

Discussion paper

EUROPEAN EMPLOYMENT OBSERVATORY
GERMANY

Positive employment effects of restructuring and low wages

Quarterly review of labour market trends and policies
4th Quarter 2006

by

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Contents

Executive Summary	4
1. Introduction	5
2. Update on economic and labour market trends	5
Recent labour market trends.....	5
Economic development and forecasts	6
3. Labour market policy developments	8
3.1. Policy actions	8
Taxes	8
Social insurance	8
3.2. Public and scientific debate	9
Second interim report on Hartz reforms	9
Minimum and combined wages for the low-wage sector.....	10
New issues	10
4. Recent labour market reports.....	11
Literature	12

Glossary

Business Foundation Allowance	<i>Gründungszuschuss</i> : New regulation of business foundation support for unemployed UB-I recipients for a period of 15 months at maximum (valid since August 1 2006). During the first nine months, a lump sum of EUR 300 is paid in addition to UB-I as a contribution to social insurance costs. During the following six months the lump sum is continued to be paid only if the business became the main entrepreneurial activity.
Hartz reform	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 the “Hartz Commission” established by the German government in 2002. The reform has four parts: Hartz I (2002): introduction of public temporary work agencies (Personnel Service Agencies – PSA) Hartz II (2002): reorganisation of public employment services; mini-jobs, ICH-AG Hartz III (2004): restructuring of public employment services to the Federal Employment Agency Hartz IV (2005): merger of unemployment aid and social assistance to UB-II
Midi-Jobs	Registered employment with monthly wages between 401 and 800 € and reduced social insurance premiums.
Mini Jobs	<i>Geringfügige Beschäftigung</i> : Jobs with monthly incomes up to EUR 400. These can be regular or occasional jobs and jobs in addition to regular employment. Employers pay 30 % of wages to social insurance.
National Training Pact	Agreement between the Federal Government and the employers associations to offer additional dual training places. The pact started in 2004.
Rehabilitation benefit	<i>Eingliederungszuschuss</i> : a wage subsidy for employers who employ long-term or disabled unemployed. Subsidies are limited to 50 % of wages for 12 months. For disabled or older workers the limits are 70 % of wages for a maximum period of 24 months.
Social benefits	<i>Sozialgeld</i> : non-employable persons in a subsistence-based partnership with at least one employable person receive social benefits. Above the age of 16 rates are equivalent to UB-II.
Subsistence-based partnerships	<i>Bedarfsgemeinschaft</i> : These partnerships are defined by the Hartz-IV act as the private income and property units obliged to individual transfers among its members.
UB-I	<i>Arbeitslosengeld I</i> : Regular unemployment benefits for singles provide 60 % of the last net income for 12 months. For parents the rate is 67 %.
UB-II	<i>Arbeitslosengeld II</i> : Means-tested basic income for job seekers, paid after expiration of regular unemployment benefit. The basic rate is 345 EURO per month.
1 € Jobs Auxiliary public jobs	Temporary jobs for UB-II recipients in the field of social and public services. They are remunerated by EUR 1 or 2 in addition to UB-II benefits. Jobs need to be for the public benefit and have to be additional to jobs in the premier labour market.

Executive Summary

With the fundamental organisational and conceptual reform of labour market policies in Germany – known as the Hartz reforms – the German Federal Government targeted at both, reducing unemployment and improving the financial situation of the social security system. Until now the effects of this reform are rather limited as the Federal Government states in its recent interim evaluation report. Some of the instruments improved labour market flexibility some had positive effects on employment probabilities, but others did not work or even lowered placement opportunities. Most importantly, no positive macro-effects can yet be discerned.

The positive job performance on the German labour market therefore can hardly be addressed to labour market reforms. In fact, the labour market itself created the favourable employment trends, more or less disregarding the activities in the policy fields. On the one hand restructuring efforts of businesses brought considerable improvements of labour productivity. On the other hand, trade unions and workers made important wage (or working time) concessions during the last years which resulted in decreasing labour unit costs. Both sides therefore contributed to rising international competitiveness and strengthened economic growth and employment. As these are long-lasting improvements business cycle forecasts see a continuation of the positive trends in labour demand during this and the next year.

While the Hartz reform raised the efficiency of the Federal Labour Agency it shifted a considerable part of unemployment risks from unemployment insurance to tax-financed public budgets. Although this opened the opportunity to lower unemployment insurance rates by 2.3 percentage points, it did not help to narrow the tax wedge. The VAT rate increased by 3 percentage points, contribution rates to public pensions and health insurance increased, and income tax exemptions were abolished. Overall the German Federal and Länder governments are still expanding public redistribution. The employment performance therefore appears to be well below its potential which could be achieved through more restrictive fiscal and social policies.

The debate on appropriate approaches for the low-wage sector got a new direction with the suggestion of trade unions and the Social Democratic Party to introduce minimum wages by legislation. The idea to extend the number of low-wage jobs through tax preferences (combined wages) lost parts of its attractiveness in the public. Political decisions, however, are not yet taken and cannot be expected soon. The major policy task is still the reduction of the substantial imbalances in this labour market segment rather than wage guarantees for low-wage earners.

New policy approaches are presently being developed in the fields of family-oriented taxation and unified labour law. Both projects are still in a preliminary phase.

1. Introduction

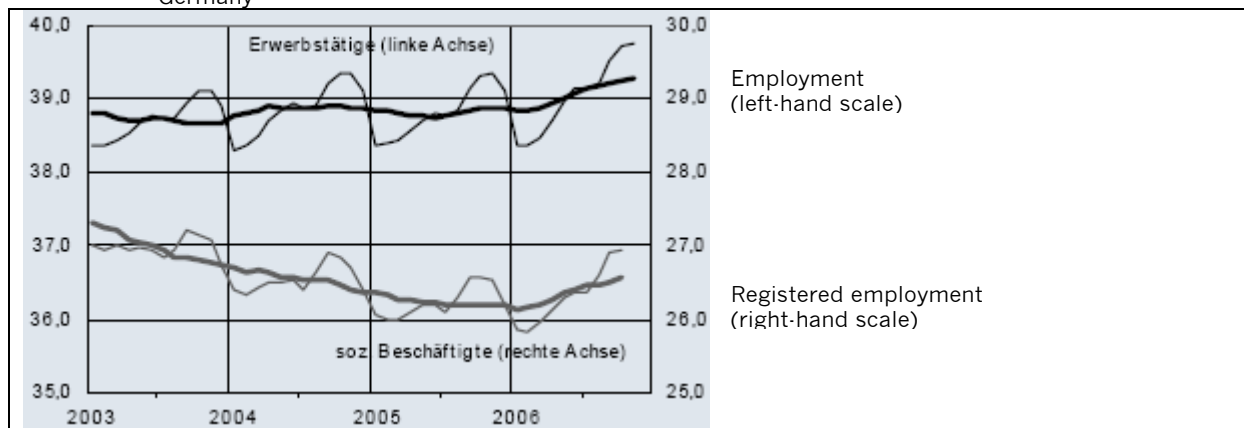
The comprehensive labour market reforms known as the Hartz reforms are all in action since the beginning of 2006. This brought labour market policies in Germany into calmer waters. The activities during the fourth quarter 2006 were rather focused on reviews and evaluation of the regulations in work. This report therefore concentrates on the description of the recent developments on the German labour market and the presentation of latest evaluation results on the Hartz reforms. Moreover, two most interesting studies on gender discrimination and budgetary effects of immigration are reviewed.

2. Update on economic and labour market trends

Recent labour market trends

Employment: In 2006 the German labour market experienced an unexpected upswing. Employment grew by 1 % (+426,000) during the 12 months from November 2005 to 2006. Registered employment increased even stronger by 1.5 % (+392,000 - see Chart 1). In addition to the cyclical upswing employment growth is associated to the anticipated rise of the VAT rate. Employment in the construction industries was particularly affected. The positive development could be observed in both Western and Eastern Germany.

Chart 1 Employment 2003 to 2006
Absolute values in million persons
Germany



Source: Bundesagentur für Arbeit

Unemployment: The reduction of unemployment accelerated in the last quarter of 2006. Compared to the previous year registered unemployment declined by 597,000 to 4.008 million in December 2006. The unemployment rate was 10.8 % (7 % by ILO standard). This was one percentage point less than in the previous year. In Eastern Germany the unemployment rate was almost double the rate of the Western part (17.3 % compared to 9.1 %). 1.3 million were UB-I recipients and 2.6 million UB-II recipients. In addition 1.9 million non-employable persons were supported through social benefits (*Sozialgeld*). The financial burden on municipalities was increasing significantly.

Vacancies: In December 2006 job vacancies increased by 50 % compared to the previous year. This refers to registered vacancies while the total unfilled post is estimated to be above 1.2 million.

Dual training: The dual training market was still imbalanced at the end of September 2006. 20,400 applicants were still registered as searching for a dual training place in

school year 2006/07, and additional 28,300 returned to the market as they did not start training or their training contract was cancelled. 7,600 training places were still vacant.

Active labour market policy: Almost 6 million persons entered one of the active labour market policy measures in 2006 (Table 1). 1.56 million persons still participated in these measures by December. Beyond placement services and training measures, many participants entered active support measures for people on the job. 756,200 persons entered auxiliary public jobs (1 € jobs) and 84,000 were in job creation programmes. 760,200 were in support programmes for people on the job – rehabilitation benefits for long-term unemployed and business foundation allowances in particular.

Newly published figures on employment rates show that only two ALMP areas achieve rates above 50 % (training measures and on the job support). The rates of employment creation programmes and other measures like the freely selected measures undertaken by regional labour offices are below one quarter. These figures refer to all exits from ALMP between May 2005 and April 2006 and measure those that were in registered employment 6 months afterwards.

Table 1 **Active labour market policy 2006**
Germany

	Stocks Dec. 2006	Entries 2006	Exits 5/05-4/06 in registered employment 6 months after exit*
	1000 participants		% of exits
Improving chances on primary labour market	631.6	3851.5	
Placement services support to job seekers	110.2	2353.0	
Training and qualification	188.6	1144.0	54,0
Preparatory measures to training	332.8	354.5	
Support of people on jobs	394.1	760.2	59.1
Support of employees	131.0	546.5	
Support of self-employment	263.1	213.7	
Employment creation	359.0	840.6	15.4
Auxiliary public jobs for UB-II recipients	305.8	756.2	
Job creation measures	53.2	84.4	
Other support measures (free selection)	176.1	524.3	21.6
Total	1560.8	5976.6	

* for selected measures only

Source: Bundesagentur für Arbeit (Dec. 2006)

In 2006 the Federal Labour Agency achieved a considerable financial surplus of 11 billion EURO due to rising revenues and declining expenditures. In 2007 the revenues will decline as the unemployment insurance rate was reduced from 6.5 to 4.2 %. The Federal Government had to bear expenditures for UB-II recipients of 21 billion EURO.

Economic development and forecasts

With GDP growth of 2.5 % and an average employment increase of 0.7 % the year 2006 was surprising many economic actors. Both rates were well above the 2000 to 2005 averages. In particular, manufacturing industries, construction and trade/hotels/transport contributed to economic growth while business services and the public sector remained below the average expansion. Growth was largely determined by foreign trade, however,

business investments started to expand. The economy profited from low wage increase (+0.7 % in 2006) and rising labour productivity (+1.9 % per hour). This resulted in a decline of labour unit costs by 1.1 %. 2006 was the third year in series with lower labour unit costs (see *Statistisches Bundesamt 2007*).

Growth will continue at lower rates during this and the next year if economic forecasts are more accurate than in the previous year. The published forecasts show that GDP growth will range around 1.7 % in 2007 and 2.1 % in 2008 (Table 2). By the end of the year 2006 the research institutes were far more optimistic about 2007 than earlier. This might be due to the unforeseen good progression in 2006 and the generally enhanced economic climate. The deceleration of growth is substantiated with the slight worldwide economic slowdown, the increase in VAT by 3 percentage points and the harder line of fiscal policy. On the other hand the institutes agree that the current cyclical upturn along with high export growth will partly compensate the demand curbing effects of fiscal measures.

Table 2 Economic forecasts for 2007 and 2008
Germany

Institution	Date of publication	GDP (% change to previous year)		Employment (% change to previous year)		Unemployment Rate (%)	
		2007	2008	2007	2008	2007	2008
Ifo Institut	December 06	1.9	2.3	0.8	0.5	9.5	9.1
IfW (Institut für Weltwirtschaft)	December 06	2.1	1.8	0.9	0.7	10.5	9.9
RWI (Rheinisch-Westfälisches Institut für Wirtschaftsforschung)	December 06	1.9	-	-0.1	-	9.5	-
IWH (Institut für Wirtschaftsforschung Halle)	December 06	1.4	-	0.4	-	10.0	-
IMK (Institut für Makroökonomie und Konjunktur)	December 06	1.5	-	0.4	-	9.8	-
IMF	December 06	1.5	-	0.5	-	7.8 ¹	-
OECD	November 06	1.8	2.1	0.6	0.5	7.7 ¹	7.2 ¹
Council of Economic Experts	November 06	1.8	-	0.7	-	10.2	-
European Commission	Autumn 06	1.2	2.0	0.5	0.6	8.4 ¹	7.8 ¹
Association of Economic Institutes (ARGE-Institute)	October 06	1.4	-	0.6	-	9.9	-

¹Standardised unemployment rate
Source: Economix

For 2007 the institutes forecast unemployment rates slightly below 10 %. This means approximately 4.3 million persons at the annual average. Employment will increase between 0.4 and 0.9 %. Considering the positive productivity effects of economic restructuring and the reluctant wage increase in recent years, the reduction of labour unit costs will continue to affect labour demand positively. Employment increase can therefore be expected to continue at the upper border of the forecasts.

This however also depends on the results of wage bargains which are actually starting. The construction industry's trade union IG BAU demanded for 5.5 % wage increase and the metal industry's IG METALL for 7 %. This would certainly be a radical change of wage

policy in Germany even if negotiations end with much lower increase. As the Statistical Office calculated, real wages in Germany declined in 2006. This will probably not be repeated in 2007.

For 2008 growth will accelerate again to approximately 2.1%. Employment will expand at reduced rates between 0.5 and 0.7 %. Unemployment might decrease further. However, the effects of the health care system on non-wage labour costs – which will become effective in 2008 – are far from being clear at the moment.

3. Labour market policy developments

3.1. Policy actions

By 1 January 2007 a series of legislative changes became valid:

Taxes

- *VAT rate* was raised from 16 to 19 % for regular turnover. The tax rate for food and other selected products remained at the level of 7%.
- *Additional income tax on high incomes*: The income tax rate for earnings above EURO 250.000 was raised from 42 % to 45 %. In 2007 revenues from business for self-employment are exempted from this rule. A revision of corporate taxes is planned for 2008.
- *Commuter allowance*: Travelling disbursements to short-distance workplaces (less than 21 km) are not allowable as income-related expenditures.
- *Child benefits*: The duration of child benefits payments was shortened from 27 to 25 years.
- *Workplace at home*: The allowances for domestic workplaces were restricted to people for whom the workplace at home is the central location of work.

Further changes were introduced in the taxation of pension and redundancy payments. All changes were part of the tax revision programme of the Federal Government which intended to reduce public deficits according to EU rules.

Social insurance

- *Unemployment insurance*: Unemployment insurance rate was reduced from 6.5% to 4.2%.
- *Pension insurance*: The rate of contribution to statutory pension insurance was increased from 19.5% to 19.9%.
- *Health insurance*: The big public health insurances raised contribution rates from 0.3 to 1.6 percentage points. On average an increase by 0.7 percentage points is expected.
- *Income thresholds* for pension and health insurance were slightly raised. The maximum monthly gross income for which contributions are imposed is EURO 5,250/4,550 for pension insurance (West/East), and EURO 3,562.50/3,976 for health insurance.
- *Bonuses* for work on Sundays, public holidays and night work are subject to social insurance as far as they are paid on top of a basic hourly wage of EURO 25. The income tax limit for bonuses is EURO 50.
- *Mini-jobs*: The lump-sum social insurance rate for minor employment was increased to 30% instead of 25%. 13 % are paid to public health insurance, 15 % to pension insurance and 2 % are taxes.

While these changes will help to reduce public deficits at least in the short-run, they widen the tax wedge further. Negative effects on employment and social insurance budgets are likely. Moreover, the tax reform is implemented in a period of relatively strong growth which – by itself – contributes substantially to the reduction of public deficits. From this

viewpoint, the programme is actually neither fully required nor does it reduce the high taxes on labour. Again budgetary problems are solved at the expense of the already heavily burdened labour market.

3.2. Public and scientific debate

Second interim report on Hartz reforms

At the end of December 2006 the Federal Ministry for Labour and Social Affairs published the second interim report of the Hartz reform evaluation (BMAS 2006). As the first report, the evaluation covers steps I to III of the Hartz reform while the creation of the basic income for unemployed (Hartz IV) is not yet included. New and final results are presented on the reform of unemployment insurance and the effectiveness of labour market policies.

Institutional reform of unemployment insurance:

The report underlines that the institutional reform of unemployment insurance contributed to greater transparency, effectiveness and efficiency of the Federal Labour Agency. A new management structure was introduced which uses target agreements with local labour agencies as its main instrument. Annual management targets are defined at the federal level and applied to regional and local units. This however creates the problem that the achievement of targets is decentralised while instruments and budgets are managed centrally. The report therefore calls for a “basic cultural change” in the organisation of the Federal Labour Agency which is supported by trust in the competences of local units and their staffs. The implementation of “customer information centres” proved to be efficient. 84 % of all financial requests could be answered during the same day, and 60 % of the time of placement staffs could be used for counselling.

“Customer satisfaction” improved slightly. Approximately half of the employees were satisfied with the services provided by the labour agencies. The employers however gave an “ambivalent” assessment of the services. In the public the reform of unemployment insurance did not contribute to a better image of the Federal Labour Agency.

The report criticises a one-sided orientation on operational management targets within the Federal Labour Office. The concentration on rapid integration rather than early prevention of long-term unemployment does not lead to aggregated economic savings. New budgetary conflicts are arising between unemployment insurance (UB-I) and social integration (UB-II).

Effectiveness of labour market policies:

The volume of training measures was reduced by 75 % between 2000 and 2005. This was associated with a “creaming” process as the placement rate was set to 70 % by central management. Training vouchers enforced this trend as only qualified persons were able to handle the instrument. Training measures became more effective and early exits declined. The report, however, states that the concentration on target groups with great training needs disappeared during the reform process. The promotion of poorly qualified persons became more difficult under present conditions due to the short-term labour market orientation of training measures. Longer training measures proved to be more effective than short-term measures.

Wage subsidies in form of “rehabilitation benefits” proved to be effective in the sense that supported long-term unemployed or disabled persons had a significantly higher probability to get a regular job. In particular women in Eastern Germany profited from the programme. Persons who would have left the labour market were activated.

Business foundation allowances in the earlier forms of ICH-AG and transition benefits were also effective in enhancing the employment probabilities. This coincides with former

evaluation results. Both instruments wage subsidies and business foundation allowances however include substantial dead-weight losses.

For other labour market policy instruments, the evaluation results were mixed:

- Placement vouchers lead to earlier exits from unemployment.
- The stricter application of deletion periods for unemployment benefits reduced abuse and raised the acceptance of jobs.
- The obligation of early announcement of unemployment by employees endangered by redundancies did not work as labour offices did not adequately react to these announcements.
- Transfer unemployment benefits for mass redundancies did not positively affect employment probabilities of workers.
- Personal Service Agencies and job creation programmes (ABM) prolonged unemployment spells.
- Other instruments like income guarantees or social security allowances for older workers were largely unknown to companies and even placement staffs in the labour offices.
- Mini-jobs were additional jobs for students, pensioners, or employees rather than paths to regular employment.

Summarising the evaluation results the report states that the Hartz reforms "... further improved labour market flexibility and extended employment potentials in certain segments. However, the new regulations had just a minor impact in overcoming unemployment. ... The macro-economic evaluation did not identify positive effects on the exits from unemployment." (BMAS, p. XXV).

Minimum and combined wages for the low-wage sector

The initiative of the German Government for the low-wage sector is focusing on two measures as far as the still undocumented plans reveal (Handelsblatt 17.01.2007, p. 12):

- The introduction of legally mandatory minimum-wages in a wider scope of branches. Until now such minimum wages are implemented in the construction industry and related sectors (roofer, varnisher etc.). The Government plans envisage to include the cleaning business, medical assistants, security services, waste managements, butchers, hair dressers and gardeners. The idea to extend minimum-wage regulations to agency work lead to a substantial legal debate.
- The introduction of combined wages for low-wage earners. The reduction of social contribution rates appears as the most favoured alternative.

The political and scientific debate on combined wages was already presented in the Quarterly Report III/2006 (Vogler-Ludwig 2006, p. 9). The Federal Ministry of Labour and Social Affairs initially intended to present its low-wage concept by the end of 2006. The debate among the coalition partners however is ongoing. Rapid decision cannot be expected.

New issues

- Following press releases, the Bertelsmann Stiftung – a company-based policy consulting foundation – prepares the concept of a unified labour code which merges a series of labour regulations and court decisions. The work still is in a preliminary phase and cannot be expected to be discussed by the Parliament before the next election period.
- The Federal Ministry for Families prepares a suggestion for family-oriented tax system (*Familiensplitting*) which provides advantages to families rather than couples. The proposal will be published in the course of 2007.

4. Recent labour market reports

Hirsch, Schank, Schnabel (2006):

Gender Differences in Labour Supply to Monopsonistic Firms: An Empirical Analysis Using Linked Employer-Employee Data from Germany, November 2006.

Wage discrimination of women was analysed in a series of studies with the result that wage differentials between men and women can only partly be explained by variables like age, education, job-tenure etc. The unexplained part of the estimates was often taken as an indication of wage discrimination. Researchers of the University Erlangen now found some evidence for an alternative explanatory approach. Their paper shows that the labour supply elasticity for men is nearly double as high as for women. This means that women are less sensitive to wage cuts. The reasons why women are more likely to accept lower wages than men might be a higher objection of longer commute, lacking persuasive power within the family to move, their defined role as secondary wage earner etc.

The researchers conclude that discrimination of women in parts can be explained by profit-maximisation behaviour rather than prejudices against women. The bargaining power of employers is strengthened through the preference of women for stable employment. It creates an employer monopsony which would not exist in case of perfect competition on labour markets. This thesis still has to be undermined by data showing differences for monopsonistic and perfect competitive employer structures.

Forschungsinstitut zur Zukunft der Arbeit (2006):

Kosten-Nutzen-Bilanz der Zuwanderung: Öffentliche Haushalte profitieren vom Beitrag der in Deutschland lebenden Ausländer. Cost-benefit analysis of immigration.

IZA Compact. December 2006.

<http://www.iza.org/>

With its study on the financial impacts of immigration the Institute for the Study of Labour (IZA) submitted an important empirically-based contribution to a long-lasting debate (Forschungsinstitut zur Zukunft der Arbeit 2006). The IZA comes to the conclusion that public households profit from the contributions of foreigners living in Germany, despite the lack of immigration rules and the negligence of integrating immigrants into the labour market. According to the IZA the 2004 balance of transfers and contribution amounted € 2,000 for every immigrant living in Germany with a foreign nationality. Over the lifetime every foreigner provides a financial net-contribution of € 11,600 on average. With 7.2 million foreigners living in Germany the overall contributions amount to €84 billion.

In comparison Germans had a balance of transfers and contributions of € 3,400 in 2004. The difference to foreigners is particularly attributed to lower incomes during the active phase. Children and older persons of both groups however received similar net transfers in 2004. In the long run the positive contributions of immigrants will become important for the stabilisation of the welfare state, not least because of the advantageous aging profile compared to Germans. The IZA concludes that it is wrong to see immigration as "immigration into the welfare system". It sees possibilities to enhance the positive balance achieved through selective immigration regulations and better integration policies.

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