



# IZA COMPACT

Considering the Future of Labor

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## Reform of the Unemployment Insurance: Different Pricing Options Lead to Significant Cost Reductions

German politics would be well-advised to implement a fundamental reform of the unemployment insurance in order to endorse the necessary reorganization of the German labor market. IZA proposes different insurance contracts and pricing options, which help shorten the duration of unemployment by a changed individual search behavior and lead to lower non-wage labor costs.

The current design of the unemployment insurance system is one of the institutional disincentives that have to a large extent caused and further aggravated the problem of structural unemployment. The level of benefits on the one hand, and the duration of benefit claims on the other, play an important role in this context. Both substantially raise reservation wages, i.e. the minimum pay below which job applicants would decline a job offer. In addition, the unemployment insurance in its present organization is negatively affected by collective bargaining interests since the financing of labor market policies can be used to compensate for negative consequences of insider behavior in collective bargaining. Moreover, the existence of unemployment insurance increases the willingness of firms to lay off employees. A major consequence of wrong work incentives and misguided labor market policies are over-the-top unemployment insurance contributions, which in turn cause a further increase in unemployment.

A reform of unemployment insurance that eliminates - or at least reduces - such disincentives is therefore overdue and could make a significant contribution to the fight against mass unemployment. A recent IZA study commissioned by the Bertelsmann Foundation presents a concrete reform

proposal after discussing different reform options to raise overall economic efficiency by positively affecting the insurance-induced behavior of firms and workers (↪ Hilmar Schneider/Marcus Hagedorn/Ashok Kaul/Tim Mennel, Reform der Arbeitslosenversicherung. Benchmarking Deutschland Aktuell, published by the Bertelsmann Foundation, Gütersloh 2004).

### Learning from Abroad? Pros and Cons of Different Reform Options

Supported by a large number of empirical studies, the unemployment insurance in particular suffers from a general problem faced by insurances: The provision of insurance benefits increases the probability and the size of claims (moral hazard). Therefore an important issue is whether the task of the statutory unemployment insurance - protection against loss of income and consumption in the case of unemployment - could as well be performed by individual provision or private insurance



Schneider, Hilmar  
Hagedorn, Marcus  
Kaul, Ashok  
Mennel, Tim  
**Reform der  
Arbeitslosenversicherung**  
Bertelsmann Stiftung, Gütersloh 2004  
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### >> New Layout

For more than six years now, the IZA Compact Newsletter provides up-to-date information on the institute's activities to a growing subscriber base around the world. We believe this is long enough to warrant a redesign of our layout. Any feedback you may have on the new look is more than welcome!

and credit markets. This would, however, involve considerable risks. Individual provision could indeed solve the moral hazard problem, but only at the cost of new inefficiencies caused by the need to build up individual savings and keep them accessible at all times (“precautionary saving”). These resources would not be available for private consumption, which would further aggravate the consumer reluctance currently witnessed in Germany. At the same time, the imperfection of credit markets and the “failure” of insurance markets (adverse selection) serve as justification for the existence of an statutory unemployment insurance.

In order to reduce moral hazard for job seekers, individual provision could be strengthened by introducing personal insurance accounts within the scope of the unemployment insurance system. The contributions by employees would then be credited to their personal insurance account. When a worker becomes unemployed, the insurance benefits would be deducted from his personal account. Ultimately, however, this system as applied e.g. by Chile under different circumstances (IZA Compact, February/March 2004) would essentially mean abandoning the principle of solidarity insurance.

A substantial problem arises in the system of insurance accounts when the account coverage is below the level of benefit claims. Even though this issue could be resolved by making a state insurance step in to cover the resulting debt, this would again call the positive impact of this incentive mechanism into question. While it would also be conceivable to use mortgages on individual retirement accounts, this would shift the entire risk of income loss to the individual and could lead to major losses in old-age provision. When combined with pension claims, personal insurance accounts would thus contain no guarantee of a minimum level of benefits. Against this background, an implementation of this model cannot seriously be considered for Germany.

The current system of unemployment insurance is also prone to criticism in other respects. It provides massive incentives for firms to use temporary layoffs at the expense of society to compensate for temporary demand shocks. This leads to the question whether firms should bear a fair share of the arising costs by paying unemployment insurance contributions depending on their firing behavior (experience rating). This sort of arrangement has proven effective in reducing temporary layoffs in the United States.

Despite recent changes, Germany’s dismissal protection legislation still serves as a functional equivalent for preventing temporary layoffs. Adopting a system of experience rating based on the U.S. model would unnecessarily add to the existing dismissal protection and possibly have a counterproductive effect. Moreover, experience rating could make firms even more reluctant in their hiring behavior. It would also tend to aggravate economic crises because firms which incur operating losses in periods of underutilized production capacities would additionally be charged above-average unemployment insurance contributions. An introduction of experience rating in Germany therefore does not seem feasible under the current institutional framework. To achieve positive effects, dismissal protection would need to be reduced simultaneously. But the overall economic effect of such an approach would be questionable (IZA Compact, January 2005).

The instrument of a wage insurance is another possible element in the set of reform options. It is especially targeted at the long-term unemployed. Individuals in this group mostly receive job offers for which the wage level is distinctly below the level achieved in previous jobs. In this case, the willingness to accept a job offer decreases substantially. The wage insurance would now step in to provide a greater incentive to accept such a job offer. It would temporarily compensate for part of the wage difference to the previous, better paid job. This sort of benefit must be distinguished from regular insurance benefits available for shorter unemployment spells. A wage insurance exists in the United States,

Canada, Switzerland, and to some extent even in Germany. Empirical studies show that it can effectively complement the unemployment insurance even though critics point out that it could undermine flexibility and offer incentives for abuse.

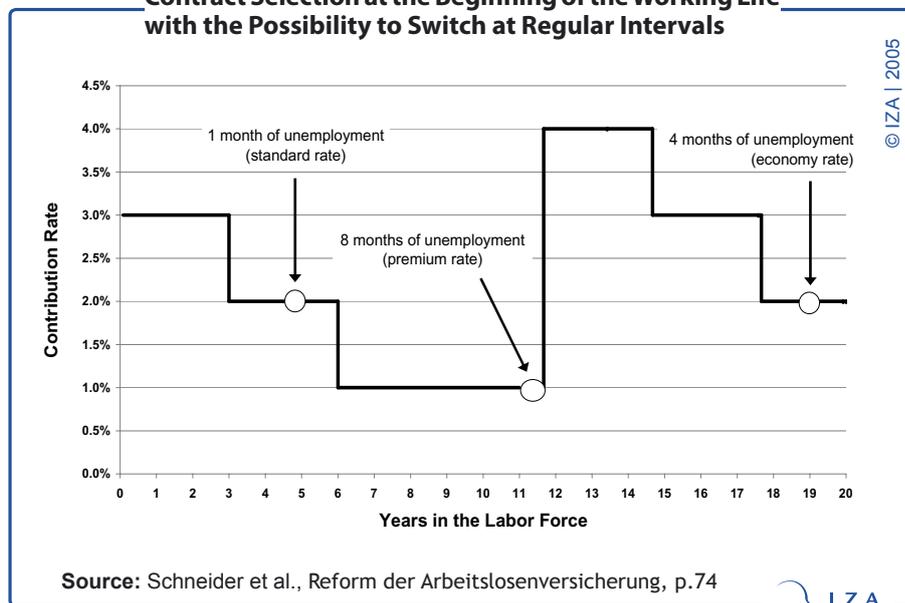
But would a fundamental reform of the entire system not be superior to the constructions described above? There are a number of proposals which largely center on the concept of dynamic insurance contracts. For lack of practical experience with such models, the analysis relies on simulation models of optimal unemployment insurance. But the results are clear enough to suggest a cost-effective insurance solution with the largest possible benefits.

**Basic Principles of the IZA Reform Proposal**

Optimal unemployment insurance rests on two pillars - a solidary insurance component and individual provision through saving. It must not only address the tradeoff between these two components (foregone consumption due to precautionary saving vs. limited benefit levels to achieve shorter unemployment spells), but also account for the heterogeneity of employees. On the basis of individual wealth, reemployment prospects, and risk aversion, it must be possible to shift the weight of individual provision towards solidary insurance and vice versa.

A single insurance contract with a guaranteed wage replacement rate, as currently existing in Germany, naturally fails to meet these requirements. To achieve an optimal cost-benefit allocation, the

**Contract Selection at the Beginning of the Working Life with the Possibility to Switch at Regular Intervals**



statutory unemployment insurance should include optional benefits allowing workers to choose the weight of the solidary component themselves according to their individual preferences (principle of self-selection). The unemployment benefits should be staggered over the claims period because optional and decreasing benefits create job search incentives. Benefit payment schemes with waiting periods can provide adequate insurance for high-income employees with a large extent of individual provision. The unemployment insurance contributions depend directly on the individually selected insurance profile, i.e. premiums are more expensive for optional benefits that provide better coverage but reduce search incentives.

Based on these considerations, the IZA reform proposal contains the following core elements:

- Allowing a variety of insurance contracts and pricing options
- Taking personal income levels into account when determining benefit options
- Strengthening individual provision in the form of saving.

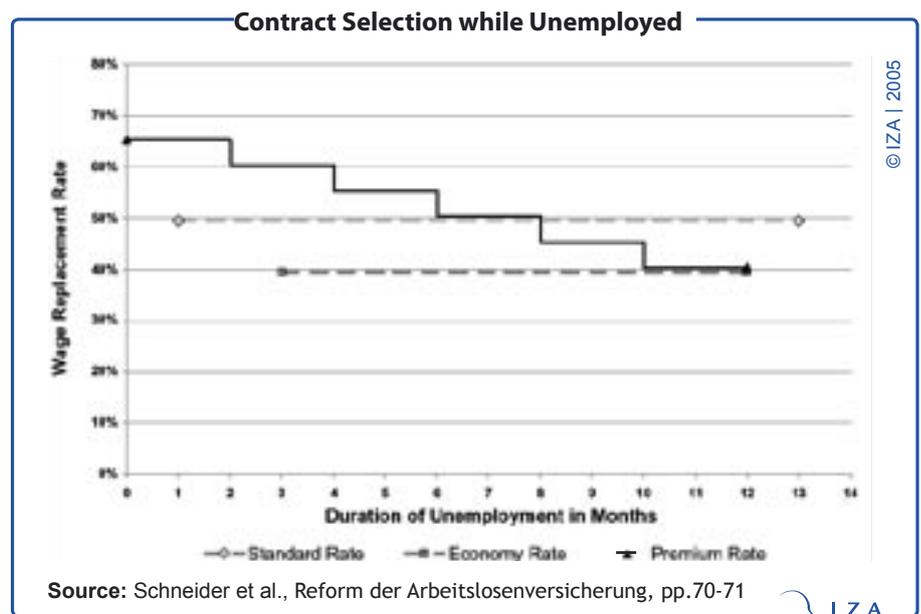
According to this concept, each employee selects an insurance contract from a set of options. Initially, there are two basic alternatives: First, at the beginning of his working life, the employee can choose an insurance contract with guaranteed benefit payments in the case of unemployment (ex ante pricing). More generous benefits require higher insurance contributions. If no claims are filed over a longer period, the contributions are partially refunded. At predefined terms, the contract can be modified or replaced with a different benefit payment scheme.

The second alternative (ex post pricing) is modeled after a car insurance based on different contribution scales. In this case, claimed benefits will result in higher contributions while a no-claims bonus is awarded if the insurance remains unused. When damage (unemployment) occurs, the policyholder can choose the benefit payment scheme that offers the best possible coverage under the individual circumstances. Upon re-entry into employment, the reclassification into a new contribution scale depends on the selected contract (higher scale for broader coverage) and the duration of unemployment (higher scale for longer spell).

The contract design should also include the aspect of human capital accumulation. This means, for instance, that insurance benefits should take participation in effective training programs into account. To make training more attractive, participation should be rewarded with higher benefits. However, at the end of the training program, benefit payments must consequently decrease more strongly to provide an additional search incentive and to account for the improved labor market prospects of the program participant. The same should apply to the incentives set by the pricing of contributions.

The contract design must be tailored to the income bracket of a worker. For low-wage earners, a decrease in the level of benefits makes no sense as benefit payments would fall below the level of social welfare benefits. Contributions must also be priced in a way not to undermine the reemployment incentives.

For both insurance contract schemes, the policyholder's claims record must be the main determinant of the level of contributions. Those who claim no benefits for a longer period of time must be rewarded with lower contributions. While this principle plays a key role in most private insurances, it has not yet found its way into the social security system. From an actuarial perspective, there is no good reason for confining this approach to private insurance contracts. The only problem arises when unemployed workers withdraw from the labor market entirely. The unemployment insurance lacks an instrument to penalize this behavior. A possible solution would be to transfer the sanctioning mechanism in an adequate manner to future pension claims. Under the current system, the opposite is the case: In addition to immediate benefit payments, an individual registered as unemployed continues to secure pension claims although an interest in reemployment may not even exist.



### Potential Cost Reduction by Introducing Flexible Pricing Options

Model	Relative Cost
Maximum entitlement period of 18 months; typical wage replacement rate of 65% (reference scenario)	100
Maximum entitlement period of 12 months; typical wage replacement rate of 65% (entitlement period effect)	84
Flexible pricing options, not accounting for endogenous behavioral changes (selection effect)	57
Flexible pricing options, additionally accounting for endogenous behavioral changes (behavioral effect)	50

Source: Schneider et al., Reform der Arbeitslosenversicherung, p.80

### The Different Pricing Options of the IZA Reform Proposal

According to the IZA proposal, employees could not only choose between different contract schemes, but also between various pricing options (↪ [Figure: Contract Selection, p. 2](#)). They would first be offered a “standard rate,” which contains a one-month waiting period before benefit receipt and a wage replacement rate of 50% awarded for a maximum of twelve months. The standard rate is complemented by two optional rates. The “premium rate” also covers the first twelve months of unemployment, but without a waiting period. The payment scheme, however, is fundamentally different: The wage replacement rate is 65% during the first month and decreases by 5% every two months. Accordingly, during the last two months of coverage the replacement rate would fall to 40% of previous income. The second option, the “economy rate”, is designed for high-income earners, who can draw largely on their private savings in the event of unemployment. As this rate includes a three-month waiting period and a wage replacement rate of 40% for a maximum of nine months, it provides strong incentives for quick re-entry into employment. Low-income earners are not eligible for the “economy rate” because a wage replacement rate of 40% could make them fall below the level of social welfare benefits.

The size of contributions depends on the level of insurance coverage provided by the selected contract scheme and the selected pricing option (↪ [Figure: Contract Selection while Unemployed, p. 3](#)).

Contribution rates for the different pricing options amount to 1% of gross wages for the economy rate, 3% for the standard rate and 5% for the premium rate. Incentives are set according to the model of private health insurance. At the beginning of his working life, the employee selects one of the pricing options and pays the

required contributions. The contribution rate is unaffected by the policyholder’s claims record. If no claims are filed for a longer period of time, contributions are partially refunded. While employed, the policyholder may switch to a different contract scheme every two years. The contribution rate will be adjusted accordingly.

This option allows each policyholder to start his working life with an unemployment insurance for a fixed contribution rate of 3% of gross wages. Once contributions have been paid for a predefined period, the policyholder is entitled to benefit claims in the event of unemployment. When the policyholder has been employed over a longer period without claiming benefits, the contribution rate will be lowered. Reductions by one percentage point take place in three-year intervals until the minimum rate of 1% is reached.

In the event of unemployment, the policyholder registers at the local job center and at the same time selects one of the three benefit payment schemes. The advantage of this concept is that the amount of available private savings and the individual reemployment prospects can best be assessed at the time of unemployment. Depending on the duration of the unemployment spell and the selected payment scheme, the contribution rate is raised accordingly upon reemployment. The maximum contribution rate is 5%. There are thus a total of five contribution scales ranging from 1 to 5%.

#### Simulation Results: Insurance Options Lead to Enormous Cost Reductions

The IZA study uses a simulation technique to calculate the amount of cost reduction that can be achieved in relation to the current system of unemployment insurance. The current system is presumed to yield a typical wage replacement rate of 65% for a maximum of 18 months. The

benchmark of 100 was assigned to the costs generated by this system. When the benefit entitlement period is reduced from 18 to 12 months, the same wage replacement rate and identical search behavior would lead to a cost reduction of 16% (↪ [Table: Potential Cost Reduction, p. 3](#)). This scenario was used as a reference for the models with flexible pricing options. In a third step, the costs of the models with different pricing options were calculated assuming an unchanged search behavior. A comparison with the results of the previous step makes it possible to assess the self-selection effect, which for these models amounts to approximately 27 percentage points. As simulated in a last step, the cost reduction resulting from behavioral changes in terms of higher search intensity achieved by different pricing options accounts for additional 7 percentage points. The selection effect is obviously more significant than the behavioral effect.

All components combined, about 50% of the costs generated in the reference scenario could be saved without even accounting for the positive impact of the reform on labor demand. In sum, it can be stated that a certain minimum level of benefits from unemployment insurance can be achieved at substantially lower costs by replacing uniform rates with flexible pricing options. The effect is mainly due to a reduction of moral hazard. The selection effect, i.e. the lower extent of redistribution between different risk classes, plays the key role in this context. An additional effect is caused by changes in individual search behavior as a result of the chosen benefit payment scheme. An implementation of this reform proposal would lead to considerably shorter unemployment spells for a large share of the unemployed. This would be an important contribution to the necessary reorganization of the German labor market.

Klaus F. Zimmermann is Ranked **Top Ten in Research and Media Presence**

## IZA Director Achieves Top Ranking among German Economists

In a recent ranking by the renowned German daily *Handelsblatt*, IZA Director *Klaus F. Zimmermann* is the only German economist to be listed among the Top 10 in terms of both research (5th) and media presence (4th). Only three other economists receive a Top 25 ranking in both categories. Zimmermann deplors this obvious dualism between research-

ers and communicators: “An economist who engages in policy advice should also have a strong position in research.”

The ranking results underscore IZA’s successful strategy to conduct high-quality scientific research while at the same time providing effective policy advice. The *Handelsblatt* article also highlights

the role of Bonn as a center of academic excellence. Apart from the highly productive economics faculty at the University of Bonn, the Bonn Graduate School of Economics (BGSE), with which IZA cooperates closely, is lauded as a pioneer in graduate education.

↪ <http://www.iza.org/ranking>

## IZA Policy Fellows New Labor Market Network Established

IZA has established an exclusive circle of "Policy Fellows", with which the institute cooperates in a unique way. This network of influential representatives from business, politics, society, and the media complements the academic network of IZA Research Fellows. By cooperating actively with these decision-makers beyond purely scientific matters, IZA aims at satisfying the increasing demand for

policy advice and improving the communication of these services to the public. IZA is the first German research institute to implement this innovative approach to an enhanced intellectual exchange between academic research and political practice. The inaugural meeting of this network was held in Berlin on April 28-29, 2005. An opening speech by *Josef Ackermann*, CEO of Deutsche Bank Group,

was followed by a lively discussion on the future potential of the IZA Policy Fellows. The network is coordinated by *Florian Gerster* (IZA Director for Policy Fellows, former State Minister). IZA Director *Klaus F. Zimmermann* regards this new IZA initiative as "an important step towards a successful process of labor market policy reform that accounts for both economic and social criteria."

### The founding members of the IZA Policy Fellow network include:

*Dr. Stephan Articus* (Executive Director, German Association of Cities); *Dr. Norbert Bense* (Member of the Board, Deutsche Bahn AG); *Prof. Dr. Friedrich Buttler* (Regional Director, International Labour Organization); *Dr. Kurt Demmer* (Director, IKB Deutsche Industriebank AG); *Dr. Achim Dercks* (Deputy General Manager, DIHK Berlin); *Dr. Michael Domitra* (Head of the Manager Circle, Friedrich Ebert Foundation); *Dr. Christiane Ebel-Gabriel* (Secretary-General, German Rectors' Conference); *Günter Ederer* (Economics Writer, TV Writer and Film Producer); *Dr. Nico Fickinger* (Economics Editor, FAZ); *Georg Fischer* (Head of the Social Protection/Integration Unit, European Commission); *Olaf Gersemann* (Chief Foreign Correspondent, Financial Times Deutschland); *Katrin Göring-Eckardt* (MP and Chair of the Green Party Faction); *Prof. Stanisława Golinowska*, PhD (Director, Institute of Public Health, University of Krakow); *Johann Hahlen* (President, Federal Statistical Office Germany); *Dr. Norbert Hoekstra* (Head of Division, Federal Ministry of Finance); *Dr. Karen Horn* (Economics Editor, FAZ); *Cherno Jobatey* (Anchorman, ZDF Morgenmagazin); *Christoph Kannengießer* (Deputy Secretary-General, Konrad Adenauer Foundation); *Dr. Markus Klimmer* (Principal, Public Sector Practice, McKinsey&Company German Office); *Dr. Heinz Klinkhammer* (Member of the Board, Deutsche Telekom AG); *Prof. Dr. Dieter Lenzen* (President, Free University of Berlin); *Prof. Dr. Miriam Meckel* (Permanent Undersecretary for Europe, International Affairs and Media, NRW); *Friedrich Merz* (MP, CDU/CSU Faction); *Dr. Horst Neumann* (Member of the Board, AUDI AG); *Dirk Niebel* (MP and Secretary-General, FDP Faction); *Nikolaus Piper* (Chief Economics Editor, Süddeutsche Zeitung); *Prof. Detlef W. Prinz* (Proprietor, Prinz Medien); *Klaus Regling* (Director General for Economic and Financial Affairs, European Commission); *Thomas Rommerskirchen* (CEO, Medienverlag Rommerskirchen GmbH); *Dr. Ulrich Roppel* (Director, Federal Miners' Insurance); *Prof. Dr. Bert Rürup* (Darmstadt University of Technology); *Dr. Annette Schavan* (Minister of Culture, Youth and Sports, Baden-Württemberg); *Dr. Wilhelm Schäffer* (Head of Department, Ministry of Economics and Labor, NRW); *Walter Scheurle* (Member of the Board, Deutsche Post World Net); *Hanns-Eberhard Schleyer* (Secretary-General, German Confederation of Skilled Crafts); *Hubertus Schmoldt* (Chairman, IG BCE Mining, Chemical and Energy Industrial Union); *Dieter Stein* (Managing Partner, Ray & Berndtson); *Prof. Dr. Thomas Straubhaar* (President, HWWA Hamburg Institute of International Economics); *Heinrich Tiemann* (Undersecretary, Federal Ministry of Health and Social Security); *Prof. Dr. Norbert Walter* (Chief Economist, Deutsche Bank Group); *Claus Wisser* (Founder and CEO, WISAG Service Holding); *Dr. Monika Wulf-Mathies* (Head of the Policy and Environment Corporate Department, Deutsche Post World Net); *Walter Wüllenweber* (Contributor, Stern Magazine); *Christian Zahn* (Member of the Board, ver.di United Service Union)

### New IZA Books on Migration

## Immigration and Labor Market A Comparison of Denmark and Germany

Despite some progress in recent years, the integration of immigrants from non-Western countries in the EU labor markets still causes significant problems. This is one of the findings from a comparative research project on labor market integration of foreigners in Germany and Denmark based on new representative surveys among immigrants in both countries. Headed by IZA Director *Klaus F. Zimmermann* and *Torben Tranæs* (Research Director, The Rockwool Foundation Research Unit/RFF,

Copenhagen), an international group of researchers analyzed questions of education, training, employment and income prospects as well as the probability of self-employment among migrants and the socio-economic balance of tax revenue generated by and transfer payments awarded to immigrants. The research team included *Marie Louise Schultz-Nielsen* (RFF), *Claus Larsen* (RFF), *Niels-Kenneth Nielsen* (RFF), *Amelie Constant* (IZA), *Poul Christian Matthiessen* (University of Copenhagen), *Thomas Bauer*

(Ruhr University Bochum), *Horst Entorf* (Technical University Darmstadt), *Eskil Wadensjö* (Swedish Institute for Social Research/SOFI, Stockholm) und *Christer Gerdes* (SOFI). Their studies were mainly based on the Rockwool Foundation Migration Surveys (RFMS) for Germany and Denmark which allowed new insights into labor market integration aspects of immigrants. The research findings were published in two recent books: Edited by *Torben Tranæs* and *Klaus F. Zimmermann*, the English volume "Migrants, Work and

the Welfare State” provides a complete account of the research findings. The German volume “Zuwanderung und Arbeitsmarkt” was authored by *Klaus F. Zimmermann* and *Holger Hinte* (IZA) and offers a more policy-oriented perspective, including a comprehensive assessment of the new German immigration act as well as recommendations for a future design of active immigration and integration policies.

The following overview summarizes the most important findings of both studies.

### Migration and Immigration Policy

A look at Germany’s and Denmark’s migration history reveals that immigration occurred during similar time periods. However, due to the more active recruitment of guestworkers, immigrants in Germany clearly show longer average stays and a higher average age.

Overall, the share of non-Western immigrants in Denmark is higher while the absolute amount of immigration is by far smaller than in Germany. At about five percent, the share of foreigners in the entire Danish population barely amounts to half the German level. Yet both countries’ instruments of immigration policy exhibit similarities although citizenship legislation has recently been tightened in Denmark while Germany has carefully introduced a more liberal policy.

### Education and Training

The analysis of schooling and vocational training outcomes of immigrants exemplifies the complexity of mechanisms that affect decisions about education and training as well as their results. The conditions for success in Germany and Denmark cannot easily be identified. Nonetheless, a key finding is that immigrants of the second generation (although more successful than immigrants of the first generation in either country) significantly lag behind the native population in terms of education and training. Especially in Germany this gap is closing very slowly.

### Occupation, Self-Employment and Earnings

Over time, Germany has been more successful at integrating non-Western immigrants in the labor market. This is indicated by higher employment rates among this group when compared to the respective country’s total employment rate (↪ [Figure: Employment Rates](#)) While Denmark’s employment rate is

substantially above the European average, the rate for non-Western immigrants is distinctly below average. That this discrepancy is much greater than in Germany is partly due to the Danish system of unemployment benefits, which provides low-income earners with a higher wage replacement rate, thus effectively reducing financial incentives to take up work.

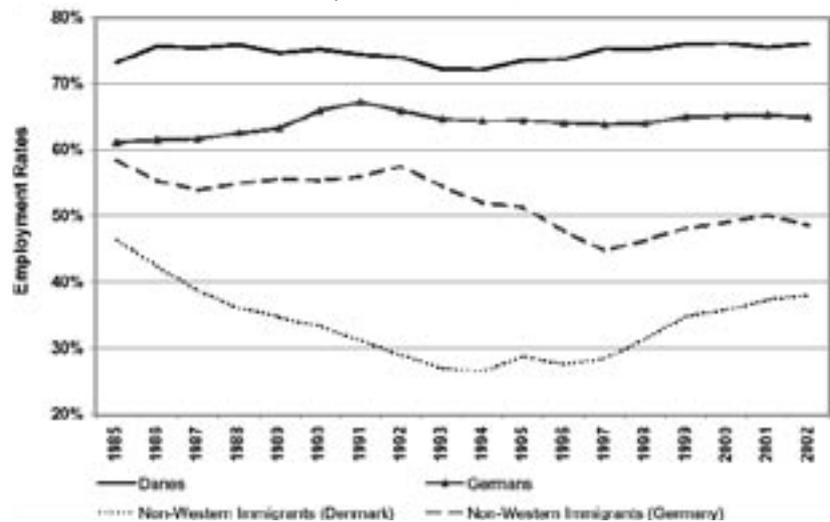
What both countries have in common is that the employment rate among immigrants has decreased over the longer term and ranges significantly below the level for natives. This observation may be attributed to the changing composition of immigrant groups over time. Since later cohorts of immigrants largely consisted of family members and asylum seekers, they were less likely to participate in the labor market than the earlier generation of

guestworkers. But massive legal restrictions, which were unnecessary from an economic point of view, certainly added to the problem as they impeded the labor market participation of immigrants.

Calculations of the income gaps between economic activity and unemployment show that employment does not pay off as much in Denmark as in Germany. The share of immigrants who earned less than an additional 100 euros from gainful employment is between 13 and 15 percent in Germany but ranges from 33 to 41 percent in Denmark. This apparent lack of work incentives is in line with the observation that unemployed immigrants often choose not to participate in the labor market.

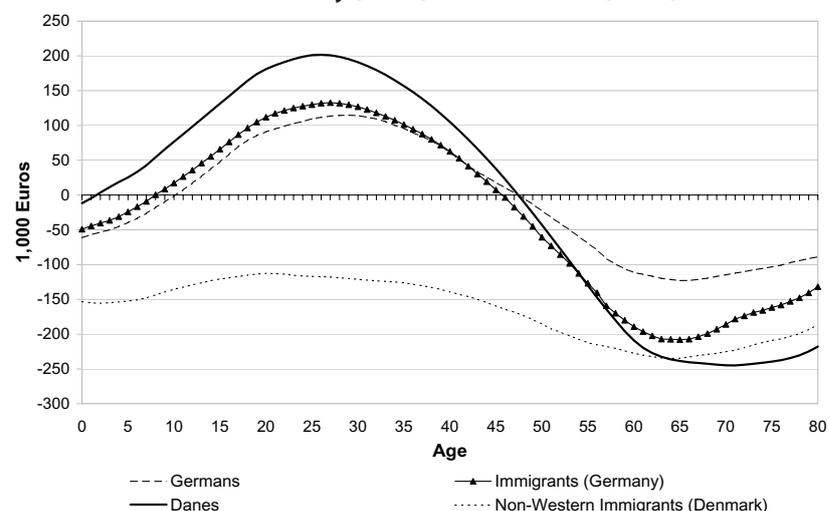
An investigation of the income determinants for non-Western immigrants in both countries reveals large gender differences

**Employment Rates among Non-Western Immigrants (16-66 years) in Germany and Denmark, 1985 - 2002**



Source: Zimmermann/Hinte, *Zuwanderung und Arbeitsmarkt*, p. 106

**Generational Accounts of Immigrants and Natives for Germany (1996) and Denmark (2000)**



Source: Zimmermann/Hinte, *Zuwanderung und Arbeitsmarkt*, pp. 201, 214

as well as an advantage for naturalized citizens. Human capital investments and language acquisition carry wage premiums in both countries. Additional work experience is likewise rewarded in Germany but does not yield notable wage increases in Denmark. Immigrants in Denmark nonetheless have a significant earnings advantage from the beginning, to which their German counterparts cannot catch up during their entire working life. Ultimately, however, this merely reflects the considerably higher level of gross wages in Denmark. Moreover, counterfactual experiments demonstrate that Denmark is better at stimulating early labor market success among qualified immigrants.

But there is a downside to this: owing to its incentive structure, the Danish welfare system selects immigrants with above-average productivity, while those who fail to achieve incomes exceeding social transfer payments choose not to participate in the labor market or have poor employment prospects.

Potential improvements of labor market integration can be seen in the promotion of self-employment among immigrants. In this respect, Germany - and Denmark even more so - has a lot of catching up to do. Progress in this area is likely to yield enormous economic effects and could be reinforced by a simpler legal framework.

### Socio-Economic Balance

The social security systems in Germany and Denmark follow different rules. The Danish unemployment insurance is based on a voluntary, largely tax-financed system. By offering low-income earners a wage replacement rate of up to 90 percent of previous income, it creates few incentives to seek employment in this segment. In contrast, the German pay-as-you-go system is meant purely as an insurance against the event of loss. The level of benefits accounts for employment history and age. As a result, the entitlement periods tend to be shorter for immigrants because of their younger average age and despite their higher average unemployment rate. Now that unemployment insurance benefits and social welfare benefits have been merged to form the new "Arbeitslosengeld II", low-income migrants in Germany are more disadvantaged than ever compared to those in Denmark if they choose not to work.

The focus on gainful employment of all essential components of the German

social security system - apart from social welfare - is a potential obstacle to the entry of immigrants. In Denmark, the favorable treatment of low-income groups, even in pension schemes, and the voluntary nature of unemployment insurance lead to a higher share of welfare recipients.

The fiscal impact of immigration in Germany is positive. The average per capita contribution to fiscal funding by foreign families whose head of household was of Turkish, Yugoslavian, Greek, Spanish or Italian origin amounted to 2,100 euros in 1996 - just slightly below the contribution of 2,700 euros by natives. Creating a generational account by connecting age-specific net tax payments with statistical life expectancy reveals the economic gain brought about by immigration: taking the average across all age groups, the net funding contributions of immigrants in Germany add up to a present value of 35,000 euros per capita. In contrast, the average German native receives a net transfer of 14,000 euros due to a much less favorable age pattern.

The situation in Denmark is different: in the year 2000 the fiscal position of immigrants was marked by an average per capita funding contribution of 4,000 euros for the Danish population, compared to a per capita net transfer receipt of 1,400 euros by the immigrant population. This discrepancy may be attributed to the more generous Danish social security system and the relatively low labor force participation, but also to more instances of benefit receipt among immigrants. Correspondingly, the generational account of immigrants shows a net transfer receipt of 93,000 euros while the Danish native makes net tax payments of 16,600 euros. If only immigrants of non-Western origin are taken into account, the results are even more alarming. Redistribution of income to their benefit amounts to

142,900 for the year 2000, while Western migrants contribute 39,700 euros and thus even exceed the balance of native Danes (↪ [Figure: Generational Accounts](#), p. 6).

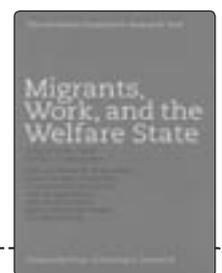
### Outlook

The demand for low-skilled labor will decrease due to structural change, increasing internationalization of product and financial markets, and the growing significance of human capital in large parts of the economy. This development carries the risk of setbacks to the economic integration of immigrants. Policymakers and society are faced with major challenges: curbing further immigration of the low-skilled will be inevitable while efforts to attract high-skilled immigrants must be increased to deal with the shortage of native personnel in this area. The results of the studies clearly speak in favor of a migration policy predominantly based on economic considerations. The findings suggest that in both countries deficits in integration as well as language acquisition and training coincide with labor market imperfections. In this respect, migrants suffer rather than profit from the wrong incentives.

Policies to revive the low-wage labor market, which have long been discussed and partially implemented in both countries, are a way to improve the labor market outcome for non-Western immigrants. But this would require changes in the current practice of issuing work permits to migrants. Strategies to enhance human capital should focus on language acquisition. This has increasingly been done in Denmark in recent years. A consistent policy of "actively supporting and demanding", which applies stronger incentives (and sanctions) to promote participation in language and integration courses, would also be beneficial to social integration in both countries.



Zimmermann, Klaus F.  
Hinte, Holger  
**Zuwanderung und Arbeitsmarkt**  
Springer, Berlin 2004  
322 Pages  
ISBN: 354023179X



Tranaes, Torben  
Zimmermann, Klaus F. (Eds.)  
**Migrants, Work, and the Welfare State**  
Univ. Pr. of S. Denmark, Odense 2005  
436 Pages  
ISBN: 8778387744

# Human Capital

## An “Unword” of Great Economic Relevance

The term “human capital” has recently been elected by a jury of eminent German linguists the “Unword of the Year” (roughly comparable to the former *American Doublespeak Award*). According to the jury, the term is increasingly applied to spheres of life that are not immediately related to economic issues. Therefore, the linguists contended, the term is used to degrade workers - and human beings in general - to purely economic subjects.

This ignorant view reflects a widespread denial of fundamental economic processes. It is a slap in the face of those who put a lot of effort into finding solutions to get the German economy back on track. We must instead try to increase public awareness of the importance of human capital (i.e. the knowledge, qualifications and abilities of individuals) for Germany’s future. Engaging in this sort of word-bashing only diverts attention from this necessary task.

A number of scientific studies analyze the influence of human capital on the employment prospects in today’s labor markets. Two recent IZA Discussion Papers, by *Eduardo Melero* (University Pompeu Fabra and IZA) and by *John T. Addison* (University of South Carolina and IZA) joint with *Clive R. Belfield* (Columbia University), investigate the effects of training on career progress, earnings of male and female workers, and establishment performance in union settings

J. Eddison/C. Belfield, Unions, Training and Firm Performance: Evidence from the British Workplace Employee Relations Survey, IZA Discussion Paper No. 1264; E. Melero, Evidence on Training and Career Paths: Human Capital, Information, and Incentives, IZA Discussion Paper No. 1377).

### The Value of Human Capital Theoretical Considerations

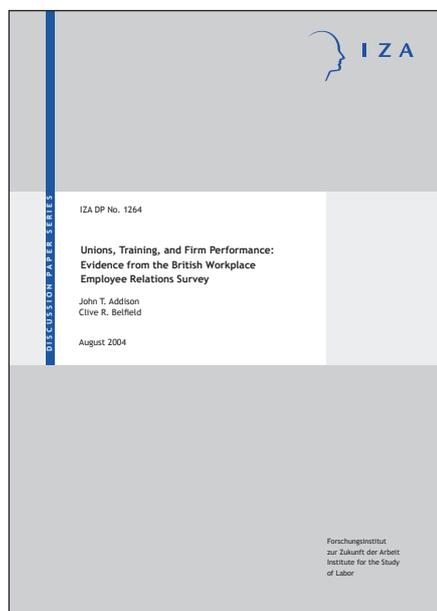
Melero uses twelve waves of the British Household Panel Survey (BHPS) from 1991 to 2002 to investigate how job-related training affects workers’ chances of obtaining a career improvement, either in form of a promotion or by leaving for a better job opportunity, and how training and promotion interact in boosting wage growth. The first question is essential for evaluating to what extent training provides workers with non-pecuniary rewards in the form of higher probabilities of a position upgrade. The second issue is important in order to distinguish which part of a wage increase is due to training and which to promotion when they occur together and to what extent they complement each other. Analyzing both questions provides a framework to investigate the differences between the shapes of men’s and women’s career paths. Interestingly, important differences between male and female workers are found in the way that training affects career moves and that training and promotion affect wage growth. Careers of

men and women seem to fit in different theoretical paradigms.

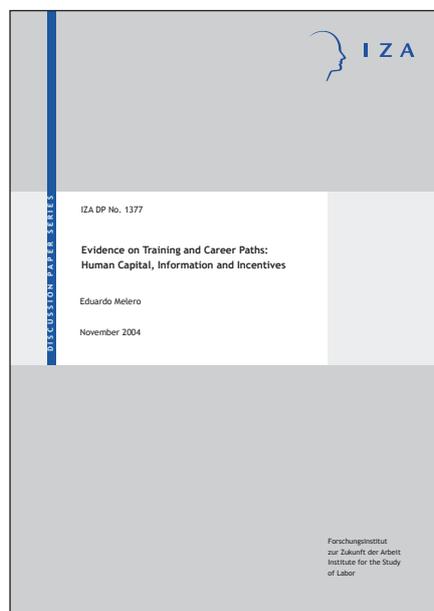
Addison and Belfield use a combination of workplace and matched employee-workplace data from the British 1998 Workplace Employee Relations Survey (WERS98) to examine the impact of unions and firm-provided training on establishment performance. While the productivity of workplace training and union impact on firm performance are two of the more controversial issues in applied labor economics, the potential for greater training in union regimes (facilitated in part by reduced voluntary turnover) and the issue of its productivity are no less valid topics of empirical inquiry. The authors consider the determinants of training to include unionism and then examine the impact of unions and training on earnings, labor productivity, and financial performance.

It is possible to identify some “broad” groups of theories regarding task assignment and career paths of workers within firms. The first group consists of theories that rely on human capital accumulation and gradual (symmetric) learning by firms of their employees’ abilities. Here promotions may be the natural consequence of the acquisition of skills that are more productive at higher-responsibility jobs, causing workers to receive promotions as soon as their abilities overstep a certain threshold. The second group is made up of theories that consider such learning as asymmetric in favor of initial employers, considering them to have better information about their employees’ abilities than other potential employers. This allows them to pay tenured workers below their current productivity. Also, in the attempt to preserve such private information, employers fail to promote some workers who would be more productive at higher-level jobs. The third group comprises theories that regard promotions as providers of incentives either to make an effort or to obtain specific human capital. According to them, promotion prospects should depend heavily on seniority but also on job-related training measures, as long as they are of a firm-specific kind. Under this regime special emphasis is placed on internal labor markets as jobs are only open to market competition at the lowest levels.

Theoretical approaches dealing with



<ftp://ftp.iza.org/dps/dp1264.pdf>



<ftp://ftp.iza.org/dps/dp1377.pdf>

male/female differences in career evolution and wage growth are usually built upon the assumptions and mechanisms of the above models. By comparing how training and other work-related variables affect promotion chances and wage growth for both genders, the performance of these different approaches can be assessed in the general framework of the British labor market.

Under a union regime a negative effect might be expected if the union premium impairs the ability of employers to finance training, or where seniority rules reduce the worker's incentive to invest in training. Yet there are situations in which unions can stimulate training. Thus, the expression of union voice, underwritten by the wage premium, should cut down on labor turnover and increase the incentive of the employer to invest in firm-specific training because of the longer payback period. Even if employers over-train in response to the union premium and turnover is too low - so that society will not benefit - there is no implication that the productivity of training should on this account be lower in union regimes. In fact, past British work on the determinants of training has generally reported a positive union effect and union recognition is reported to lead to an increased duration of training.

The incidence (and extent) of workplace training is one thing, its productive impact quite another. The traditional

approach in Britain to measuring productivity has been via earnings functions. Although there is an extensive literature on the impact of educational investments, that dealing explicitly with work-related training is less developed. Nevertheless, most studies point to statistically significant positive returns to such training even if few address the interaction between unionism and training.

#### **Do Unions Promote or Impede Human Capital Accumulation?**

Addison and Belfield discover that workers in establishments that bargain with multiple (single) unions have longer (shorter) training spells over the course of a year when compared to plants without union recognition. However, workers in nonunion establishments reported earnings premia for training, which are significantly higher than the premia for workers in union settings.

The productivity of training is mostly confirmed by the authors' findings, and single-table bargaining may even be associated with higher returns to training. Overall, unionization is not beneficial to either productivity or financial performance of establishments. However, the sources of unions' negative effects do not seem to stem from a reduced payoff to training in union regimes.

Both studies find that labor turnover is lower in unionized establishments

because both male and female workers employed in these firms are less willing to quit for a better job. But Melero's work also reveals that unionized firms yield higher chances of internal progress for male workers, especially if they do not belong to the union. The results for women show a similar pattern, although to a smaller and statistically insignificant extent. The career progress of men, however, seems to be more related to internal labor market structures, largely depending on effort and training carried out within the firm, whereas women's careers are more closely related to the value of their human capital. This is shown by the fact that their training with previous employers positively affects their employment with prospective ones in terms of both salary and position. However, workers usually do not have to wait until promotion to benefit from returns to training. This suggests that promotion prospects are not the main incentive to obtain additional skills but rather a consequence of human capital accumulation. Promotions nonetheless significantly increase the wage returns to training for male employees.

These two studies are merely examples of the vast research activities on human capital issues. Rather than being denounced as the "Unword of the Year," human capital should be recognized as one of the key elements shaping the future of labor.

#### IZA Discussion Paper

## **New IZA Study Employee Motivation Suffers from Too Much Control**

Trust in employees may have a strong positive impact on their voluntary performance, while too much control has a strong demotivating effect. These are the findings of a recent study by IZA Research Director *Armin Falk* (also University of Bonn) and *Michael Kosfeld* (University of Zurich) on the "hidden cost of control" (↪ A. Falk/M. Kosfeld, Distrust: The Hidden Cost of Control, IZA Discussion Paper No. 1203).

The study is based on behavioral experiments with 144 Swiss students, who were given the roles of principal and agent (or "boss" and "employee"). They were able to adjust their performance (or control efforts) according to the be-

havior of the other side. The experiment showed that the negative effects of strong control on employee motivation were dominant. Although the presence of extensive control mechanisms can stimulate performance, the employees' motivation and voluntary performance diminished when control was perceived as a sign of distrust. Even a high level of control will probably result in a level of employee performance that could have been achieved by trust as well.

Ultimately, however, there is no perfect solution for employee control. Motivation, of course, also depends on other factors. It is important for the employer to examine the available incentive

mechanisms and to distinguish between "intrinsically motivated" and "opportunistic" employees. For instance, if the employer has only weak incentives at his disposal, it may be better to trust since controlling demotivates the intrinsically motivated employees but only marginally increases the performance of opportunistic employees. As incentives get stronger, however, the disciplining effect will eventually dominate the demotivating effect.

↪ <ftp://ftp.iza.org/dps/dp1203.pdf>



## Guido Westerwelle: Benefits of Change Outweigh the Risks

A record number of invited guests witnessed the 6th IZA Tower Talk on August 19, 2004 at the Post Tower, headquarters of IZA's sponsor Deutsche Post World Net in Bonn. *Guido Westerwelle*, Chairman of the Liberal Democratic Party (FDP), talked about the economic and social impact of EU accession and globalization, focusing on the resulting need for policy reforms.

Germany's future economic success will hinge on people's mental readiness for change, Westerwelle contended. Facing the urgent need for reform, Germans should recognize the benefits of change rather than fearing the potential risks. He warned that the desperate attempt to fend off political, economic and social modernization carries a higher risk than change itself, and that Germany's declining competitiveness calls for the rapid implementation of reforms over the next years.

The FDP politician proposed a four-point plan to initiate the moderniza-

tion process, including (1) a fundamentally revised and simplified tax system to provide new work and investment incentives and to discourage shadow economic activities, (2) the redesign of German labor law to create more flexibility, reduce employment protection, and give priority to firm-level over collective bargaining agreements, (3) intelligent structures to create more individual responsibility in the social security systems, and (4) new education and research policies leading to enhanced autonomy and competition among educational institutions.

Westerwelle also demanded that the welfare state be reorganized to better reflect the basic principles of individual accomplishment, return on investment, and actual need. In the subsequent discussion, Westerwelle leveled harsh criticism at the labor unions for their "less than constructive" role in the reform process.



IZA Tower Talk

**Dr. Guido Westerwelle** has been Chairman of the FDP (Liberal Democratic Party) since May 2001. Since February 1996, he has been a member of the German Bundestag. Westerwelle is also a member of the Board of Trustees of the Theodor Heuss Foundation. Between December 1994 and 2001 he was Secretary-General of the FDP. He joined the FDP in 1980 and has been practicing law in Bonn since 1991.

## Hans Barbier: Correcting the Major Flaw in Economic Policy

Now head of the Ludwig Erhard Foundation, the former economics editor of the FAZ newspaper remains as poignant a commentator as ever: "Germans don't work enough", claimed *Hans Barbier* at the 7th IZA Tower Talk, which took place at the Post Tower in Bonn on October 12, 2004. Barbier demanded that the upcoming labor market reforms should raise the value of work again by providing effective incentive mechanisms. A society of free citizens acting upon their individual initiative must fulfill its responsibility to support those in need, he said. But it should not de facto subsidize those who occupy a "grey area between unemployment insurance and welfare receipt," i.e. those who choose - in a perfectly rational way, given the current system - not to work even though they could.

According to Barbier, the "Hartz IV" reforms, which bundle unemployment and welfare benefits together, finally aim at correcting the major flaw in economic

policymaking. In order to increase cost-consciousness, he suggested that the old unemployment insurance system be replaced over the medium term with a mandatory insurance against basic risks, complemented by an additional private insurance. This view was shared by *Hilmar Schneider*, IZA Director of Labor Policy, who also agreed with Barbier that the misguided trend towards early retirement must be reversed. At the same time, demographic change requires a substantial redesign of old-age insurance and healthcare. "We have to learn again how to save for retirement", argued Barbier in favor of a capital-funded pension scheme. At the same time he called for the introduction of flat-rate "health premiums" in combination with tax-financed subsidies for the disadvantaged. "In reality our system of 'solidarity' has long lost touch with the true meaning of solidarity," Barbier contended.



IZA Tower Talk

**Dr. Hans D. Barbier** has been Chairman of the Ludwig Erhard Foundation since 2002. He was previously chief economics editor at the FAZ newspaper. Barbier was awarded the Bernhard Harms Medal of the Kiel Institute for World Economics, the Ludwig Erhard Prize for Economic Journalism and the Alexander Rüstow Prize of the Action Group Social Market Economy (ASM).

## Peer Steinbrück: Germany Is Not a Bazaar Economy

At the 8th IZA Tower Talk on January 12, 2005, the Northrhine-Westphalian Minister President *Peer Steinbrück* gave a speech on the topic "Between welfare state and bazaar economy: The future of social labor market policy in Germany".

He underscored the need to vigorously pursue the "Hartz" reforms, calling them the most far-reaching labor market and social policy reforms in post-war Germany. But he also warned not to expect short-term employment effects from these programs. Steinbrück harshly criticized the tendency of the German public to resort to the "vale of tears" and called for more optimism in modernizing society and economy.

Educational policy is at the core of Steinbrück's reform proposals. The goal should be to counter the demographic decline by tapping unused human capital potential, such as the group of high-skilled young mothers, through better childcare facilities.

Steinbrück was avidly opposed to the "bazaar economy" theory, which holds that Germany suffers from globalization as the country's export balance increasingly contains assembled products for which parts were previously imported from low-wage countries. He pointed at Germany's distinctly positive trade balance with Eastern Europe. According to Steinbrück, there is no reason to be pessimistic as Germany stands to profit from a more intensive division of labor, particularly with the new EU member countries.

In the subsequent discussion, the Minister President rejected the call for additional tax breaks. Instead he pleaded for using a larger share of tax revenues to pay for social security in order to take some of the financial burden off the labor market. Steinbrück explicitly lauded the IZA research activities and the institute's contribution to the scientific evaluation of the "Hartz" reforms.



**Peer Steinbrück** was Minister President of North-Rhine Westphalia between November 2002 and June 2005. Since 2000 he has been member of the state parliament (Landtag). He was previously a State Minister in the areas of Commerce, Transportation, and Finance. Steinbrück joined the Social Democratic Party (SPD) in 1969 and the German Metalworkers Trade Union (IG Metall) in 1995.

## Herbert Henzler: Germany – From Champion to Bench Player?

The renowned political advisor and former head of McKinsey Germany, *Herbert Henzler*, spoke at the 9th IZA Tower Talk on June 7, 2005. His presentation dealt with the long-term prospects of the German economy, which Henzler sees as threatened by the widespread illusion about Germany's actual position in global competition. The creeping loss of market power in pharmaceuticals and telecommunications reveals that the title of "world champion in exports" hardly reflects reality.

At the same time, public awareness of how strongly Germany's economic prospects are influenced by exogenous factors is still underdeveloped, claimed Henzler. The international integration of financial markets cannot be slowed down, nor can Germany forever evade the need for deregulation in the face of global competition. Given the rapid progress in information and production technology, today's firms must continually assert their productivity advantages.

In this context, Henzler criticized the lack of an entrepreneurial culture in Germany: The share of self-employed in the workforce has continuously fallen for the past 25 years while the share of government employees has risen. Apparently, many people are "avidly opposed" to the idea of entrepreneurship, partly because the German system of higher education is too disconnected from entrepreneurial practice.

Henzler's proposal consisted of five components: (1) a complete reorganization of the social security system, (2) increased productivity growth, e.g. through IT investment, (3) a more favorable business environment through a better image of entrepreneurship and the removal of bureaucratic obstacles, (4) a massive promotion of technological innovation, and (5) a program to boost education in pre-schools as well as universities. Henzler warned, "In the global game, we are not yet confined to the bench, but we are no longer in the starting lineup."



**Dr. Herbert A. Henzler** headed the German branch of McKinsey&Company before becoming vice chairman of the advisory council at Credit Suisse Group and honorary professor for strategic and organizational consulting at the University of Munich. He is also a member of the FC Bayern Football AG supervisory board and chaired the commission for deregulation of the State of Bavaria.

## First Annual IZA Workshop on Behavioral and Organizational Economics

Why do firms exist? What determines whether workers are paid a piece rate or a fixed wage? These are key questions for organizational economics, which seeks to understand the relationships between the law, institutions, and employee performance. Recent research in behavioral economics offers a new perspective on these fundamental questions, enhancing our understanding of the psychological foundations of incentives.

The First Annual IZA Workshop on Behavioral and Organizational Economics, organized by IZA Research Director *Armin Falk*, *David Huffman* (IZA), and IZA Program Director *Bentley MacLeod* (University of Southern California) at IZA on May 30-31, 2005, brought together leading researchers working at the intersection of these two fields, to discuss the most recent advances in this extremely promising research area. Consistent with the view that different, complementary methodologies are needed for scientific progress, the resulting workshop

program reflected a relatively even balance of different approaches to economic research: empirical research using field data, economic theory, laboratory experiments, and field experiments.

The three papers in the first session, by *Lorenz Goette* (University of Zurich), *Henry Farber* (Princeton University), and *Bruce Shearer* (Université Laval), addressed fundamental questions regarding incentives: do workers work harder when the wage is high? How large is this response? In the past, the standard prediction that workers increase effort when the wage is high has been surprisingly difficult to verify, e.g. the response of effort to a temporary wage increase is often zero or even negative. One explanation is that wage increases are not exogenous in previous studies. Another explanation is that wage increases can interact in perverse ways with non-financial, psychological motivations of workers, such as personal goals, and lead to a decrease in effort. The papers in this session provided some of the first convincing evidence on this issue, by using rich data on within-day effort choices, by creating exogenous changes in the wage using field

experiments, and by considering both financial and psychological motivations of workers.

The second session investigated the impact of other important incentive schemes: team incentives, tournaments, and relative pay. The papers in this session concluded that a broader, psychologically more realistic perspective on human motivation is needed to explain the response of effort under these incentives. *Dorothea Kübler* (Technical University of Berlin) presented evidence from a laboratory experiment showing a gender difference in the impact of team incentives on effort. *Matthias Kraekel*

(University of Bonn) derived novel theoretical results for tournament theory, in the case that workers experience emotions such as anger or pride. *Iwan Barankay* (University of Essex) used data from a firm that changed incentives from relative pay to piece rates, and showed that workers' motive for cooperation under relative pay was an important factor in explaining lower effort under this system.

The second day of the workshop began with a session focusing on another fundamental question in organizational economics: why jobs are designed the way they are. Although job design played a central role in Adam Smith's *Wealth of Nations*, in his discussion of specialization and its impact on worker motivation, this question has been understudied in economics. A paper by *Michael Gibbs* (University of Chicago) investigated job design empirically, and concluded that the optimal structure of job design is consistent with predictions of psychological models of job design. *Ricardo Alonso* (Northwestern University) presented a theoretical model of the optimal degree of delegation to employees within an

organization. A paper by *James Rebitzer* (Case Western University) studied a different issue in the design of workplace institutions: the bounded rationality of employees and the potential for employee mistakes. The final session studied the way that different institutions and incentive schemes function, when contracts are incomplete and employee effort is not enforceable. Given that effort is typically not fully enforceable, this research agenda is of central importance in understanding the functioning of organizations. Results from a laboratory experiment, presented by *Martin Brown* (University of Zurich), high-

lighted the importance of the perceived fairness of compensation for determining whether workers shirk, and whether the relationship between a firm and a worker is short- or long-lived. A paper by *Ferdinand von Siemens* (University of Munich) proposed a new model of bargaining, in a setting with incomplete contracts and unobserved, heterogeneous preferences regarding fairness. *Regina Riphahn* (University of Basel) presented an empirical study on the impact of bonus incentives in a large firm.

With this successful start of its Annual Workshop Series in Behavioral and Organizational Economics, IZA underscores the crucial importance of empirical and theoretical research in the field. Thorough analyses and innovative research in this area help to understand and deal with organizational change in firms against the background of globalization and growing competition.



## First IZA Social Policy Evaluation Annual Conference (SPEAC)

As a new initiative to sharpen its focus on the Evaluation of Labor Market Programs, IZA has started the Social Policy Evaluation Annual Conference (SPEAC) as a platform for leading international researchers to discuss both international experiences with social policies and methodological advances in program evaluation. SPEAC 2005 took place from February 23 to 25 at Australian National University in Canberra. Co-organized by *Holger Bonin* (IZA) and *Deborah Cobb-Clark* (SPEAR Centre), it received generous financial support from the Department of Family and Community Services (FaCS) in the Australian Government.

The focus of SPEAC 2005 was on policies targeting at children. *Jochen Kluge* (RWI Essen) questioned the wisdom of educational psychology that older school entrants fare better. Using school regulations in Germany allowing deferred enrolment, he showed that after controlling for selection effects, holding children back a year does not secure a better performance. *Chris Ryan* (Australian National University) investigated the consequences of an Australian policy that caused pupils to obtain an extra



year of schooling in primary school. Adding an early year at school seems to improve the performance in higher grades substantially. *Analia Schlosser* (Hebrew University of Jerusalem) looked at effects of a program providing further instruction to under-performing Israeli students. This program raised school enrolment rates, but considering the costs involved was less efficient than alternative programs based on incentives for teachers and students.

Several presenters studied the impact of child support policies. *Guido Friebel* (University of Social Sciences, Toulouse) analyzed the introduction of a take-it-or-leave-it "daddy month" in Sweden. While this reform raised the fraction of fathers taking parental leave, it did not change their behavior in terms of engaging in more child care. *Rebecca Edwards* (Reserve Bank of Australia) calculated the value of parental leave for Australian women. Examining compensating wage differentials, she showed that women eligible to maternity leave place a value on this institution, which outweighs the estimated cost.

*Ian Walker* (University of Warwick) looked at the effect of changes in liabilities of fathers in British divorce legislation. The resulting large financial obligations of non-custodial parents significantly reduced dissolution risks. The theme of marital stability was also discussed by *Avner Ahituv* (University of Haifa) who looked at the interplay of job stability, wage rates and divorce in a sequential dynamic model accounting for feedback effects. His study confirmed a positive correlation between job stability, wages and marriage rates.

Other papers dealt with selected international labor market policies. *Marianne Bitler* (RAND Corporation) argued that the focus of evaluation research on mean impacts misses a great deal. She showed quantile treatment effects of a U.S. welfare program, which exhibited systematic heterogeneity in impacts on earnings,

transfers, and income. *Michael Lechner* (University of St. Gallen) explained how to create valid instruments by variation in participation rates of agents living in a single local labor market but in different Swiss cantons with different policies. *Jochen Kluge* (RWI Essen) evaluated Polish labor market programs by employing "moving windows" of pre-treatment labor market histories that control for changes in the macroeconomic environment. In a related study, *Steve Stillman*

(Statistics New Zealand) used data from New Zealand to observe that shorter benefit duration and more experience in and out of benefit spells raises post-benefit employment propensities.

Some papers evaluated very distinct programs. *Dean Karlan* (Princeton University) studied in a field experiment how individuals with time-inconsistent preferences or self-control problems can benefit from appropriately designed commitment savings products. *Rodrigo Soares* (University of Maryland) took a value-of-life approach based on survival functions to estimate the welfare costs of violence in over 70 countries. This showed that non-monetary costs of violence are generally as important as material costs. *Andrew Leigh* (Australian National University) investigated the relation between redistributive taxes and inequality. On the basis of a tax redistribution index exogenous to behavioral response, he concluded from variation across U.S. states, that more or less redistributive tax schemes do not affect the distribution of wages.

*Robert Fairlie* (University of California at Santa Cruz) studied the possibilities to promote self-employment. Based on city-level variation in minority business programs in California, he documented that self-employment gains of black men coincided with the timing of these programs. Finally, two policies to help the unemployed were studied by *Jeff Borland* (University of Melbourne) and *Thomas Kaplan* (University of Wisconsin-Madison). Borland examined the effects of a jobseeker diary designed to increase job search effort in Australia. The obligation to verify job search reduced the time on payments for one half of the participants. Kaplan studied the "Wisconsin BadgerCare" program covering health care of poor single mothers. These responded with higher earnings, although the improvement was small.

SPEAC 2005 was a promising start of this new IZA conference series. As many practitioners from FaCS joined the meeting, it met perfectly with IZA's and the SPEAR Centre's objective to communicate the latest developments in program evaluation among policy makers.

## The Older Worker in the Labor Market: Work Time And Work Incentives

The IZA Research Program "The Future of Labor" held an international workshop on May 16-17, 2005, in Lisbon, Portugal to discuss a series of invited papers dealing with the position of older workers, with a special focus on retirement and labor-force participation issues. The workshop was organized by *Ana Rute Cardoso* (IZA) and IZA Program Director *Daniel Hamermesh* (University of Texas at Austin). IZA gratefully acknowledges financial support by the Bank of Portugal, Foundation Calouste Gulbenkian, Portuguese Employment Office (IEFP) and the Luso-American Foundation.

*Richard Disney* (University of Nottingham) presented an optimizing model of saving and labor-force participation that paid careful attention to the structure of social security/old age tax and benefit programs in 22 countries over 3 time periods. The estimated effects of the social insurance programs allow for differences due to country-specific factors, so the author was able to focus on within-country changes in the structure of a program. The results make it quite clear that the changes in the programs affected women's labor-force behavior in expected ways, but had no impact on men's behavior. In countries where programs were changed to represent private pension schemes, the effects on total household savings rates were found to be negative.

*Axel Börsch-Supan* (University of Mannheim) inquires into the extent to which the drop in the economically active population (due to the aging of the population) will affect the rate of growth of per-capita GDP. Using the example of Germany, he finds that increased accumulation of capital and increased immigration are unlikely to be sufficient to compensate for the declines in productivity associated with the aging of the work force. The only apparent solutions are improvements in the rate of human capital accumulation among the remaining (fewer) workers.

*Sergi Jiménez-Martín* (University Pompeu Fabra) presented an optimizing model that is calibrated over data covering the Spanish labor market. The focus is on an institutionally required minimum public pension level, which is found to raise the rate of labor-force exit before age 65 from 60 percent to 75 percent. *John Rust* (University of Maryland) examines how

one might design efficient social insurance programs. The particular focus is on the recent plans for partial privatization of the American public retirement program. Ignoring issues of how to move from an unfunded public program to a partially funded mixed program, he finds that the mixed program would increase social welfare under reasonable assumptions about rates of return on assets in which the program would invest as compared to an unfunded public program.

*James Banks* (University College-London) examines recent new English data on health and retirement. While many researchers have examined the role of changes in health in moving people out of the workforce, almost all have focused on self-assessed health. The research question is whether self-assessments provide enough information to gauge the effect of health on labor-market activity. With data on both self-assessed health and objective measures of health (blood pressure, blood markers, etc.), he finds that self-assessments encompass most of the relevant information that is useful in predicting whether older people continue working.

*Michael Hurd* (RAND Corporation) studies the impact of unexpected changes in wealth on people's expectations of when they will retire. The particular example is the large increase and subsequent large decrease in the value of older workers' holdings of shares in the U.S. in the late 1990s and early 2000s. The evidence makes it clear that the growth in wealth in the late 1990s did nothing to induce earlier retirement, while the subsequent stock market bust did slightly extend people's expected working lives, perhaps by ½ year.

*Agar Brugiavini* (University of Venice) looks at gender differences in the responses to variations in the generosity of public pensions. While we generally expect women to be more responsive to changes in work incentives, she shows that the retirement behavior of Italian men responded more to changed incentives than did women. This surprising result is attributed to older women's facing greater constraints on their labor-supply behavior.

*Ana Llana-Nozal* (Free University of Amsterdam) estimates a complex model

of the impact of disabilities on work activity using British data. The novelty is the availability of huge amounts of information on the individual early in life. The author shows that parental background, and early childhood treatment and behavior have substantial effects on the incidence of accidents during young adulthood, and that accidents greatly reduce the likelihood of working in the labor market.

*Daniel Hamermesh* (University of Texas at Austin) examines how working in the market alters the mix of activities undertaken at home. Using a large time-budget study of the United States, he finds that work substitutes mainly for pure leisure activities, and much less so for household production and personal maintenance. The study also suggests that the rigidities of work schedules alter the amounts of different activities undertaken at home, again to the special detriment of leisure.

*John Abowd* (Cornell University) applies the data from a massive project integrating American data sets on firms and individuals to study how employers combine technology and workers' characteristics. A particular focus on the demand for older workers indicates that they are relatively complementary with technology, although they are less likely to be utilized where the firm has an unusually high ratio of computer software to hardware.

Using American data, *Frederic Vermeulen* (Tilburg University) examines the behavior of elderly couples to focus on the jointness of work and leisure. He shows that couples react together to health and other shocks facing experienced by one spouse. The model is also used to show that retirement responds only very slightly to changes in eligibility rules for retirement benefits.

Perspectives and challenges of an aging labor force in Western industrialized societies need to be at the center of any policy aimed at a successful future of labor. This IZA workshop gave new momentum to a crucial research topic in labor economics.

## Labor Markets and Institutions: Determinants and Outcomes

How do labor market institutions shape labor market outcomes, and what determines the choice of these institutions? On December 3-4, 2004, leading European and North American experts in this area gathered at IZA to discuss the most recent theoretical and empirical advances in these research questions. The workshop was organized by IZA Program Director *Pierre Cahuc* (University of Paris I) and *Winfried Koeniger* (IZA) with generous support of the Fritz Thyssen Foundation.

Several papers investigated the role of employment protection legislation (EPL) in the labor market. For the German case, evidence was provided that variable enforcement of dismissal protection does not seem to have a sizeable effect on worker flows (↪ IZA Compact January 2005). However, employment protection should matter more for temporary than for highly persistent shocks. This hypothesis was supported by constructing a measure of job flows caused

by the seasonal cycle for 14 OECD countries. In another contribution, answers of European households were analyzed, finding that perceived job security is stronger influenced by unemployment benefits than employment protection. Furthermore, it was theoretically and empirically shown that the male breadwinner conception is an important determinant of EPL. This conception's strength was shown to be related to religious values: their differences can explain variation in the strictness of EPL. Other studies dealt with the effects of unemployment insurance and job search assistance on labor market transitions. For France, empirical evidence was provided that job search assistance has reduced the duration and recurrence of unemployment. Comparing the experiences of European countries, another paper found that higher unemployment benefits reduce exit rates from unemployment. However, such benefits might lead to more subsequent employment stability if the recipients have been

unemployed for a short term. Furthermore, the workshop presented research results on credit market structures and labor market institutions. Labor market regulation and redistribution seem to be more pronounced in countries with more credit market imperfections. Another session presented research results on interactions of unions and labor market outcomes. Evidence was presented that union density increases unemployment and wages, and in turn unemployment raises union density. A theoretical contribution analyzed the endogeneity of bargaining regimes, arguing that more regulated product markets, in which more rents are available, make union bargaining more attractive with adverse consequences for employment.

This successful workshop underscores the importance of IZA research activities in the field. Please visit the IZA homepage to read or download the studies presented.

### IZA Summer School

## IZA European Summer School in Labor Economics

The 8th IZA European Summer School in Labor Economics took place April 18-24, 2005, at the conference center of Deutsche Post at the Ammersee Lake (near Munich) in Bavaria, Germany. This year, 36 students from seventeen different nationalities attended the event.

*Frank Vella* (European University Institute) and *Patricia Apps* (University of Sydney) were the lecturers in this edition of the Summer School. Vella's lectures concentrated on "Semiparametric Estimation of Micro Econometric Models", whereas Apps taught on "Modeling the Labor Supply Decisions of multi-person Households". Each student presented his/her work either giving a talk or hosting a poster session. Those students not giving a formal presentation were

asked to either chair or discuss a paper. In a final session, *Jean-luc Doumont*, an expert in professional communication, provided advice on "How to Make the Most of Your Presentation".

*Claudio Lucifora*, member of the IZA Summer School Advisory Committee in representation of the European Association of Labour Economists, and *Rudolf Winter-Ebmer*, also a member of the Advisory Committee, representing the Centre for Economic Policy Research, participated in the event.

The Summer School is funded by the European Union, under the Sixth Framework Programme, Marie Curie Conferences and Training Courses.



MARIE CURIE ACTIONS

The forthcoming IZA European Summer School in Labor Economics will take place April 3-9, 2006. *Gilles Saint-Paul* (University of Toulouse) will lecture on "Labor Market Models for the New Economy" and *Peter Gottschalk* (Boston College) will lecture on "Topics in Inequality and Mobility". The application deadline is January 20, 2006.

↪ <http://www.iza.org/summerschool>

### Forthcoming IZA Conferences

30.06.2005 - 03.07.2005	Fourth IZA/SOLE Transatlantic Meeting of Labor Economists	Buch/Ammersee, Germany
11.09.2005 - 12.09.2005	Second IZA Annual Migration Meeting (AM <sup>2</sup> )	University of Illinois, Chicago, US
15.09.2005 - 18.09.2005	IZA/CEPR European Summer Symposium in Labour Economics (ESSLE)	Buch/Ammersee, Germany
26.09.2005 - 27.09.2005	Income Distribution, Health, and Social Insurance of an Aging Population	IZA, Bonn, Germany
23.10.2005 - 24.10.2005	IZA Prize Conference and Award Ceremony	Berlin, Germany
28.10.2005 - 29.10.2005	Interaction within the Family: Collective Approach and Bargaining Models	Turin, Italy

New ARGE Director Klaus F. Zimmermann

## IZA Director Now Heads Association of German Economic Research Institutes (ARGE)

Klaus F. Zimmermann, IZA Director and President of the German Institute for Economic Research (DIW Berlin), was elected Director of the Executive Board of the Association of German Economic Research Institutes (ARGE) in April 2005. He succeeds IZA Fellow *Thomas Straubhaar* (President of the Hamburg Institute of International Economics, HWWA), who had held this office since 2001.

Zimmermann emphasized the significance of the ARGE institutes' scientific excellence and political independence. "In view of the enormous economic policy challenges ahead, the ARGE institutes play a key role as providers of scientifically founded concepts and solutions. Our policymakers must continue the reform process that has been started in the German economy and society. The providers of policy ad-

vice in Germany are well positioned to offer these services based on the highest scientific standards."

The newly or re-elected Assistant Directors are *Ulrich Blum* (IWH Halle), *Johann Eekhoff* (University of Cologne), *Wolfgang Franz* (President of ZEW Mannheim), *Hans-Werner Sinn* (President of ifo Institute, Munich) and *Thomas Straubhaar*. *Dennis Snower* (President of IfW Kiel) and *Christoph Schmidt* (President of RWI Essen) will continue to hold this position.

The ARGE members - DIW Berlin, HWWA, ifo, IfW, IWH and RWI - produce the renowned spring/fall joint forecasts on "The State of the World Economy and the German Economy".



Reform Proposal

## Joint Proposal by German Research Institute Directors to Stimulate Economic Growth

In March 2005 a reform proposal to stimulate economic growth and employment was put forward to German policymakers by IZA Director *Klaus F. Zimmermann* jointly with *Michael Hüther*, Director of the Cologne Institute for Business Research (IW Köln), and *Thomas Straubhaar*, President of the Hamburg Institute of International Economics (HWWA). The proposal contains an action program consisting of three components:

- 1 Lowering unemployment insurance contributions and abolishing the "solidarity surtax" while raising the value-added tax.
- 2 Extending the legal provisions for temporary employment contracts and considering (in the medium run) the replacement of layoff protection with severance pay schemes.
- 3 Reducing bureaucracy with regard to legal restrictions on the use of future technology and other regulations impeding employment (e.g. the planned anti-discrimination act).



IZA Program Director Publishes New Book on Migration

## New Book by IZA Program Director Barry Chiswick: The Economics of Immigration

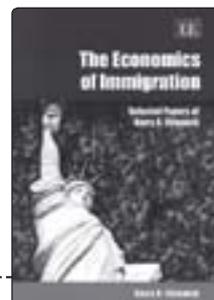


Immigration has become a significant public policy issue in all of the developed countries, as well as an important area of study for academic researchers. IZA Program Director *Barry R. Chiswick* (University of Illinois, Chicago) has been a pioneer in research on the economics of

immigration and has published numerous seminal studies on the labor market, the educational and linguistic adjustment of immigrants, and their impact on the host economy. He has also written extensively on various aspects of immigration policy. "His contributions have marked the pace of research on migration for over two decades, provoking the right questions and guiding the field," said IZA Director *Klaus F. Zimmermann*.

Now Chiswick's most influential and widely-cited papers, published over a span of 25 years in a variety of journals

and conference volumes, are available in a single volume entitled "The Economics of Immigration". It contains a foreword by Nobel Laureate *Gary S. Becker* (University of Chicago and IZA) and an original introductory essay by the author. The collection is available from Edward Elgar Publishing.



Chiswick, Barry R.  
**The Economics of Immigration**  
 Edward Elgar Publishing,  
 Cheltenham 2005  
 424 Pages  
 ISBN 184376458X

Global Development Award 2004

## IZA Discussion Paper Wins Award

Authored by *Guido Friebel* (University of Toulouse, IZA and CEPR) and *Sergej Guriev* (New Economic School, Moscow and CEPR) IZA Discussion Paper No. 1025 was awarded the "First Place Medal for Outstanding Research on Conflict, Human Security, and Migration" by the Global Development Network. The awarded paper deals with "Smuggling humans: A Theory of Debt-Financed Migration".

[ftp://ftp.iza.org/dps/dp1025.pdf](http://ftp.iza.org/dps/dp1025.pdf)

## IZA Prize 2005

## Joseph E. Stiglitz Joins IZA Prize Committee



The nomination period for this year's IZA Prize in Labor Economics ended on April 30, 2005. More than 500 IZA Research Fellows had the exclusive right to nominate candidates for the fourth IZA Prize, which will be awarded in Berlin on October 24, 2005. The prize-winner will be selected by a committee including Nobel Prize laureates *George Akerlof* (University of California, Berkeley) and *Joseph Stiglitz* (Columbia University) as well as CEPR President *Richard Portes*. Stiglitz replaces *Gary Becker* (University of Chicago), who had been on the committee for the previous three years. IZA Director *Klaus F. Zimmermann* and Research Director *Armin Falk* will again coordinate the selection process.

The annual prize is awarded for outstanding academic achievement in the field of labor economics. It is meant to stimulate research that tries to find answers to the important labor market policy questions of our time. Past prize-winners are *Jacob Mincer*, *Orley Ashenfelter* and *Edward Lazear*.

## New IZA Researchers

## New Visiting Research Fellow

*Michael L. Bognanno* (Temple University) is currently visiting IZA for six months as a Visiting Research Fellow. Bognanno received his Ph.D. from Cornell University in 1990 and joined Temple University in the same year. His research interests are in the area of personnel economics; more specifically they concern executive pay, promotion and incentives.

The IZA Visiting Fellow Program, which is targeted at members of the worldwide IZA network, has by now been firmly established as an attractive form of research cooperation.



## New IZA Research Associate

*Zhong Zhao* joined IZA as a Research Associate in January 2005. He is currently on leave from Peking University. He holds a bachelor's degree in economics from the Renmin University of China and a doctorate degree in economics from the Johns Hopkins University. Zhao also held visiting assistant professor positions at the University of Southern California in the spring of 2004 and served as short-term consultant to the World Bank on several occasions. His main areas of interest are labor economics, applied micro econometrics, and social program evaluation.



## New Resident Research Affiliates

Within the scope of the promotion of young researchers, IZA regularly provides possibilities for selected postgraduates to promote their dissertation at the institute. With *Johannes Abeler*, *Steffen Altmann*, *Felix Marklein*, *Philippe Raab*, *Matthias Wibral* (all Bonn Graduate School of Economics/BGSE) five young labor economists at present are integrated as external Resident Research Affiliates into the research activities of IZA, thereby benefiting from both the institute's manifold resources and the cooperation with experienced IZA researchers. This program is part of the ongoing intensive cooperation between BGSE and IZA.

## IZA Guest Researchers

From November 2004 until May 2005 the following renowned economists stayed at IZA to discuss issues of labor market research and policy:

*Catalina Amuedo-Dorantes* (San Diego State University, California and IZA); *Gadi Barlevy* (Federal Reserve Bank of Chicago); *Alan Barrett* (ESRI, Dublin and IZA); *Erling Barth* (Institute for Social Research, Oslo and IZA); *Gerard J. van den Berg* (Free University of Amsterdam and IZA); *Annette Bergemann* (Free University of Amsterdam and IZA); *Graziella Bertocchi* (University of Modena and Reggio Emilia); *Lex Borghans* (University of Maastricht and IZA); *Barry R. Chiswick* (University of Illinois, Chicago and IZA); *Piero Cipollone* (Bank of Italy); *Leif Danziger* (Bar-Ilan University and IZA); *Don J. DeVoretz* (Simon Fraser University and IZA); *Burcu Duygan* (European University Institute); *Gil S. Epstein* (Bar-Ilan University and IZA); *Josef Falkinger* (University of Zurich and IZA); *Antonio Filippin* (University of Milan and IZA); *Charles Grant* (University of Reading); *Volker Grossmann* (University of Zurich and IZA); *Thomas Hintermaier* (Institute for Advanced Studies (IHS), Vienna); *Steinar Holden* (University of Oslo); *Hans K. Hvide* (Norwegian School of Economics and Business Administration and IZA); *Herwig Immervoll* (OECD and IZA); *David A. Jaeger* (College of William and Mary and IZA); *Alain Jouten* (CREPP, University of Liege and IZA); *Pramod N. (Raja) Junankar* (University of Western Sydney and IZA); *Stepán Jurajda* (CERGE, Charles University, Prague and IZA); *Rafael Lalive* (University of Zurich and IZA); *Edward Lazear* (Stanford University and IZA); *Hartmut Lehmann* (University of Bologna and IZA); *Marco Leonardi* (University of Milan and IZA); *Thierry Magnac* (University of Toulouse I and IZA); *Gerald Marschke* (State University of New York, Albany); *Pedro S. Martins* (Queen Mary, University of London and IZA); *Peter R. Mueser* (University of Missouri-Columbia and IZA); *David Neumark* (Public Policy Institute of California and IZA); *Francesco Pastore* (University of Naples II and IZA); *Michele Pellizzari* (Bocconi University, Milan and IZA); *Miguel Portela* (Tinbergen Institute and IZA); *Dragos Radu* (HWWA, Hamburg); *Robert M. Sauer* (Hebrew University, Jerusalem and IZA); *Sylke V. Schnepf* (University of Southampton and IZA); *Saul Schwartz* (Carleton University); *Kenneth Troske* (University of Missouri-Columbia and IZA); *Frederic Vermeulen* (Tilburg University and IZA); *Ian Walker* (University of Warwick and IZA); *Bas ter Weel* (University of Maastricht and IZA); *Justin Wolfers* (Wharton School, University of Pennsylvania and IZA); *Christopher Zeiss* (University of Frankfurt)



## Challenges for Germany's Next Government

German politics are stuck between a rock and a hard place. While the long overdue reforms implemented by the Schroeder administration have not yet borne fruit, they have seriously eroded public trust. Nonetheless, there is no alternative to the reform process that has been initiated by the current government coalition. Getting this message across to the people would require a joint effort by the government and



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opposition parties. So far, however, no convincing effort has been made. This is why the recent electoral victories for the Christian Democrats cannot be attributed to the voters' confidence in a superior political strategy, but rather to feelings of uncertainty and disappointment with the objectives and the status quo of the recent labor market and welfare state reforms.

Ultimately, the entire concept of the German "social market economy" is put to test. Issues of social justice and efficient utilization of economic resources will need to be separated from each other more strictly in the future. The core question should be how to create more value added, not how to distribute the created output more fairly. Fairness of opportunity must have priority over distributive justice. Social solidarity and individual responsibility need to be balanced in a new, reasonable way. Those who demand and receive solidarity must also be willing to reciprocate. This is a matter of social fairness, not an erosion of the welfare state.

The blueprints of inevitable reform programs are readily available:

**1** The reduction of bureaucracy and a reform of German federalism are an absolute necessity. The veto powers of the state representatives in the *Bundesrat* must be curtailed. As the fiscal equalization scheme between the German states (*Länderfinanzausgleich*) fails to provide incentives for improvement, it should be replaced with a system that provides states and communities with more independent funding sources. Election schedules should be moved closer together, the merging of smaller states should be promoted, and legislative terms should be extended to six years in order to provide policymakers with a longer time horizon for sustainable policy measures.

**2** The German economy desperately needs to be revived. Longer working hours without extra pay, for instance, are well suited to fight the shortage of qualified workers and to make simple tasks less expensive. Future-oriented branches of the economy, such as education and training, research and development, healthcare, private care (*Zivildienst*) and household services, must be strengthened by market means. This could be done, for example, by introducing a voucher system for education and childcare, abolishing the alternative civilian service, modifying the private foundation law to stimulate science sponsoring activities, and establishing agencies with the specific task to bring together supply and demand in the area of simple services.

**3** A radical reduction of government subsidies, combined with a VAT increase, could help in the short or medium term to simplify the German tax system, lower the non-wage labor costs, and provide resources for new core areas of government funding. The long-term goal of a "major" tax reform should be to shift the focus back from direct to indirect taxation. A reduced VAT would be conceivable for goods and services produced with a large share of low-qualified labor.

**4** The German social security systems must be "disentangled" and opened to competition wherever possible. In the long run, we will not be able to avoid extending the average working life and introducing additional models of private old-age provision in order to stabilize the pension funds. In the health sector, the "health premium" model is an adequate means to disconnect healthcare financing from labor costs. The unemployment insurance could also be organized more efficiently by introducing a premium system with optional benefits.

**5** Any reform in the area of labor market policy will require a lot of patience. The programs need time and must be thoroughly evaluated. While hectic "reforms of the reforms" would be ill-advised, it would certainly make sense to consider a fundamental fresh start: A pure insurance agency could administer the unemployment insurance benefits for the short-term unemployed who are likely to find a new job on their own. A restructured Federal Employment Agency, which would engage in thorough profiling of the newly unemployed, could take care of potentially problematic cases, such as untrained individuals and older workers. The communities could draw on their knowledge of the local environment in providing support and job placement for the long-term unemployed. Those who receive government transfers would be mandated to perform socially useful tasks. This would result in greater willingness to accept regular jobs.

By implementing this set of reforms, our social market economy would not betray its own principles - it would merely secure its own future.



### Imprint



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