Complementarity and Labour Market Institutions

Daan van der Linde

While Dutch public opinion, press and academia have generally favorably judged the German Hartz labour market reforms and called for similar reforms in Dutch labour market institutions, in this article it is argued that the *overall* effect of copying single elements from any model—be it German, Danish or Anglo-Saxon—may be detrimental, and reform should be implemented cautiously and slowly. While theory predicts that pressures of globalization and European integration will bring countries to develop similar structures, processes, and performance (Kerr 1983), recent reform in the Netherlands (labour market, healthcare, housing market and expected reform of the tax system) may better be understood as a set of oscillating policies responding to issues with oscillating urgency.

I interpret the "German model" as a model of labour market institutions, and by applying the notion of complementarity of institutions argue seemingly narrow reform

on the labour market may have far-reaching implications throughout other spheres of the economy at different points in time. This challenges the ability of policymakers to play "institutional LEGO" (Amable and Petit 2001), picking and mixing labour market reforms to reach economic objectives. I conclude by arguing against the literature that claims complementarity gives rise to a self-reinforcing and stabilizing mechanism. Only by taking a wider perspective on reform can we tame the recent Dutch reform enthusiasm.

Complementarity and a "German model" of labour market institutions

While for some time economic woes were addressed by macroeconomists, the big issues in economic policy have become labour market issues. Freeman (1998) argues the "war of the models" is nowadays fought over labour market institutions. This reading seems in line with the "German success story", often presented in terms of its labour market institutions. Dutch economists, the press and public opinion have generally favorably judged German labour market reform which, by the stagnation of wages combined with (and following from) a trimmed social security system, caused Germany's export industry to flourish while reducing persistently high levels of unemployment (e.g. Eichhorst et al., 2010). Newspaper headlines and commentaries include "Germany is our great example" (Jürgens 2013) and "Frau Merkel, hilfe!" (Borst 2013) [1].

Dutch economists Bovenberg and Gradus (2013) and Eijffinger (Couzy 2012) argue that the German example

shows how labour market reform during the crisis can pay for itself—while Dutch reform lags behind. Eijffinger compares economic growth in Germany and the Netherlands in 2012, claiming the difference could be explained by the fact that the Dutch failed to reform as the Germans did.

In many respects causally inferring the impact of such institutional reform is risky. Lacking a counterfactual, one may shed doubt on directly attributing an outcome to any reform. In the public debate counterfactual cases are often selected not on the basis of their similar features, but on the basis of differing outcomes—see this logic applied above by Eijffinger. Can we really explain lagging economic growth in the Netherlands or France due to the fact that their own "German" reform was absent? A more fruitful avenue seems selecting counterfactual cases not based on different outcomes, but based on similarities in all respects but the reform. This however introduces a methodological question: which similarities should one take into account?

Freeman (1998) claims this latter problem to be especially important. While differences in domains which are unaccounted for in a cross-country comparison may bias findings that link a reform to a specific outcome, a more fundamental issue is the fact that a similar institution in one country may function entirely differently across another, given differences in the overall institutional structure (or "model," if you will). Beyond the singular reform, it may indeed, to a large extent, be due to the *interactions* of institutions that produce certain outcomes. This clearly problematizes outright the copying of institutions or reforms across countries, decreasing the scope for what Amable and Petit (2001) call policymakers playing "institutional LEGO."

Hall and Soskice (2001, henceforth HS), following earlier work by Aoki (1994), articulate the idea of interactions between institutions in their Varieties of Capitalism (VoC) approach. In their terminology, *institutional complementarities* refer to institutions where "the presence (or efficiency) of one increases the returns from (or efficiency of) the other" (17). As complementarities may link different domains of the economy, HS predict clustering along dimensions within countries: The financial system or the type of industrial relations within a country is not a random draw from a range of alternative ways of organizing them, but the result of intricate linkages. Germany's system of co-ordinated wage bargaining is coupled to a system of corporate governance that allows long-term and patient financing, while American financial markets have a strong focus on short-term gains and shareholder value coupled with a largely deregulated and flexible labour market.

The Dutch market for mortgages serves as a useful illustration for this notion of complementarity. Mortgages at and over the home value at time of purchase are provided without down payment in the Netherlands, yet in order to decrease the risk of default the lender usually requires permanent employment contracts. Combined with unemployment insurance, such labour market institutions as permanent contracts thus are clearly complementary to (mobility in) the housing market. If this relationship is proven complementary, the introduction or increased use of fixed-term or zero-hour contracts in the Netherlands or the growing number of self-employed (zzp) may thus (unintentionally) transform other domains of the economy.

The *aggregate* effect of such labour market reforms is thus the sum of any direct effect (e.g. labour market flexibility)

and the interaction between the new and existing institutions (e.g. the housing market). As these effects may crystallize out at different points in time, estimating an aggregate effect is troublesome. Depending on the relative strength of both components, outcomes may cancel each other out and give rise to new reform in other domains. This temporal issue forms an explanation for the oscillating nature of reform. "Fixing" the labour market today may require "fixing" the housing market tomorrow.

Complementarity and stability

Does a theory of complementarity allow for this type of oscillating transformation? While in agreement that *external* shock such as the financial crisis may disrupt an institutional equilibrium, HS pose an auxiliary hypothesis regarding the *internal* dynamics of transformation and claim complementarity has a stabilizing effect on the institutional order. As the theory of VoC is a firm-centric, it predicts firms may pressure governments to aid in the development of complementary institutions or the scope of existing institutional arrangements may broaden to other spheres. Within this framework reform is thus unlikely to be independent from the functionality of institutions (conditioned by its complementarity) (Höpner 2005). This dynamic can be expected to function as a stabilizing mechanism, reinforcing existing institutional arrangements[2].

With a similar reasoning, any policy proposal that may lead to institutions to stray away from their equilibrium is expected to be thwarted by firms which may be able to resist

change in existing complementary institutions. HS (2001) underwrite this, suggesting "institutional complementarities generate disincentives to radical change. Firms and other actors may attempt to preserve arrangements in one sphere of the economy in order to protect complementary institutions or synergies with institutions elsewhere that are of value to them (64)."

The latest reform of the Dutch labour market in some respects seems to strengthen labour market protection and arguably reinforces the institutional equilibrium. The reform seeks to prevent further dualization of the labour market by decreasing the scope for employers to repeatedly rehire workers on temporary contracts, yet at the same time labour market protection is weakened by reducing the duration of unemployment insurance, easing regulation regarding the termination of contracts and lowering severance pay.

The wording of the reform package sheds little doubt on whether the reform constitutes reinforcement or a drift from an institutional equilibrium: The cabinet "strives for a new balance between flexibility and security on the labour market (…)" (Wet werk en zekerheid 2014 – The Work and Security Act). Only by considering the wider implications of reform by taking into account its direct and interaction effects may we be able to tame Dutch reform enthusiasm. It is exactly here we can and should learn from the experience of other countries or "models."

Notes

1. More recently however some have concluded less cheerfully about the German "success story" (Haegens 2012; Kretschmar 2013).
2. Contrary to the conventional view suggesting globalization will inevitably lead to liberalization, deregulation and convergence in economies throughout the world, VoC therefore predicts co-ordinated market economies (CME) such as Germany and the Netherlands will withstand this type of convergence in their economic institutions, able to exploit their comparative institutional advantage.

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