

Jobs and Equality in Germany: Which Way Forward?

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High employment and low inequality have been central goals in Germany for half a century. Through the 1970s there was considerable success at achieving both. In the past two decades a low level of inequality has been maintained, but employment has been stagnant. Increasing employment very likely requires that more Germans will work in low-productivity, low-pay service jobs. But that need not imply an abandonment of the commitment to low inequality. Indeed, in my view expanding employment in this way is probably necessary to ensure the sustainability of a relatively egalitarian distribution of income. The key is to focus on the degree of inequality among *households*, rather than among employed individuals.

An Equality-Jobs Tradeoff?

It is helpful to think about inequality at three levels: (1) earnings inequality among employed individuals; (2) earnings inequality among households; (3) income inequality among households when investment income, taxes, and government transfers are included ("disposable income inequality"). Arguments about a tradeoff between jobs and equality typically refer to the distribution of earnings among employed individuals. But earnings are pooled within households. What should be of greatest concern, therefore, is the degree of inequality of disposable income among households.

High employment is not antithetical to low inequality among households. On the contrary: *high employment is critical to maintaining low between-household inequality*. This is true in two respects.

First, employment affects the distribution of earnings across households. A generation ago it was normal for many working-age adults to not be in the labor force. They were mainly women, and their husbands were employed. The fact that some adults were employed and others not had little impact on the distribution of earnings among households because inequality of employment occurred mainly within, rather than between, households. That is no longer the case. Women increasingly are in paid work, so inequality of employment occurs more and more between households. In other words, instead of there being many

households with one (usually male) earner and one (usually female) non-earner, there now are more households with two earners and more with no earners. This increases inequality of earnings between households.

Second, high employment is needed to fund a generous welfare state. Population aging is increasing the costs of the public pension system, and capital mobility is putting downward pressure on tax rates. With tax revenue squeezed at the same time that welfare state costs are rising, something has to give. One option is to adjust the pension system — raise the retirement age a bit, reduce benefit levels somewhat, tax back the benefits of well-to-do retirees at steeper rates. But this may not yield enough cost savings. Another option is to increase immigration. But if many of those migrating in have limited skills, this may end up adding to the cost of the welfare state, at least in the short- and medium-term. The best solution is to increase the employment rate. Doing so is doubly beneficial: it yields an increase in tax revenues without an increase in tax rates; and to the extent it moves some current recipients of government benefits into the work force, it reduces welfare state costs.

What Is the Main Source of the German Employment Problem?

Ideally, Germany could solve its employment deficit entirely through new high-skill, high-productivity, high-paying jobs. A recent OECD (2001) study discovered that in most affluent countries, employment growth in the 1990s did include many such jobs — mainly in producer and (some) social services. But this is very likely a partial solution at best. Many new jobs will probably have to come in relatively low-productivity consumer-oriented services, such as wholesale and retail trade, hotels, restaurants, and various community/social/personal services.

In a comparative context, Germany's employment deficit is mainly in consumer service jobs. Private-sector consumer services employs about 5 percentage points less of the working-age population in Germany than in the typical Anglo (English-speaking) country, and 10 percentage points less than in the United States. The level is higher in Germany than in three of the four Nordic countries, but those countries use extensive public employment (in a variety of sectors) to compensate for their low levels in private consumer services. Public employment in Germany, by contrast, is much lower. What accounts for Germany's relatively low level of employment in consumer services?

One view is that the problem lies on the *supply side* of the labor market: many Germans do not want to work in such jobs. In other words, there may be abundant employer demand for workers in such jobs, but people are unwilling to accept the jobs — because they are considered demeaning ("below my skill level") or because they pay less than the social wage (unemployment benefits and/or social assistance). The government's recent policy initiatives suggest that

it views this as the problem. In early 2002 it introduced an employee subsidy in the form of a reduction in payroll contributions for workers in low-wage jobs. In early 2003 this policy was amended to fully exempt from payroll contributions workers in jobs paying less than 400 Euros per month and partially exempt those in jobs paying between 400 and 800 Euros. Currently the government is attempting to pass legislation that would tighten restrictions on receipt of unemployment benefits and increase work activity requirements.

Another problem on the supply side is that a variety of policies and institutions discourage women from entering or remaining in the labor force. These include half-day schooling, a shortage of child care spaces, a three-year parental leave, family-based (rather than individualized) pensions, and joint taxation with steep marginal tax rates for a second earner.

Other analysts suggest that the problem lies primarily on the *demand side* of the labor market: too few jobs are created. Why might that be the case? There are several possibilities.

One is a sluggish macro economy, which limits consumer demand. German monetary policy and fiscal policy over the past two decades have been more restrictive than in the United States. Yet there are other European countries (e.g., Denmark, the Netherlands) that have had higher employment and/or faster employment growth despite similar macroeconomic policy. In any event, government policy makers now have very limited autonomy in this area.

Employment protection regulations may be too strict. This creates a disincentive for employers to hire, because they are unable to get rid of workers during a downturn. I doubt that this is the key in Germany. Since the mid-1990s employers have been able to hire workers on fixed-term contracts (up to two years), which in principle should allow considerable flexibility if the need to downsize arises.

Wage levels may be too high. This has received a great deal of discussion, but I am skeptical about its importance. Germany's degree of earnings inequality among employed individuals is about average among affluent countries (Kenworthy 2004). Moreover, a recent study by Richard Freeman and Ronald Schettkat (2000) found that although Germany's overall pay structure is more egalitarian than that of the United States, the ratio of wages in the lowest-paying service sectors to average wages is approximately the same in the two countries. In other words, because many of these jobs are outside of the collective bargaining system, German employers in low-end private services do not have to pay higher relative wages than American employers.

Payroll taxes may be too high. These represent a direct 20% increase in labor costs for the employer. That figure is higher if employers are forced to raise wages in order to offset the fact that workers themselves must pay 20% in social security contributions.

I am not certain which of these explanations is correct. In all likelihood, the shortage of employment in consumer-related services is due to a combination of several of these factors. My sense is that the most important is high payroll taxes, but more research on this question would be helpful.

High Employment and Low Inequality

Is promoting employment in low-productivity, low-pay jobs a good thing from an egalitarian point of view? That depends on which level of inequality is prioritized. More Germans would be working in jobs at the low end of the pay scale, which presumably would increase earnings inequality among employed individuals. (Then again, this may have happened already, even though the official figures for earnings inequality do not show it. Because of high payroll taxes and perhaps other factors, a range of "off the books" jobs in consumer services have developed in recent years, usually at low pay levels and without unemployment insurance or pension entitlement.)

What effect would an expansion of low-wage jobs have on earnings inequality among households? On the one hand, with more individuals earning low wages, we would expect a widening of household earnings inequality. On the other hand, to the extent some (many?) of those who move into such jobs come from zero- or single-earner households at the low end of the distribution, the new earnings, even though relatively low, should help to pull up the earnings of the household. This would have the effect of reducing earnings inequality across households.

The inequality that Social Democrats should care most about, in my view, is inequality of disposable income across households. Here, I think, there is good reason for optimism. If policy reforms succeed in generating a growing number of low-end service jobs (or bringing them out of the black market into the formal sector), there will be many individuals and households with low earnings. But this can be remedied with an employment-conditional negative income tax — something along the lines of the Earned Income Tax Credit in the United States or the Working Families Tax Credit in the United Kingdom. These programs provide a tax refund to households with low earnings. If (as is often the case) the refund is greater than the amount the household owes in income taxes, the household receives the difference as a cash benefit. In order to encourage labor force participation, the amount of the tax credit increases with earnings up to a point, and then begins to decrease. The credit in the United States has existed since the mid-1970s, and most studies have concluded that it heightens labor force participation, effectively targets transfers to households most in need (more so than a subsidy to low-earning individuals, since some such individuals may be in

higher-earning households), creates minimal stigma, and has low administrative costs.

My suggestion, then, is that German policy makers give serious consideration to reducing payroll taxes on low-productivity consumer-related service jobs — as has been done already for employment in private households. If this or some other policy reform succeeds in stimulating a large number of relatively low-paying jobs, something along the lines of an employment-conditional negative income tax can ensure that Germany not only achieves high employment but also maintains low inequality.

References

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