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COMPACT

CONSIDERING THE FUTURE OF LABOR

Can Monetary Policy Help Reduce Unemployment? A Fresh Look at the Inflation-Unemployment Tradeoff

New IZA research, conducted through a major IZA research project headed by IZA program director *Dennis J. Snower* offers a fresh perspective on the relation between inflation and unemployment, with far-reaching implications for monetary policy. It calls into question the mainstream view that in the long run unemployment is independent of inflation. It suggests that expansionary monetary policy can reduce unemployment, at the expense of higher inflation, even in the long run. The theory is supported by a new appraisal of the empirical evidence. Initial results, theoretical and empirical, are presented in a series of IZA Discussion Papers (No. 635, 636, 645, 646), authored by *Liam Graham* (Birkbeck College, London), *Marika Karanasou* (Queen Mary College, London), *Hector Sala*, and *Dennis J. Snower* (both Birkbeck College, London).

The project is concerned with the following questions:

- ▶ How does monetary policy affect output, employment and unemployment through time?
- ▶ Is this influence short-lived or very prolonged?
- ▶ Is there only one unique unemployment rate – the NAIRU (non-accelerating inflation rate of unemployment) – at which inflation remains stable?
- ▶ Does inflation fall without limit when the unemployment rate is above the NAIRU, and rise without limit when unemployment is below the NAIRU?
- ▶ What should the objective of monetary policy be? Should it be confined to achieving an inflation target?

The Conventional Wisdom

The relation between inflation and unemployment is arguably the most important

tradeoff in economics. Over the postwar period, many recessions have occurred when contractionary monetary policy was implemented to reduce inflation. Expansionary monetary policy played a significant role in the U.S. boom of the 1990s. The decisions of the European Central Bank have an important influence on European unemployment. Thus it is of great importance to understand how inflation is related to unemployment and how monetary policy affects them.

Ever since *Alban W. Phillips* discovered an inverse relation between inflation and unemployment in the United Kingdom between 1861 and 1957, the Phillips curve has been called “a fact in search of a theory.”

This inflation-unemployment tradeoff appears to have been reasonably stable until the end of the 1960s. In the late 1960s, however, *Edmund Phelps* and *Milton Friedman* began questioning the existence of an inflation-unemployment tradeoff. They argued that nominal wages and prices are irrelevant to people’s economic decisions, because people have no “money illusion.” In other words, they are under no illusion that the absolute levels of their money wages and prices matter to their decisions. Rather, firms’ demand for labor and households’ labor supply depends on the wage level relative to the price level. Thus the rate of inflation should be irrelevant to unemployment. Since unemployment depends on real wages (wages relative to prices), a given unemployment rate must be compatible with any inflation rate.

This theory sounds plausible: For instance, the adoption of the Euro did not lead to wild fluctuations in European unemployment since the unit of account in which their wages

and prices are evaluated is of no importance to firms and workers. All that matters is their purchasing power, namely, what they can spend relative to what they earn. For the same reason, it may be argued, monetary policy cannot be expected to have any long-term effects on unemployment. Changes in the money supply are merely changes in the unit of account. As long as all wages and prices move in proportion to the money supply, unemployment should remain unaffected.

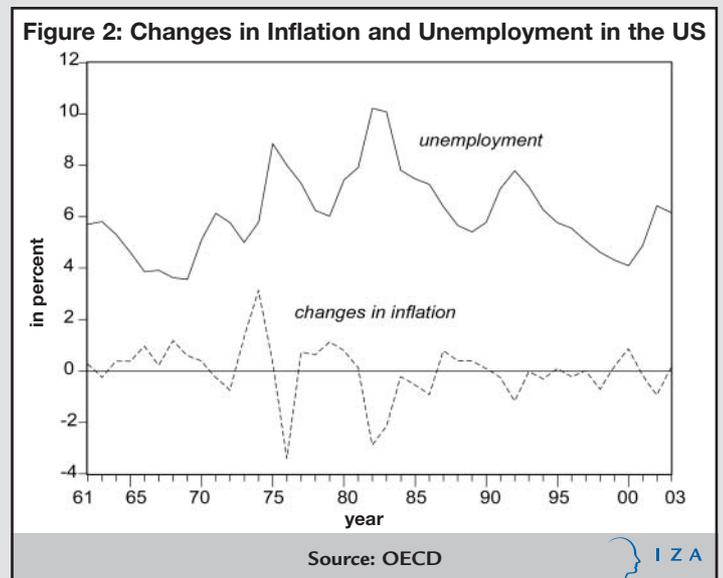
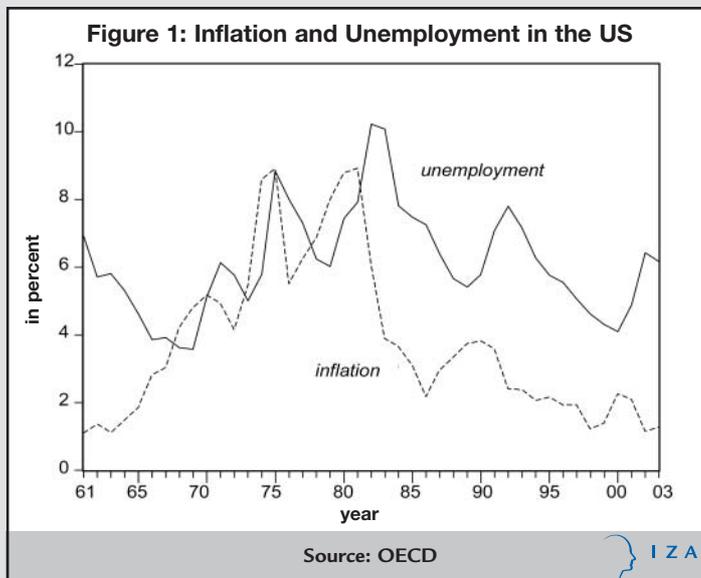
In the short run, of course, people’s expectations may be out of touch with reality. If wage setters do not anticipate an expansionary monetary policy, wages will not adjust promptly. Then wages may fall relative to prices, leading firms to demand more labor and unemployment to fall. But errors in expectations do not last long. Data on wages, prices, and monetary policy instruments is readily available, and thus there is no reason for people to remain systematically out of the picture for more than a few weeks, or even days. Costs of price change and staggered wage-price contracts may also delay the adjustment process, but not for very long.

By implication, monetary policy can have only very short-term effects on unemployment and other measures of real economic activity. Monetary policy affects inflation and little else. When inflation is too high, it is important for the monetary authority to be credibly committed to reducing inflation, because then people’s expectations will fall into line quickly. As a result, inflation may be reduced without any prolonged increase in unemployment.

This view became popular because the inflation-unemployment tradeoff appeared to

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break down during the 1970s when rising inflation took place at the same time as rising unemployment in various OECD countries. This breakdown is illustrated in *Figure 1*▲, which shows the U.S. inflation and unemployment rates between the early 1960s and the present. Observe how inflation and unemployment moved in opposite directions during the 1960s but not consistently thereafter.

So most economists came to believe that there is no relation between unemployment and inflation. Rather, there was a specific unemployment rate – called the NAIRU – at which inflation remained constant. When unemployment fell beneath the NAIRU, inflation would keep rising; and when unemployment rose above the NAIRU, there would be limitless deflation. In short, there is an inverse relation between unemployment and the *change* in inflation. This became the new conventional wisdom. It is illustrated in *Figure 2*▲, which plots U.S. unemployment against the change in inflation. Although the inverse relation is not a close one, it is nevertheless identifiable.

Problems with the Conventional Wisdom

While this has been the mainstream economic theory for more than three decades now, there are several considerations that call the conventional wisdom into question. First, this is clearly not the way central bankers and other policy makers think. They do not believe that monetary policy affects only inflation, except for brief periods in which expectations are unrealistic and costs of wage-price change need to be overcome. If that were the case, the central bankers' job would be easy, since their inflation targets could be achieved without much sacrifice of unemployment or lost output.

Second, the mainstream view has difficulty explaining the long-run tradeoff between inflation and unemployment originally documented by A. W. Phillips and many others for long periods before 1970. Since then, a growing number of economists have found that

countries experiencing large and long declines in inflation also experience increases in their NAIRUs. However, this is just another way of saying that there is an inverse relation between inflation and unemployment in the long run.

This is illustrated in *Figures 3a-d*▶, which show the inflation and unemployment rates of France, Germany, Spain and the U.K. Observe that in all these countries, the inverse relation between inflation and unemployment breaks down during the 1970s, but then reappears again. Unlike the U.S., these countries provide little, if any, evidence that the inflation-unemployment tradeoff was replaced by an inverse relation between unemployment and the change in inflation.

Finally, the NAIRU is hard to measure. Supposing that it is reasonably stable through time, there is little evidence that inflation rises without limit when unemployment is low, and falls without limit when unemployment is high. Of course it can be assumed that the NAIRU changes through time and that these changes are exactly what is required by the mainstream view.

On this basis, the NAIRU in Europe must have risen during the 1970s, most of the 1980s, and the early part of the 1990s, because during these periods unemployment increased without substantial changes in inflation. It is easy to imagine the reasons for the rise of the NAIRU in the 1970s: at around this time many European countries experienced large demographic changes (the influx of women and young people into the labor force), increases in union density, unemployment benefits and benefit durations, and other welfare entitlements as well as increased stringency of job security legislation. But all these trends ceased and partially reversed themselves in the 1980s and 1990s. The alleged fall in the U.S. NAIRU in the second half of the 1990s (when unemployment fell while inflation remained constant) is also hard to explain.

With hindsight, it is of course always possible to identify new constellations of economic variables that could plausibly have pushed the NAIRU in any direction required by the underlying theory. But the selective nature of this exercise has made many observers uncomfortable.

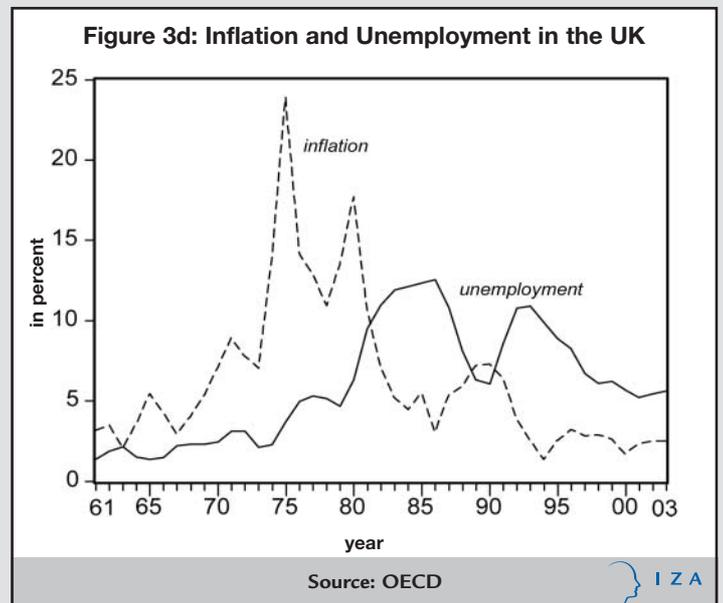
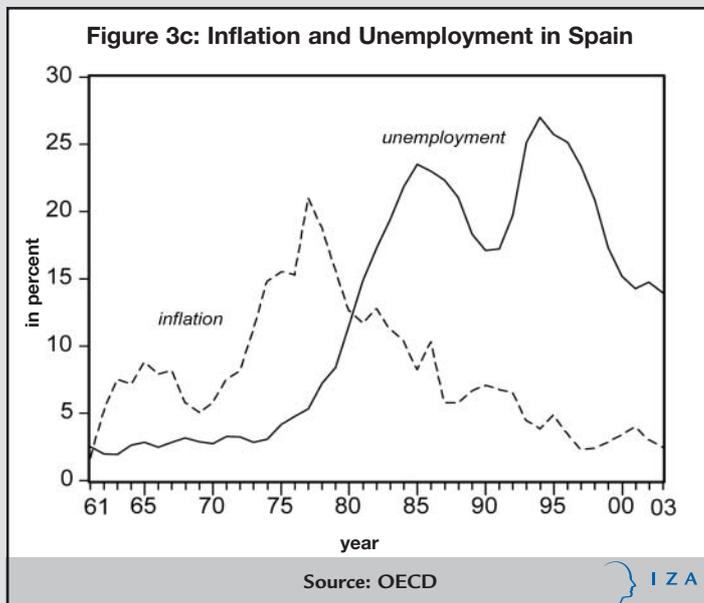
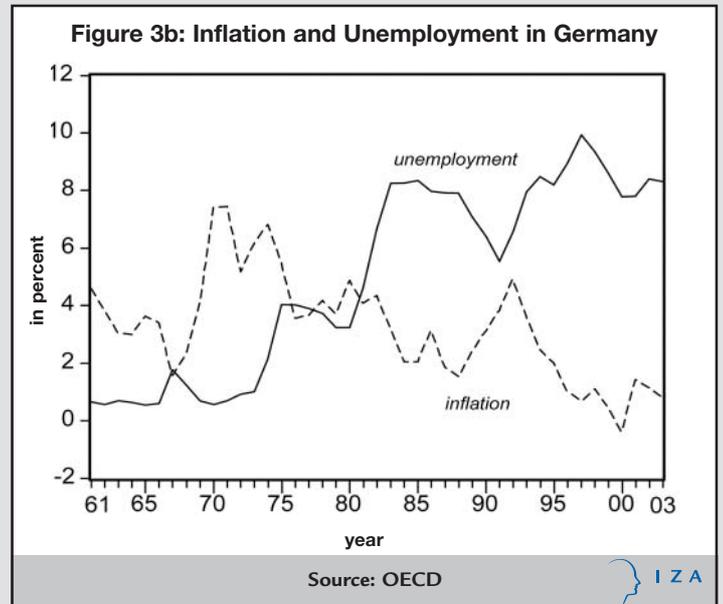
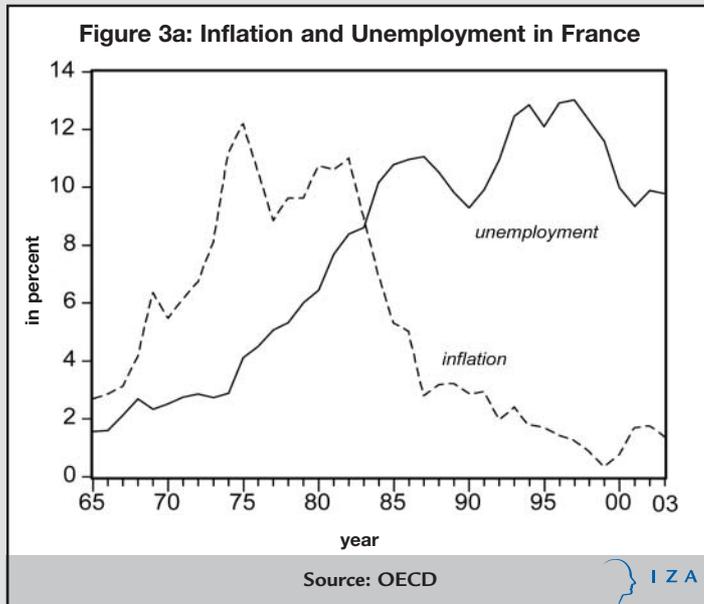
The New Approach: Frictional Growth

The new approach to the inflation-unemployment tradeoff can be understood in four straightforward steps. First, under overlapping wage-price contracts (fixing wages or prices over their contract periods), it is easy to see that current wages depend on past wages (since the current wage contract overlaps with contracts that were signed in the past) and expected future wages (since the current contract will also overlap with contracts that are yet to be agreed in the future).

Second, observe that when wage setters discount future and when they face risk, so that the future is more uncertain than the present, then current wages will depend more heavily on past wages than on expected future wages. Similarly, since prices depend on wages, current prices will depend more heavily on past prices than on expected future prices. The reason is straightforward: The wages set in the past are certain and available at present, whereas future wages are uncertain and have not yet come into force.

Third, under these circumstances, current inflation moves sluggishly in response to monetary shocks. In short, there is inflation inertia. Moreover, when the money supply grows in the presence of inflation inertia, the price level chases after a moving target. This target is the "frictionless price level," i.e. what the price level would be in the absence of nominal frictions.

When the money supply grows in the presence of price inertia, the price adjustments to each successive change in the money supply are never able to work themselves out fully. By the time the current price level has



begun to respond to the current increase in the money supply, the money supply rises again, prompting a new round of price adjustments. In effect, the price level chases after the growing money supply, but never catches up with it.

And finally, since the current price level depends more heavily on the past price than on the expected future price, an increase in money growth causes the price level to lag further behind its moving target. Whereas the frictionless price level increases proportionately to the money supply, the actual price level increases less than proportionately, falling further behind the money supply. As a result, people's purchasing power rises and unemployment falls. In sum, there is a long-run tradeoff between inflation and unemployment.

This reasoning helps us understand what is wrong with the argument that monetary policy cannot affect unemployment in the long run because there is no money illusion. When

people have no money illusion, a proportional change in all wages and prices – past, present, and future – makes no difference to their decisions. But under inflation inertia and money growth, current wages and prices do not move proportionately to the money supply. Thus the absence of money illusion does not mean that monetary policy cannot affect real economic activity in the long run.

Implications

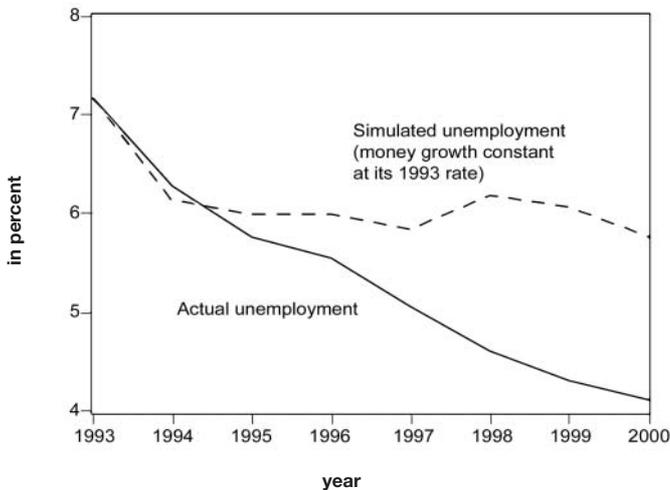
The new approach suggests a reevaluation of how monetary policy affects macroeconomic activity and sheds new light on macroeconomic events. Consider, for example, the puzzling U.S. macroeconomic developments of the 1990s, when the unemployment rate declined and inflation remained subdued, even though money growth surged. *Figures 4a-c* describe the role of monetary policy in the U.S. economy through the prism of a frictional growth model.

Figure 4a depicts the time path of the actual unemployment against the one unemploy-

ment would have followed, in this model, had money growth remained constant at its 1993 rate. The difference between these two trajectories represents the unemployment effect that is attributable to money growth. *Figure 4b* illustrates the actual inflation rate against the simulated inflation rate under money growth fixed at its 1993 rate, so that the difference represents the inflation effect attributable to money growth. *Figure 4c* depicts the actual inflation rate against the simulated inflation rate under productivity growth fixed at its 1993 rate, so that the difference represents the inflation effect attributable to productivity growth.

Although these figures are merely suggestive, they make the following simple points: First, the surge of money growth over the second half of the 1990s in the U.S. can account for about two thirds of the decline in unemployment over this period (*Fig. 4a*). Second, the money growth surge was of course associated with a rise in inflation (*Fig. 4b*). But, third, this inflationary influence was substantially

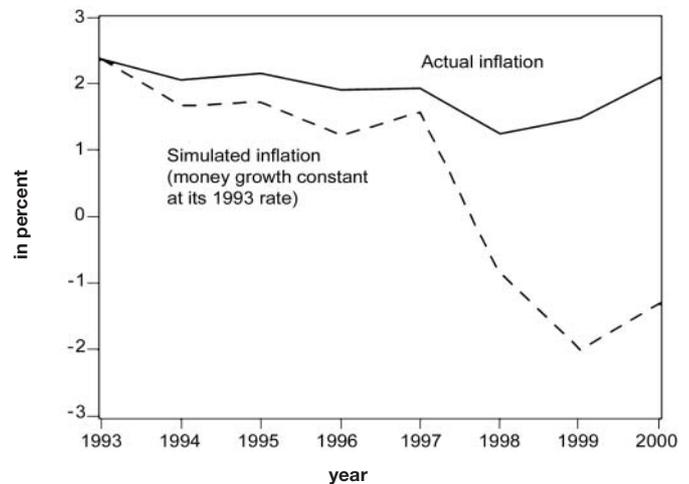
Figure 4a: Money Growth and Unemployment in the US



Source: IZA Discussion Paper No. 636



Figure 4b: Money Growth and Inflation in the US



Source: IZA Discussion Paper No. 636

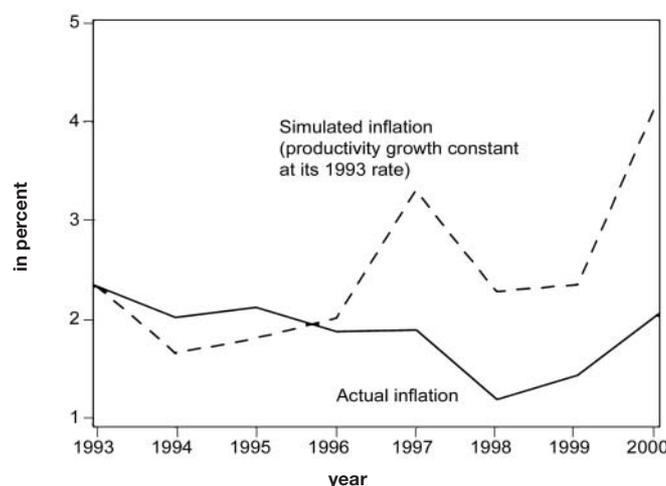


undone by the fall in inflation associated with the increase in productivity growth over the period. And finally, the increase in productivity growth was itself stimulated by the expansionary monetary policy, through its effect on capital accumulation.

In this way, the analysis of frictional growth represents a promising new approach to the evaluation of monetary policy. It suggests that since the effects of monetary policy on inflation and unemployment generally take a long time to work themselves out, variations in monetary policy cannot be expected to be closely correlated with variations in inflation and unemployment.

This is so even though monetary policy has a major influence on both inflation and unemployment through time, even in the long run. In addition, the analysis has the following striking implications:

Figure 4c: Productivity Growth and Inflation in the US



Source: IZA Discussion Paper No. 636



► Due to lags in the response of wages and prices to monetary policy, expansionary policy need not be accompanied promptly by a surge of inflation.

► Monetary policy can have a long-term effect on unemployment.

► Monetary policy can reduce unemployment without causing inflation to rise without limit. Conversely, it can raise unemployment without leading to limitless deflation.

► In view of the long-term effects of monetary policy on unemployment, it is no longer obvious that the objective of monetary authorities should be restricted exclusively to fighting inflation. On the contrary, it may be desirable for monetary policy to be formulated to achieve both inflation and unemployment objectives.

In short, monetary policy may have more important and lasting effects on real macroeconomic activity, and on unemployment in particular, than the conventional wisdom allows for.

IZA Prize in Labor Economics 2003

IZA Research Fellows Worldwide Nominate This Year's Prize Winner

IZA invites all Research Fellows to participate in the nomination process for the IZA Prize in Labor Economics 2003. The Prize is awarded for outstanding academic achievements in the field of labor economics and carries a cash award of €50,000. In 2002, the award went to inaugural laureate *Jacob Mincer* (Columbia University, New York).

Along with IZA Director *Klaus F. Zimmermann* and IZA Research Director *Gerard A. Pfann*, the IZA Prize Committee includes three recipients of the Nobel Prize in Economics: *George A. Akerlof* (University of California, Berkeley), *Gary S. Becker* (University of Chicago) and *James J. Heckman* (University of Chicago).



As in 2002, IZA has set up an online nomination system that can only be accessed by IZA Research Fellows. At www.iza-prize.org (and in the "IZA Prize" section of the IZA homepage) nomination proposals can be submitted to the Committee.

The nomination period ends on May 31, 2003, after which the Prize Committee will reach its decision. The official award ceremony will take place on September 22, 2003, in Berlin. Prior to the event, this year's prize-winner will be publicly announced by IZA. All IZA Research Fellows are cordially invited to take part in the award ceremony in Berlin. For further information regarding participation guidelines, or for any questions and comments on the IZA Prize, please contact prize@iza.org.

Labor Market Reform in Germany: Workfare Scheme Needed as a Complement to Current Government Plans

A sweeping reform that would put the German labor market back on the road to success is not yet in sight. Even the recent statements by the German Chancellor still lacked a comprehensive reform concept. Nonetheless, they contained some elements that should be implemented immediately – and expanded as soon as possible. Particularly noteworthy is the plan to reduce the maximum entitlement duration of unemployment assistance (*Arbeitslosenhilfe*) and to merge these benefits with welfare benefits (*Sozialhilfe*) under a common roof of tax-financed living income (*Existenzsicherung*). This would help reduce unemployment by creating new incentives for workers to take up employment as well as for employers to hire unemployed workers. These measures, however, do not go far enough.

In order to produce a more substantial labor market effect, there have been arguments for a reduction in government-provided living income. But given the constitutional mandate of certain welfare state provisions, this concept is not easily embraced by a majority in German society. IZA therefore favors an approach that would make the provision of a living income conditional on the willingness to take up socially beneficial work. A link between revised welfare benefit entitlements and a workfare scheme would be the most effective step to achieve sustainable labor market effects.

This far-reaching proposal targets the low-skilled and the long-term unemployed, which are the groups most affected by the German labor market crisis. The unemployment rate of low-skilled workers in Germany has reached an alarming level. According to recent OECD data, the German rate exceeds the EU average by 30%. At 1.5 million individuals, unemployment among the low-skilled accounts for almost 40% of total unemployment in Germany. Labor market policy should therefore aim first and foremost at improving the employment prospects of this target group.

Large Target Group for Workfare

Before considering specific programs in the low-wage sector, it is necessary to determine the size of the potential target group. According to official statistics and data from the German Socio-Economic Panel (GSOEP), at least 740,000 individuals among current welfare recipients are generally capable of taking up employment. A recent report by the Federal Statistical Office, prepared for the German government, arrives at an even higher estimate: Discounting those who are unable to work for family or health reasons, there may still be more than one million potential workers among welfare recipients. Given an additional 1.3 million recipients of unemployment assistance, the overall target group for

the workfare scheme comprises well over 2 million individuals. There is no doubt that a target group of this size is sufficiently large to warrant specific programs. More than that, failure to take action in this case would further aggravate the German unemployment problem.

Incentives to Search for a Regular Job

The different wage subsidy schemes implemented – or currently debated – in Germany yield very little positive effects (see *H. Schneider/K.F. Zimmermann/H. Bonin/H. Brenke/J. Haisken-DeNew/W. Kempe, Beschäftigungspotenziale einer dualen Förderungsstrategie im Niedriglohnbereich*, IZA Research Report No. 5). IZA therefore favors a concept under which a living income is only provided if the transfer recipients, given their ability to work, accept socially beneficial employment (see *Klaus F. Zimmermann, Beschäftigungspotenziale im Niedriglohnbereich, Vierteljahrshefte zur Wirtschaftsforschung 72/2003, Vol. 1, p. 11-24* and *Holger Bonin, Wolfram Kempe, Hilmar Schneider, Kombi-lohn oder Workfare? Zur Wirksamkeit zweier arbeitsmarktpolitischer Strategien*, IZA Discussion Paper No. 587, 2002).

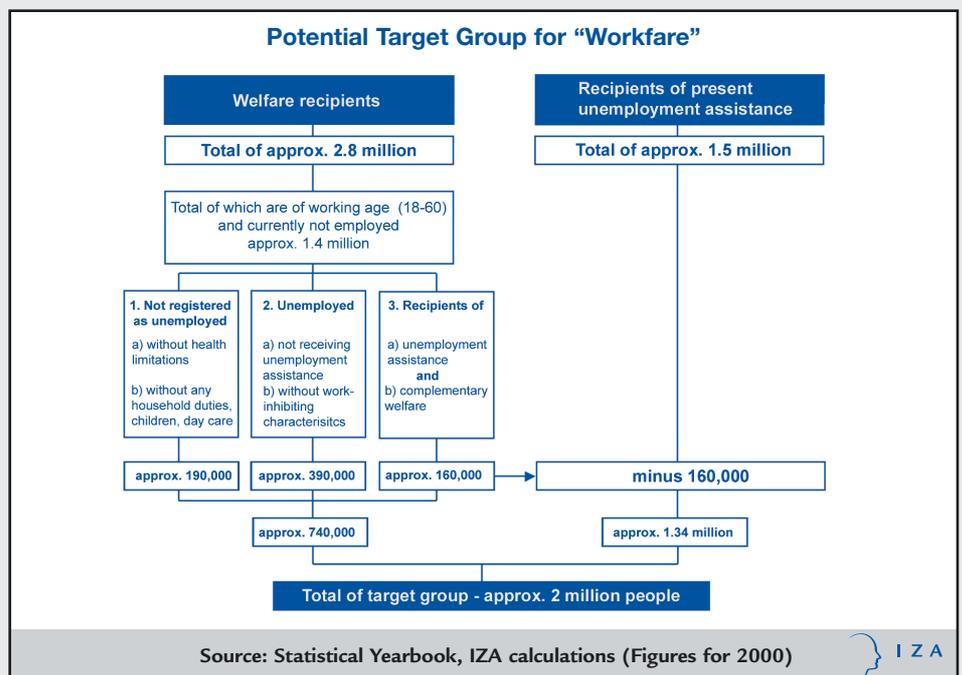
With the exception of disabled individuals, all unemployed workers with transfer entitlements would receive an offer by local authorities to take up a socially beneficial full-time job in the public sector. The individual workfare wage will continue to depend on such factors as family composition. From the point of view of the individual, this wage will directly compete with the market wage attainable for regular employment – because both jobs will require the same amount of time.

Under the new system, one could expect that individuals will choose to minimize their utility loss. In other words, they will choose to get off welfare as soon as they find a regular job with better income prospects.

As a simple calculation shows, any fears that the public employment system would swell to astronomic proportions are unfounded. The living income for a single person with no children would translate into a net hourly wage of 3.50 Euro for a government-provided full-time job. The government would then only need to offer jobs and training courses to those welfare recipients who cannot achieve a higher net wage on the regular labor market. According to IZA estimates, this will only affect a very small proportion of all welfare recipients.

The demand could be somewhat higher during the initial phase of the program if jobs are provided for the interim period in which the individual searches for regular work. The labor market will certainly need time to accommodate the increase in low-wage job seekers. But over the medium to long term, the demand by workers for publicly provided low-wage jobs should be rather low.

The positive effects of workfare could be reinforced, for instance, through the provision of adequate child-care facilities. This would make it easier for welfare recipients with preschool children to take up employment – and more difficult for them to prove that employment would be unreasonable. An estimated 100,000 individuals could thus be motivated to search for a job. By the same token, many older unemployed workers could be brought



back into employment if their only alternative were socially beneficial work.

After a transitional period, workfare could also lead to substantial net savings. Calculations based on an IZA model show that more than 8 billion Euro in public funds could be saved even if the criteria for “inability to work” were defined rather broadly.

Courage to Explore New Ways

The simple alternative to either take up socially beneficial work in return for a tax-financed living income or to seek employment prospects in the regular labor market would open up a large new employment potential. For the vast majority of welfare recipients who are able to work, taking up a regular job would be profitable because it would yield a higher net income for the same amount of working hours. Moreover, the program would reach a clearly defined target group. Fiscally ineffi-

cient windfall gains would be prevented. This mechanism would also circumvent the “part-time trap”: As opposed to merely subsidizing low-wage jobs, there would be no incentives for individuals to reduce their working hours. At the same time, the workfare requirement would reduce welfare abuse and help refute unjustified accusations of laziness directed towards transfer recipients. Workfare would also discourage shadow economic activities because individuals would no longer be able to claim transfer entitlements while working illegally.

But despite all the advantages of workfare, it is not surprising that the concept has been met with little acceptance in such countries as the United Kingdom, where a similar program has already been implemented. Any concept that makes welfare recipients worse off than under the status quo (which does not require them to work) will provide ample fodder for social and political controversy. What is

more, the vested interests of unions and job holders are at stake. If previous welfare recipients were to constitute a new low-wage sector, union bargaining power would inevitably decrease, and labor market insiders would feel at least a marginal amount of wage pressure.

Nonetheless, the devastating situation of the German labor market makes a move in this direction inevitable. Germany should take this opportunity to show that it is willing to explore new avenues in labor market policy in order to substantially and sustainably reduce unemployment. Neither the current implementation of the “Hartz Commission” proposals nor the most recent labor market concept put forward by the federal government have the potential to achieve this goal. The implementation of a workfare scheme, on the other hand, would signify the fundamental change that Germany desperately needs.



The Rise and Fall of Swiss Unemployment – The Situation of the Low-Skilled

Switzerland, traditionally a ‘zero unemployment’ economy, has seen an unprecedented rise in joblessness in the 1990s. However, unlike, for example, in western Germany during the same period, Swiss unemployment fell back to a rather low level after 1997. A recent IZA study (*Patrick A. Puhani, The Rise and Fall of Swiss Unemployment – Relative Demand Shocks, Wage Rigidities, and Temporary Immigrants, IZA Discussion Paper No. 684*) used micro data to determine whether Switzerland has experienced similar negative relative demand shocks for low-skilled workers as documented for other western countries during the end of the 20th century. Since low skilled workers belong to a “problem group” among the unemployed in many countries, taking a closer look at the Swiss labor market might provide valuable insights for countries like Germany, the U.S. and the UK, bearing in mind that Swiss labor market institutions are hybrids of the Anglo-Saxon and ‘Rhineland’ systems.

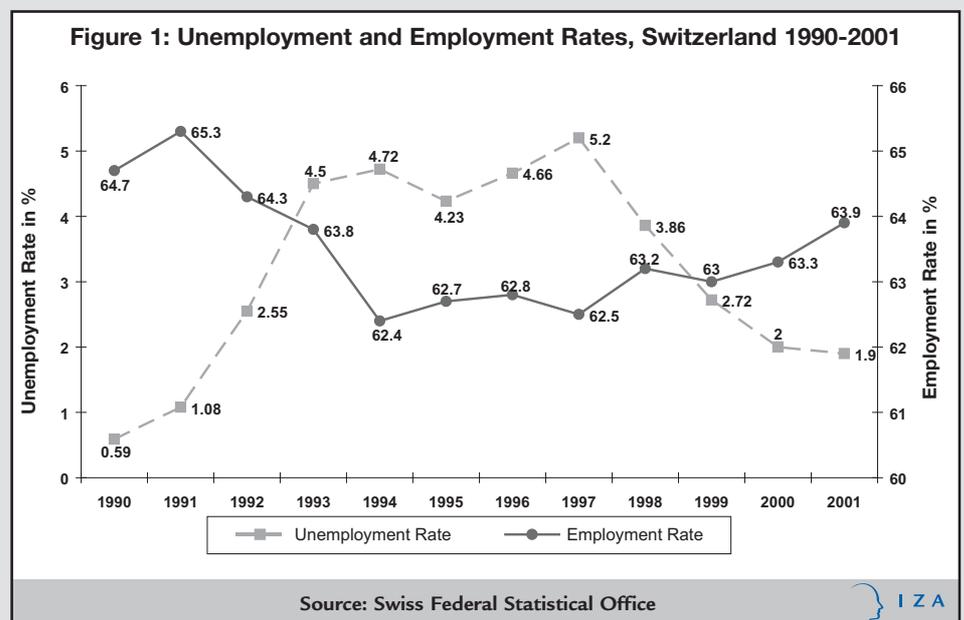
Deregulated Labor Market and Dual System of Vocational Training

What is quite unique about the Swiss labor market is the fact that it is very flexible in terms of employment regulations (more similar to the U.S. than to Germany) but operates a vocational training system not unlike the one in Germany. OECD (1993) employment protection indicators rank Switzerland among the least regulated labor markets, closer to the U.S. than to Germany or France. Collective bargaining coverage, too, is much lower than in Germany or France, which

witness coverage rates above 90 percent as opposed to 50 percent for Switzerland in 1994 (OECD, 1997). Moreover, collective bargaining is very decentralized (much more than in Germany). Swiss collective bargaining agreements may bind a whole industry nationwide, but may just as well merely cover a regional industry or a single company.

Since the period of high unemployment during the 1990s was a rather short one, the analysis tested whether the Swiss wage structure has reacted flexibly to potential shocks.

As Swiss labor market institutions are more similar to those of the U.S. than to those of most continental European economies, one may expect an absence of wage rigidities for institutional reasons (e.g. trade unions). Another feature of the Swiss labor market is its high share of immigrants (around 25 percent). Switzerland issues – among others – temporary annual work permits, which may be used to control labor supply. Therefore, the analysis also tested whether the skill structure of temporary workers in Switzerland was adjusted to relative demand shocks.



The findings are interesting:

(1) No Rise in Wage Inequality

The Swiss labor market experienced a negative net demand shock against low-skilled workers in the 1990s. However, this applies only to those workers who do not have an apprenticeship certificate. The Swiss apprenticeship system is similar to the German one. Thus, the evidence in the study supports earlier scientific evidence indicating that low-skilled American workers with a high school degree show a lower skill level than those holding a German-style apprenticeship certificate. The secular relative demand shock against the 'low-skilled' in the U.S. literature refers to workers with a high school certificate or less. Switzerland, however, provides a large group of workers with apprenticeship training, so that workers with an educational level below apprenticeship are a much smaller group in Switzerland than the 'low-skilled' in the United States. This is one potential explanation why Switzerland has been able to prevent wage inequality increases comparable to those in the U.S.

(2) Wage Rigidity for Low-Skilled

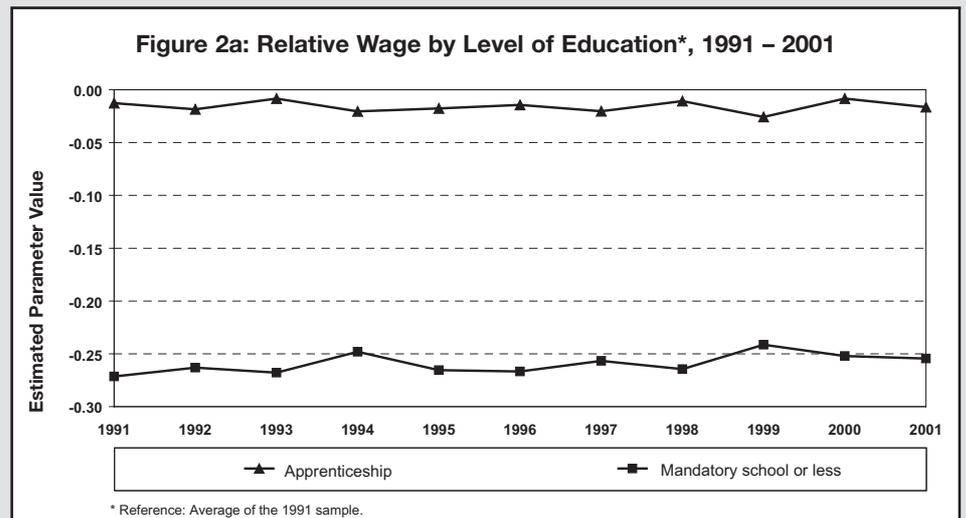
Relative wages for the least skilled (without as much as apprenticeship training) have not fallen in the face of a negative relative net demand shock. Although trade unions are by far not as strong in Switzerland as they are in Germany, evidence from the Swiss Federal Statistical Office (*Bundesamt für Statistik*) shows that between 1999 and 2001 the average collectively bargained minimum wages (*Gesamtarbeitsvertragliche Mindestlöhne*) for unqualified workers rose by 7 percent whereas those of qualified and highly qualified workers rose by about 3 percent. These results give credence to the view that union policies generated unemployment-causing wage rigidity for the very low-skilled in Switzerland. Although this result may be somewhat surprising given the decentralized Swiss wage bargaining system, one explanation might be the emergence of a public debate on minimum wages, which saw its culmination in the late 1990s. Public debates may co-ordinate wage demands even in a decentralized system.

(3) Only Temporary Adjustment of Labor Immigration

Evidence was found indicating that the share of temporary immigrant workers was reduced among the low-skilled when Swiss unemployment was at its peak. By the year 2001 however, the relative share of temporary immigrant workers among the low-skilled had increased again. Hence, adjustment of the skill mix of immigrants with an annual work permit to the relative demand shocks against this group seems to have been only temporary in nature, whereas wage rigidity and the increase in relative unemployment incidence persisted for workers with education below apprenticeship.

The Swiss experience demonstrates the advantages of the German-style apprenticeship system at a time of skill-biased technological change. In the U.S., the largest low-skilled group (high school graduates) obtains no vocational education like in Germany or Switzerland, which might be the reason why skill-biased technological change has led to relative and absolute real wage declines for this group during the last two decades. On the other hand, Anglo-Saxon-style wage flexibility would have been necessary for the

least-skilled in the Swiss labor market (those without even as much as an apprenticeship certificate): public and union pressure to keep or improve their relative wage position seems to be related to the increasing relative unemployment and non-employment incidence of this skill group.

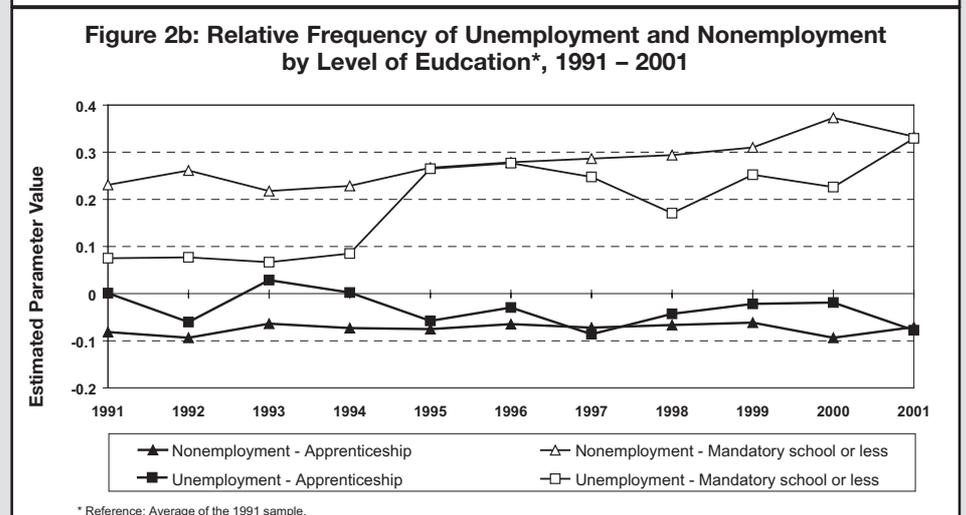


Source: Swiss Labor Force Survey



Figure 2a and 2b show how the wage and unemployment/non-employment structures in Switzerland changed over time for workers with a low level of education ('apprenticeship' or 'mandatory school or less'). In Figure 2a, a positive slope means that the

wage for the respective group increased relative to the average. In Figure 2b, a positive slope means that the unemployment (or non-employment) likelihood for the respective group increased relative to the average.



Source: Swiss Labor Force Survey



Successful Inaugural “IZA Tower Talk” with Florian Gerster, Head of the Federal Employment Services

The new “IZA Tower Talk” event series started on January 29, 2003, with inaugural guest speaker *Florian Gerster*, head of the Federal Employment Services (BA) in Nuremberg. The Tower Talks take place in the recently opened “Post Tower”, the corporate headquarters of Deutsche Post World Net in Bonn. In his guest lecture and the ensuing discussion with IZA Director of Labor Policy *Hilmar Schneider*, Gerster criticized the shortcomings of German labor market policy and laid out the role of his institution in solving the country’s unemployment crisis.



Tower Talk: Florian Gerster, Hilmar Schneider

The event was opened by *Klaus Zumwinkel*, CEO of Deutsche Post World Net and President of IZA, who emphasized his company’s strong commitment to supporting reform efforts in Germany. IZA Director *Klaus F. Zimmermann* urged politicians to summon the courage to quickly implement much-needed reforms of the German labor market before the window of opportunity closes again.

In the first part of his speech, Florian Gerster drew a rather bleak picture of Germany’s economic fortunes and referred to the country as today’s “sick man of Europe”. According to Gerster, the precarious situation of the German labor market requires a thorough review of social standards. Welfare state expenditures currently account for about 34% of tax revenues. Even worse, non-wage labor costs – at over 42% – “are stalling the labor market”. This is why Gerster regarded “easing the financial pressure on labor” as the most important mission of German economic policy. To achieve this goal, he stressed the need for cooperation across party lines.

Gerster also called for “changes of the incentive system”. He condemned the current practice of replacing only one out of six or seven retirees with a younger worker as an “abuse of early retirement for downsizing purposes”. Considering that older unemployed workers currently receive unemployment assistance for up to 32 months, the head of

the BA proposed to reduce the entitlement period to a maximum of 18 months as a way to eliminate work disincentives. (Editor’s comment: This proposal, also supported by IZA, has meanwhile been taken up by the federal government as part of its recent labor market reform efforts.)

With regard to the German pension system, Gerster attacked the traditional notion of treating the level of pension entitlements as a “fixed variable” to be financed by adjusting social insurance contributions as needed.

the BA to live up to its role as a “mediator between labor market supply and demand”.

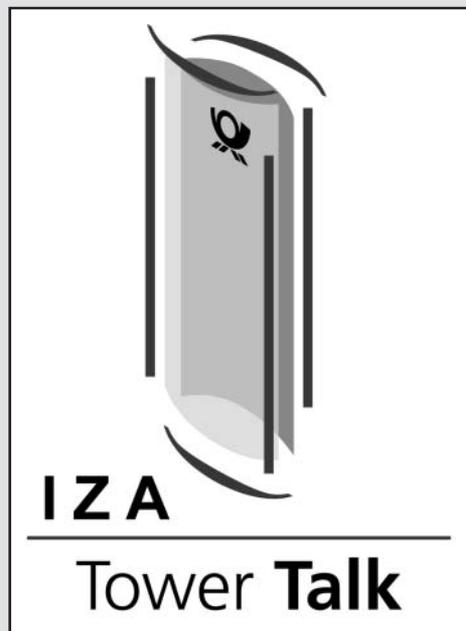
During the subsequent discussion with IZA Director of Labor Policy *Hilmar Schneider*, Gerster identified the BA’s goal for this year as achieving a one-week reduction of the average unemployment duration. This alone would mean an increase in employment of 100,000 individuals per year. Gerster said he is convinced that the majority of the German population would be willing to support painful but credible reform efforts.



Klaus F. Zimmermann, Florian Gerster, Klaus Zumwinkel, Hilmar Schneider

According to Gerster, the key question is, “How much welfare state can an economy really afford?”

Commenting on the difficult in-house situation at the BA, Gerster said that his staff is still “hopelessly caught up in red tape resulting from policymakers’ exaggerated attention to detail,” which makes it all but impossible for



The “IZA Tower Talk” series addresses current issues and challenges in labor market policy. High-ranking experts from politics, business and academia present their views and engage in controversial discussions with an invited audience. The objective of this new event series is to stimulate the process of designing and implementing much-needed labor market reforms in Germany. The Tower Talks are moderated by *Hilmar Schneider*, IZA Director of Labor Policy, and take place at the new corporate headquarters of Deutsche Post World Net, the “Post Tower” in Bonn.

IZA Director K. F. Zimmermann Renews Contract with Deutsche Post



K. F. Zimmermann

K. Zumwinkel

Klaus F. Zimmermann has extended his contract as Director of the Institut für the Study of Labor for another five years. He reached this agree-

ment with Deutsche Post World Net, IZA's main sponsor. One of Germany's most distinguished economists, Zimmermann will continue to head an institution that is unique among German research institutes.

Established in 1998 on an initiative by Deutsche Post, IZA enjoys the financial independence necessary to play a critical yet constructive role in labor market research and policy advice.

Klaus Zumwinkel, Deutsche Post CEO and IZA President, welcomed the agreement reached with Zimmermann and said he expects IZA to "continue its success story and keep up its ac-

tive contribution to solving Germany's labor market problems."

IZA Director Klaus F. Zimmermann, who is also President of the German Institute for Economic Research (DIW Berlin) and Economics Professor in Bonn and Berlin, praised Deutsche Post's continued support of labor market research as a great example of corporate citizenship and fruitful cooperation between business and science in times of empty public coffers. "IZA has established itself firmly in the national and international labor economics communities and will continue to make its voice heard in the future", Zimmermann said.



The Success Story Continues: IZA and Deutsche Post Support Bonn Graduate School of Economics

After five years of successful cooperation with the University of Bonn, IZA's sponsor – the Deutsche Post Foundation – has decided to renew its financial support of the Bonn Graduate School of Economics (BGSE) for another five years.

At the same time, IZA is intensifying its cooperation with the BGSE. With the beginning of the 2003 summer semester, IZA's teaching activities at the BGSE will be expanded through additional courses offered by IZA staff members (▼). The Graduate School will also continue to profit from IZA's global

network of Research Fellows: A number of renowned economists from around the world, who are visiting IZA through the Institute's guest researchers program, discuss recent research findings and methods with junior economists in the IZA Research Seminar and the Bonn Economics Research Seminar at the University. In addition, IZA will play a vital role in improving the international composition of the Graduate School. IZA will continue to offer selected Ph.D. students a position as Resident Research Affiliates, which allows them to take full advantage of the IZA research and information infrastructure.

Several students have already successfully completed their Ph.D. theses under the supervision of IZA Director Klaus F. Zimmermann (► p. 10).

This cooperation between IZA and the University of Bonn is exemplary of a fruitful relationship between public and private sector research and educational institutions.



Armin Falk

Armin Falk to Become IZA Research Director and Full Professor of Economics at the University of Bonn

Armin Falk has accepted to become new IZA Research Director as of October 2003. At the same time he will start as a Full Professor of Economics at the University of Bonn, thus enhancing IZA's active role in university teaching and research. He studied Economics at the University of Cologne and received his Ph.D. in Economics from the University of Zurich in 1998. Currently he has the chair of Ernst Fehr at the University of Zurich. His research interests include Behavioral Economics, Labor

Economics, Economic Psychology and Experimental Economics. His studies elaborate on the psychology of incentives, the nature of incomplete markets, social interaction phenomena, determinants and consequences of fairness and reciprocity, reasons for wage rigidities and tax compliance. He has published in such journals as *Journal of Political Economy*, *Scandinavian Journal of Economics*, *Economic Inquiry* and *European Economic Review*. IZA Compact will report on Armin Falk's new tasks and visions as IZA Research Director in a future issue.

Christian Belzil Enhances IZA Team and Teaching Program at the University of Bonn

In Summer 2003 Christian Belzil will join the IZA staff on a part-time basis and help strengthen the IZA teaching program at the University of Bonn and the Bonn Graduate School of Economics. Christian Belzil graduated from the University of Montreal, where he obtained a B.Sc. and an M.Sc. in 1984 and obtained his Ph.D. from Cornell University in 1990. He is currently Full Professor of Economics at Concordia University in Montreal. He has published numerous papers on the economics of education and human capital (the return to schooling and the level of intergenerational human capital transfers), on the effects of unemployment insurance on the labor market and on the distinction between unemployment and employed job search. Christian Belzil has also worked on dynamic models of fertility and female work interruptions as well as on the effects of job creation and job destruction on wages using matched employer/employee data. His published articles are found in journals such as *Econometrica*, *Review of Economics and Statistics*, *Journal of Labor Economics* and *Journal of Applied Econometrics*.



Christian Belzil

SHORT REPORTS

+++ IZA calls for applications to Bonn Graduate School of Economics / Deadline May 15 +++

Highly qualified students with a German Diploma or a foreign Masters Degree in economics or related fields, such as mathematics, statistics, business administration, accounting and finance, are encouraged to submit their applications to the Bonn Graduate School of Economics (BGSE). The Bonn Graduate School of Economics offers a full set of courses in microeconomics and macroeconomics, as well as applied econometrics. IZA plays a central role in the BGSE doctoral education program. The institute participates in the selection and supervision of Ph.D. students. On a regular basis, IZA also offers lectures and seminars in econometrics and labor economics. A limited number of BGSE students are invited to work at IZA as resident research affiliates. The next possible date of entry into the Bonn Graduate School of Economics is October 1, 2003. Applications must arrive by May 15. BGSE offers a limited number of grants. For further information see www.bgse.uni-bonn.de.



+++ "Empirical Analysis of Labor Markets" – September 1-12, 2003 in Cologne / Admission Deadline July 31 +++

An international seminar on empirical labor market analysis co-hosted by the Central Archive for Empirical Social Research (ZA) and IZA addresses postgraduate and Ph.D. students who wish to broaden their theoretical knowledge as well as their practical experience in the area of handling micro data. During

the first week, there will be a focus on basic theoretical and methodical aspects of labor market data analysis while the second week will build on this knowledge in conducting empirical analyses of selected labor market statistics. The seminar comprises six five-day units, some of which can be chosen from parallel time slots. IZA lecturers include *Thomas Bauer*, *Holger Bonin* and *Hilmar Schneider*. Interested candidates should possess sound knowledge of statistics and econometrics and should have experience with statistical software. Application and additional information at www.gesis.org/Veranstaltungen/ZA/CSS/index.htm. The contact person is *Rainer Metz* (tel.: +49-221-47694-36; e-mail: metz@za.uni-koeln.de).



+++ Successful 6th IZA European Summer School in Labor Economics +++

From April 7-13, the 6th IZA Summer School in Labor Economics took place at the Management Center of Deutsche Post World Net (German Postal Services) in Buch on Lake Ammersee, Bavaria. Again a larger number of selected Ph.D. students were given the unique opportunity to discuss their own research findings and ideas with established researchers in the field. *Jeffrey A. Smith* (University of Maryland and IZA) lectured on the "Evaluation of Active Labor Market Programs". Using practical examples, this lecture covered the latest statistical developments in the evaluation by labor market policies. The lecture by *Christopher A. Pissarides* (London School of Economics and IZA) on "The Search and Matching Approach to the Analysis of Labor Markets" discussed the role

of frictions in economic analysis by focusing on equilibrium search and matching models, as applied to labor markets. The participating graduate students presented their own research covering a wide range of topics in the field, including among others the evaluation of active labor market policies in various countries, labor supply, gender differences, and the interaction between human capital and labor market success.



+++ IZA Research Fellow Avi Weiss Has Become Chief Economist at Israel Antitrust Authority +++



In March 2003, IZA Research Fellow *Avi Weiss* (Bar-Ilan University) has become Deputy General Director and Chief Economist of the Israel Antitrust Authority. Weiss supervises a staff of over a dozen trained economists with experience in anti-

trust. He will continue his research and teaching activities but has taken a partial leave of absence from Bar-Ilan. As a renowned anti-trust expert, *Avi Weiss* aims at promoting the level of competitiveness in the Israeli economy. He has been an IZA Research Fellow for three years and has authored several IZA Discussion Papers.



IZA Research Affiliates Uwe Sunde and Wendelin Schnedler Receive Doctorate – Sunde Becomes IZA Research Associate



K. F. Zimmermann, U. Sunde, M. Merz

Uwe Sunde, who has been a Resident Research Affiliate at IZA for two years, passed the final examination for his doctoral degree in February 2003. He will continue his work at IZA as a Research Associate. His research interests include search and matching, human capital formation and labor market flexibility. He will also coordinate IZA's teaching activities and cooperation with the University of Bonn.

As part of this cooperation, IZA offers several Ph.D. students from the Bonn Graduate School of Economics to participate in IZA activities and fully utilize the institute's resources as Resident Research Affiliates. In his thesis *Uwe Sunde* examined aggregate effects of individual education and search decisions in the context of long-term development, earnings inequality, and the patterns of job creation. Along with IZA Director *Klaus F. Zimmermann*, who supervised *Sunde's* thesis, *Monika Merz* and *Matthias Kräkel* (both University of Bonn and IZA) were part of the examination committee.

Wendelin Schnedler, who spent two years as an IZA Resident Research Affiliate until September 2002, has also passed his final doctoral exam in February. His thesis on "The Value of Information in Hidden Action Models" was supervised by IZA Director *Klaus F. Zimmer-*

mann. *Schnedler* is currently a Research Fellow of the Leverhulme Centre for Market and Public Organisation (CMPO) at the University of Bristol. Among the first congratulators were *Urs Schweizer* (Bonn Graduate School of Economics and *Matthias Kräkel*).



U. Schweizer, W. Schnedler, K. F. Zimmermann, M. Kräkel

IZA DISCUSSION PAPER SERIES

From January to April 2003 IZA Discussion Papers included the following titles
(a complete list is available on our homepage at www.iza.org - all papers are downloadable):

- 746 Andreas Ammermueller, Hans Heijke, Ludger Woessmann**
Schooling Quality in Eastern Europe: Educational Production During Transition
- 745 Ludger Woessmann**
Educational Production in East Asia: The Impact of Family Background and Schooling Policies on Student Performance
- 744 Martin R. West, Ludger Woessmann**
Which School Systems Sort Weaker Students into Smaller Classes? International Evidence
- 743 Guido Heineck, Johannes Schwarze**
Substance Use and Earnings: The Case of Smokers in Germany
- 742 Richard A. Easterlin**
Building a Better Theory of Well-Being
- 741 Barry T. Hirsch, David A. Macpherson**
Wages, Sorting on Skill, and the Racial Composition of Jobs
- 740 Barry T. Hirsch, Stephen L. Mehay**
Evaluating the Labor Market Performance of Veterans Using a Matched Comparison Group Design
- 739 Michael Fertig**
Who's to Blame? The Determinants of German Students' Achievement in the PISA 2000 Study
- 738 Volker Grossmann**
Managerial Job Assignment and Imperfect Competition in Asymmetric Equilibrium
- 737 Alison Booth, Marco Francesconi, Gylfi Zoega**
Unions, Work-Related Training, and Wages: Evidence for British Men
- 736 Iben Bolvig, Peter Jensen, Michael Rosholm**
The Employment Effects of Active Social Policy
- 735 Raphaël Desmet, Alain Jousten, Sergio Perelman, Pierre Pestieau**
Micro-Simulation of Social Security Reforms in Belgium
- 734 Stefan Wolter**
Sibling Rivalry: A Six Country Comparison
- 733 Stefan Wolter, Stefan Denzler**
Wage Elasticity of the Teacher Supply in Switzerland
- 732 Armin Falk, Andrea Ichino**
Clean Evidence on Peer Pressure
- 731 Barry R. Chiswick, Noyna DebBurman**
Educational Attainment: Analysis by Immigrant Generation
- 730 Mariacristina Piva, Marco Vivarelli**
Innovation and Employment: Evidence from Italian Microdata
- 729 Alexandru Voicu, Hielke Buddelmeyer**
Children and Women's Participation Dynamics: Transitory and Long-Term Effects
- 728 Michael Lechner, Jeffrey A. Smith**
What is the Value Added by Caseworkers?
- 727 Martin Raiser, Mark Schaffer, Johannes Schuchhardt**
Benchmarking Structural Change in Transition
- 726 Steffen Habermalz**
Job Matching and the Returns to Educational Signals
- 725 Steffen Habermalz**
An Examination of Sheepskin Effects Over Time
- 724 John T. Addison, Ralph Bailey, W. Stanley Siebert**
The Impact of Deunionisation on Earnings Dispersion Revisited
- 723 Melvyn Coles, Barbara Petrongolo**
A Test between Unemployment Theories Using Matching Data
- 722 C. Katharina Spiess, Felix Büchel, Gert G. Wagner**
Children's School Placement in Germany: Does Kindergarten Attendance Matter?
- 721 Harminder Battu, McDonald Mwale, Yves Zenou**
Do Oppositional Identities Reduce Employment for Ethnic Minorities?
- 720 Tapio Palokangas**
Labour Market Regulation, Productivity-Improving R&D and Endogenous Growth
- 719 James W. Albrecht, Pieter Gautier, Susan Vroman**
Equilibrium Directed Search with Multiple Applications
- 718 Ekkehart Schlicht**
Consistency in Organization
- 717 Alexander Hijzen, Holger Görg, Robert C. Hine**
International Fragmentation and Relative Wages in the UK
- 716 Michael Rosholm, Lars Skipper**
Is Labour Market Training a Curse for the Unemployed? Evidence from a Social Experiment
- 715 Ernst Fehr, Urs Fischbacher, Bernhard von Rosenblatt, Jürgen Schupp, Gert G. Wagner**
A Nation-Wide Laboratory: Examining Trust and Trustworthiness by Integrating Behavioral Experiments into Representative Surveys
- 714 Michael Fertig**
Educational Production, Endogenous Peer Group Formation and Class Composition - Evidence from the PISA 2000 Study
- 713 Ira N. Gang, John Landon-Lane, Myeong-Su Yun**
Does the Glass Ceiling Exist? A Cross-National Perspective on Gender Income Mobility
- 712 Ernst Fehr, Joseph Henrich**
Is Strong Reciprocity a Maladaptation? On the Evolutionary Foundations of Human Altruism
- 711 Christopher J. Ruhm**
Healthy Living in Hard Times
- 710 Zvi Eckstein, Yoram Weiss**
On the Wage Growth of Immigrants: Israel, 1990-2000
- 709 Leif Danziger, Shoshana Neuman**
Delays in Renewal of Labor Contracts: Theory and Evidence
- 708 Claus Schnabel, Joachim Wagner**
Determinants of Trade Union Membership in Western Germany: Evidence from Micro Data, 1980-2000
- 707 Claus Schnabel, Joachim Wagner**
Trade Union Membership in Eastern and Western Germany: Convergence or Divergence?
- 706 Sourafel Girma, Holger Görg**
Blessing or Curse? Domestic Plants' Survival and Employment Prospects after Foreign Acquisitions
- 705 Giorgio Brunello, Daniele Checchi**
School Quality and Family Background in Italy
- 704 Michael Ransom, Ronald L. Oaxaca**
Intrafirm Mobility and Sex Differences in Pay
- 703 William C. Horrace, Ronald L. Oaxaca**
New Wine in Old Bottles: A Sequential Estimation Technique for the LPM
- 702 M. Ayhan Kose, Eswar Prasad, Marco E. Terrones**
How Does Globalization Affect the Synchronization of Business Cycles?
- 701 Laszlo Goerke, Jakob B. Madsen**
Earnings-Related Unemployment Benefits in a Unionised Economy
- 700 Thomas Bauer**
Flexible Workplace Practices and Labor Productivity
- 699 David N. Margolis, Véronique Simonnet**
Educational Track, Networks and Labor Market Outcomes
- 698 Torben Andersen, Jan Rose Skaksen**
Product Market Integration, Comparative Advantages and Labour Market Performance

IZA GUEST RESEARCHERS

From January until April 2003 the following renowned economists stayed at IZA to discuss issues of labor market research and policy:

- John M. Abowd**
(Cornell University)
- Xiaodong Gong**
(Australian National University)
- Robert M. Hutchens**
(Cornell University)
- Ashok Kaul**
(University Pompeu Fabra, Barcelona)
- Bertrand Koebel**
(University of Magdeburg)
- Astrid Kunze**
(Norwegian School of Economics and Business Administration)
- Hartmut Lehmann**
(Heriot-Watt University, Edinburgh)
- Claudio Lucifora**
(University Cattolica del Sacro Cuore)
- Shelly Lundberg**
(University of Washington)
- Erik Plug**
(University of Amsterdam)
- Solomon Polachek**
(Binghamton University, New York)
- Michael Polder**
(BIRC, Maastricht University)
- Jonathan Pingle**
(University of North Carolina, Chapel Hill)
- Pablo Ruiz Verdu**
(University Carlos III, Madrid)
- Jan C. van Ours**
(Tilburg University)
- Arthur van Soest**
(Tilburg University)
- Joachim Wolff**
(University of Munich)

O P I N I O N

Agenda 2010 – Germany on the Move



Germany is caught in a trap of stagnation and structural rigidity. By now it has become clear that pure macroeconomics cannot lead the country out of the crisis. As a consequence, unemployment in Germany will climb above 4.5 million this year and continue to rise in 2004.

In this deplorable situation, Chancellor Schröder's proposals to resolve the structural crisis of the German economy, put forward in his Reform Agenda 2010, offer some encouragement. First initiatives by the Federal Minister of Economics and Labor, as well as the recommendations by the "Rürup Commission" for a reform of the social security systems, have given an indication as to where the journey is headed. But while the government has certainly chosen the right path, true change will require quick and decisive action to implement the proposed measures, many of which merely represent first steps towards more far-reaching reform efforts. Schröder's plans have drawn strong opposition from his fellow Social Democrats, the unions, and –

with respect to the planned reform of the Crafts Code – even from business leaders. However, any compromise that would delay or dilute the planned reforms could jeopardize the entire mission.

Business leaders complain about plans to broaden the "master craftsman privilege", which requires a master craftsman certificate as a qualification to start an own business in the handicraft sector. This rule currently applies to 94 different professions. Schröder's plan is to allow journeymen to start their own business in 62 professions. This proposal would also harmonize German regulations with EU law. In the remaining 32 professions, which involve potential dangers to the health and lives of individuals, extensive professional experience would be required for journeymen to become self-employed. These and other modifications of the Crafts Code would enhance competition and pave the way for new jobs in this sector. Therefore, despite staunch opposition from the German handicraft industry, this reform must be implemented as soon as possible. It would serve as an example for similar competition-enhancing measures in the service industry or in the health care sector, which is another target for deregulation identified in the Chancellor's reform agenda.

Further proposals within the "Agenda 2010" that are both courageous and consistent include the reduction of the maximum entitlement period for unemployment benefits to 12 months, the merging of unemployment assistance and welfare benefits, and the delegation of responsibility for the job placement of able welfare recipients to local job centers. This would render the public administration more efficient, reduce the financial burden on the communities, and put more pressure on unemployed individuals to accept a job. Such reforms are, of course, politically difficult to implement. But their realization would still allow the welfare state guarantees of the labor market to be kept on a socially fair level.

Another important mission of the Agenda 2010 is to ensure the financing of the social security systems in the face of an ever-decreasing number of workers. In this area, Chancellor Schröder has tried to define a course without anticipating the proposals by the Rürup Commission. These proposals have meanwhile been put forward, and they point towards substantial structural reforms.

Given the staggering costs of the health care system, the Commission has suggested alternative financing methods, such as expanding the mandatory health insurance towards a general worker's insurance, or introducing a system of health insurance premiums independent of income but with the possibility of tax-financed subsidies for the less fortunate. The premium system seems best suited to ensure allocative efficiency. While social policy solutions should be tax-financed, the cost consciousness of the insured should be enhanced through the introduction of co-payments.

Significant modifications of the pension insurance system, on the other hand, are still not in sight. The Rürup Commission has at least noted that it will be necessary to raise the retirement age to 67, abandon the early retirement policy, and recalculate the pension formula to reflect the changing ratio of workers and retirees. These measures will help keep the level of pensions insurance from rising further, but they will be insufficient to sustainably lower the financial burden on labor.

Some of these reform proposals certainly fall short. But taken together, the bundle of measures currently debated could provide a strong impetus. The positive effect on employment will be even larger if the government does not sacrifice economic growth for the sake of fiscal consolidation.

K. F. Zimmermann



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 Graphics/Photographs: IZA
 Layout/Printing: Verlag Erik Dynowski,
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