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Comparative Political Economy

Germany's and Italy's labor market policy and economic performance leading up to the global financial crisis of 2007

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1. Introduction

The current Global Financial Crisis and European Debt Crisis have had a major impact on European economies, resulting in extremely high unemployment and declining GDP. Germany seems to be barely affected. Popular German Media have claimed to have found the reason for this in the labor market reforms, namely the *Hartz* reforms as part of the *Agenda 2010*, introduced in 2003 (Handelsblatt, 2010) (Zeit Online, 2012). The reforms in the 2000s in Germany have continuously neo-liberalized the labor market, allowing for more and more unregulated temporary work arrangements to be used (Menz, 2010) (Tompson & Price, 2009).

In comparison to the success of Germany, the EU's largest economy by GDP as of 2011 (The World Bank, 2013), the fourth largest economy in the European Union, Italy, seems to do notably worse, despite numerous similarities to Germany. Both countries are relatively large in population, are regionalized, and have a high quality export economy, which is true for Italy mostly in the north.

Most strikingly, both countries have undertaken considerable neo-liberal labor market reforms (Tompson & Price, 2009).

Looking at this policy shift from a constructivist point of view can explain how such a change can occur. The second theoretical perspective, Keynesian Welfare National State (KWNS) and Schumpeterian Workfare Postnational Regime (SWPR), investigates the issue based from a critical perspective. Therefore the question to be answered in this paper will be:

> How can constructivist ideas explain the difference in Germany’s and Italy’s economic performance in the 2000s, by examining labor policies, and to what extend does a shift from Keynesian Welfare National State to Schumpeterian Workfare Post-National Regime occur?

Firstly, this paper will elaborate on the theories used and why they are used. Secondly, empirical findings will be presented for each country separately. Thirdly, a comparison of the findings will indicate possible answers to this puzzle. Before stating limitations to the findings and concluding this paper, three additional theories will be briefly assessed and how they could contribute to this topic.

2. Theory

2.1 Constructivist Approach

Constructivism sees reality as socially constructed and economic action taking place in a social context (Clift, 2012). As Ruggie defines it, “[i]n short, constructivism is about human consciousness and its role in international life” (Ruggie, 1998). It goes beyond the material and structural sphere and focuses on the “causal and constitutive role of ideas” (Clift, 2012). The focus is put on ideas and how ideas then influence action and or institutions.

Multiple scholars have developed several frameworks dealing with socially constructed reality and ideas. Mark Blyth divides ideas in blueprints, weapons, and cognitive locks. Like Leonard Seabrook, who states that, “[i]n general, economic constructivists rely on the concept of uncertainty to stress the importance of intersubjective understandings” (Seabrooke, 2007), Blyth sees uncertainty to be the reason for ideas to be important. Where outcomes are uncertain, it is pure believe of what works best, which will determine a specific action (Blyth, 2001). By challenging the previous ideas, which created specific institution, new ideas can be used as weapons as well as cognitive locks, where actors are confined by prevalent ideas.

More broadly, Martha Finnemore and Kathryn Sikkink ask general questions about the emergence and rise, the institutionalization, and how, why, and when ideas matter “in any particular circumstance" (Finnemore & Sikkink, 2001). They find current issues to be one factor of how influential an idea becomes.

For the issue in question, it suffices to find and examine the relevant ideas dominant at the time in question and what impact they had on society, politics, and policy making.

2.2 Keynesian Welfare National State and Schumpeterian Workfare Post National Regime

Although it is rather generalizing, the period after the Second World War can economically be divided in two major periods: A Fordism economy under KWNS and a Post-Fordism economy under SWPR. Bob Jessop summarizes the two economic ideas by focusing on four dimensions (Jessop, 1999).

The KWNS is a form of economic governance, which pays particular attention to full employment through demand side management (Torfing, 2009). Jessop's four dimensions of KWNS are: "promoting the conditions for capital's profitability", "reproducing labour power as a fictitious commodity", being "national", and also "statist" (Jessop, 1999). For the labor-market and the puzzle at hand, the aim for full employment through demand side management is of particular interest.

In the 1980s, the KWNS has been "at different times and speeds, in different fields and in different countries" (Torfing, 2009) substituted by the SWPR. Crises like the oil shocks have challenged the idea of unlimited growth and permanent full employment as well as internationalization, which led to ineffective Keynesian policies. Jessop describes the shift in the four dimensions as shifting to "Schumpeterian" modes of intervention, i.e. promoting innovation and flexibility, as changing from "a welfarist mode of reproduction of labour power" to a "workfarist mode", as weakening the nation state and embedding the economy in a post-national framework, and as emphasizing "networked, partnership-based economic, political, and governance mechanisms (Jessop, 1999). It is the change from full employment through demand side management to a framework of promoting innovation and flexibility in an international environment manipulating the supply side (Torfing, 2009). Thus, the SWPR subordinates the social policy "to the demands of greater labour-market flexibility and lower social expenditure" (Torfing, 2009). Although, the change from KWNS to SWPR is generally said to have started mainly in the 80s, economic pressures of the 2000s and the economic crisis have pushed several countries to liberalize their labor-market further.

3. Empirical Data and Application of Theory

3.1 Germany

3.1.1 Empirical Data

Since 1990, Germany has had major labor-market reforms, as visualized by the OECD’s indicators of Employment-Protection dropping from 3.17 in 1990 to 2.12 in 2008 (OECD, 2013). In words, the OECD puts it, “[t]he adaptation and implementation of the four laws known collectively as the Hartz reforms in 2002-05 marked perhaps the single biggest change in German labour-market policy in a generation” (Tompson & Price, 2009). Additionally, the OECD’s index of employment protection does not only recognize the *Hartz* reforms as a big change in employment protection, but also the *Gesetz zur Regelung der Arbeitnehmerüberlassung* (law on temporary employment), which loosened the regulation for temporary work agencies and fixed term contracts (OECD, 2004) since 1995.

The significant *Hartz* labor-market reform was conducted in four steps and had the following major impacts: Firstly, it loosened the regulation on temporary employment even further, amending the previously mentioned law on temporary employment. Secondly, it created so called “mini-jobs”, which are no-tax jobs with close to no social benefits, working up to 15 hours a week, with a salary of no more than 400 Euro. Thirdly, unemployment assistance was drastically cut with abolition of the *Arbeitslosenhilfe* (unemployment assistance), leaving all unemployment with *Arbeitslosengeld II*, formerly called social assistance, which was also cut as part of the reform. Lastly, the secondary labor-market, consisting of “out-of-sector” jobs, temporary employment and mini-jobs, “has been massively expanded” into the private sector (Menz, 2010). The reforms have created a first and secondary labor-market with the effect that “[s]ince 2000, income inequality and poverty have grown faster in Germany than in any other OECD country” (OECD, 2008).

3.1.2 Constructivist Approach

During the 1990s, Germany experienced over all a solid GDP growth of around two percent (The World Bank, 2013). Despite this decent economic situation, unemployment rose up to 10 per cent in 1997 (The World Bank, 2013). When the red-green coalition was re-elected in 2002 on the promise to lower unemployment (Tompson & Price, 2009), the government took it as a mandate to reform and used this inertia to overcome the opposition to the drastic reforms (Tompson & Price, 2009). In his *Regierungserklärung* (government policy statement) of 2003, Gerhard Schröder, German head of government at the time, states that economic growth has been slow and that non-wage labor costs have reached an unbearable limit. Therefore it is necessary to create a new environment for growth and employment (Schröder, 2003).

With internationalization of the economy, a related discussion then emerged, the *Standortdebatte* (debate about Germany as a business location). With competition from Asia and other emerging markets, politicians and leading business representatives lobbied for more flexible working conditions and lower wages, in order to stay competitive in the global economy. This was one of the arguments used to push through the reforms.

Adding to the internal political pressures and ideas, the EU has repeatedly urged countries to create a more liberal labor-market. The EU’s European Employment Strategy (EES) calls for “moderate wage policy”, “efficiency of labour market institutions”, and the identification of new sources of jobs through local initiatives” (Eurofund, 2013). Also the European Court of Justice has ruled against the state of Lower-Saxony, when it demanded companies tendering for public bids to pay wages according to *Tarif* (industry-wide standard wage).

The main idea, found repeatedly, is that liberal labor-markets support economic success and increase employment. On a European level this is the consensus as well as on a German level, where loosening labor regulation was chosen to tackle the unemployment problem. It is a choice of action, when facing uncertainty, but even after almost 20 years of reforms, a clear answer is still up for debate.

3.2 Italy

3.2.1 Empirical Data

Italy seems to outperform Europe in the post-war period up until 1990, when workers did not keep up with rising efficiency in the rest of Europe (The World Bank, 2013). Fiscal pressures, as a result, forced the Italian government to act. Struggling with high social expenditure and low volume of taxes, Italy has implemented major liberal labor-market reforms, similar to Germany, as can also be observed in the OECD’s index of employment protection. For Italy, it has dropped from 3.57 in 1990 to 1.98 in 2008, which is the fourth lowest, of all OECD countries at that time. The effect of labor-market policy can be detected in employee turnover, which for Italy increased by 5.3% from 1992 to 2007 (Simoni, 2012).

Two major reforms, as described by Tompson and Price’s OECD report, had a major impact on the labor-market: the *Treu* and the *Biagi* reform, of 1997 and 2002 respectively. The 1997 *Treu* reform was the start of creating a secondary labor-market, as it was the case in Germany. Regulation for existing workers was not changed, while regulation for temporary and agency work, as well as “other ‘atypical’ working arrangements” (Simoni, 2012) was loosened. More specifically, among other measures, “it eased regulation […] of temporary work via private agencies” and “legalized workerdispatching services” (Tompson & Price, 2009). In 2001 this liberalization was continued by “further deregulating flexi-contracts” (Simoni, 2012). The *Biagi* reform was another step in the same direction by loosening regulation on private employment agencies, part-time work, and other forms of “non standard forms of employment” (Tompson & Price, 2009).

The enablement of temporary and low-paid work has created a dual labor-economy, consisting of older established workers with decent wages, certain welfare benefits and a degree of employment protection on the one hand, and a young generation in fixed term, low paid jobs without welfare benefits (Briziarelli, 2011). Young people are living off their family capital, because their wage and welfare benefits are not enough to sustain a decent living (Briziarelli, 2011). In 2008, Italy had “the 6th largest gap between rich and poor of all 30 OECD countries” (OECD, 2008).

3.2.2 Constructivist Approach

The Italian labor-market reform process began out of the 1992 currency crisis (Simoni, 2012) when reforms seemed unavoidable. A technocratic government in 1992 and 1993 implemented small reforms on wage-bargaining, but because unemployment rose and fiscal budgets became tighter, the government adopted the *Treu* reform. It was the pressure to do something in the face of tight budgets.

As it happened in Germany, another foreign ideological input came from the EU, where the European Employment Strategy and the Lisbon Strategy have called for more flexibility on the European labor-market (Tridico, 2012).

A third ideological root for liberalizing the labor-market is Silvio Berlusconi himself, who was Prime Minister of Italy during the *Biagi* reform. He got into politics to “secure his economic foundations” (Briziarelli, 2011). He did not only have large stakes in the Italian economy, but also controlled large parts of the media. He was possible to spread his economic ideas and influence public opinion. In this case it has to be asked, if the idea of personal gains was the reason for loosening labor regulation.

Berlusconi’s personal ties aside, as we saw earlier in the case of Germany, the all underlying assumption is that a liberal labor-market with flexibility and a “second-class” labor market benefits a country in terms of economic growth and unemployment.

3.3 Labor-market reforms and the shift from KWNS to SWPR

While analyzing Italy and Germany, certain common changes become apparent. Firstly, both countries have to end Keynesian style intervention, due to the internationalization of their economy. Secondly, focusing on the supply side, i.e. labor, driven by the task to lower unemployment, the policy choice is to make the home economy fit for global competition by promoting competition and innovation. Thirdly, by emphasizing the international competition aspect, policies subordinate social issues to economic issues. This shift is exemplified by the *Standorddebatte* in Germany and the fact that politicians accept social tensions arising due to the dual labor-market and temporary and low-wage work arrangements.

Interestingly, Germany and Italy both became more Schumpeterian while trying to tackle unemployment, despite full employment traditionally being associated with Keynesian policies. Less welfare and more workfare were the strategies in both cases.

4. Comparison

Summarizing the analyses of Germany and Italy, both have liberalized their labor-markets, allowing for more temporary work arrangements, agency work, and lose employment protection. Both countries have this way created a dual labor market. They have based their action on the assumption that a flexible labor-market will lower unemployment. Looking at unemployment, the reforms seem to have worked. Italy's unemployment started dropping in 1999, two years after the first reform was put into place, whereas Germany's unemployment began to decrease in 2006, two years after the first reform (See Appendix 1). This indicates that the assumption can be correct in the short run. Despite recognizing the possibility that other factors have influenced the labor-market even more, it can be assumed that such liberal policies indeed help lower unemployment.

Another similarity is the fact that despite being hit by the crisis, Italy and Germany both were not hit too badly. Italy did a lot better compared to its Southern European neighbors Spain, Portugal and Greece. A reason for this could be Germany's and Italy's similar response to the crisis. Both countries loosened limitations on short-time work to prevent large-scale layoffs. Still, the economic performance is still very different. How can this be explained?

Firstly, we have to acknowledge, that the Italian liberalization was more drastic as illustrated by the OECD's employment protection index (See Appendix 2). The reforms were adopted simultaneously to the largest privatization plan in the OECD at that time (Simoni, 2012), liberalizing two parts of the economy at the same time in a very short period of time, the labor-market and the product market.

Secondly, Italy managed to reduce its unemployment continuously from 1999 to 2008, until the crisis hit. Since then, unemployment has been on the rise, with barely any change in sight (Briziarelli, 2011). Consequently Italian's internal market is also slowing down, which is not the case in Germany. So far German consumers have not reduced their spending (SpiegelOnline, 2011). In this sense, the fact that Germany has not yet progressed as far as Italy in terms of temporary work arrangements, due to a later implementation of reforms, might have helped to prevent a worse crisis.

Thirdly, the wage development shall be examined. The previous analysis has showed that in both countries a low-wage sector has opened up. Wage inequality has risen more in Germany than in Italy between the mid 1980s and the late 2000s, but Italy has been more unequal from the beginning (OECD, 2011). Looking at the GINI coefficient, although Germany's wage inequality has risen by a lot, it is still "more equal" than Italy's, which supports the thesis that if a labor-market has liberalized for too long, the internal market slows down and the economy suffers.

The comparison indicates that similar labor-market policies have in the short run had a similar effect (see Appendix 1). Neither of the two countries strictly follows the Euro Area's unemployment trend (The World Bank, 2013), but show a change in unemployment after the reforms. In the long run facing the crisis, the result was a different one. Due to the multiple factors affecting the economy and also the labor market, the long-term effects can not clearly be found in this analysis.

5. Other Theories

Several other theories could help to analyze the problem from a different angle. The Varieties of Capitalism (VoC), as proposed by Hall and Soskice (2001), is actor centered and focuses on institution and compares Liberal Market Economies with Coordinated Market Economies as ideal types. By creating a secondary labor-market, Germany and Italy, both have become distant from one ideal type. Looking more closely at education and training systems and inter-firm, intra-firm and industrial relations within the VoC framework, further inside into the effects of the labor-market reforms and the consequences can be gained, helping to explain the long-run effects better.

A second helpful approach could be the Social Structure of Accumulation (SSA). It explains waves of economic expansion and examines the relation between capital accumulation and institutions (Diebolt, 2002). This perspective explains why crises occur and therefore would be beneficial by finding reasons for the crisis in Italy, while the crisis in Germany has been minimal. One question that could be asked in this framework could be if capital or labor has gotten too strong and caused the economic troubles in Italy.

A third and last point of view that might be helpful is Esping-Andersen's welfare regime typology (Esping-Andersen, 1990). Although not examined in this paper, the change in the labor market could have had significant impact on the welfare regime. Such a change could possibly be one reason for Italy's problems. Also the liberal reforms might have had a different impact in different welfare regimes. It might be possible, that the German welfare regime was better able to cushion the consequences of the reforms.

6. Limitations

The economy and the labor-market are influenced by several factors. A definite nominal impact of the reform can therefore not be found. Richard Koo, a Taiwanese researcher, has claimed, based on an extensive model, that in Germany, the Agenda 2010 is to 49% the reason for Germany’s current economic success (SpiegelOnline, 2013). As with every model, it is based on assumptions, which makes it subjective and no data set can include all the relevant factors. The second limitations are the indicators used in this analysis. Indexes like the GINI coefficient or the Employment Protection Index are just generalized measures, where detailed and multifactored analysis will give more insight. All one can take from this analyses is a trend of the reform’s consequences. Analyzing more countries and including more data and perspectives, will clarify the effects.

7. Conclusion

The analysis leaves us with several findings. The idea of liberalizing labor-markets has been prominent during the 1990s and the 2000s. Internationalization of the economy has made Keynesian demand control ineffective. International competition, lobbyism, and the hope for a change to the better have had the effect that workers and society accepted less benefits and more insecure working conditions, all based on the assumption that what is good for business will eventually be good for the people.

Based on those assumptions, trying to tackle unemployment and fiscal pressures, Italy and Germany have gone from a welfare to a workfare regime, which in the short run seems to be effective. This occurs on the cost of a widening income gap and the creation of a dual labor-market.

The long-run effects are still to be assessed when more data for the years after the crisis become available. Hints show that it is dangerous to liberalize to an extend where the internal economy slows down. To temporarily lower unemployment, though, liberalizing the labor-market seems to work quite well. As for the claim that the Agenda 2010 is the reason for Germany’s current success, the reforms have helped to lower unemployment, but one should be careful to what extent the policies can have an effect. One might even suggest the opposite that Germany was lucky that it has not yet liberalized further.

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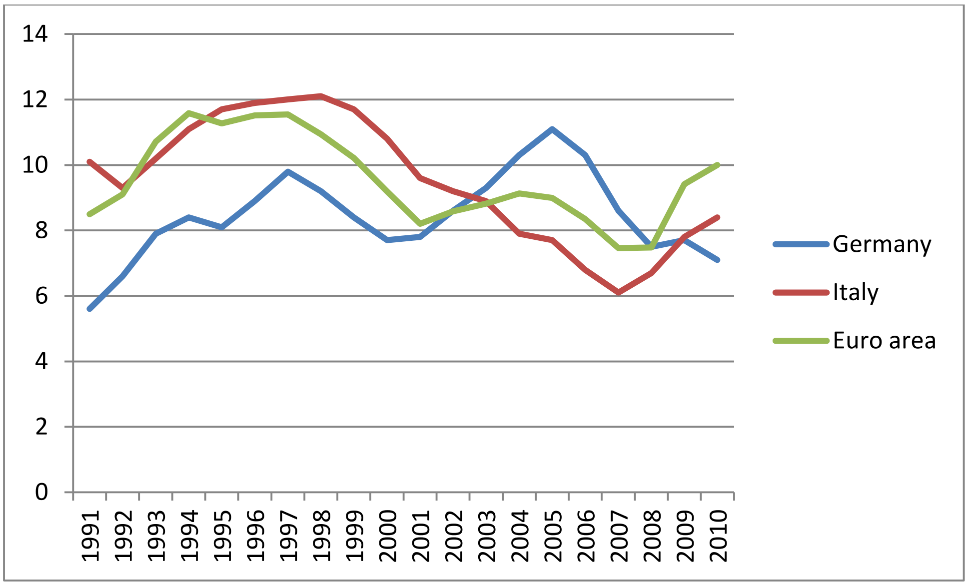
Appendices

Appendix 1



Unemployment as percentage of total workforce

(Source: The World Bank DataBank)

Appendix 2

OECD Indicators of Employment Protection

(Source: OECD Data Bank)