

Discussion paper

EUROPEAN EMPLOYMENT OBSERVATORY
GERMANY

First experience with Hartz reform

Quarterly review of labour market trends and policies
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by

Kurt Vogler-Ludwig

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Glossary

Agenda 2010	Principal economic and social reform programme of the SPD-Bündnis90/Die Grünen government coalition passed in March 2003
ICH-AG	Business foundation grant (<i>Existenzgründungszuschuss</i> ; § 421 I SGB III) for UB-I recipients, which supports unemployed becoming self-employed for up to three years (1 st year: 600 € per month, 2 nd year 360 €, 3 rd year 240 €)
Job Summit	Agreement between red-green government and CDU/CSU opposition from 17 March 2005 on principles of further labour market reforms
Hartz reform	<p>Reform of unemployment insurance under the Federal Employment Service (<i>Bundesagentur für Arbeit</i>) and active labour market policies, named after Peter Hartz, principal staff manager of Volkswagen and the president of “Hartz Commission” established by the German government in 2002.</p> <p>The reform has four parts:</p> <p>Hartz I (2002): introduction of public temporary work agencies (Personnel Service Agencies – PSA)</p> <p>Hartz II (2002): reorganisation of public employment services; mini-jobs, ICH-AG</p> <p>Hartz III (2004): restructuring of public employment services to the Federal Employment Agency</p> <p>Hartz IV (2005): merging of unemployment aid and social assistance to UB-II</p>
1 € Jobs	Jobs in the area of social and public services for UB-II recipients. They are remunerated by 1 or 2 € in addition to UB-II benefits. Jobs need to be additional to jobs in the premier labour market and to normal activities of the institutions.
UB-I	<i>Arbeitslosengeld I</i> : Regular unemployment benefit
UB-II	<i>Arbeitslosengeld II</i> : Means-tested basic income for job seekers, paid after expiration of regular unemployment benefit
Minor employment	<i>Geringfügige Beschäftigung</i> : Jobs with monthly incomes less than 400 €. These can be regular or occasional jobs and jobs in addition to regular employment. Employers pay 25 % of wages to social insurance.
National Training Pact	Agreement between the Federal Government and the employers associations to offer 60,000 additional dual training places in 2004, and another 30,000 in 2005.

1. Introduction

With a new grand coalition government Germany has regained its operational power at the political level. The coalition of CDU/CSU and SPD is based on a strong parliamentary majority of 73 % of the seats which even allows changing the constitution. This asset, however, is of low value if the space of political consensus remains tight.

The treaty between the coalition parties reflects these limitations given by a Christian Democratic Party which failed the majority for its reform programme and a Social Democratic Party which is endangered by the newly formed left-wing party (Die Linke/PDS). Thus the continuation of the reform process started by the former red-green government can already be seen as a success. But the coalition treaty leaves many controversial issues undecided, and a minimal consensus programme can hardly show an escape from the low-growth/high-unemployment imbalance which governs Germany now since almost three decades. Factual reality will therefore become a strong determinant of the political agenda.

2. Update on economic and labour market trends

2005 in retrospect

Little progress to the general labour market situation but significant structural change was brought by the year 2005 (Table 1). Estimates including the fourth quarter show that only a minor 0.13 % increase of total employment will be achieved. The small rise has to be attributed to the strong increase of both, self-employed jobs (+3.8 %) and minor jobs (+2.9 %). This was just sufficient to compensate the further decline of regular employment registered by social insurance (–1.5 %). As the Council of Economic Advisors stated, labour market policies of the last years created a two-class labour market through extending atypical forms of employment rather than increasing the number of regular jobs (SVR 2005, p. 5).

Unemployment figures increased significantly due to the labour market reforms of 2005 (Hartz IV reform) which revealed unemployment hidden by social benefits and active labour market policy programmes. The increase of unemployment by 12 % against the previous year is largely attributed to these policy reforms. In parallel the strong growth of registered vacancies (+41.6 %) partly is also affected by policy reforms as the rising number of “One-EURO-Jobs” are counted as vacancies at placement time. (The figure nevertheless includes a rise of regular labour demand.) The rate of registered unemployment increased consequently, however, the ILO unemployment rate did not change significantly over the year.

Most recent figures on economic growth, published by the Federal Statistical Office mid November, indicate the continuation of the moderate cyclical upswing. Real GDP grew by 1.4 % in the 3rd quarter 2005, double the rate of the 2nd quarter (calendar-adjusted values).

The Federal Labour Office also recognised signs of a recovery on the labour market. In particular, the monthly decrease of unemployment by 25,000 over the last four months until October 2005 is taken as a positive signal. Moreover, the increase of vacancies in businesses by 88,000 since the beginning of the year seems promising. The number of youths without training offers decreased to 33,800 in mid October. The supplementary placement round undertaken by labour agencies in the 4th quarter will try to exploit the offer of training places which actually amounts to 11,000.

Table 1 German Labour Market in 2005

	'000	%-change to previous year
Labour force	42,798	0.20
Potential labour supply	44,557	0.26
Employment	38,917	0.13
Self-employed workers	4,377	3.77
Employees and civil servants	34,540	-0.32
Employees (registered by social insurance)	26,166	-1.49
Minor employment	6,573	2.85
Unemployment		
Registered unemployment	4,890	11.59
Hidden unemployment	1,236	-12.03
<i>Unemployment rate (registered unemployment)*</i>	<i>11.8</i>	<i>1.30</i>
<i>ILO unemployment rate*</i>	<i>9.3</i>	<i>0.10</i>
Registered vacancies	405	41.61

* percentage rates and difference of percentage rates to previous year

Source: Council of Economic Advisors 2005

Wage increase was moderate in 2005. The 1.2 % increase of collective wages against the previous year was partly compensated by the cut of fringe benefits. Thus effective wages increased by 0.8 %. A low inflation rate of 0.5 % and the productivity increase of 1.4 % resulted in decreasing real unit labour costs. Real net wages decreased by 1.1 % ([Deutsche Bundesbank 2005](#)).

First experiences with Hartz IV

Recent reviews of the Hartz-IV implementation in 2005 revealed surprising developments even unexpected by the Federal Government:¹

- The number of employable beneficiaries among the applicants exceeded the expected level by 45 % (5 m instead of 3.45 m).
- The number of subsistence-based partnerships (*Bedarfsgemeinschaften*) is 47 % higher than expected (3.71 m instead of 2.52 m). These partnerships are defined by the Hartz-IV act as the private income and property units obliged to individual transfers among its members.
- Total expenditure on unemployment benefits II will exceed budgetary planning by 75 % in 2005 (25.5 m € instead of 14.6 m €).

The main reasons for this overshooting of targets can be identified in four areas:

- Young people detected unemployment benefits II as an opportunity to establish their own households. This was possible through the regulation of the Hartz IV act that parents are not obliged to give financial support to their children beyond the age of 15 if they are employable. In addition, employability is assumed if the person can work at least 3 hours per day. This wide definition extended the group of beneficiaries into the

¹ The facts are taken from the review undertaken by the magazine DER SPIEGEL from 10 October 2005. The review is largely based on internal documents of the Federal Government. A first government report on the current evaluation studies of the Hartz reform is expected by end 2005.

young generations searching for an independent living. The number of unemployed youths increased by 80,000 since the beginning of 2005.

- In contrast to previous regulations, EU foreigners are eligible for UB-II if they could be allowed to take a job in Germany. The earlier regulation required former employment in Germany.
- Self-employed workers with low incomes tried to get UB-II as it includes social insurance premiums which are expensive on private markets.
- Mini-jobbers tried to improve their income situation also with the help of the extensive employability regulation.

The overdraw of budgetary plans can only partly be explained by the rising numbers of beneficiaries. Several additional factors are responsible for the increase. While the reform brought sensible cuts for higher income earners among the unemployed, the attractiveness of social benefits was raised by higher payments compared to the former social and unemployment aid. Moreover, particularly during the starting phase of Hartz IV the control of requests could not be done in detail. This is now corrected through more rigorous checks. Finally, the wide definition of employability allowed municipalities to categorise social aid recipients as UB-II beneficiaries. This brought substantial savings to municipal budgets.

In contrast to the expected expenditure cuts Hartz IV presently appears as a generous social aid programme. The coalition treaty of the new government includes some steps to modify the regulation (see below). The most important question, however, will address the employment effects of the programme. First indication might be given by the summary of evaluation reports expected for the end of 2005.

2006 forecasts

With total GDP growth estimated at 0.8 % economic forecasts for 2005 were quite accurate – at least those of the middle of the year (see *Vogler-Ludwig 2005, Table 1*). The new round of predictions for 2006 was opened in October by the Community of Economic Research Institutes which forecasted a minor acceleration of growth to the rate of 1.2 % and employment increase of ½ %. The Council of Economic Advisors (*Sachverständigenrat*) did not fully coincide and expects slightly lower rates for GDP and employment growth. Unemployment rates will stagnate more or less around 11 % (Table 2).

Table 2 Economic forecasts for 2006
Germany

Institution	Date of publication	GDP growth (% change to previous year)	Employment growth (% change to previous year)	Unemployment rate (%)
Community of economic research Institutes	Oct 05	1.2	0.5	10.9
Council of Economic Advisors	Nov 05	1.0	0,4	11.6

Source: Economix.

Foreign trade and private investment will continue to increase by rates between 4 and 6 % while private and public consumption will stagnate. Economic development in 2006 will therefore not change the insufficient demand situation on the German labour market. In contrast, it will lead to a further decline of jobs registered by social security. This will perpetuate the budgetary problems of social insurance.

3. Labour market policy developments

Policy actions

Germany elected a new parliament on 18 September 2005 with at least three important results: a clear majority of votes for parties left of the conservative reform parties (CDU/CSU and FDP), the strengthening of the left and right wings of the political spectrum at the expense of the big parties (CDU/CSU and SPD), and in consequence the entrance of a new left wing party (Die Linke) into the Bundestag. Given this vote, the big parties decided to establish a grand coalition which was concluded on November 11.

Beyond the definition of targets the coalition treaty contains a great number of policy actions planned or suggested for the legislative period until 2009 (Table 3). In many cases it remains unclear when and how the measures will become effective. Nevertheless, some key points can be discerned:

- Non-wage labour costs will be reduced by 1.6 percentage points (-2 % unemployment insurance, +0.4 % pension insurance) with the target to keep contributions rates to social insurance below 40 %. The actual rate is 41 % according the official calculations and 41.93 % according to the employers' counting².
- This will be financed through an increase of VAT from 16 to 19 %. One percentage point will be used for non-wage labour cost; the other two will help Länder governments to balance their budgets.
- The qualifying period for newly engaged workers will be extended from 6 to 24 months. In compensation fixed-term periods for labour contracts will need a justification during the first 24 months.
- The Hartz-IV-regulations will become more restrictive through specifying subsistent-related partnerships. Young and unmarried persons will be excluded from unemployment benefits II until the age of 25. EU foreigners will need a previous job in Germany in order to be eligible. Overall savings will amount to 3.5b €.
- Special attention will be given to young and older workers through specific labour market and training programmes.

Public and scientific debate

The present debate on the coalition treaty is controversial. While the trade unions accepted the treaty in general, some of the employers' associations (Federal Association of Employers BDA, Central Association of Crafts Business ZDH) strongly opposed it. They particularly doubt the effectiveness of measures to restrict non-wage labour costs and expect higher rates for health and social care insurance for the near future (Handelsblatt 17 11 2005). The Federal Association of Industrial Employers (BDI) tries to moderate the critique and to come to a more general consensus with the government.

In addition, the opposition parties FDP and Bündnis 90/DIE GRÜNEN consider a suit against the 2006 budget at the constitutional court as it might not conform to legislation. There is the demand to the Federal President not to sign the budget act as new public debts in 2006 will exceed public investment expenditure. This is prohibited by the constitution except in the case of a macro-economic imbalance.

Nevertheless the coalition treaty is generally accepted as a useful and workable agenda for the next four years, but is seen as a compromise which is determined by the present dis-

² The employers include 0.9 % extra contributions paid by the employees to health insurance and 0.25 % paid by child-less workers to social care insurance.

tribution of political powers. Taking the structure of the parliament into account, it can be seen as a success that the Hartz Reform will be continued without principal adjustments and budget consolidation is at least planned in the mid-term. Nevertheless, many commentators missed the vision of an effective reform programme and criticised the tax increase for VAT and the additional income tax for high-income earners (Handelsblatt 16.11.2005).

Table 3 Coalition treaty (relevant parts)

Subject	Planned Policy Action
Economy and Technology	<ul style="list-style-type: none"> • Degressive depreciation on capital goods • Public private partnerships • Financial support for SMEs • One-Stop-Shops for start-ups • Rise of R&D expenditure to 3 % of GDP until 2010 • Extension of venture capital • High-tech strategy with innovative clusters (life-sciences, materials, nano-technology, air/space craft, environmental technologies etc.) • Deregulation of telecommunication networks • Support of the new Lisbon Strategy
Labour Market	<ul style="list-style-type: none"> • Reduction of unemployment insurance premiums from 6.5 to 4.5 % financed through the increase of VAT from 16 to 19 % (2007) • Increase of pension insurance premiums from 19.5 to 19.9 % (2007) • Reform of public health insurance • Continuation of the National Training Pact • Promotion of disadvantaged youths • Promotion of older workers • Promotion of low wage sector (combination of wages and social benefits) • Continuation of active labour market policy until evaluation results will be available (2007) • Reduction of "Personnel Service Agencies" (public temporary work agencies) • Extension of ICH-AGs until 30.06.06. Combination with transition benefits planned. • Seasonal unemployment benefits (construction industries)+ • Supply of internationally comparable unemployment statistics
Labour law	<ul style="list-style-type: none"> • Extension of qualifying period from 6 to 24 months • Extension of the expatriates act to cleaning business • Extension of the temporary regulation for working time act • Opening of retail shops at four Sundays per year • Extension and development of co-determination • Combating black economy and illegal work • Restrictive regulation of labour immigration
Hartz IV	<ul style="list-style-type: none"> • More precise definition of subsistence-based partnerships and quasi-married couples (exclusion of unmarried children younger than 25 from UB-II) • Exclusion of foreign workers without a previous job in Germany from UB-II • Equal benefits in eastern and western Germany • Organisational reforms including the extension of the present cooperation with municipalities • Protection of pension-related financial assets of UB-II recipients • Combating abuse • Expected budget savings: 3.5b €
Education and training	<ul style="list-style-type: none"> • Continuation of the investment programme for full-time schools • Development of education and training monitor (Bildungsberichterstattung) • Evaluation of the new Vocational Training Act • Checking possibilities for step-by-step dual training • Continuing the modernisation of dual training • Promotion of migrants • Continuation of entry qualification for disadvantaged youths • Promotion of continuing training by improving transparency on training markets and supporting training-related savings • Improving the competitiveness of universities

Source: CDU, CSU, SPD Coalition Treaty 2005.

The most critical point, however, can be seen in the fact that many of the actions planned for the next four years remain vague, will have to wait for evaluation results, or do not even address the key problems.

From the view-point of the author of this article these key points are:

- There is no vision of a growth economy. The suggested innovation policies and the support of SMEs are nothing new and a strategy towards high or at least dynamic employment can hardly be discerned. Germany can be expected to remain in the sub-optimal low-growth and high-unemployment imbalance. The creation of new jobs, however, would be the pivotal point of the unemployment problem.
- The negative effects of the tax wedge on employment are underestimated. A reduction of non-wage labour costs by 1.6 percentage points will hardly remove these effects. A substantial revision of the transfers and services provided by public social insurance is needed in order to achieve noticeable employment gains.
- There is no new definition of public services and provisions which would be needed in the future to reduce public expenditure and lower taxes. No vision of a slim state can be discerned in the coalition treaty. In contrast, VAT will be raised and income tax reforms will concentrate on the abolition of tax exemptions rather than the reduction of tax rates.
- Labour law will be revised only in a few points. The extension of the qualifying period for newly recruited workers will only have marginal effects on employment and labour market flexibility.
- There is no reform of education policies while the systems perform poorly. The introduction of full-time schooling can hardly be seen as the panacea for the low grades of German students in the PISA study. A substantial reform of curricula, pedagogical approaches, organisation of schools, and labour contracts with teachers seems to be required.
- Similarly, vocational training is seen as a competitive advantage while it faces enormous problems (see Vogler-Ludwig 2005). Steps towards a modular system of training which includes continuing training cannot be discerned.

The present compromise as it is fixed in the coalition treaty reflects the political weakness of reform protagonists and the strong demand for maintaining the welfare state. This, however, lies like a heavy blanket over the German labour market.

The coalition treaty did also not follow the recommendations of the Council of Economic Advisors which urged for an enforcement of the reform process in Germany. It concentrates on institutional reforms rather than economic policies:

- The reform of the federal system which disentangles competences and financial relations between the Federal and the Länder governments in order to widen the scope for policy action.
- An activating labour market policy which improves the job opportunities of long-term unemployed and less qualified workers through further reforms of social benefits, collective bargaining, and redundancy regulations.
- A reduction of the tax wedge on wages through the reduction of non-equivalent provisions in social insurance.
- The development of a dual income tax system which removes the tax disadvantages of Germany.
- The modernisation of financial markets.

The German problem therefore is not the lack of knowledge how to solve the unemployment problem but the lack of political majorities for such a policy.

4. Recent labour market reports

Allmendinger, Eichhorst, Walwei (IAB):

IAB-Handbuch Arbeitsmarkt. Analysen, Daten, Fakten. (*IAB Handbook Labour Market – Analysis, Data, Facts*). Campus 2005.

This publication is more than the presentation of data and analytical research. The handbook undertakes a policy-oriented analysis of the German labour market development and gives research-based recommendations to public employment and labour market politics. It starts with an extensive analysis of the German labour market and its prospects in the short and long run. The second section concentrates on two focus points: low-wage labour markets and working time policies. Finally, a comprehensive data section includes macro and regional indicators for labour market, working time, education and training, including international comparisons.

The research-based analysis in the first section leads to the diagnosis that unemployment in Germany has structural rather than cyclical determinants. Cyclical macro-politics can hardly remove the imbalances on the labour market. Under the prevailing conditions only the western German labour market can be expected to recover moderately in the long-run while eastern Germany will remain in the unfavourable employment situation. This underlines the need for substantial reforms in Germany.

The analysis of regional labour markets came to the result that comparative regional advantages and disadvantages can better explain the diverse developments than factors like sectoral specialisation or wage differentials. This leads to the conclusion that innovation politics and technical progress are the keys to economic development in combination with the improvement of “micro-economic conditions”. The section includes a review of recently implemented labour market policy measures.

The analysis of the German low-wage sector indicates that low-wage employment increased to 17 % of total employment in 2001 and mainly affects women, young workers and low-skilled workers. Upward mobility of low-wage earners decreased in recent years and is well below other industrialised countries. Tax and labour market policy reforms did not help to improve the integration of less competitive workers. The new Hartz reform is expected to change this situation.

The summary of studies on working hours – which was an important element of German employment politics for decades – comes to the disillusioning result that no distinct conclusions can be drawn, neither for the shorting of working hours nor for their present extension. Research results remain contradictory due to their time horizon and the estimates of productivity and wage reactions. Working time adjustments appear as the micro-economic instrument to optimise labour inputs and working hours on an individual basis rather than a macro-economic employment policy instrument.

Council of Economic Advisors:

Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 2005/06: Die Chance nutzen - Reformen mutig voranbringen. Wiesbaden.

The latest annual report of the Council of Economic Advisors devotes a substantial part to the analysis of the German labour market. Under the title “Labour Market: Continue with the Reform Course” the council analyses unemployment in Germany, its determinants and the strategy to remove imbalances.

The analysis of labour market dynamics comes to the result that transfer rates of unemployed workers into employment decreased significantly in the period 2001 to 2003 in

comparison to previous years. This can be measured for low and medium skilled workers in eastern Germany in particular. Nevertheless, the overall turnover rate of employment increased – by more than one percentage point – to 9.5 % in western and 15 % in eastern Germany. This means that staffs were exchanged every 10.5 or 6.7 years on average.

The section also undertakes estimates of the so called employment threshold – the minimum rate of GDP growth which leads to rising employment. The findings indicate a decline of the threshold in recent years compared to the mid nineteen-nineties. The diversity of results however does not allow precise estimates.

The section recommends opening the labour market for low-skilled workers in the short-run through a reduction of tax burdens and the widening of wage relations. The introduction of legal minimum wages is seen as counter-productive. The loosening of redundancy protection can also help improving the employment situation. A broad flexibility is needed for a well functioning labour market rather than the creation of a wide range of “peripheral” jobs.

Employment politics will be short-sighted if they are confined to fine-tuning of policy programmes in different areas of labour market measures. As the experience from other European countries reveals comprehensive reform packages are needed. Such “package deals” have a higher probability of success. The report suggests such a package in detail, accompanied by the critique of one council member (Peter Bofinger) who urges for a stronger macro-orientation of employment politics.

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