



# IZA

# COMPACT

## CONSIDERING THE FUTURE OF LABOR

### An Improved Economic Framework for Increased Employment

#### Seven Proposals for a Modern Labor Market Policy in Germany

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#### The German Labor Market: A Construction Site for Reform

The German unemployment problem is still awaiting the implementation of desperately needed solutions. Since the 1970s structural unemployment has risen with every recession. Contrary to most other developed countries, the decrease in unemployment in a phase of economic growth is weaker than its increase in the previous phase of recession. Moreover, the risks of unemployment are not shared equally. Most likely to be affected are the low-skilled and the elderly. For the latter in particular, layoffs often lead to long-term unemployment.

The persistence of unemployment indicates that the job crisis in Germany is predominantly structural in nature. One major source of these structural problems are disincentives put in place by labor market institutions. The expansion of the welfare state has, with the best of intentions, created numerous rules protecting workers. In the process, policymakers have failed to ensure that the different labor market players – employees, unemployed, employers, unions and politicians – act in the interest of society as a whole. Voiced demands alone will not solve this problem. Likewise, the call for increased job opportunities for the elderly will ring hollow if the government at the same time, through early retirement programs, keeps supporting the idea of gradually removing elderly employees from companies. Job opportunities in the low-wage sector cannot be created if the social safety-net regulations for the low-skilled make legally employing these workers financially unattractive. Demands for moderate wage demands will be widely ignored if the government is willing to use labor market policy instruments to compensate for the negative employment effects of excessive pay hikes.

The message is loud and clear: Economic policy needs to reshape the conditions for private market participants so that they can once again operate efficiently. Labor market and social policy have to be clearly separated in order to overcome the current mingling of economic policy aims which has been detrimental for growth and employment. Only under these conditions can the labor market functions be improved in a way that would entail a substantial increase in employment.

This is the objective of IZA's seven proposals for a modern labor market policy reform. They aim at improved work incentives and a radical rearrangement of labor market policy institutions. At the core is the strict separation of unemployment insurance and active labor market policy. This is why the IZA policy proposals go far beyond those made by the Hartz commission to reform the Federal Employment Services (*Bundesanstalt für Arbeit*). IZA's elements of reform also provide impetus to a new understanding of collective wage bargaining autonomy, to a move towards increased flexibility of labor relations, to responsible education policies, and to the adoption of adequate responses to the demographic challenge.

It is not so much the lack of economic insight that impedes the healing process of the German labor market, but rather the society's lack of willingness for conflict. IZA's reform proposals contain economic guidelines for a modern labor market policy. It is not impossible to improve the policy framework for more employment. Implementing the proposals, however, will require a lot of courage from the policymakers in power.

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## Removing Work Disincentives

- Developing the Low-Wage Sector via Workfare
- Abandoning the Single Wage Earner Model
- Terminating Government Assistance for Early Retirement Schemes

### Tapping Unused Labor Force Potential through Reforms of the Tax and Transfer System

By international standards, labor market participation in Germany is relatively low. Thus important labor market potential remains untapped. Individuals who do not have a prospect of returning to the labor market invest little in human capital. After withdrawal from the labor market, previously acquired human capital lies idle and degenerates. Increased labor supply can be the engine for economic growth and employment success.

Experience from other countries shows that there is no immediate trade-off between high labor force participation and low unemployment. The size and the

structure of the labor force are not merely a mirror image of unemployment, but they are also strongly influenced by institutions. In Germany, the tax and transfer system creates several negative work incentives, which contribute to unemployment, particularly among unskilled, female, and elderly workers. To a certain extent, the unfavorable position of these problem groups on the labor market is due to relatively low participation.

Therefore, any kind of direct or indirect subsidy provided to individuals withdrawing from the labor market should be abolished.

### Developing the Low-Wage Sector via Workfare

The current German system of livelihood protection through unconditional welfare benefits (*Sozialhilfe*) impedes the establishment of a low-wage sector. For many of the unskilled, the gap between the achievable wage income and the income attainable from welfare benefits is so small that taking up a job is simply not attractive. Companies, unable to fill their vacancies due to a lack of interest in low-paid work, have gradually eliminated job opportunities for the unskilled.

The adoption of *workfare*, i.e., the concept of livelihood protection through labor, can solve the incentive problem associated with the provision of social welfare benefits. All individuals who qualify for social transfer payments, but are able to work, should only

receive full benefits in exchange for taking up publicly provided, socially useful employment. The placement process could be handled by *workfare* agencies created in the wake of reforms of unemployment assistance and welfare, to be discussed below.

The obligation to work in order to receive welfare benefits would make jobs that pay just a little more than the level of social transfers attractive again. For the same amount of working hours invested individuals could achieve higher net earnings. Most transfer recipients who are able to work would then return to the labor market. As a result, the pay scale would be extended at the lower end. This would constitute an important contribution to labor market flexibility.

### Abandoning the Single Wage Earner Model

While women have gained ground in the area of education, they still participate substantially less frequently in the labor market than men. The labor market thus loses vital human capital. Even today the social role model seems to hold that mothers withdraw from the labor market in order to raise their children. This is not only due to a lack of child-care facilities. German tax law and social insurance regulations contain several elements that are based on the traditional model of the single

breadwinner. As a result, if the spouse takes up employment, the marginal tax on her income is often very high.

As far as income taxation is concerned, in particular the existing system of joint income splitting for married couples (*Ehegattensplitting*), which means that for tax purposes fifty percent of the couple's income is assigned counterfactually to each spouse, creates negative work incentives. The current splitting rule generates a tax

advantage that is positively correlated with the income disparity between the two partners. Consequently, it is relatively unattractive for the household to earn a second taxable income since it first has to compensate for the loss of the splitting advantage.

To reduce the high marginal tax rate on second earner incomes, which mostly harms women, the current practice of income splitting should be replaced by a system that could be referred to as real income splitting (*Ehegattensplittung*), which is very similar to the current tax treatment of divorced couples. Under this concept, spouses as a general rule would be taxed separately on the basis of their respective labor income. In cases where one spouse does not work or earns little, however, the breadwinner would be allowed to assign a certain amount of subsistence payments to the partner. This (notional) alimony payment would be tax deductible, thus guaranteeing the tax exemption of basic living earnings.

Real income splitting would lower the marginal tax rate on the second earner's income, creating incentives to take up employment. At the same time, the system imposes a higher marginal income tax rate on bread-

winners, whose labor supply, however, tends to be rather inelastic. Therefore, the implementation of a real income splitting concept could generate additional tax revenue, which should be used to support families, e.g. through improved child-care provision.

As far as social insurance regulations are concerned, the current practice of free coinsurance of spouses should be abolished. This especially applies to statutory public health and long-term care insurance, which offer insurance of non-working family members at no extra premium for the breadwinner. In this situation, spouses who take up a job have to pay contributions, but this does not lead to better insurance coverage. As a result, statutory health and long-term care insurance contributions are regarded entirely as a tax on labor income.

Likewise, entitlement to survivor's pensions without paying contributions has become obsolete with better labor market opportunities for women. Guaranteeing pensions for the surviving spouse at no cost reduces incentive to build up an own retirement account through gainful employment.

### Terminating Government Assistance for Early Retirement Schemes

In Germany, the labor market prospects of elderly workers are particularly dim. Partly due to age-related productivity risks, partly due to seniority wages, elderly workers are comparatively expensive to employ. Therefore, employers have incentives to lay off the elderly members of their workforce first. This problem warrants concerted action on the part of trade unions and employers.

Current firing regulations further reduce the employment opportunities of elderly workers. According to German labor market laws, employers who need to lay off part of their workforce have to consider the social consequences of a layoff. Therefore layoffs often do not target the least productive employees but those who have the option to leave into early retirement.

The government currently supports early retirement through different channels. Early exit from the labor market is encouraged directly via financial assistance of part-time work for elderly workers and the special opportunity of early retirement in the case of long-term unemployment. Reforms already enacted envision that these specific early retirement programs will expire after a transition period. This period, however, should be shortened as much as legally possible. Moreover, in order to prevent people from circumventing hurdles to early retirement on a health track, early retirement should no

longer be granted to unemployed with only partial incapacity to work.

Indirect incentives for early retirement arise from the fact that the cut in pension benefits for those who retire before reaching the statutory retirement age is, from an actuarial perspective, too small. Put differently, longer employment is financially unattractive, as the gain in pension does not outweigh the additional contribution payments. Consequently pension losses for early retirees should be increased so that they become actuarially fair. By the same token, individuals who work beyond the legal retirement age should be rewarded with a higher, actuarially fair pension increase. In order to take into account changes in payroll contribution and replacement rates, as well as the development of survival rates, the actuarial pension adjustment factors should be re-evaluated on an annual basis.

Eliminating incentives for early retirement, at least in the medium term, will help reduce unemployment of elderly workers. The prospect of a longer working life makes it more attractive for employers, but also for employees, to invest in human capital formation and suitable workplaces in order to preserve the employability of elderly workers up to the statutory retirement age.



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## Reforming the Unemployment Insurance System

- Institutional Separation of Insurance and Job Placement
- Autonomy of Unemployment Insurance
- “Two + Twelve Concept” – Waiting Period and Shorter Unemployment Benefit Duration
- Benefit Entitlements Linked to Job Search Intensity
- Merging of Unemployment Aid and Social Welfare

### Strengthening the Responsibility of Individuals and Collective Bargaining Parties for Labor Market Activity

Unemployment insurance in Germany is organized by the Federal Employment Services (*Bundesanstalt für Arbeit*). This public agency manages the payment of unemployment benefits, but at the same time it engages in labor market policies, such as job creation programs and training programs. These measures can hardly be reconciled with the pivotal aim of unemployment insurance, which is to guarantee income security during a certain period of unemployment in order to make efficient job search possible. In fact, the substantial current engagement of the Federal Employment Services in active labor market policies primarily pursues broader economic objectives within the scope of structural and regional policies. Funding these broad aims through payroll contributions is inappropriate since it puts the fiscal burden entirely on labor.

One explanation for the far-reaching activities of the Federal Employment Services in the realm of labor market policies is its organizational structure. The self-governing body of the Federal Employment Services is filled with an equal number of policy makers, employers and union officials whose interests are not necessarily identical to those of the unemployed. In fact, the implementation of labor market policies by the Federal Employment Services interferes in many cases with the

outcomes of the collective bargaining process, backing wage agreements that are detrimental to employment and relieving unions and employers' organizations of their social responsibilities. It therefore seems essential that the Federal Employment Services be transformed into a truly autonomous body.

The current level of benefits provided by unemployment insurance in Germany also warrants a closer look. The core objective of providing adequate income during a period of unemployment must be reconciled with the potential negative impact on search intensity. A feature of the present unemployment insurance system is a generous income replacement rate in combination with a very long benefit entitlement duration. The latter is virtually unlimited because tax-financed unemployment aid (which is still rather generous) automatically starts after unemployment benefits paid from contributions expire. The amount of unemployment aid is typically higher than the level of welfare benefits so that the problem of a welfare trap, which locks unskilled workers in unemployment, appears aggravated. On the whole, the generous social protection of the unemployed most likely increases the level of unemployment in Germany by prolonging the average duration of an unemployment spell. ●

### Institutional Separation of Insurance and Job Placement

In the future, the Federal Employment Services should focus exclusively on providing insurance against income losses in case of unemployment. This implies that the responsibilities for job placement as well as other measures of active labor market policy have to be taken over by

other institutions. These activities should be organized through private, competitive firms, which would then serve all job-seekers instead of just those who have paid contributions to the unemployment insurance.





### Autonomy of Unemployment Insurance

The unemployment insurance administered by the Federal Employment Services must not rely on government subsidies to balance its budget, but solely on revenue derived from payroll contributions. This would keep the financial burden on labor from unemployment insurance at the lowest possible level. Since non-insurance tasks no longer strain the budget of

the Federal Employment Services, contribution rates for unemployment insurance would most likely be considerably lower than today. Parallel to fiscal independence, the transformed Federal Employment Services, should become an independent self-governed body abandoning the representation of political pressure groups on its board.



### “Two + Twelve Concept” – Waiting Period and Shorter Unemployment Benefit Duration

As a means to avoid windfall gains, no unemployment benefits should be granted during the first two months of an unemployment spell. (Those unemployed without sufficient savings to sustain this period could receive non-bureaucratic help in the form of a repayable government loan.)

In order to increase job search intensity, transfers should not run for more than a year without exception, so that unemployment benefits would expire no later than 14 months after entry into unemployment. For those

individuals who continue to be unemployed after this period, the system of livelihood protection through workfare would take over. In addition, workers may be prompted to buy additional private insurance against the income risk associated with long-term unemployment.

The proposed two+twelve concept, which implies cutting the existing maximum benefit duration quite substantially in some cases, especially for elderly workers, would make it possible to maintain the current replacement rate of unemployment benefits.



### Benefit Entitlements Linked to Job Search Intensity

The unemployed should receive insurance benefits only if they are in fact searching for a job. Recipients of unemployment benefits should therefore be obliged to substantiate their job search effort on request by the Start

Centers. Job-seekers who fail to show credible documentation of their search activities should be subject to a reduction and, after repeat failure to comply, a termination of their unemployment benefits.



### Merging of Unemployment Aid and Social Welfare

Unemployment aid, which is paid to the long-term unemployed after their unemployment benefits have expired, is not an integral element of unemployment insurance, but rather a welfare program to guarantee a secure livelihood. Consequently it is funded through taxes rather than payroll contributions.

Since unemployment aid runs parallel with the system of welfare benefits, however, the unemployed are treated unequally. Those long-term unemployed who have once received unemployment benefits often receive higher transfer payments than those who have not had access to unemployment benefits (e.g. because they were not employed long enough prior to unemployment).

Securing the livelihood should exclusively be the mission of the social welfare system, organized according to the workfare principle. Unemployment aid should therefore be abolished as soon as possible. With unemployment aid and welfare benefits merged, the fiscal responsibility for providing the means to secure livelihood should be transferred from the municipalities to the federal government and the states. Thus the financial burden would shift to those federal levels that are responsible for permanent unemployment and poverty.

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## Reorganizing Active Labor Market Policies

- “Start Center” as a Central Point of Contact for the Unemployed
- Private Placement with Government Bonus Payments
- Placement Co-Financing by the Newly Employed
- Market-Based Assignment to Labor Market Programs
- Evaluation of the Placement Bonus Incentive System
- Establishment of Service Agencies

### Restoring Employment Success as the Core Objective of Labor Market Policies

One of the characteristics of current labor market policy in Germany is that it is very much dominated by the pursuit of social, structural or environmental ends. Hence swift re-integration of the unemployed into the labor market, the ultimate goal of labor market policy, often takes a back seat. The overlap of different policy objectives makes monitoring of the implemented policies difficult. As a result, there is a serious lack of efficiently designed policy tools and uncertainty about the optimal scope of government intervention. A prerequisite of successful labor market policy in the future will be that decision makers once again clarify their goals, and that any objective not directly related to the labor market is returned to its proper policy realm.

On the institutional level, the co-existence of employment and welfare offices with labor market responsibilities creates inefficiencies through overlap. Moreover, the system encourages that the fiscal burdens from long-term unemployment are shifted back and forth between the welfare offices, financed by the municipalities, and the employment offices, financed by the federal state via the Federal Employment Services (*Bundesanstalt für Arbeit*). For example, it frequently happens that muni-

cipalities, in order to reduce the welfare bill, temporarily place welfare recipients in sponsored jobs that renew entitlement unemployment benefits. If fiscal considerations and not reemployment success start to dominate the objectives of job creation programs, this is certainly to the disadvantage of the individuals affected.

At present, mostly semi-public education providers or employment agencies (*Beschäftigungsgesellschaften*) do the design of labor market initiatives. They sell their product to employment and welfare offices, which are more often than not evaluated on the basis of their success in spending their budget completely, rather than in enhancing employment. Clearly there is a need to first formulate precise labor market requirements before a system of cost-benefit controls can be installed. For this to be effective, the suppliers of labor market programs should be institutionally separated as far as possible from the public bodies demanding them.

Finally, labor market policy should be used to develop currently untapped employment opportunities. In Germany, the area of services to private households in particular bears substantial employment potentials that appear well worth targeting.

### “Start Center” as a Central Point of Contact for the Unemployed

As soon as possible, a nationwide network of public *Start Centers* should be installed that would replace the hitherto competing local employment offices and job assistance departments of the welfare offices. These Start Centers would not engage in job placement activities, but act for all job-seekers as the first point of contact, with the task to categorize them according to a standardized point system designed to evaluate job placement prospects. The profiling statement would be taken to one (or several) private job placement agencies by the job-seeker.

Under this system, welfare recipients looking for employment would receive special attention. As a rule, the Start Centers would refer them to a local *workfare agency* providing socially beneficial work. At the same time, welfare recipients may also seek the additional service of a job placement agency.

The core tasks of the Start Centers would be to profile the unemployed and to manage the financial issues connected to the job placement procedure (including handling the cost of necessary measures to improve employability). In addition, they should provide certain



administrative services. First, they should report cases to the unemployment insurance agency so that unemployment benefits can be granted. Besides, the job centers should continually monitor the unemployed. If they discovered reasons to cut individual benefit payments,

for instance because a job-seeker receiving unemployment benefits fails to prove searching actively for a job, or because a welfare recipient does not cooperate with a workfare agency, they would have to report these cases to the responsible institutions to take action.

#### Private Placement with Government Bonus Payments

The Start Centers should pay the job placement companies for each successful placement according to a payment scheme depending on perceived placement difficulty as indicated by the profiling statement. This procedure would prevent job placement agencies from engaging in cream skimming. The federal government and the states should fund the Start Centers so that they stay financially independent from the placement agencies.

The placement agencies should only be rewarded in full if they place individuals in stable jobs. The placement reward should therefore be paid in twelve monthly rates conditional on continuation of employment. Thus it can be guaranteed that the placement agencies are also concerned about the quality of job matches.

#### Placement Co-Financing by the Newly Employed

For individuals who find employment via a placement agency, it should be mandatory to bear part of the placement costs. Preferably the size of the co-payment would be related to earnings in the new job. It should be paid in one installment after a period of six months, which implies that the worker contributes only if he or she is brought into stable employment. The co-payment would therefore prevent abuse of the award system through phony job placements. In addition, individual

initiative is encouraged, for those agents who manage to find employment without outside help could save the co-payment.

Job-seekers and placement agencies should be free to negotiate the exact amount of the co-payment within certain limits. This practice would encourage competition among the placement agencies, which would use the price of their service to the job-seeker as a marketing parameter.

#### Market-Based Assignment to Labor Market Programs

If a placement agency concludes that the employment prospects of a job-seeker can be effectively increased through qualification, it will offer participation in specific labor market programs to its client. (Participation would never lead to an extension of unemployment benefits.) For their services, the providers of labor market programs would receive a certain share of the placement award from the placement agencies, which is subject to negotiation. Since this money is only payable if the participant becomes reemployed, this would lead to a more success-oriented program design.

Program providers would make their profits from their share in the placement rewards. The costs of the qualification measures, on the other hand, would be

carried by the Start Centers, except for a certain share to be borne by the program participant in order to strengthen individual responsibility with regard to program choice. The size of the co-payment, payable only after returning into employment, would particularly depend on the total cost of the selected program. This orientation would enhance cost efficiency, given that agents are free to reject measures proposed by the placement agency (and propose measures they themselves deem suitable).

This framework would strengthen the competition among the providers of qualification measures. Only those labor market programs that effectively improve the participant's job placement prospects would have a chance to survive.



### Evaluation of the Placement Bonus Incentive System

The proposed reorganization of institutions for labor market policy is firmly based on the idea to create checks and balances among the interacting parties through economic incentives. But since the award for successful placements (as a function of the profiling result) must be set by the Start Centers a priori, the question of the optimal design of prices warrants careful consideration. Since

operating with the wrong award scheme could lead to inefficient placement, continuous scientific evaluation of the generated reemployment dynamics is crucial. If doubts regarding the economic efficiency of the placement process and of the assignment to labor market programs arise, the award scheme has to be adjusted on the basis of the evaluation results.

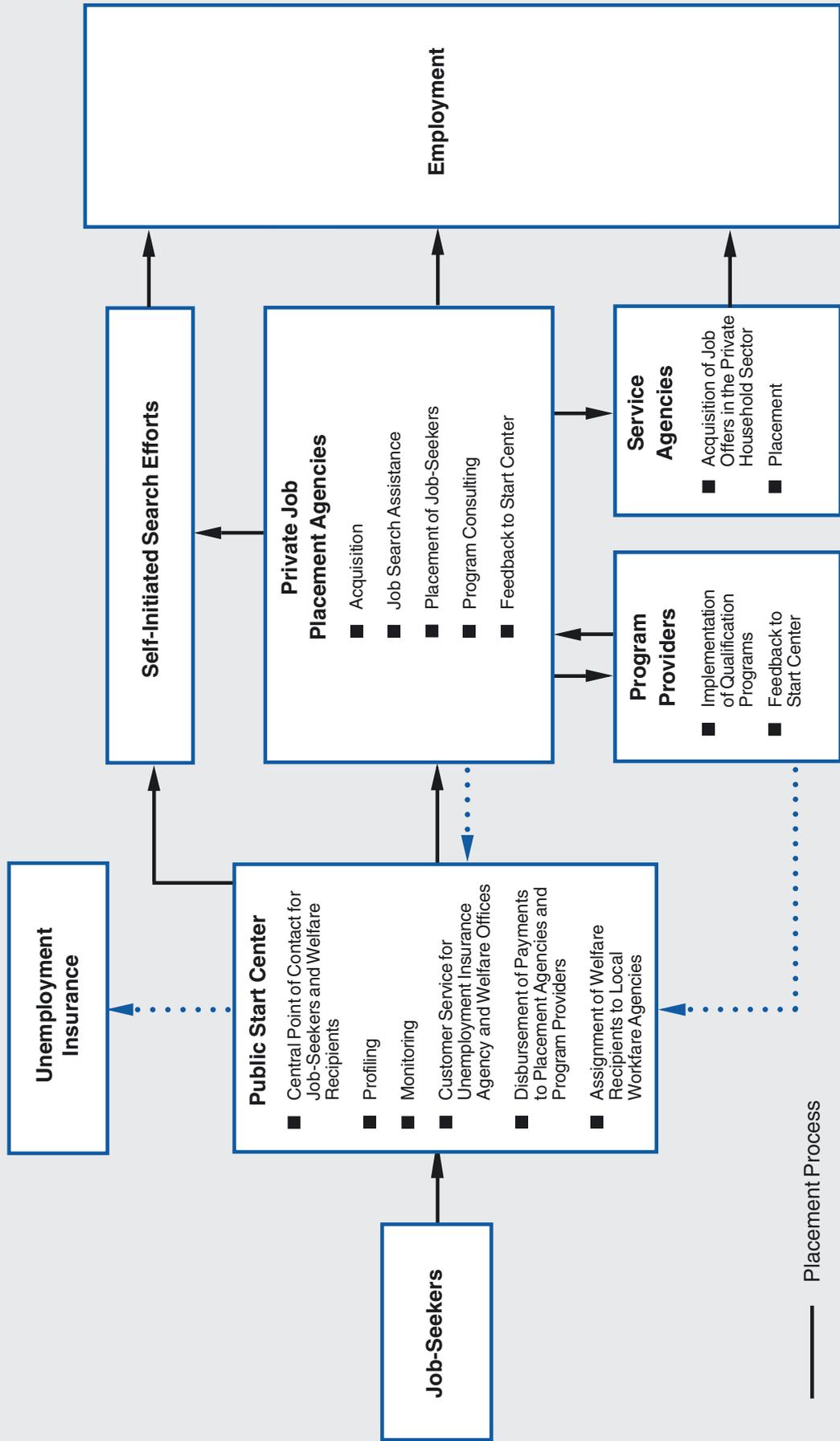


### Establishment of Service Agencies

Evidence suggests that services to private households constitute a major source of employment still underdeveloped in Germany. Improved organization of this particular labor market could not only help legalize the black market activities in this domain, but also substantially expand demand. It is therefore useful to implement professional service agencies for the

registration and placement of household aids, which could manage demand fluctuations, job flows, vacation and sickness replacements, etc. more easily than the individuals who supply or demand private household services themselves. In particular, specialized service agencies would manage to merge several part-time activities into a full-time profession.

## IZA Proposal for Reorganizing Active Labor Market Policies



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## Towards Decentralized Bargaining Procedures

- Abolishing the General Validity of Wage Agreements
- Redefining the Favorability Principle
- Giving Priority to Internal Company Agreements

### Misconceptions of Collective Bargaining Autonomy Put Jobs at Risk

The notion of collective wage bargaining autonomy is held in high esteem in Germany. It implies that work conditions are regulated by employers and employees without governmental intervention. The German Constitution protects collective bargaining autonomy through the freedom of coalition-building. The same freedom, however, includes the right not to belong to any bargaining party. As a general rule, collective agreements therefore should apply only to members of the bargaining parties.

The current interpretation of the constitution allows for the violation of this principle for the sake of the “common interest”, which has led to the possibility that the government declares certain parts of collective bargaining agreements to be generally valid. From the economist’s viewpoint, what is publicly regulated in the name of common interest must comply with a strict

criterion – government intervention must lead the economy closer to efficiency than an open competition between the employers and employees who are tied to collective wage bargaining agreements and those who are not. Usually this will not occur because wage interventions and restraints on individual flexibility tend to cause compensatory shifts towards activities in the shadow economy and capital flight, which have negative effects on employment and income. Moreover, it is necessary to take into account the violation of interest for those who claim their freedom not to join a collective agreement.

At present, many German decision makers take the stance that collective bargaining autonomy requires the protection of bargainers against competition from outsiders. This is, however, a misguided interpretation. If decentralized bargaining turned out to be more efficient, this would certainly be in the common interest.

### Abolishing the General Validity of Wage Agreements

Through declarations of general validity (*Allgemeinverbindlichkeitserklärungen*), which are used by the government to extend collective bargaining agreements to non-organized employers and employees, policymakers significantly interfere with the needs for flexibility on the German labor market. To the extent that they practically impose minimum wages, they are a threat to employment,

in particular in labor-intensive sectors. They may also lead to activities in the shadow economy.

Considering the potential negative economic feedbacks, the restraints put on intra-firm decision-making by declarations of general validity of collective agreements do not seem justified. For the most part, they should thus be abolished.

### Redefining Favorability Principle

According to the German Works Constitution Act (*Betriebsverfassungsgesetz*), corporate management and works committees are generally not allowed to negotiate agreements over issues that are subject to collective wage bargaining agreements. This right is only given if the collective bargaining agreement contains an opening clause, or if the agreement at the firm level is more generous than the collective agreement. This is referred to as the so-called favorability principle (*Günstigkeitsprinzip*).

So far, courts have interpreted the favorability principle in a strictly material sense. This interpretation completely

neglects the question of individual employment risk, which is equally important from an economic stance. Thus employees do not have the option to trade higher job stability for wage cuts (or rather wages growing at a slower pace).

Since the current interpretation of the favorability principle therefore may only contribute to unemployment, an economically more meaningful definition of the concept should be installed that includes the aspect of job security.



### Giving Priority to Decentralized Bargaining

The Works Constitution Act generally declares decentralized agreements at the firm level as void unless the corresponding collective bargaining agreement contains a relevant opening clause (*Öffnungsklausel*). This constraint on decentralized bargaining severely limits the possibility of implementing agreements that take into account the economic situation in the individual firm.

Nonetheless, it is increasingly the case that employers and employees reach firm-specific agreements even if this practice is basically illegal. This may indicate that individual employees are willing to put a larger weight on job security

than trade unions bargaining over collective agreements. In order to legalize this practice, agreements reached at the firm level should, as a rule, legally dominate collective bargaining agreements. This would constitute a reversal of the current situation – a collective wage bargaining agreement would only be relevant if no company agreement existed.

In the medium term, the relevant paragraph should be completely erased from the German Works Constitution Act. This would allow for free competition between collective and decentralized agreements.

5

## Stepping Towards Labor Market Flexibility

- Replacing Layoff Protection with Severance Pay
- Abolishing the Right to Switch to Part-Time Work
- Auctioning Off Temporary Immigration Certificates
- Eliminating the € 325-Jobs

### Antagonism between the Legal System and Labor Market Requirements

The ability to adjust to the ever changing economic environment is a prerequisite to business success. However, government regulations – even though in good intention – often impede flexible adjustment. It is therefore crucial to weigh legitimate interests against each other and to continuously evaluate their validity. Enhanced flexibility should always be the choice if it is likely to create more jobs than it would destroy.

Current labor legislation in Germany is characterized by rigid protection of existing employment relationships. This limits the scope for adjustment within companies. Among the most constraining factors are the rules governing layoff protection, co-determination, part-time work options, and temporary employment. Nonetheless, there is a strong demand for flexibility, which leads to other forms of employment such as outsourcing, tax-exempt minor employment, or shadow economic activities.

Employment protection is an economically feasible method to increase efficiency because it guarantees employees a return on their investment in human capital that they would not have made otherwise. At the same time, employment protection has a negative impact on the employers' propensity to hire new workers. There is a need for a more balanced relationship between the protection of workers and adjustment needs of firms.

There is also a need for enhanced flexibility of the German labor market because shortages of high-skilled workers cannot be filled with native workers despite high unemployment. Even the new immigration law will not eliminate the bureaucratic impediments to temporary labor immigration. Allowing a larger number of labor migrants for a limited time could help to deal adequately with short-term labor market disequilibria.

### Replacing Layoff Protection with Severance Pay

Layoffs are heavily regulated in Germany. Since there exists a monetary equivalent for legally guaranteed layoff protection, an employer can choose to pay a worker some financial compensation for dismissal. But the costs associated with this practice reduce hirings, especially of applicants who may not be able to live up to the employer's expectations in the long run. Since this is often true for older job-seekers, they are particularly prone to long-term unemployment.

Under the current law, a layoff is only legitimate in cases of gross misconduct or for operational reasons. According to the common interpretation by the courts, a lack of motivation to work, for example, is not considered gross misconduct. Employers who want to get rid of unproductive employees are thus forced to fabricate a reason for dismissal. This often results in lawsuits that carry monetary risks.

The current system of layoff protection should be replaced by legal rules for mandatory severance pay. Employees would then receive a certain percentage of their salary, differentiated according to job tenure, as a

compensation for dismissal. Since a reason for dismissal would not usually be required (of course, severance pay would not apply in cases of gross misconduct), this system could substantially reduce the probability of lawsuits.

Currently, most of these legal disputes end up with a settlement that leaves both parties with a share of the legal costs. Therefore, the severance pay system would benefit employers and workers alike, if the legal compensation scheme is moderate. While the new regulations would result in more layoffs, they would also increase the propensity to hire. The net result would be more jobs. At the same time, employers would no longer have to account for social criteria when laying off workers during a recession, which previously has often led to inefficient firings. Layoffs for operational reasons would be based solely on the productivity of the employee.

A reform of layoff protection should be favored over an increase in fixed-term contracts as it makes employers and employees more inclined to invest in human capital.





### Abolishing the Right to Switch to Part-Time Work

The present law gives every full-time employee the right to switch to a part-time job. Under certain circumstances, the employer can deny this right for operational reasons. In practice, this regulation restricts employers' flexibility. The cost of dividing a job in half is usually higher than the gain from having two part-time employees. In order to fill the new position, the employer will usually have to find someone who is also willing to work part-time.

Given the present shortage of high-skilled labor in Germany, additional restrictions on working hours increase the affected firm's competitive disadvantage. Moreover, the right to part-time work constitutes a hiring obstacle for workers who are likely to exercise this right – primarily young women. This regulation should therefore be abandoned completely.



### Auctioning Off Temporary Immigration Certificates

In some dynamic sectors of the German labor market, the labor supply of natives does not keep pace with the fast-growing demand. Temporary labor migration could help overcome short-term labor market imbalances that impede economic growth. In order to identify the fields of temporary labor shortages and to ensure an efficient selection of the best-suited immigrants, each year a limited number of residence and work permits should be auc-

tioned off to employers who seek to fill vacancies temporarily with labor immigrants. These auctions would skim off part of the employers' profits from immigration, which in turn could be invested in education and training of unemployed natives. The new immigration law leaves it up to government agencies to allow temporary labor immigration on a case-by-case basis. An auction system would be far superior in solving the information problem.



### Eliminating the € 325-Jobs

With the introduction of minor jobs (with monthly earnings of less than € 325) that are exempt from social security contributions, policy makers have tried to meet the demand for flexibility rather than eliminating the sources of inflexibility. These jobs are an exception from the ability-to-pay principle of income taxation and the equivalence principle that should govern social security contributions. Moreover, the current regulations for minor employment reduce flexibility further since secondary wage

earners face an income loss when exceeding the monthly earnings threshold of € 325. Consequently, jobs that pay between € 325 and € 800 a month have been all but eliminated. This problem could be solved – albeit only with high fiscal costs – by gradually raising payroll contribution rates at the lower end of the earnings distribution. However, the proposals to enhance labor market flexibility and the introduction of real income splitting for tax purposes would make the € 325-jobs redundant.

## 6 Education as a Key to the Labor Market

- Expanding Pre-School Education, Introducing Child-Care Vouchers
- Modernizing the Dual System of Vocational Training
- Implementing Preventive Measures to Secure Human Capital
- Modernizing the System of Higher Education

### Creating and Securing Human Capital

It should not have taken the OECD's PISA Study to demonstrate that the German education system is in need of reform. The confrontation with an increasing internationalization of labor markets reveals that the educational institutions in German have lost some of their power to compete. Decision makers, it seems, have still not fully realized that human capital formation is the key to labor market success. This is reflected, for instance, by a shortage of educational child-care facilities, a high regional variance in school performance, a long duration of schooling and training, and a large share of unskilled workers in the labor force.

Education policy must not only aim at the accumulation of more and more up-to-date knowledge. Strong emphasis should be placed on fostering the acquisition of learning ability, i.e., learning how to learn. It is now well understood that the foundation for this ability is best laid in early childhood, but school curricula

should also target the goal of developing the capacity of lifelong learning.

Educational reforms with the aim to improve labor market performance must also seek to create equal opportunity for different social classes. One of the important messages contained in the PISA study is that existing talent is wasted in Germany since access to education is unevenly distributed among the population. Disparities in employment prospects and potential income are thus inherited from one generation to the next.

While government action in the educational sector is certainly justified, it is also true that individuals must take the ultimate responsibility for the investment in human capital formation. Therefore, it is also necessary to strengthen the allocation of education resources through the price mechanism so that the cost-benefit aspects of human capital formation becomes more transparent.

### Expanding Pre-School Education, Introducing Child-Care Vouchers

The ability and the willingness to learn are shaped to a large extent in early childhood. Therefore learning should be encouraged at a very young age by offering child-care facilities with adequate educational programs to all children aged two and older. Higher quality of pre-school education would help create the basis for school performance and, in the long term, labor market success.

This proposal requires expanding the supply of kindergartens substantially. The additional tax revenue generated by the transition from joint income splitting to real income splitting for married couples, for example, could be used to finance this expansion of pre-school education.

As a rule, it is more efficient if government support for education centers on subsidizing the subject (the child) rather than on subsidizing the object (the education facility)

as is the current practice in Germany. Therefore, public financing of kindergartens should to a large extent be replaced with vouchers given to parents. To address distributional concerns, the value of the vouchers may be negatively related to household income. With a system of regressive vouchers, parents would continue to share the cost of a kindergarten slot, but competition among the providers of pre-school education would be increased. In particular, kindergartens would then have to adjust the quality of their services, e.g. the hours of operation, to meet the demand of parents, who are free to leave the voucher at the facility of their choice. In this system, the main task for the government would be to certify pre-school institutions that, by meeting certain educational standards, are eligible for receiving parents' vouchers.



### Modernizing the Dual System of Vocational Training

Germany's dual system of vocational training is one of the strengths of the German labor market and should be maintained, albeit in a modernized form. In order to prepare apprentices for technological innovations and rapidly changing professional requirements, the focus of vocational training has to shift back to the core occupations. At the same time, to keep vocational training attractive for employers, it is necessary that they can extract a higher rent from training as they have more time to teach firm-specific knowledge.

A change in vocational training curricula could correct these issues. First a general part of classroom training should teach the core qualifications required for a limited number of broadly defined occupations. This general training part of the apprenticeship program should be designed to occupy not more than fifty percent of the apprenticeship period. The other part of the apprenticeship could then be devoted mainly to in-company teaching of firm-specific skills.



### Implementing Preventive Measures to Secure Human Capital

In the current situation, workers tend to invest too little to maintain and enhance their human capital. This is not only due to the lack of information on the (short) half-life of one's own knowledge. On-the-job training often is not fully rewarded because the qualifications achieved are not transparent to future employers. In-company training courses therefore should receive some sort of certification. In order to give workers in small and medium-sized firms better opportunities to enhance their human capital, improved availability of external training programs spanning across firms is recommended. In order for high-skilled workers to receive high-quality further training, universities should offer more courses (subject to enrolment fees) especially targeted at this audience.

The generous benefits provided by the welfare state in the case of unemployment also discourage workers from sufficient human capital investment on private initiative. In fact, many workers participate in training programs only after they have become unemployed. Since educational programs in unemployment are often rather expensive and of dubious effectiveness, additional incentives for private training initiatives on-the-job should be created. For instance, if placement fees are installed in the future, part of the co-payment required from the reemployed worker could be waved for those who can prove that they have regularly participated in training programs before becoming unemployed.



### Modernizing the System of Higher Education

At present, university education in Germany is basically provided free of charge. To improve universities' orientation toward the requirements of their students, tuition fees should be universally introduced. This would not only help universities to gain financial autonomy (allowing them, for example, to offer more incentives to motivate faculty members), but it would also guarantee that students consider the cost and benefits of their studies more carefully. In order to ensure equal access

opportunities, student loans should be offered to all applicants, in addition to scholarships for gifted students. The system of student loans could be designed similar to the existing loans given to economically disadvantaged students at the end of their university career.

In addition, to broaden the financial basis of the universities, it is useful to set incentives for private donors, by changing the rules concerning inheritance and foundation endowment accordingly.

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## Addressing Demographic Challenges

- Systematic Funding of Social Insurances
- Taking Pension Reform a Step Further
- Raising the Legal Retirement Age
- Creating Competition in Health and Long-Term Care Insurance
- Introducing a Point System for Immigrants

### Labor Market Risks from Demographic Trends

In Germany, the share of the elderly will increase strongly while the population is shrinking rapidly. It has been predicted that Germany's labor force will have dropped substantially by the end of the decade. The economic implications of this trend are difficult to predict. A declining labor supply, however, is likely to result in slower growth. If productivity improvements fail to counteract this trend, then GDP per capita could fall.

Demographic aging also puts a strain on public budgets. Government spending per capita is likely to increase because individuals who have left the labor force are typically recipients of net transfers from the public

coffers. The aging process will have a particularly strong negative impact on the different branches of statutory social insurance that cover risks typically increasing with age, i.e., the statutory pension, health care and long-term care insurances. As these insurances offer (defined) benefits which are financed on the basis of a pay-as-you-go system, there is the serious danger of a substantial increase in payroll contribution rates in the future. Since contributions to a pay-as-you-go system contain an implicit tax on labor, this would create negative work incentives, which could aggravate the labor shortage due to demographic changes.

### Systematic Funding of Social Insurances

Contributions to mature pay-as-you-go systems are a burden on labor. In the aging German society, the share of the contributions to the statutory social insurances that is tantamount to a tax on labor because the return to these contributions is less than the return achievable on the capital market will increase. This creates negative work incentives or a trend toward insurance-free, if perhaps less productive jobs. Moreover, if the employers cannot shift their payment of insurance contributions entirely onto the workers, they have to bear part of the cost – and decrease their labor demand.

To prevent employers and workers from resorting to inefficient insurance-free forms of employment, social insurance regulations should be changed so that all labor earnings are subject to contributions. Besides, the numerous non-insurance benefits should be properly financed by taxes. Contributions would then be raised only for their original purpose and could be lowered to the level required to finance the insurance benefits. This would keep the implicit tax on labor as small as possible under the pay-as-you-go system.

### Taking Pension Reform a Step Further

Even after the pension reform of 2001, the replacement level of mandatory public pensions in Germany remains too high to avoid a substantial increase in contribution rates under demographic pressure, beyond the level that has been promised by policy makers. In fact, the enacted formula to reduce replacement rates over the long term does not adequately respond to the demographic strains on pay-as-you-go financing.

To stabilize contribution rates to Social Security, future pension levels should first be tied to the development of the average length spent in retirement. This reform would cope with the impact of rising life expectancy and early

retirement. Second, individual pension levels should be scaled according to the number of children. After all, the generational contract not only depends on contributions, but also on offspring to provide future contributions. Pensions should therefore be cut for retirees who did not raise children. The money saved by not having children helps these individuals compensate for a lower retirement income.

In addition to income from the public pension insurance, private pension plans, just introduced on a voluntary basis, should become mandatory so that sufficient retirement income is guaranteed despite falling public pension levels. The obligation to build up a private pension account would

prevent free-riding by those who rely on the expectation that society will take care of them. The government should set incentives to save into private pension plans by granting deferred taxation. The practice of matching private savings

with public subsidies, established by the Pension Reform Act of 2001, however, should be abolished. The funds currently used for this complex subsidy scheme should instead be put into servicing the public debt.

### Raising the Legal Retirement Age

Over the last decades, the average lifespan spent in retirement has increased substantially due to increased life expectancy. Since today's retirees are much healthier than those of the past, the German statutory retirement age of 65 is no longer justified by reasons such as physical incapacity or constrained productivity. The retirement age should therefore be gradually increased to 70 within the next two decades. Flexible entry into retirement could be maintained by allowing individuals to retire earlier if they accept benefit cuts amounting to the actuarial value of forgone contributions. Given the importance of direct taxation of labor income in generating

tax revenue, the establishment of longer working lives through a higher statutory retirement age would help stabilize the government budgets. The mandatory public pension insurance, however, can be relieved through later retirement only if the additional contributions paid are not fully compensated by entitlement to higher pensions. The pension formula therefore has to be adjusted accordingly, which implies that the pension level is lowered indirectly. Such a policy change might create negative work incentives, but the impact of these can be limited by making all labor earnings subject to insurance contributions.

### Creating Competition in Health and Long-Term Care Insurance

In Germany, the social coverage of health risks is not only threatened by future spending increases due to demographic change. Restricted competition among public health insurance companies as well as lack of control and asymmetric information create additional cost pressure. Substantial organizational changes are necessary to control the fast-rising burden that is put on labor by health and long-term care.

Most importantly, competition should be opened between the numerous providers of health and long-term care insurance. This requires that the system of mandatory public health insurance, which only covers employees who are below a certain income threshold, is extended to all employees. At present, high-income workers who have systematically lower health risks are allowed to buy health insurance from private providers, which prevents from an efficient allocation of risk between the public and private

insurers. After the establishment of mandatory universal coverage the hitherto public providers of health and long-term care insurance should be privatized.

To make competition work, it is furthermore necessary that insurance companies be allowed to provide different service packages, in contrast to the current system of basically uniform services of public health insurers stipulated by the government. In a fully privatized market for health insurance, the government's only tasks should be to guarantee the free mobility of customers between insurance providers, and to define a mandatory minimum coverage for health risks, which must be offered by any insurance company to any applicant (if of course not at uniform cost). Beyond this minimum coverage, individuals could choose to buy additional insurance benefits according to their individual preferences.

### Introducing a Point System for Immigrants

Immigration raises the potential economic performance of a country. The incumbent population especially benefits from immigration if immigrants fill labor shortages and integrate easily into the labor market. Given the magnitude of the looming demographic disruptions, immigration cannot be a substitute for labor market reforms and effort at fiscal consolidation. As a very flexible complement to domestic reforms, however, immigration is a powerful tool for economic policymakers.

In order to take full advantage of the positive effects from immigration, Germany should start selecting labor migrants systematically. Temporary migration of workers

who fill short-term shortages should be regulated through an auction system. Permanent immigration, on the other hand, should be controlled by means of a point system as it is envisioned by the recently enacted immigration law. To design the point system according to the needs of the German labor market, a trial phase with small immigration quotas should begin immediately. This is essential to have an efficient point system ready when, due to demographic change, the demand for immigration will rise sharply at the end of the decade. Of course, the trial phase should be evaluated scientifically, in order to identify those immigrants who have the best labor market prospects.

## O P I N I O N

## The German Labor Market – Bound for Consistent Reform?



“On a trip to the Land of Cockaigne, a group of frogs jumped into a pail of milk and indulged themselves. Few of them noticed at first that they would not be able to get out easily because the walls were too slippery. One frog just barely managed to get out and began to wail loudly. The others, however, continued their self-indulgence without a care in the world. As the milk level dropped further, the walls became unclimbable. Suddenly, the frogs all started thrashing about and doing everything to stay afloat. After a while, some gave up and drowned. The others kept on struggling until they felt chunks of butter forming underneath their feet, which gave them a false sense of security. Only one of the frogs eventually summoned the courage to take a forceful leap to safety.”

This fable has a lot in common with the problems of the German labor market. In the 1960s, labor market problems seemed solved. Full employment was defined as an unemployment rate of close to zero. Economic growth – at an impressive average of four percent – guaranteed a high standard of living and encouraged the creation of a comprehensive social welfare system on the basis of seemingly secure growth prospects. Early warnings that this was merely a fair-weather system were ignored. Even as global crises and impending demographic changes caused the first disruptions of the system in the 1980s, nothing was done to change course. Distracted by the subsequent positive trend in global economic development, and later by German reunification, labor market policy has been dominated by social policy objectives throughout the past two decades. The “Christian socialism” of the Kohl era continued to shape national policy during Schröder’s first term. Under the Schröder administration, the fall turned into a nosedive, which resulted in the shattered reputation of the Federal Employment Services (Bundesanstalt für Arbeit) in Nuremberg.

In this kind of situation, marginal changes in labor market policy are useless. The only way out of the current dilemma is a complete reorganization of labor market policy and the social security system. This can only be done, however, if the government initiates the necessary steps during the first year of the administration’s four-year term. The closer election day comes, the smaller the chance of achieving reforms, because voters tend to punish governments for painful reform measures even before the programs begin to produce benefits. As the time window is about to be closed again, our policymakers must take swift action. Against this background, IZA has designed an action program for improving the economic framework to increase employment.

The new administration has once again declared unemployment as the main focus of government activity. Although several details of Schröder’s new course of action may be flawed, at least he has summoned the courage to initiate the right steps. These include combining the political responsibility for economics and labor in one ministry, improving macroeconomic conditions through a reinterpretation of the European Stability and Growth Pact, encouraging female labor market participation by the establishment of all-day schools, and implementing key proposals of the Hartz Commission. The planned merging of unemployment aid and social assistance will lead to a reduction of transfer payments to the unemployed. This is a painful but inevitable first step out of the crisis.

The labor market problem can only be solved, however, with a consistent long-term approach to combat the causes of unemployment. This includes the development of the low-wage sector and the deregulation of health services as well as child care and long-term care for the elderly. We must provide more work incentives by turning away from the single wage-earner model and abolishing the subsidization of early retirement. The reorganization of unemployment insurance according to market-based criteria must go even further than proposed by the Hartz Commission. Active labor market policy, which needs to be subjected to thorough scientific evaluation, should focus exclusively on an effective reintegration of the unemployed into the labor market. The responsibility of the collective bargaining parties for unemployment must become more institutionalized, and agreements within individual companies should receive a larger weight. The lack of labor market flexibility has become a symbol of Germany’s inability to undertake reforms. To achieve more flexibility, a legally governed system of severance pay should replace our rigid system of layoff protection. Furthermore, we should encourage competition among our educational facilities, improve the efforts to reform our pension system, raise the retirement age, and allow more immigration to prepare our country for the demographic changes ahead.

IZA’s “Seven Proposals for Modern Active Labor Market Policy” are meant to stimulate our policymakers to take decisive action – not only in the interest of the unemployed, but also for the sake of Germany’s future as a business center.

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