The Double Squeeze: Labor Reform and Globalization in Germany

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Over the past forty years, Germany has presented itself as an interesting case in how domestic policy and global economic integration can reshape the country's entire income distribution. Years ago, Germany was characterized by relatively egalitarian wage structures and strong social protections; over the past years, however, Germany has experienced notable increases in income inequality since the early 2000's. The Hartz labor market reforms implemented from 2003 to 2005, combined with Germany's deeper integration into global markets following the EU's eastward expansion in 2004, have fundamentally altered the distribution of economic gains across German society.

Figure A investigates the fact that Germany's coefficient for disposable household income has risen from 24.4% in 1978 to the 28.8% mark by 2012. This increase proves striking given its timing: inequality remained mostly stable through the 1990's before a sharp increase around 2002. Figure B shows that the top 10% of earners captured an increased share of pre-tax national income, rising from 28.12% in 1980 to 37.49% in 2024. Simultaneously, Figure C illustrates the bottom half of earners' income shares decline from 24.53% in 1980 to 19.12% in 2024. The middle class, shown in Figure D, also experienced losses, with their shares falling from 47.35% to 43.39% during the same period.

Two of the primary factors that drove Germany's inequality included comprehensive labor market reforms, which fundamentally altered unemployment insurance and active labor market policies, and accelerating economic integration following the EU expansion, which exposed these German workers to competitive pressure. While these factors are distinct in themselves, they reinforced each other and created what has been termed the "double squeeze" on German workers (Immel, 2021).

Between 2003 and 2005, Germany implemented four labor market reform packages, known commonly as the Hartz reforms. While the first three packages focused on improving job placement services and deregulating temporary employment, the fourth package proved controversial as it fundamentally restructured the entire German unemployment benefit system.

Prior to these reforms, Germany's unemployment insurance was broken into three tiers. Workers received unemployment benefits equal to 60-67% of previous earnings for up to 32 months. After this initial stage, long-term unemployed workers would file for unemployment assistance at 53%-57% of their previous earnings, with no time limit. The final tier, social assistance, granted means-tested support for those who never qualified for insurance benefits in their previous roles (Engbom et al., 2015). The fourth Hartz reform collapsed the system into two tiers. The first tier maintained the 60-67% rate but shortened the maximum duration to 12 months for most workers. The second tier replaced these unemployment and social assistance programs with flat-rate benefits set at lower levels than the prior assistance payments. In turn, the results represented a dramatic cut in benefits for the long-term unemployed, whose support was no longer based on their prior earnings (Engbom et al., 2015).

The reforms had diverse effects on household incomes. Some former unemployment assistance recipients lost eligibility entirely as benefits were offset by family income; among those still eligible, nearly half received higher transfers due to lower previous earnings, while the others experienced significant cuts (Immel, 2021).

The policy changes increased inequality in various ways. First, the reforms directly affected the income of transfer-dependent households; research at the county level shows that excluding all households relying on these government transfers reduced inequality increases by nearly 40%, suggesting that benefit cuts contributed to this rising inequality (Immel, 2021).

Second, these reforms increased the share of households relying on transfer payments as job search requirements became stricter and reduced benefits pushed more individuals into the lower tier of support. Third, and most importantly, the reforms altered the bargaining position of unemployed workers. With reduced long-term benefits and stricter job obligations, workers' reservation wages sank. It was found that the earnings of workers returning from short-term unemployment fell by nearly 10% relative to those of continuously employed workers after these reforms (Engbom et al., 2015).

This wage pressure was not confined to the unemployed; the expanded supply of workers willing to accept lower wages placed pressure throughout the entire labor market. Further data from German labor markets show a decline in wages and an increase in wage inequality following these reforms, with lower-skilled workers and those in unstable job markets experiencing the largest losses (Giannelli et al., 2016).

Real wages fell during the reform period of 2003-2005 and further declined in the post-reform period of 2006-2009; disadvantaged groups, including those of unskilled workers, previously unemployed, and temporary workers, experienced the bulk of these wage losses in comparison to the overall median wage decrease (Giannelli et al., 2016). Figure C illustrates the dynamic: the bottom half of earners experienced their sharpest decline in income share, beginning in 2003, falling from 22.41% to 18.53% by 2014. Further, Figure A supports these causal effects, as the Gini shows its steepest increase from 2003 to 2007.

While domestic policy reshaped Germany's labor market from within, external economic integration further increased competitive pressure on German workers. Germany's economy is dependent on exports, with trade accounting for 88% of GDP, compared to the 59% average for OECD countries (Quitzau, 2022). The extreme openness made German workers vulnerable to

shifts in global competition. The 2004 European Union expansion east marked a critical turning point; on May 1, 2004, Poland, Slovakia, Hungary, the Czech Republic, and five other countries joined the EU, eliminating trade barriers and bringing wages to one-fifth to one-tenth of the German level (Braakmann & Vogel, 2010). German firms had the power to easily outsource production and alter the balance of power in wage negotiations.

When comparing firms in border counties to similar firms abroad, it was found that the 2004 expansion led to negative wage effects for skilled workers in consulting, research, and related areas, with some sectors experiencing wage reductions even as employment levels stabilized (Braakmann & Vogel, 2010). The research found no evidence that short-term employment declined significantly, suggesting that workers absorbed the competition through wage adjustments rather than job losses.

The expansion was carried out through a variety of channels. Increased competition from lower-wage countries created downward pressure upon manufacturing wages, particularly for mid-skilled workers whose jobs could be relocated (Braakmann & Vogel, 2010). The threat of offshoring tightened employer bargaining positions even as the relocations often did not occur. Further, the expansion of temporary agency work, eased through the Hartz 1 reforms, allowed these firms to easily replace domestic workers with those in the new EU member states.

Germany's export-oriented manufacturing sector highlights these dynamics; German exports to these developing economies increased 10% annually through the 1990's and early 2000's, compared to only 3% growth in exports to other developed countries (Quitzau, 2022). This shift reflected these firms' strategy of keeping high-value design and engineering work inside Germany while increasingly outsourcing manufacturing and assembly to lower-wage countries. The results widened the gap between skilled workers who were benefiting from export

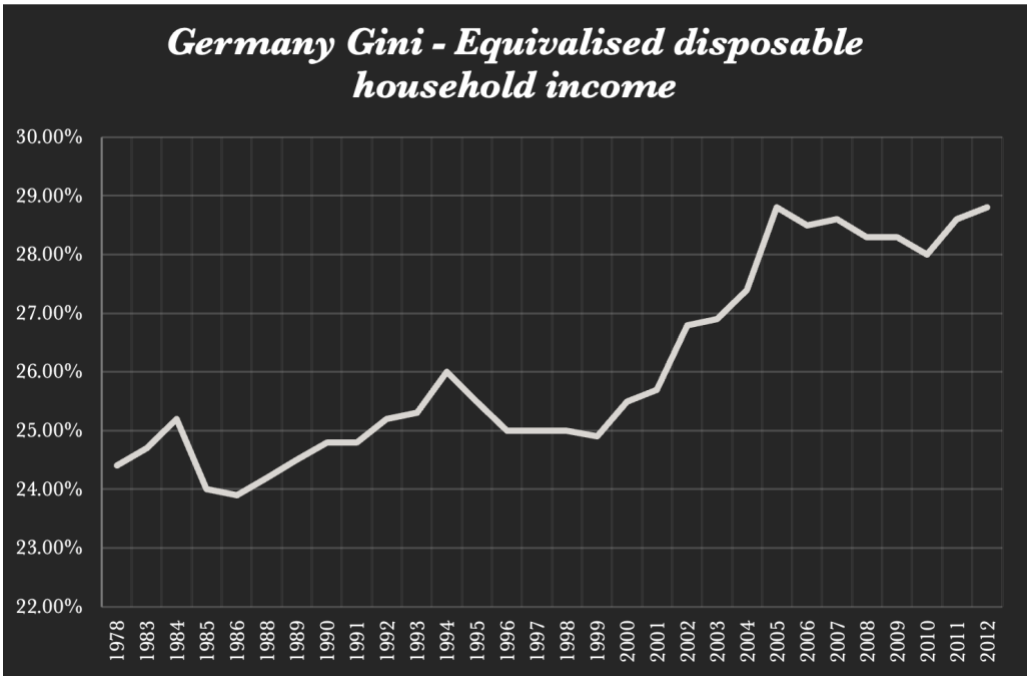
growth and lower-skilled workers competing with offshore alternatives. The effects of EU expansion contradicted expectations about which workers would be most vulnerable to international competition. Rather than primarily affecting these lower-skilled manufacturing workers, evidence shows that high-skilled workers in border regions, particularly those in consulting and research, also experienced significant wage pressure, underscoring that economic integration affects the broader labor market more than traditionally assumed (Braakmann & Vogel, 2010).

The interaction between globalization and domestic reform proved consequential. The Hartz reforms made it easier for firms to use competitive pressure as leverage in wage negotiations by creating flexible domestic labor markets with weaker worker protections. Simultaneously, global competition provided an economic justification for domestic reform aimed at improving competition through wage moderation. Germany's experience with rising inequality is the result of identifiable policy choices and economic integration. The country's inequality increased neither gradually nor uniformly, but instead concentrated in the years 2003-2007, corresponding to the implementation of Hartz market reforms and the EU's eastward expansion.

The combination of reduced long-term benefits, tighter job requirements, and labor market deregulation shifted bargaining power toward employers, resulting in wage reductions of 10% or more for workers returning from unemployment and wage stagnation across the market. Accordingly, Germany's dependence on exports and the 2004 EU expansion exposed workers to competitive pressure from lower-wage countries, reinforcing domestic reform and pushing wages downward even as employment levels remained stable.

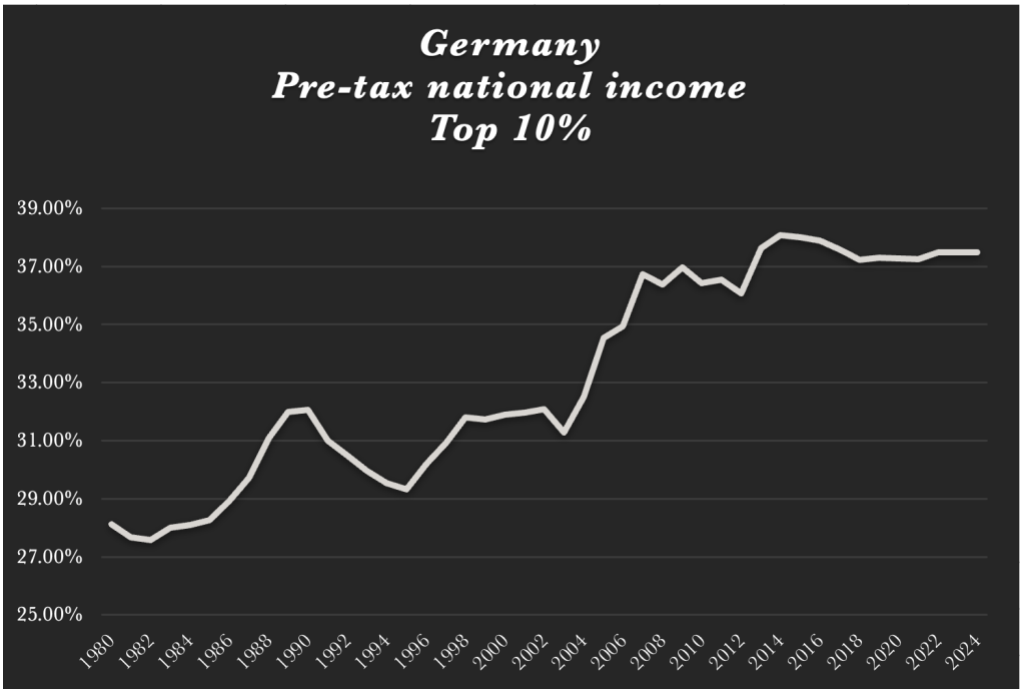
Appendix:

Figure A: Equivalized Disposable Household Income (Gini)



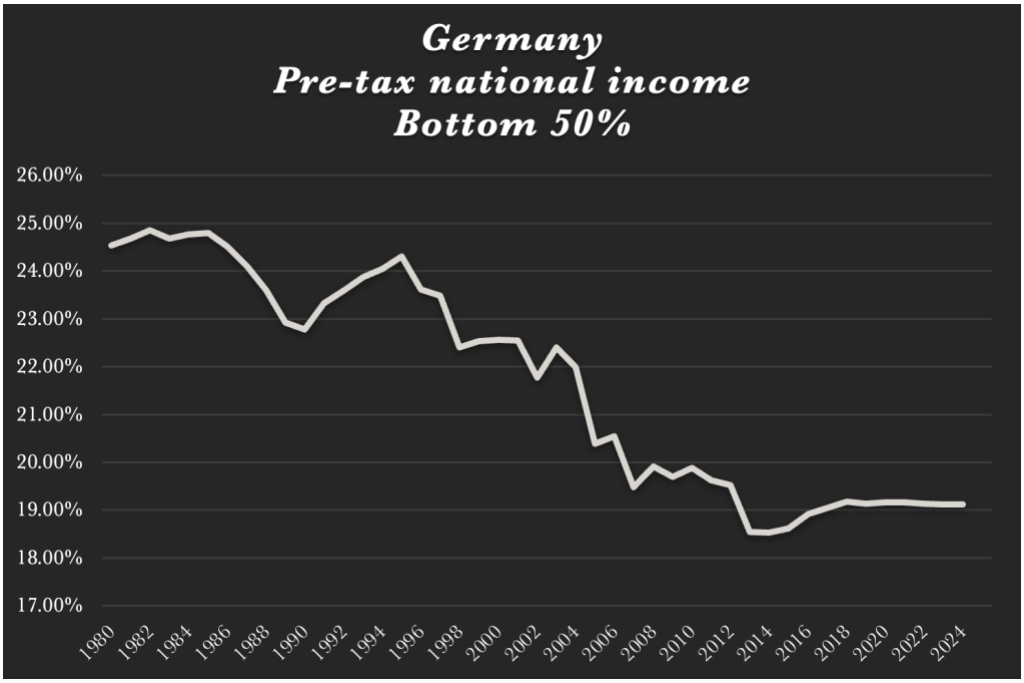
Source: The Chartbook of Economic Inequality

Figure B: Pre-tax National Income for Top 10%



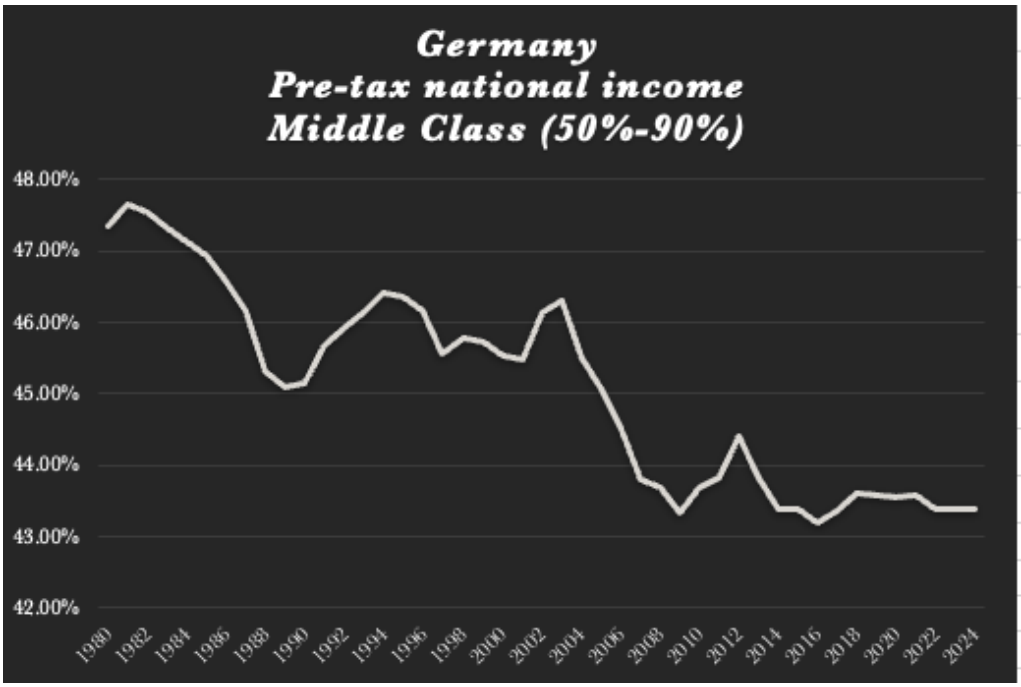
Source: *World Inequality Database*

Figure C: Pre-Tax National Income for Bottom 50%



Source*: World Inequality Database*

Figure D:
Figure: (100% - Figure B) – (Figure C) = Figure D



Source: World Inequality Database

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