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Labour Demand in Germany: An Assessment  
on Non-Wage Labour

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# LABOUR DEMAND IN GERMANY: AN ASSESSMENT OF NON-WAGE LABOUR COSTS

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## Abstract

The data indicate that non-wage labour costs in Germany have reached a record high in recent years. From 1972 to 2001, the ratio of non-wage labour costs to direct compensation in West German manufacturing industry rose from 55.6% to 81.2%. The topic of non-wage labour costs is increasingly being discussed among and between the political parties because non-wage labour costs are likely to have major negative effects on employment. We follow the real options approach, which allows us to investigate the value to a firm of waiting to adjust labour when the firm's revenues are stochastic and adjustment costs are sunk. Simulation exercises show that the interaction between hiring and firing costs, non-wage labour costs and uncertainty can have important ramifications for employment dynamics.

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**JEL-Classification:** D81, J23, J31, J32

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## 1. Introduction

Non-wage labour costs are the subject of intensive political debate. Payroll taxes drive a wedge between the cost of a worker to an employer and the wage received. If wages and prices are relatively flexible, high non-wage labour costs are unlikely to have major negative effects on employment in the long-run. However, in countries where wages and prices are inflexible, employment will suffer if non-wage labour costs increase. Many of the job losses will fall on low-paid workers, due among other things to the existence of binding wage floors such as legal or collectively-bargained minimum wages. Increasing non-wage labour costs also tend to encourage substitution away from labour to more capital-intensive methods of production. Therefore, reducing social insurance contributions ranks high on the German political agenda.<sup>1</sup>

Non-wage labour costs are those categories of the enterprise's total labour costs comprising other than direct compensation. Non-wage labour costs account for a very substantial and rising proportion of total labour costs. There are several ways of defining non-wage labour costs. The annual analysis of non-wage labour costs in Germany by the "Institut der deutschen Wirtschaft" is based on official statistics from the Federal Statistical Office in Wiesbaden, which conducts surveys on labour costs every four years. The official statistics distinguish between compensation for hours actually worked and non-wage labour costs. Non-wage labour costs are differentiated into pay for days not worked, special payments, statutory social welfare costs and other non-wage labour costs. The statistics differentiate between statutory non-wage labour costs, and non-statutory costs resulting from collective bargaining and additional benefits provided by the employer.<sup>2</sup> Table 1 below sets out the latest aggregate data on the development of wage and non-wage labour costs in West German manufacturing industries (see Schröder, 2002a).

**Table 1: Annual Labour Costs in West German Manufacturing Industry per Employee in €**

	1972	1975	1978	1981	1984	1988	1992	1996	1998	2000	2001
Direct Compensation	7535	9600	11557	13616	15406	17580	21314	24218	25000	26455	27025
Non-Wage Labour Costs	4188	6304	8099	10276	12198	14149	17139	19852	20450	21505	21940
Share of Non-Wage Labour Costs in %	55.6	65.7	70.1	75.5	79.2	80.5	80.4	82.0	81.8	81.3	81.2

<sup>1</sup> Over the last decade, Germany appeared to be unable to reform labour market institutions and the welfare state in order to reduce high and rising unemployment rates. In this respect it forms an unholy triple alliance of reform laggards with France and Italy (see Minford and Naraidoo, 2002).

<sup>2</sup> However, one should bear in mind that some non-statutory non-wage labour costs - such as holidays - may result from the implementation of labour law and additional collective agreements by the social partners. To a certain extent these kinds of costs might also be attributed to statutory non-wage labour costs.

In West German manufacturing industry, non-wage labour costs reached an all-time high of €21940 in 2001.<sup>3</sup> From 1972 to 2000, the ratio of non-wage labour costs to direct compensation grew by 25.6 percentage points to 81.2%. However, this cost dynamic has slowed in recent years. A striking feature is that the share of non-wage labour costs is almost constant over the period 1988-2001. For 2003, a further rise in non-wage labour costs is predicted. In January 2003, the contribution rates for all types of social insurance were raised again and a further increase of statutory social welfare contributions of employers is expected for 2004. This means uncertainty for firms about whether and, if so, when a further increase is to be expected.

The disaggregate data in Table 2 indicate that the rise of non-wage labour costs from 1992 to 2001 can be attributed to increases in both the statutory and the non-statutory elements. A special role is played by the increases in the costs of social security contributions, which rose at a significantly higher rate in the East than in the West. Furthermore, increases in costs caused by sick pay, and holidays and holiday payments, were of importance.

**Table 2: Non-Wage Labour Costs in Manufacturing Industry as % of Direct Compensation**

	West Germany		East Germany	
	1992	2001	1992	2001
<b>Statutory Non-Wage Labour Costs</b>	35.4	37.1	34.6	37.8
Employer's Contribution to Social Security	25.4	28.4	26.2	28.9
Paid Public Holidays	4.5	5.0	3.7	4.6
Sickness Payments	5.1	3.3	3.9	3.2
Other Statutory Allowances	0.4	0.4	0.8	1.1
<b>Non-Statutory Non-Wage Labour Costs</b>	45.0	44.1	31.7	30.5
Holiday Payments	19.3	18.6	13.6	15.4
Special Payments	9.2	8.3	3.9	4.0
Pension Schemes	7.4	7.7	0.7	1.7
Capital-Forming Payments	1.3	1.1	0.1	0.4
Other Non-Wage Labour Costs	7.8	8.4	13.4	9.0
<b>Total Non-Wage Labour Costs</b>	80.4	81.2	66.3	68.3

Source: Schröder (2002a); the calculations are based on compensation for hours actually worked.

Table 3 indicates that there is significant variation in wage and non-wage labour costs across countries. Hourly labour costs in West German manufacturing amounted to €26.16 in 2001. This was above of all countries compared. A great deal of this difference was due to non-wage labour costs (€ 11.72 per hour in West Germany). Given this evidence, there is widespread agreement among the employers and the main political parties that non-wage labour costs are “far too high” and have to be reduced because they drive up labour costs and thus reduce the demand for labour, particularly for hard-to-place workers. Firms also claim that uncertainty about the future level of non-wage labour

<sup>3</sup> In East German manufacturing industry, annual direct compensation (non-wage labour costs) reached €18825 (€12855) in 2001 and therefore the share of non-wage labour costs reached 68% of total compensation. Though rising, non-wage labour in eastern Germany were still lower than in western Germany. The differences result from less generous fringe benefits such as vacation and supplementary pension schemes.

costs is an impediment to job creation. Therefore, they form expectations and beliefs on the future behaviour of the driving economic variables, which cannot be predicted with certainty. The modelling framework has to account for this distinct challenge and has to formalise this issue in a coherent economic model.<sup>4</sup>

**Table 3: International Comparison of Hourly Wages in the Manufacturing Industry (2001, in €)**

	<b>Total Hourly Wage Costs</b>	<b>Direct Hourly Wages</b>	<b>Non-Wage Labour Costs</b>	<b>Share of Non-Wage Labour Costs in %</b>
Austria	21.00	10.90	10.10	93
Belgium	23.15	11.84	11.31	96
Canada	18.03	13.07	4.97	38
Denmark	24.50	19.58	4.91	25
Finland	22.12	12.51	9.61	77
France	18.93	9.89	9.03	91
<b>East Germany</b>	16.86	10.09	6.79	68
<b>West Germany</b>	26.16	14.44	11.72	81
Greece	8.86	5.27	3.59	68
Ireland	16.01	11.47	4.54	40
Italy	15.92	8.14	7.77	96
Japan	22.22	13.13	9.09	69
Netherlands	21.98	12.18	9.80	80
Norway	25.33	17.12	8.22	48
Portugal	6.75	3.79	2.96	78
Spain	14.68	8.01	6.67	83
Sweden	20.91	12.35	8.56	69
Switzerland	24.96	16.37	8.59	53
UK	19.23	13.41	5.82	43
US	22.99	16.57	6.42	39

Source: Schröder (2002a, 2002b) gives some more details about the calculation of non-wage labour costs. International comparisons of non-wage labour costs (“Personalzusatzkosten”) are regularly published by the “Institut der Deutschen Wirtschaft” in Cologne (see [www.iwkoeln.de](http://www.iwkoeln.de)). The data have been converted into € using the average annual exchange rates.

Orthodox theory suggests to calculate the net present value (*NPV*) of a mooted employment decision. When the present value of future profits is bigger than the present value of the costs of hiring a worker – that is, the *NPV* is positive – then go ahead. All employment calculations therefore rely on predicting uncertain future profits. But the traditional theory also assumes, implicitly, that employment decisions are a now-or-never choice. In many circumstances this is unrealistic and waiting offers a valuable chance to learn more about the likely fate of the decision. The ability to delay a partially irreversible employment decision is like a financial “call option”. The firm has the right, but not the obligation, to

<sup>4</sup> An interesting feature is that some European countries succeeded to restore lower rates of unemployment in the 1990s despite a high share of non-wage labour costs. A remarkable example for the way out of Europe’s labour market misery is the Netherlands. The Dutch employer associations and unions reached a historic agreement on wage moderation (the so-called Wassenaar Agreement) in 1992. It turned out that wage moderation was an essential ingredient of the Dutch success story. The Dutch experience is consistent with the well-known hump-shaped relationship between the degree of bargaining coordination and the real wage level of Calmfors and

buy (hire) a security (new employees) at a specified price (the hiring cost) at a future time of its choosing. This option has a value. When the firm makes the investment it exercises (or, in financial jargon, “kills”) its option. It follows then, that the cost of that “killed” option (the value of waiting for better information) ought to be included when calculating the *NPV*. Before a hiring decision goes ahead, the present value of future profits should exceed the hiring costs by at least the value of keeping the real option alive.<sup>5</sup> In other words, real options are directly analogous to a traditional American call option.<sup>6</sup> While real options are similar, the primary distinction is the non-financial nature of the underlying asset being acquired.<sup>7</sup>

Against this background, the paper proceeds as follows. The application of the real options approach to employment determination is sketched in Section 2. Section 3 discusses the simulation results. A summary and some policy conclusions are provided in Section 4. Two appendices provide technical results used in the body of the paper.

## 2. Labour Demand and Non-Wage Labour Costs in a Real Options Framework

In valuing real options, one inevitably faces a trade-off between the analytical and computational tractability, and the complexity of the underlying model. In the light of this trade-off, academic economists have found it convenient to impose sufficient structure on the model to give closed-form solution. Following this strategy, we consider a representative firm facing the constant returns to scale *CES* production function

$$Y = [\theta K^{-\mu} + (1 - \theta)L^{-\mu}]^{-1/\mu}, \quad (1)$$

where  $Y$  denotes output,  $-1 < \mu < \infty$  is the substitution parameters,  $0 < \theta < 1$  is the distribution parameters,  $L$  is the number of employees, and  $K$  is the capital stock. We allow for imperfect competition, i.e. we assume that the firm faces an isoelastic demand function

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Driffill (1988) saying that labour markets work best in those countries with either very decentralised or very centralised wage formation systems.

<sup>5</sup> In fact, that is usually happening in practice. Firms calculate the *NPV*, but discount predicted profits using a „hurdle“ required rate of return which is much higher than the standard discount rate to account for the uncertainty underlying the project. Applying traditional options-pricing theory to employment decisions leads to the conclusion that such hurdle rates are perfectly sensible. However, the real options theory allows firms to set them on a more rational basis than gut instinct.

<sup>6</sup> A European option can only be exercised on the expiration date whereas an American option can be exercised at any time up to and included the expiration date.

<sup>7</sup> The analogy arises because labour adjustment costs are at least partially sunk. Real option theory therefore provides an extremely useful method of unlocking the value in employment decisions. The real options literature is too vast to survey here. Excellent surveys are provided by Amran and Kulatilaka (1999), Copeland and Antikarov (2001), Coy (1999), Dixit and Pindyck (1994) and Lander and Pinches (1998).

$$p = Y^{(1-\psi)/\psi} Z, \quad \psi \geq 1, \quad (2)$$

where  $p$  represents the price,  $Z$  denotes the demand shock, and  $\psi$  is an elasticity parameter that takes its minimum value of 1 under perfect competition (see Abel and Eberly, 1994). Therefore, current profits, measured in units of output, are defined as

$$\Pi = Z \left[ \theta K^{-\mu} + (1-\theta)L^{-\mu} \right]^{\frac{-1}{\mu\psi}} - w(1+\tau)L, \quad (3)$$

where  $\tau$  denotes the ratio of non-wage labour costs to the constant wage,  $w$ .<sup>8</sup> To keep the model simple we abstract from taxes other than those included in the non-wage labour costs. The representative risk-neutral firm maximises its discounted flow of profits

$$V = \max_L \int_0^{\infty} \left[ Z \left[ \theta K^{-\mu} + (1-\theta)L^{-\mu} \right]^{\frac{-1}{\mu\psi}} - w(1+\tau)L \right] e^{-rs} ds, \quad (4)$$

where  $V$  denotes the intertemporal profit function and  $r$  is the real interest rate. To evaluate the impact of non-wage labour costs upon labour demand, it is necessary to recognise that production and employment are inherently dynamic and uncertain processes. We therefore assume that the stochastic demand factor  $Z$  follows a geometric Brownian motion

$$dZ = \eta Z dt + \sigma Z d\varpi, \quad (5)$$

where  $\varpi$  is a Wiener process,  $d\varpi = \varepsilon \sqrt{dt}$  (since  $\varepsilon$  is a normally distributed random variable with mean zero and a standard deviation of unity),  $\eta$  is the drift term and  $\sigma$  is the variance parameter. Thus, we have an optimal stopping problem – we must determine when it is optimal to hire or fire workers, given the stochastic evolution of  $Z$ . Additionally, it is assumed that the payroll tax  $\tau$  follows the following jump processes

$$d\tau = dJ_1 + dJ_2, \quad (6)$$

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<sup>8</sup> Higher taxes on labour will raise the cost of employing someone and will therefore reduce employment to the extent that wages do not fall correspondingly. Under competitive markets, wages will fall by the amount of the tax increase provided that labour is supplied inelastically. However, labour markets may not be competitive. Unions and employers may take tax changes into account when bargaining for wages. Trade unions may, for instance, try to shift the higher burden of taxation to employers. So it depends on the bargaining structure at the



where  $dJ_1$  and  $dJ_2$  are the increments of Poisson processes (with mean arrival rates  $\lambda_1$  and  $\lambda_2$ ). It is assumed that if an “event 1” (“event 2”) occurs,  $\tau$  increases (falls) by  $\phi_1$  ( $\phi_2$ ) percent with probability 1.<sup>9</sup> Over each time interval  $dt$  there is a probability  $\lambda_1 dt$  (or  $\lambda_2 dt$ ) that it will rise (drop) by  $\phi_1 \tau$  ( $\phi_2 \tau$ ). Additionally, we assume that  $(dJ_1, dJ_2)$  and  $d\varpi$  are orthogonal, i.e.  $E(d\varpi dJ_1) = 0$ ,  $E(d\varpi dJ_2) = 0$  and  $E(dJ_1 dJ_2) = 0$ . Equations (5) and (6) indicate that there are two sources of uncertainty. Type I uncertainty represented by the geometric Brownian motion captures price and/or demand uncertainty. Instability of this type may be helpful in predicting the variability in profits. To understand the policy impact upon labour demand, we have additionally assumed type II uncertainty (represented by the two jump processes). This newly added uncertainty represents political uncertainty about future changes in non-wage labour costs and allows investigating how uncertainty about future non-wage labour costs alters incentives for employment. In our work, the timing of the potential policy shifts is exogenous.<sup>10</sup> In other words, our model contains two uncorrelated jumps and the behaviour between the jumps is that of a „Gaussian“ diffusion („Poisson-Gaussian model“). The critical question for the firm is how best to respond in such an uncertain environment.<sup>11</sup> Using Itô’s Lemma, the Bellman equation for the value  $V$  at time zero is

$$rV = \max_L \left\{ Z \left[ \theta K^{-\mu} + (1-\theta)L^{-\mu} \right]^{\frac{-1}{\mu\psi}} - w(1+\tau)L + \eta Z V_Z + \frac{1}{2} \sigma^2 Z^2 V_{ZZ} + \lambda_1 [V(\tau(1+\phi_1)) - V] - \lambda_2 [V - V(\tau(1-\phi_2))] \right\} \quad (7)$$

To find the optimal condition for employees with the existence of firing costs and hiring costs, we need to obtain the value of the marginal employed worker first ( $v = V_L$ ) and then compare the

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labour market and the bargaining power of the parties involved how taxes will affect wages. Given this ambiguity, we consider the hourly wage to be exogenous.

<sup>9</sup> Given the high level of unemployment, the German government has implemented an environmental tax reform in several stages since 1999 and has used the proceeds to cut employer and employees contributions to the pension fund. This policy-induced fall of non-wage labour costs may be represented by „event 2“ in equation (6). Environmental taxation is often seen as an attractive solution for cutting unemployment. Such a reform may yield a „double dividend“: not only an improvement in environmental quality but also a boost to labour demand. The idea of a „double dividend“ has been discussed extensively in the economic literature. Now, the consensus view among economists seems to be that a green tax reform is unlikely to generate a significant „double dividend“ if previous policies have been economically rational and if other distortions in the economy exist. Excellent surveys of the debate are available in Goulder (1995) and Bovenberg (1999).

<sup>10</sup> In practical terms, we are not exploring endogenous uncertainty but exogenous uncertainty that may (or may not) be resolved with time but cannot be resolved by action on part of the firm. Alternatively, one could assume endogenous uncertainty. Jumps might be correlated because their amplitudes are drawn from correlated distributions, or through the correlation in the jump times (the jumps may be simultaneous, or have correlated stochastic arrival intensities). This correlated „double-jump“ approach is richer and more complete. A general characterisation of such affine jump-diffusions models is available in Duffie et al. (2000).

<sup>11</sup> Bentolila and Bertola (1990) have developed a dynamic model of labour demand with type I uncertainty, but have not considered policy uncertainty (type II uncertainty).

marginal value of employees with the marginal hiring and firing costs. We take the derivative of (7) with respect to  $L$

$$rv = ZF(K, L) - w(1 + \delta) + \eta Zv_Z + \frac{1}{2} \sigma^2 Z^2 v_{ZZ} + \lambda_1 [v(\tau(1 + \phi_1)) - v] - \lambda_2 [v - v(\tau(1 - \phi_2))] \quad (8)$$

and

$$F(K, L) = \frac{1 - \theta}{\psi} L^{-\mu - 1} \left[ \theta K^{-\mu} + (1 - \theta) L^{-\mu} \right]^{\frac{-1}{\mu\psi} - 1}. \quad (9)$$

The solution for  $v(Z)$  consists of the particular integral and the complementary function. We first deal with the identification of uncertainty effects in the very special case where hiring and firing costs are zero. This special case turns out to be useful as a starting point and for comparisons. Then we turn to the general case with positive hiring and firing costs. In the absence of hiring and firing costs, the particular integral may be expressed as

$$v^P(Z) = E \left[ \int_0^{\infty} [ZF(K, L) - w(1 + \tau)] e^{-rs} ds \right] \quad (10)$$

which is the expected present value of the marginal employed worker.  $E[\cdot]$  denotes the expectation operator given information at initial time  $t = 0$ . This integral can be rewritten as (a proof is given in Appendix A)

$$v^P(Z) = \frac{ZF(K, L)}{r - \eta} - \frac{w}{r} - \frac{w\tau}{r - \lambda_1\phi_1 + \lambda_2\phi_2}. \quad (11)$$

The real discount rate for  $ZF(K, L)$  is  $r - \eta$  since  $Z$  grows at an expected rate of  $\eta$ . The wage,  $w$ , is exogenous and has a discount rate of  $r$ . The current value of  $\tau$  has a discount rate adjusted by the possibilities of jumps in the future value of  $\tau$ .

The firm's option value of hiring in the future and its option value of firing once the worker is employed are measured by the complementary function:

$$rv = \eta Zv_Z + \frac{1}{2} \sigma^2 Z^2 v_{ZZ} + \lambda_1 [v(\tau(1 + \phi_1)) - v] - \lambda_2 [v - v(\tau(1 - \phi_2))]. \quad (12)$$

Letting  $v^G$  be the value of the option, the general solutions for the hiring and firing options ( $v_H^G$  and  $v_F^G$ ) have the following forms, respectively (see Appendix B for details),

$$v_H^G(Z) = A_1 Z^{\beta_1} \quad (13)$$

and

$$v_F^G(Z) = A_2 Z^{\beta_2}, \quad (14)$$

where  $\beta_1$  and  $\beta_2$  are the positive and negative roots of the following characteristic equation:

$$\frac{1}{2} \sigma^2 \beta(\beta - 1) + \eta\beta - r = 0. \quad (15)$$

To satisfy the boundary conditions that  $v_H^G(0) = 0$  and  $v_F^G(\infty) = 0$ , we use the positive solution for  $v_H^G$  and the negative solution for  $v_F^G$ .

We now add fixed marginal hiring ( $H$ ) and firing ( $F$ ) costs to the model with both  $H$  and  $F$  being payable by the firm.<sup>12</sup> When there are fixed costs of either hiring or firing, the firm will consider the option value of maintaining her current position against the alternative of hiring or firing. In other words, it should be evident that the hiring and firing policy of the optimising firm is discontinuous. In some periods the optimal strategy of the firm will be to adjust the number of workers. Under other demand conditions a wait and see attitude will be chosen. More specifically, employment inaction will always be chosen when deviations of the expected marginal product of labour from the optimal level do not justify the costs of employment adjustment. Hiring and firing costs therefore generate a corridor of inaction (wait and see attitude for the time being) within which firms do not change their workforce. This region is identified by the upper,  $Z_H$ , and lower,  $Z_F$ , control barriers. The definitions of the hiring and firing barriers,  $Z_H$  and  $Z_F$ , are given by the value-matching and smooth-pasting conditions below. It is straightforward to show that according to the value-matching conditions the firm would find it optimal to exercise its option to hire or fire the marginal worker once  $Z$  hits one of the two barriers:

$$\frac{Z_H F(K, L)}{r - \eta} - \frac{w}{r} - \frac{w\tau}{r - \lambda_1 \phi_1 + \lambda_2 \phi_2} + A_2 Z_H^{\beta_2} = H + A_1 Z_H^{\beta_1} \quad (16)$$

and

$$-\left[ \frac{Z_F F(K, L)}{r - \eta} - \frac{w}{r} - \frac{w\delta}{r - \lambda_1\phi_1 + \lambda_2\phi_2} \right] + A_1 Z_F^{\beta_1} = F + A_2 Z_F^{\beta_2}. \quad (17)$$

The left-hand sides of (16) and (17) show the marginal benefit from hiring/firing a worker and the right-hand sides the corresponding marginal costs. The marginal benefit of hiring a worker is equal to the sum of the present discounted value of his productivity net of wages and the value of the option to fire him. The firm's ability to fire raises the benefit from employing a worker. The marginal cost of hiring is the sum of the direct hiring costs and the sacrificed option to hire him in the future. By hiring a worker today, the opportunity to do so in the future – when conditions may be more favourable – is sacrificed. Similarly, by firing a worker, the opportunity to do so in the future – when demand conditions may be even more adverse – is sacrificed, and the opportunity to hire is gained. The smooth-pasting conditions ensure that hiring (firing) is not optimal either before nor after the hiring (firing) threshold is reached. In technical terms, this means

$$\frac{F(K, L)}{r - \eta} + A_2 \beta_2 Z_H^{\beta_2 - 1} = A_1 \beta_1 Z_H^{\beta_1 - 1} \quad (18)$$

and

$$-\frac{F(K, L)}{r - \eta} + A_1 \beta_1 Z_F^{\beta_1 - 1} = A_2 \beta_2 Z_F^{\beta_2 - 1}. \quad (19)$$

Equations (16) - (19) form a non-linear system of equations with four unknown parameters,  $Z_H$ ,  $Z_F$ ,  $A_1$ , and  $A_2$ , and can be solved numerically once the solutions for  $\beta_1$  and  $\beta_2$  are obtained from (15). In order to visualise our approach to employment determination, we next consider calibrations of the model. These make the model amenable to graphical analysis.

### 3. Calibration and Results

The preceding section has laid out the model economy. Having illustrated that the stochastic framework has important ramifications for the dynamic behaviour of labour demand, we proceed in this section to use the theoretical models derived above to carry out a number of simulations to shed

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<sup>12</sup>  $H$  can be thought of as representing the screening and training costs associated with the recruitment of a new

light on the workings of the models and the economic forces at work.<sup>13</sup> For this reason, the model is calibrated in order to match characteristics of the German economy. In other words, an intuitive interpretation of the model is provided, and throughout the remainder of the paper no background in stochastic calculus is necessary to understand the arguments in the text.

The unit time length corresponds to one year. Our base parameters are  $\sigma = 0.15$ ,  $\eta = 0.0$ ,  $\lambda_1 = 0.1$ ,  $\lambda_2 = 0.1$ ,  $\phi_1 = 0.1$ ,  $\phi_2 = 0.1$ ,  $K = 1$ ,  $r = 0.04$ ,  $w = 1$ ,  $H = 0.1$ ,  $F = 0.6$ ,  $\Psi = 1.5$ ,  $\mu = 0.4825$ ,  $\theta = 0.3$ , and  $\tau = 0.75$ . Where possible, parameter values are drawn from empirical labour studies. The firing and hiring parameters are consistent with those in Bertolila and Bertola (1990) for Germany. Their estimated firing costs for Germany are in the range  $0.562 \leq F \leq 0.750$  and their hiring cost estimate (excluding on-the-job-training) for Germany is 0.066 of the average annual wage. Our specification ( $H = 0.10$ ) is also broadly consistent with the recruiting and training cost of two months in Mortenson and Pissarides' (1999) calibration.<sup>14</sup> They suggest that this number is consistent with survey results reported in Hamermesh (1993). The elasticity of substitution between capital and labour  $1/(1+\mu) = 0.7$  has been taken from Pissarides (1998). Point estimates for  $\tau$  have been derived from Table 1. Finally, the price elasticity of demand parameter is set at  $\Psi = 1.50$  as in Bovenberg et al. (1998). The determination of some parameters, however, requires the use of judgement, i.e. they reflect a back-of-the-envelope calculation.<sup>15</sup>

To motivate the analysis of policy uncertainty, special attention has to be paid to the calibration of the Poisson processes. The Poisson process implies that the likelihood of a policy change is determined by the arrival rate  $\lambda$ . This means that the time  $t$  one has to wait for the switch event to occur is a random variable whose distribution is exponential with parameter  $\lambda$ :

$$F(t) \equiv \text{prob}\{\text{event occurs before } t\} = 1 - e^{-\lambda t}. \quad (20)$$

The corresponding probability density is

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employee and  $F$  as the severance costs imposed by legislation when dismissing an employee.

<sup>13</sup> The numerical boundary value problem is solved with the method of Newton-Raphson for nonlinear systems. For a description of the algorithm used to compute the numerical simulations, see Press et al. (2002).

<sup>14</sup> Firing costs have increased substantially in Germany in the late 1960s and 1970s and have roughly stayed on this high level since then (see Caballero and Hammour, 1997). The OECD (1999) has compiled a comprehensive dataset describing legislative firing (procedural requirements, notification periods, severance pay, special requirements for collective dismissals, and short-time work schemes) and hiring costs (rules favouring disadvantaged groups, conditions for temporary and fixed-term contracts, training requirements) covering 22 indicators for 27 countries. These 22 indicators provide the inputs for the construction of cardinal summary indicators of employment protection across countries. These indicators of strictness of employment protection in the late 1990s are also available in the *DICE* database (for further details, see [www.cesifo.de](http://www.cesifo.de)).

<sup>15</sup> Note, however, that the goal of this paper is not to derive precise quantitative estimates of the impact of various labour market regulations, but rather to illustrate the qualitative predictions of a partial equilibrium model and to identify key features of the framework in determining the policy's quantitative impact.

$$f(t) \equiv F'(t) = \lambda e^{-\lambda t}. \quad (21)$$

In other words, the probability that the event will occur sometime within the short interval between  $t_0$  and  $t_0+dt$  is approximately  $\lambda e^{-\lambda t} dt$ . In particular, the probability that it will occur within  $dt$  from now (when  $t = 0$ ) is approximately  $\lambda dt$ . In this sense  $\lambda$  is the probability per unit of time. Moreover, the number of policy changes ( $x$ ) that will take place over any interval of length  $\Delta$  is distributed according to the Poisson distribution

$$(22) \quad g(x) \equiv \text{prob}\{x \text{ event occur}\} = \frac{(\lambda\Delta)^x e^{-\lambda\Delta}}{x!}$$

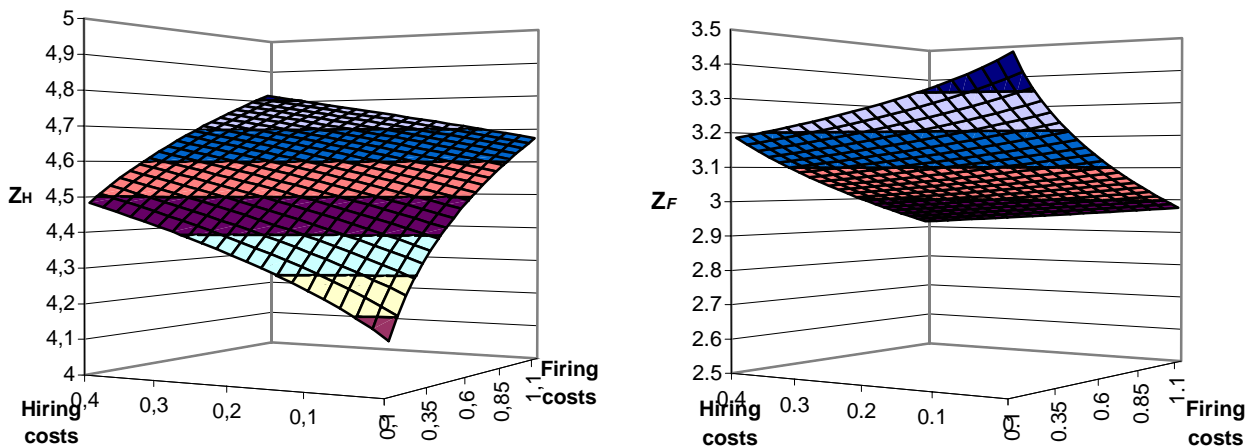
whose expected value is the arrival rate times the length of the interval  $\lambda\Delta$ . We can back out from equation (22) the agent's beliefs about policy changes. As a guide to calibration, Table 4 below provides the probabilities that either one ( $x = 1$ ) or three ( $x = 3$ ) jumps will occur within 5 years ( $\Delta = 5$ ) or 10 years ( $\Delta = 10$ ) for the four arrival rates  $\lambda = 0.01$ ,  $\lambda = 0.05$ ,  $\lambda = 0.10$  and  $\lambda = 0.15$ , respectively. For example, for  $\lambda = 0.05$  the probability that one jump will occur within 5 years is 19.5 percent.

**Table 4: Jump Probabilities for the Poisson Process**

	$\lambda = 0.01$	$\lambda = 0.05$	$\lambda = 0.10$	$\lambda = 0.15$
prob{1 event in 5 years}	0.048	0.195	0.303	0.354
prob{3 events in 5 years}	0.000002	0.002	0.013	0.033
prob{1 event in 10 years}	0.090	0.303	0.368	0.395
prob{3 events in 10 years}	0.0001	0.012	0.061	0.126

Given the high probability of increasing non-wage labour costs in Germany, a sensitivity analysis is performed over the grid  $\lambda_i \in \{0.0, 0.2\}$  for  $i = 1, 2$ .

**Figure 1: The Employment Thresholds for Alternative Hiring and Firing Costs**



First, we consider a policy which changes hiring and firing costs. Despite the fact that liberalisation of labour markets has ranked highly in European policy debates, few effective changes to the stringent nature of the employment constraints facing European firms appear to have been implemented over the last decade. Moreover, in a number of European countries the general trend towards greater employment protection would actually appear to have continued. The numerical results are given in Figure 1. The major result of the calibrations is that higher hiring and firing costs lead to an increase of the no action area, i.e. increasing hiring and/or firing increases the hiring threshold ( $Z_H$ ) and decreases the firing threshold ( $Z_F$ ). On the one hand, protection dampens unemployment because existing workers are fired less easily. On the other hand, it increases unemployment as employers are more reluctant to hire highly protected workers. The net impact upon employment turns out to be negative because the hiring thresholds are steeper, compared to the firing ones. This asymmetric widening of the region of inaction implies that German unemployment is caused not so much by an increased probability of losing one's job, but rather by a reduction in the probability of finding a job when one is unemployed.<sup>16</sup>

<sup>16</sup> This feature is consistent with the empirical evidence in Bean (1994), p. 576. More indirectly, countries where employment is protected tend also to discourage business start-ups. Fonseca et al. (2001) have shown that impediments to firm formation are strongly and negatively correlated with the employment to population ratio.

**Figure 2: The Impact of the Level of Non-Wage Labour Costs Upon the Thresholds**

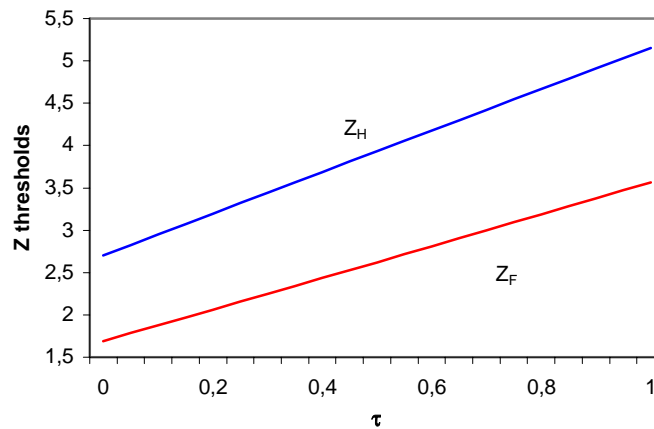
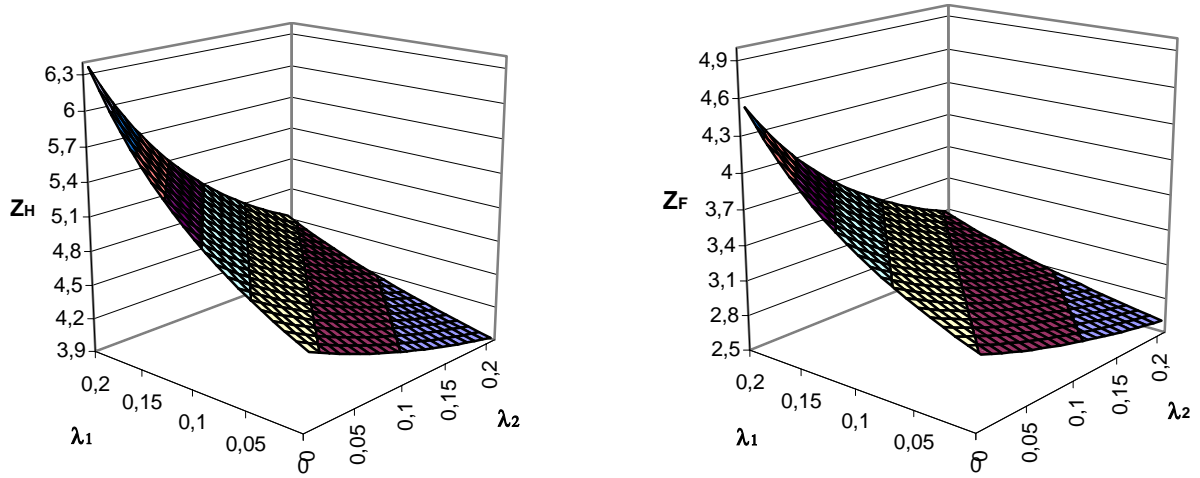


Figure 2 investigates numerically the impact of higher non-wage costs *levels*. The graph clearly indicates that a higher share of non-wage labour costs ( $\tau$ ) leads to an increase of  $Z_H$  and  $Z_F$  and a widening of the wait and see area.

Figure 3 provides a sensitivity analysis of the thresholds with respect to  $\lambda_1$  and  $\lambda_2$ , i.e. we illustrate the impact of *uncertainty* about future non-wage labour costs upon the optimal hiring and firing thresholds. Alternatively, one may say that we consider different degrees of „policy-jumpiness“. The 3-D graphs clearly indicate the entire no-action areas. If  $\lambda_1$  increases, then the  $Z_H$  investment threshold will rise – firms will be more reluctant to hire to avoid getting caught with too much workers, should the future turn out worse than expected. By contrast, if the future turns out better than expected, the firm can just hire more workers as needed. The implication is that the textbook net present value rule is blatantly inappropriate in any context other than the unrealistic setting where sunk costs are negligible and there is certainty regarding the determinants of the profitability of the project to be undertaken. On the contrary, if  $\lambda_2$  increases, then the  $Z_H$  threshold declines. In other words, uncertainty about future non-wage labour costs pushes up the real option “price” and increases the advantages to the firm of waiting. The theory therefore explains why firms often respond slowly to changes in policy variables – all of which, orthodox theory suggests, should elicit an instant response.



**Figure 3: The Impact of  $\lambda_1$  and  $\lambda_2$  Upon the Thresholds**



**Figure 4: The Threshold Values as a Function of  $\phi_1$**

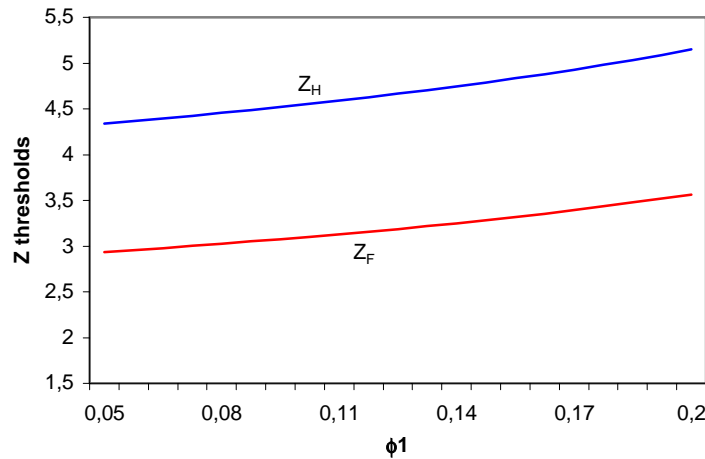
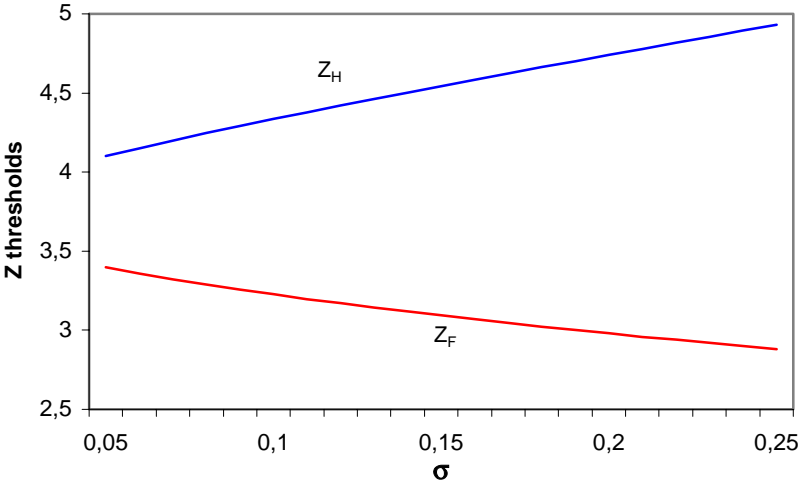


Figure 4 shows how the magnitude of the jumps (represented by  $\phi_1$ ) affects the thresholds. Two main messages emerge from Figure 4. The first concerns the hiring and firing thresholds: The simulations suggest that perceived upside risks act as an important deterrent to hirings and firings. *Pari passu*, an unreliable political environment translates into higher thresholds and hence lowers the efficiency of the economy.

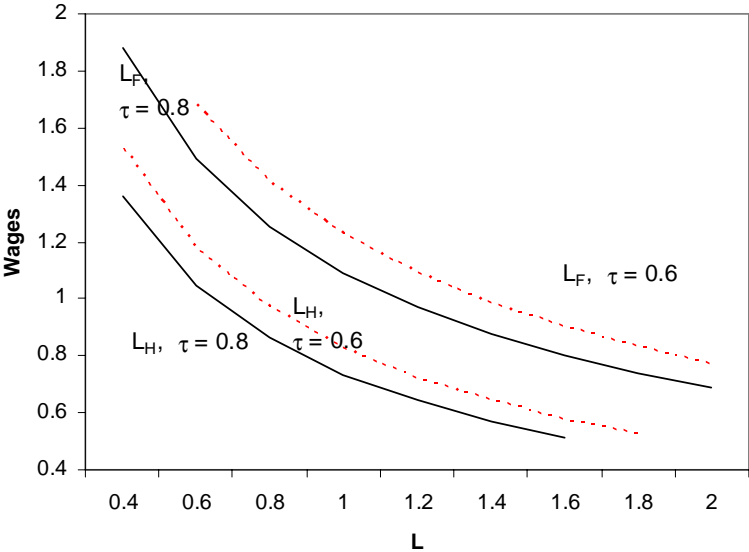
Let us now consider changes in  $\sigma$ . In other words, we analyse the sensitivity of the optimal thresholds with respect to changes in the volatility of the geometric Brownian motion representing demand and/or price uncertainty. As in the existing literature, we find that the threshold value at which hiring takes place is increasing in the “noisiness” level even though the firm is risk neutral. In volatile environments, the best tactic is to keep options open and await new information rather than take an

employment decision today. The intuition is that the firm can counteract the impact from additional uncertainty by a wait and see attitude for the time being.

**Figure 5: The Threshold Values as Function of  $\sigma$**



**Figure 6: The Impact of  $\tau$  Upon the Labour Demand Curve**



In order to gain additional insight into the model, Figure 6 shows how non-wage labour costs affect the labour demand schedule. We investigate  $\tau = 0.8$  and  $\tau = 0.6$ . For each parameterisation, the hiring and firing employment thresholds are derived for  $Z = 3.5$  with the fact that marginal values of employees from particular solutions are the same with  $Z$  and  $L$  thresholds. The firm would hire a marginal worker if the employment falls below  $L_H$ ; and the firm would fire a marginal employee if the employment level is more than  $L_F$ . The comparison of the curves reveals that higher non-wage

labour costs reduce labour demand. This again highlights the interdependencies between labour markets and a social security system which is tied to employment.

The traditional literature has often focused exclusively on the impact of certain labour market regulations, largely ignoring the role of product market regulations and the interactions between regulatory interventions in the two markets. In recent years, however, an increasing literature analysing such interactions has emerged (see, for example, the careful discussion in Blanchard and Giavazzi, 2003). As a step ahead in the analysis, we therefore provide an initial attempt to quantify such interactions. Policies in product and labour markets are normally aimed at influencing outcomes in the markets to which they directly apply. However, the empirical and theoretical findings of various recent papers suggest that policy interactions between product and labour markets can have important effects, sometimes even having an impact comparable to within-market policy influences. For instance, in some European countries, anticompetitive product market regulations and strict employment protection policies appear to have contributed equally to keeping employment rates low (see Bertrand and Kramarz, 2002, Fonseca et al., 2001, Nicoletti et al., 2001 and Nickell, 1999).<sup>17</sup> How do alternative patterns of regulations in product markets influence the hiring and firing decisions of firms in our modelling framework? In the simulations below, we think of the regulatory stance on the product markets as being captured, admittedly in abstract fashion, by the degree of product market competition,  $\psi$ . The aim of the simulations is to assess the policy relevance of cross-market effects from product markets to labour markets.

**Figure 7: Hiring and Firing Thresholds as a Function of  $\psi$**

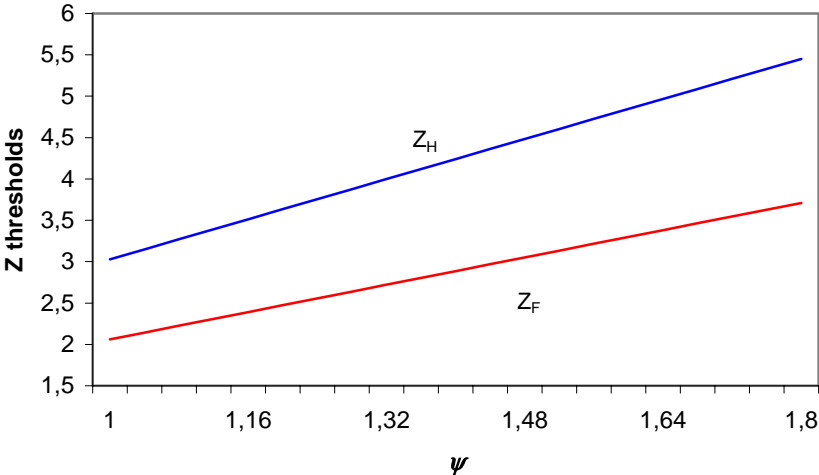


Figure 7 plots the employment thresholds as a function of  $\psi$ . As expected, anticompetitive product market regulations are found to increase the employment thresholds and to widen the inaction range. The cross-market interaction results therefore suggest that strict product market regulation is likely to

affect employment negatively.<sup>18</sup> Despite its preliminary character, the analysis thus suggests that accounting for cross-market effects is an important element of good policy design and the removal of barriers to competition in potentially competitive markets can be a complement to labour market reforms.<sup>19</sup>

#### 4. Summary Remarks and Conclusions

Germany has one of the highest unemployment rates – 11.% or 4.5 million people – in the rich world.<sup>20</sup> Against this gloomy background, chancellor Schröder and his government have taken some encouraging steps in their “Agenda 2010”. Most strikingly they have proposed substantial cuts in the duration and amounts of unemployment and non-wage labour costs (sickness benefits). The government has also suggested ways that would weaken job-protection in small companies and encourage employers to hire new workers. In detail, the government has agreed to make firing rules more flexible by letting small firms take on a sixth worker – or more – on a fixed-term contract without the other employees becoming eligible for full job protection. In larger firms, the government proposes offering anyone laid off a choice between a fixed amount of compensation, not automatically available at present, and seeking redress in the courts, in which case the worker would have to renounce all rights to financial compensation. This procedure would help to avoid the long, unpredictable and costly legal proceedings that always follow any attempt to lay off workers in Germany. Furthermore, the government says it will encourage wage bargaining at the company level by making it easier for firms to opt out of the straitjacket of sector-wide agreements when circumstances so require. Above all, the government is determined to reduce the non-wage costs of labour. Of course, the model developed in this paper is stylised and may not capture all of the details.

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<sup>17</sup> A set of indicators of various dimensions of product market regulation shedding some light on cross-country differences is available at [http://www.cesifo.de/pls/dicguest/search.create\\_simple\\_search\\_page](http://www.cesifo.de/pls/dicguest/search.create_simple_search_page).

<sup>18</sup> The larger inaction range probably represents a lower bound, in that we take the wage,  $w$ , as given when looking at changes in  $\psi$ . In practice, many regulation measures are likely to increase  $w$  as well. From a theoretical standpoint, there is a strong presumption that regulatory provisions and a lack of competition will induce an upward pressure in wage rates.

<sup>19</sup> There are at least three channels through which the strictness of product market regulations may have implications for labour markets. (1) Product market deregulation increases competitive pressures among firms, raising the elasticity of product demand. At the firm level, for given wages, a higher demand elasticity raises labour demand; (2) product market deregulation lowers entry costs. This is likely to lead to higher employment; (3) a more competitive institutional setting will also contribute to a more innovative and dynamic economy through thriving entrepreneurial activity (Acemoglu et al., 2002). While the intensity of these effects will depend also on the features of labour market institutions, their sign will generally remain the same across different institutional settings. This leads to the „all or nothing“ warning issued by Coe and Snower (1997) and Orszag and Snower (1998). They argue that piecemeal labour market reforms may have had so little success because they disregarded the complementarities between a broad range of policies and institutions.

<sup>20</sup> Germany’s labour market institutions have by and large been kept unchanged over the last thirty years. Therefore, their interaction with changes in the economic environment is the most plausible candidate for explaining rising unemployment. Economic conditions have become more volatile over the last ten years due to globalisation and the transition to the new economy. This explanation is in fact the gist of papers by Blanchard and Wolfers (2000), Chen et al. (2002) and Ljungqvist and Sargent (2002).

Nevertheless, the modelling exercise clearly indicates that such a reform package – if boldly and fully implemented – will push Germany in the right direction.

### Appendix A: Derivation of Equation (11)

Assume that the particular solution for the shadow price of employees has the following functional form as the particular integral components:

$$v = BZF(K, L) + Cw + Dw\tau. \quad (\text{A1})$$

Then, we have

$$\eta Zv_Z = \eta BZF(K, L), \quad (\text{A2})$$

$$v_{ZZ} = 0, \quad (\text{A3})$$

$$\lambda_1 [v(\tau(1 + \phi_1)) - v] = \lambda_1 Dw\tau\phi_1, \quad (\text{A4})$$

$$\lambda_2 [v - v(\tau(1 - \phi_2))] = \lambda_2 Dw\tau\phi_2. \quad (\text{A5})$$

Substituting into equation (8) yields

$$r(BZF(K, L) + Cw + Dw\tau) = ZF(K, L, N) - w(1 + \tau) + \eta BZF(K, L) + \lambda_1 Dw\tau\phi_1 - \lambda_2 Dw\tau\phi_2. \quad (\text{A6})$$

Rearranging and collecting terms yields

$$ZF(K, L)[(r - \eta)B - 1] + w[rC + 1] + w\tau[(r - \lambda_1\phi_1 + \lambda_2\phi_2)D + 1] = 0. \quad (\text{A7})$$

Equation (A8) must hold for any value of  $B$ ,  $C$ , and  $D$ , so that

$$B = \frac{1}{r - \eta}, \quad (\text{A8})$$

$$C = \frac{-1}{r}, \quad (\text{A9})$$

$$D = \frac{-1}{r - \lambda_1\phi_1 + \lambda_2\phi_2} \quad (\text{A10})$$

It is then straightforward to obtain equation (11).

## Appendix B: Derivation of Equations (13) and (14)

The homogeneous solutions to equation (12) should have the same components as the particular solutions with respect to the uncertainty variables. Assume the homogeneous solutions have the functional form

$$v = AZ^\beta + B\tau. \quad (\text{B1})$$

Then we have

$$\eta Z v_Z = \eta \beta A Z^\beta, \quad (\text{B2})$$

$$\frac{1}{2} \sigma^2 Z^2 v_{ZZ} = \frac{1}{2} \sigma^2 \beta(\beta-1) A Z^\beta, \quad (\text{B3})$$

$$\lambda_1 [v(\tau(1+\phi_1)) - v] = \lambda_1 B \tau \phi_1, \quad (\text{B4})$$

$$\lambda_2 [v - v(\tau(1-\phi_2))] = \lambda_2 B \tau \phi_2, \quad (\text{B5})$$

Now substitute into equation (12) in the text. It is straightforward to obtain the following characteristic equation:

$$r(AZ^\beta + B\tau + C) = \eta \beta A Z^\beta + \frac{1}{2} \sigma^2 \beta(\beta-1) A Z^\beta + \lambda_1 B \tau \phi_1 - \lambda_2 B \tau \phi_2 \quad (\text{B6})$$

Rearranging and collecting terms yields

$$\left( \frac{1}{2} \sigma^2 \beta(\beta-1)r + \eta \beta - r \right) A Z^\beta - r B \tau + \lambda_1 B \tau \phi_1 - \lambda_2 B \tau \phi_2 = 0 \quad (\text{B7})$$

Equation (B7) must hold for any value of  $A$ ,  $B$ , and  $C$ . Thus, we have

$$\frac{1}{2} \sigma^2 \beta(\beta-1) + \eta \beta - r = 0 \quad (\text{B8})$$

$$r B \tau = \lambda_1 B \tau \phi_1 - \lambda_2 B \tau \phi_2 \quad (\text{B9})$$

Note that (B9) holds only if  $B = 0$ . Actually, the jump uncertainty is captured in the particular solutions and therefore does not appear in the homogenous solutions. Therefore only equation (B8) consists of homogenous solutions. Note that there are two roots for characteristic equation (B8). Therefore, the general solutions are denoted by

$$v^G = A_1 Z^{\beta_1} + A_2 Z^{\beta_2}, \quad (\text{B10})$$

where  $\beta_1 > 0$  and  $\beta_2 < 0$ .

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