainly concerns large enterprises. Finally, labour contracts can be concluded between the employer and the work council. In this case, the industry-wide collective agreement is often used as reference for the negotiations within the company.

<sup>2</sup> Durtmann and Schönberg mainly studied wage developments in western Germany. In the eastern part of the country, wages were still strongly affected by catching-up effects after German reunification.

<sup>3</sup> Work councils are consultative elected bodies, representing the employees in a company. A work council can be set up in all private sector workplaces with at least five employees. In practice, they are mainly present in large enterprises. Although not formally trade union bodies, union members play a key role within them.

Since the middle of the 1990s, the application of collective agreements has shown a clear downward trend. In 1995, more than 80% of German employees were covered by union agreements, at the industry or company level. By 2013, 60% of employees in western Germany were covered by collective agreements, 52% signed at sector level and 8% at company level. In eastern Germany, only 47% of employees were covered by a collective agreement, of which 35% by sector contracts and 12% by single company contracts. Moreover, the relevance of the sector agreements has been diminished by the increased use of opt-out clauses.

The reason for these developments is globalisation. In the past, collective sector agreements assured that all enterprises were subject to similar competitive conditions. However, the maintenance of equal competitive conditions at a national level makes less sense in a globalised economy and could even be very harmful for national enterprises. German enterprises needed more flexibility to fend off growing competition from Asia and, even more importantly, from Central and Eastern Europe. The possibility for employers of moving their installations to these areas has shifted the balance of power between workers and employers. Unions and work councils were willing to strike very flexible deals with companies on wages and working conditions in exchange of job guarantees. In addition, the reduction in the coverage rate of collective agreements is also due to structural change, as sectors covered by collective agreements have lost ground to sectors in which such agreements play a less important role, such as business to business services.

Many have linked the turnaround of the German economy to the labour market reforms, the so-called Hartz reforms, which were implemented during the period 2003-2005.<sup>4</sup> However, their role was probably limited, as wages at the lower end of the income distribution already started to decline around 1995. Nevertheless, these reforms were crucial in improving the functioning of the labour market, by reducing long-term unemployment (chart 5, page 5). Before the reforms, incentives to look for paid employment were low, as in many cases the unemployed could keep a benefit related to their last earned salary until retirement (*Arbeitslosenhilfen*). In fact, the scheme functioned like an early-retirement scheme. The Hartz IV reforms ended this in 2005, by shortening the duration of the unemployment benefit (*Arbeitslosengeld I*) from 26 to 12 months<sup>5</sup> and by replacing the *Arbeitslosenhilfen* by a means-tested social assistance payment (*Arbeitslosengeld II*).

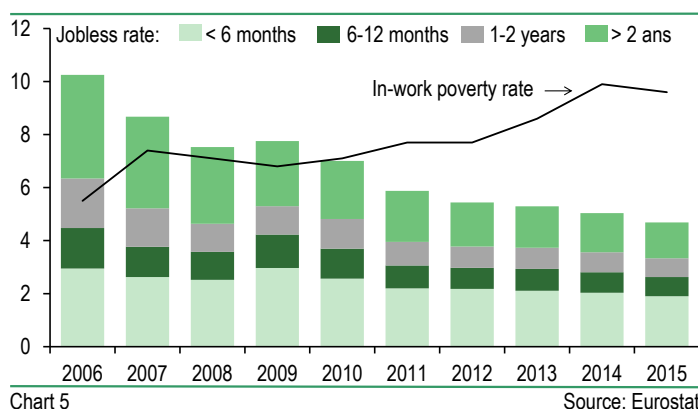
Even more than a decade later, the Hartz IV reforms remain firmly contested. Proponents argue that thanks to these reforms Germany was the only European country that experienced a substantial decline in long-term unemployment since the start of the financial and economic crisis. Whereas in the EU, long-term unemployment increased from 28.4% of unemployment in 2009 to 39% in 2016, it declined in Germany from 46% to 31.8 (Chart 5). By contrast, for the opponents, the Hartz reforms have resulted in growing poverty among workers.

<sup>4</sup> The Hartz reforms were part of the Agenda 2010, launched by SPD Chancellor Schröder.

<sup>5</sup> Older unemployed benefit from extended benefit periods: 15 months for those 50 years or older, 18 months for those 55 or older, 24 months for those 58 years and older.



### Less unemployment, more in-work poverty

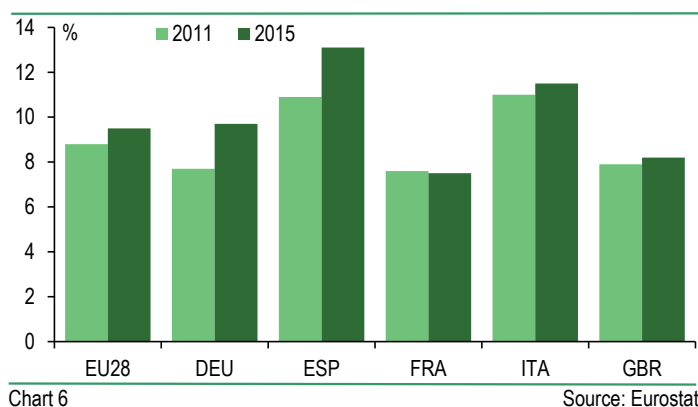


The SPD has lost much support since the introduction of the Hartz IV reforms. Its leader, Mr Schulz, is trying to gain back those voters, disgruntled by the labour market reforms, by proposing a softening of these measures. However, the proposals do not envisage the scrapping of Hartz IV. He would like to give all those who are unemployed for more than 3 months the right of retraining. During this period, the person will receive a new benefit *Arbeitslosengeld Q*, at the same level as their current unemployment benefit. The result is that he/she can receive an unemployment benefit for longer before falling back on means-tested social assistance payments.

## Increased inequality

In Germany, the decline in unemployment was accompanied by a substantial increase in the risk of in-work poverty - defined as employed persons receiving less than 60% of the overall equivalised median disposable income. It rose from 5.5% in 2006 to 9.7% in 2015 according to the EU-SILC survey (Chart 6). An increase in in-work poverty rates is also observed in other European countries, albeit to a lesser extent according to the EU-SILC survey (Chart 6). An increase in in-work poverty rates is also observed in other European countries, albeit to a lesser extent.

### In-work poverty risk has increased in Germany



The development is related to the growth of the low wage sector, i.e. workers earning less than the low-pay threshold, equal to two-thirds of median earnings. Its expansion was in particular observed in western Germany. In eastern Germany the percentage of people working in the low-wage sector has been much higher (around 40% since reunification). In 2014, 22% of employees earned less than the low pay threshold. In Western Europe, only the UK and Ireland reported similarly high percentages. By contrast, in France and Italy, the low wage sector amounted to less than 10% of wage earners. Low wage jobs are in particular prevalent in agriculture, private households and the hospitality sector. More than a third of workers in these three sectors are earning below the low-wage threshold.<sup>6</sup>

The increase of the low-wage sector is not in itself bad. For instance, it should be noted that many previously unemployed have found jobs in this segment of the labour market. Also the expansion of the low wage sector is a response to changes in the structure of the labour force. In the 1990s, part-time employment was less than 20% of total employment. However, in 2013-2016, it was around 26.5%. Moreover, the number of foreign workers has increased from 8.1% of employment in 1995 to 10.6% in 2016. About one in three foreigners work in the low-wage sector in 2016, twice as many as in 1995.

What is worrisome is the increasing risk of remaining in the low-wage segment. Wage mobility has dramatically slowed since German reunification. In the 80s, 50% of people working in the low wage sector were still there five years later. In the 1990s and 2000s, this had increased to close to 70%. This has led to a dramatic change in the age structure. In 1984, 40% of full-time employees in the low-wage sector were younger than 25. That figure was halved by 2014, resulting in a rise of the average age of the low-wage sector employees from 32 in 1984 to 39 in 2014.

The German Council of Economic Experts (Sachverständigenrat) has studied the income distribution of individuals in households with at least one member in working age i.e. between the age of 15 and 64.<sup>7</sup> They concluded that the major shifts in the income distribution took place between 1991 and 2005. The median market income, adjusted for purchasing power, remained almost unchanged during this period. However, those in the 90th and 95th percentiles experienced an increase by around 20%, whereas income in the first decile declined by 60%. This decline was associated with a sharp fall in hours worked. This group worked in 2005 55% fewer hours than in 1991.

After 2005, the Gini coefficient of these households, after taxes, has remained remarkably constant at just below 0.3.<sup>8</sup> The EU-SILC survey also notes that income inequality over the past decade has hardly changed for the overall German population. In 2015, it was 0.30, close to France (0.29) and the EU average (0.31).

<sup>6</sup> The risk of poverty of the overall population has also substantially risen over the past decade. In 2015, it stood at 16.7%, 4.5 points higher than 10 years earlier. It is at the same level as the UK, but much higher than in France, where the poverty rate has remained close to 13% during the whole decade to 2015.

<sup>7</sup> Sachverständigenrat (2016).

<sup>8</sup> The Gini coefficient is a measure for income inequality. It ranges between 0 (perfect equality) and 1 (all income is earned by only one person).



Rising income inequality has been observed in almost all OECD countries. Recently, several economists have questioned the consequences of the widening income differences in society. A study conducted by the OECD Directorate for Employment, Labour and Social Affairs argues that the increases in income inequality have dragged down growth through undermining education opportunities for the disadvantaged and lowering social mobility.<sup>9</sup> The author states that rising inequality by 0.03 Gini point over the past decades would have dragged down economy growth by 0.35 percentage point per year. He estimates that Germany might have lost 6% of GDP over the period 1990-2010. The implication would be that policies that help to limit or reverse inequality may not only make societies less unfair, but also wealthier.<sup>10</sup>

In the case of Germany, the negative effect on output looks exaggerated. In the analysis, the author neglects the growth enhancing effect of the policies that have increased income inequalities, such as the Hartz reforms. The rise in inequality is an unintended consequence. Nevertheless, it is important to pay attention to these unintended consequences, not only out of equity concerns but also for political reasons. Turning a blind eye to them might weaken the acceptance among the population of structural reforms, provoke a backlash against globalisation, and contribute to the rise of populism.

In a recent policy paper, the OECD Economics Department recognises that income inequality has increased in many OECD countries, in particular in the lower half of the income distribution.<sup>11</sup> One clearly identified source is technological progress that creates proportionally more high-skilled and better-paid jobs. This benefits in particular households in the upper-half of the income distribution. As response to these effects, the Organisation recommends increasing the provision and quality of education and training.

The OECD also found that a tightening of unemployment benefits for the long-term unemployed, as in Germany, would increase income inequality, by lifting GDP per capita and average household incomes, but reducing disposable incomes at the bottom of the distribution. Tightening unemployment benefits should be matched by other forms of social protection or targeted requalification measures. Unemployment benefits and active labour market policies should be primarily geared towards shortening the unemployment spell.

Reducing regulatory barriers to entry and competition could be important for reducing income inequality by creating more job opportunities for the lower skilled. In the case of Germany, the OECD signals that in 41 crafts professions, including in the construction industry, self-employment is restricted to holders of tertiary level vocational degrees.<sup>12</sup> Alternatively, workers in these professions can open business with a minimum experience of six years, of which four in managing positions in addition to a vocational education degree at the upper secondary level required to exercise the profession. These requirements raise entry barriers for self-employment. In a similar vein,

self-regulation by sector specific business chambers, notably in the professional services and the crafts, also risks protecting incumbents.

## The challenges for the next government

Despite considerable progress in recent years, such as the decline of the unemployment rate and the reduction in unemployment duration, the functioning of the labour market remains among the major challenges faced by the next German government. In the first place, more should be done on reducing of long-term unemployment, despite progress made since the Hartz IV reform. Nevertheless, by the end of 2016, still about 1% of the labour force was unemployed for more than 2 years.

Special attention should be given to the labour market situation of non-EU nationals. Unemployment in this group is significantly higher than among German citizens. By the end of 2016, their unemployment rate amounted to 11.4%, compared with 3.9% for the overall population. At the same time, employers complain not being able to find sufficiently skilled workers. This signals significant mismatches in the labour market. It calls for better targeting requalification measures and active labour market policies.

In the coming years, there is a risk that unemployment among non-EU nationals will rise again, as large numbers of recognised asylum seekers will enter the labour market. Many of them have no qualifications that are recognised by the German authorities. Moreover, their integration is difficult because of limited understanding of the German language. In 2015 and 2016, the number of asylum seekers amounted to 477 thousand and 746 thousand, respectively. In 2016, most of them came from Syria (36.9%), Afghanistan (17.6%) and Iraq (13.3%). In 2016, 700.000 applications for asylum were accepted, which corresponds with an acceptance rate of close to 50%, a historical high. This group is now also showing up in the labour market statistics. In May 2017, the Federal Labour Market Agency reported that just over 7% of unemployed or 200 thousand job seekers were recognised asylum seekers. By end 2017, this group could make up almost 10% of Germany's unemployed.

The reintegration of the long-term unemployed in the labour market requires a panoply of measures, many of them directed at improving qualifications. Active labour market policies should be directed at preventing people staying for more than one year unemployed. In the case of non-German nationals, priority should be given to improving their knowledge of the language. Nevertheless, active labour market policy can only play a secondary role in reducing entrenched unemployment. Improved integration of the long-term unemployed and low-skilled workers can only be achieved in the next few years if a sufficient number of jobs is available in the low-wage sector. In that respect, the introduction of the national minimum wage has made entry to the labour market for low productivity workers more difficult (*cf.* Sachverständigenrat, 2016).

To improve their employment chances, the long-term unemployed already benefit from a temporary lifting of the minimum wage legislation. This measure could be extended to unemployed refugees. In addition,

<sup>9</sup> Cingano (2014)

<sup>10</sup> DIW researchers reached a similar conclusion. See Albig *et al.* (2017)

<sup>11</sup> OECD(2015).

<sup>12</sup> OECD(2016)

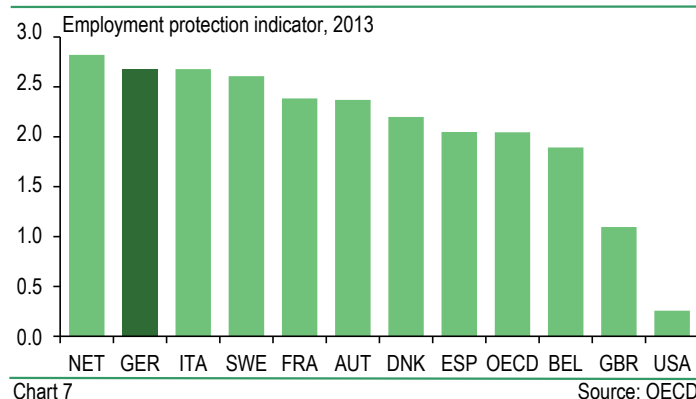


marginal employment of up to 15 hours per week, which is frequently low paid, can enable unemployed persons to maintain a certain proximity to the labour market until they find a job with more hours.<sup>13</sup> Most of these temporary jobs are found in retail and hospitality. Nevertheless, it should be remarked that these jobs often represent dead-end employment. In addition, measures to stimulate self-employment could be beneficial for long-term unemployed and refugees. This would imply the lifting barriers to entry, such as abolishing the requirement of a master craftsman's certificate in non-hazardous occupations.

Many fear that the increased migration may put greater competitive pressure on the unemployed and low-skilled people. This could further exacerbate the income difference. However, there is no conclusive evidence of long-term displacement of domestic workers by migrants. In fact, an exogenous supply shock caused by migration may also bring about positive displacement effects for domestic workers in low skilled jobs. For example, a study in Denmark showed that because of immigration, domestic workers were transitioning from manual tasks to more complex ones and thereby earning higher wages.<sup>14</sup>

Moreover, a study conducted on the effect of immigration during the Balkan Wars showed that the displacement effects were much more marked in EU countries with rigid labour market institutions than in others.<sup>15</sup> The study confirms that reducing barriers to entrepreneurship and improving labour market flexibility could facilitate the absorption of immigrants. In both these areas, Germany can still make much progress. Despite drastic reforms, it has still one of the most regulated labour markets in the world according to the OECD labour market indicator (chart 7). However, this indicator only covers the costs and procedures involved in dismissals, and does not include other labour market characteristics, such as collective bargaining.

#### Germany has one of the strictest employment protection legislations



<sup>13</sup> According to the national definition, a person working less than 15 hours a week and willing to work more is counted unemployed, if registered at the Federal Employment Agency. To be counted as unemployed for the harmonised ILO definition, the working time should not exceed one hour per week and registration is not required.

<sup>14</sup> Foged and Peri (2016)

<sup>15</sup> Angrist and Kugler(2003)

## Conclusion

The German federal election in September will decide who will become Chancellor for the coming four years. The two main contenders are the outgoing Chancellor Angela Merkel (CDU) and the SPD leader Martin Schulz. The winner will probably become the next Chancellor, if he/she can find suitable coalition partners.

As both parties have governed the country in a grand coalition during the past four years, it is difficult for them to differentiate themselves from one another. In many areas such as European policy, budget policy, energy transition, security and immigration their positions are rather similar. Martin Schulz has chosen to focus his campaign on social justice. He responds to widespread sentiment that not everybody has shared equally in the current economic boom. In particular, unskilled workers have experienced a decline in their real wages and rising poverty risk during the last decade. Nevertheless, labour market outcomes in terms of earnings and employment in Germany still compare favourably with those in many European countries.

In the inequality debate, it is often forgotten that this is not only related to income but also encompasses equality in access to care, education and employment. Concerning the latter, it is important to remember that much of the deterioration in income equality is related to the successful integration of low skilled workers in the economy. In many countries, low skilled workers are simply priced out of the market because of high wage costs. The creation of low skilled work is important as it could serve as a springboard towards better jobs. Unfortunately, many of the low paid jobs are dead-end jobs with hardly any prospects.

Recently, the CDU won three regional elections in Saarland, Schleswig-Holstein and Nord Rhine-Westphalia. Local issues have undoubtedly played an important role. Nevertheless, thanks to these victories, the Merkel campaign has gained significant momentum. Moreover, Mrs Merkel can benefit from the economic successes and an international stature. By contrast, Mr. Schulz is relatively unknown for German voters, having spent most of his active political life in the European Parliament, which he presided from January 2012 to January 2017. He has hoped to improve his election chances by making social justice an election theme. Given the booming economy, it remains to be seen whether social justice is indeed a major issue for the voters.

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