



# IZA COMPACT

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## IZA Prize in Labor Economics 2005 for Dale Mortensen and Christopher Pissarides Official Award Ceremony in Berlin

On October 24, 2005, this year's IZA Prize in Labor Economics was awarded to the economists *Dale T. Mortensen* (Northwestern University, Evanston/Illinois) and *Christopher A. Pissarides* (London School of Economics) during a festive ceremony that took place in Berlin before an audience of invited guests from Germany and abroad. The award honors the joint work by Mortensen and Pissarides on search and matching processes in the labor market. Their research has proven highly relevant for the current labor market reforms in Germany and supports the government policy to provide job-seekers with proper incentives and to shorten unemployment spells by reducing search costs through more efficient job placement.

The IZA Prize Committee, which selected the prize-winners, was coordinated by IZA Director *Klaus F. Zimmermann* and IZA

Research Director *Armin Falk* and included Nobel Prize laureates *George A. Akerlof* (University of California, Berkeley) and *Joseph Stiglitz* (Columbia University, New York) as well as *Richard Portes* (London Business School). The nominations for the IZA Prize were submitted by the network of IZA Research Fellows. According to the Award Statement, the "IZA Prize in Labor Economics 2005 honors the pioneering work of these two exceptionally creative scholars, who have revolutionized theoretical and empirical labor market research."

The high-level IZA Prize Conference "Frontiers in Labor Economics" preceding the award ceremony included presentations by such renowned U.S. economists as *Richard B. Freeman* (Harvard University), who lectured on the future of unions, and Nobel laureate *James J. Heckman* (University of



IZA Prize Laureates 2005: Christopher A. Pissarides, Dale T. Mortensen

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Klaus F. Zimmermann, Monika Wulf-Mathies



Dale T. Mortensen, Klaus F. Zimmermann, Richard B. Freeman

Chicago), who analyzed the effects of cognitive and non-cognitive abilities on labor outcomes and social behavior. *Tito Boeri* (Bocconi University, Milan) praised the achievements by Mortensen and Pissarides in promoting methodological progress in labor economics.

The invited speaker at the award ceremony, acting Minister of Finance *Hans Eichel*, not only applauded the prize-winners' contributions to labor market research, but he also emphasized the important role of IZA in the evaluation of the recent labor market reforms in Germany. During the subsequent panel discussion on "Reform Policy after the Federal Elections", Freeman, Heckman, Eichel, Zimmermann and IZA Prize-Winner Pissarides shared their views on a variety of topics ranging from unemployment insurance, minimum wages, union power and the low-wage sector to retirement age and VAT increases. The discussion, as well as the entire event, was moderated by German television

anchor *Cherno Jobatey*. The program had started with a welcome address by *Monika Wulf-Mathies* (Managing Director for Policy and Sustainability, Deutsche Post World Net). Filling in for the CEO of Deutsche Post and IZA President *Klaus Zumwinkel*, who had to cancel on short notice, she praised the successful cooperation between Deutsche Post and IZA owing to the science sponsoring activities of the Deutsche Post Foundation.

In his very personal laudation, *Gerard A. Pfann* (Maastricht University) focused more closely on the academic achievements of the prize-winners and their contributions to the development of labor economics. The analyses by Mortensen and Pissarides have led to a better understanding of unemployment and job flows. Their models, which are now widely used in labor economics and macroeconomics, have highly enriched research on unemployment as an equilibrium phenomenon, on labor market dynamics and on cyclical adjustment. They show how the intensity with

which workers search and the decision when to accept a job offer determine the distribution of unemployment durations. A major policy implication is the insight how labor market institutions such as unemployment insurance, minimum wage laws or job centers can be used to influence unemployment durations. For instance, if the level of unemployment benefits or the entitlement periods are reduced, job seekers will increase their search intensity to shorten their unemployment spell. At the same time, firms will be more willing to offer additional jobs as they find it easier and less costly to fill their vacancies.

After the IZA Prize was presented by Monika Wulf-Mathies and Klaus F. Zimmermann, Dale T. Mortensen explained in his acceptance speech how his joint work with Christopher A. Pissarides had started and developed in the 1980s. He said he was deeply honored and moved to receive this award in recognition of their successful long-term collaboration.



Gerard A. Pfann



Hans Eichel



Dale T. Mortensen



Freeman, Heckman, Jobatey, Eichel, Pissarides, Zimmermann



Christopher A. Pissarides, Dale T. Mortensen



## Award Statement of the IZA Prize Committee

The IZA Prize in Labor Economics 2005 is awarded to **Dale T. Mortensen** (Ida C. Cook Professor of Economics and Director of the Mathematical Methods in the Social Sciences Program at Northwestern University) and **Christopher A. Pissarides** (Professor of Economics and Director of the research program on Technology and Growth at the Centre for Economic Performance at the London School of Economics), for their path-breaking contributions to the analysis of markets with search and matching frictions. The vast literature that was stimulated by their fundamental contributions to search and matching theory is evidence of the power of their approach to the analysis of interactions in labor markets, marriage markets, housing markets, or generally in all markets with frictions. Both their individual contributions and their joint development of a dynamic equilibrium model of labor markets account for much of the success of job search theory and the flows approach in becoming a leading tool for microeconomic and macroeconomic analysis of labor markets. Their models, which are now widely used in labor economics and macroeconomics, have highly enriched research on unemployment as an equilibrium phenomenon, on labor market dynamics and cyclical adjustment. Dale Mortensen's and Christopher Pissarides's research on labor market search and job matching has also significantly directed and shaped the empirical literature.

Dale Mortensen has pioneered the study of individual workers' job search decisions. The insight of his classic article entitled "Job Search, the Duration of Unemployment, and the Phillips Curve" (*American Economic Review*, 1970) that labor market frictions can be represented by stochastically arriving matching opportunities has provided crucial thrust to the idea that searching for wage offers and jobs is costly when workers and firms lack full information about prices in the labor market. This pioneering work, in which unemployment is interpreted as a voluntary spell of searching for the most suited job at the best rate of pay, constituted a genuine paradigm shift in thinking about unemployment. His insight that search frictions can be modeled as random arrival of trading partners has also revolutionized research on labor turnover and reallocation, as well as research on personal relationships. Dale Mortensen subsequently continued to advance the frontiers of the field. "Search, Layoffs and Labor Market Equilibrium" (*Journal of Political Economy*, 1980), an article he wrote jointly with *Kenneth Burdett*, explains search and layoff unemployment as equilibrium phenomena and shows how the intensity with which workers search and the decision when to accept a job offer deter-

mine the distribution of unemployment durations. Mortensen's article "Property Rights and Efficiency in Mating, Racing and Related Games" (*American Economic Review*, 1982) shows that an efficient equilibrium exists in bilateral search models and that this equilibrium is attained when the entire match surplus is allocated to the contacting agent. In his article "Wage Differentials, Employer Size and Unemployment" with Ken Burdett (*International Economic Review*, 1998) he demonstrates how a search model with wage posting can generate wage dispersion.

Christopher Pissarides has broken new ground in studying macroeconomic implications of the flows approach to labor market analysis by using the matching function as a tool to study equilibrium unemployment in his article "Job Matching with State Employment Agencies and Random Search" (*Economic Journal*, 1979). The matching function relates job creation to the number of unemployed, the number of job vacancies and the intensities with which workers search and firms recruit. It successfully captures the key implications of frictions that prevent an instantaneous encounter of trading partners and has proved a particularly powerful tool for modeling two-sided search frictions that stem from information imperfections about potential trading partners, not least because it can be incorporated in models without adding excessive complexity. Pissarides further developed the matching model, which is at present the leading tool for studying imperfect labor markets in macroeconomics, in subsequent studies of equilibrium unemployment dynamics. His article "Short-Run Equilibrium Dynamics of Unemployment, Vacancies, and Real Wages" (*American Economic Review*, 1985) highlights the effects of cyclical productivity changes on vacancy posting, labor market adjustment dynamics, unemployment and wage dynamics. It rationalizes why vacancies respond more quickly and with greater amplitude to shocks than unemployment, that real wage changes do not fully reflect real output changes and that unemployment responds faster to a negative than to a positive shock.

His article "Search Unemployment with On-the-job Search" (*Review of Economic Studies*, 1994) derives new results of the matching approach that arise when on-the-job search is introduced into the model. Pissarides has elaborated the matching approach in *Equilibrium Unemployment Theory* (1990, 2000), which has become the leading textbook in the field.

Dale Mortensen and Christopher Pissarides joined forces to advance the equilibrium search approach by integrating the two lines

of research that they had shaped before. Their co-authored article "Job Creation and Job Destruction in the Theory of Unemployment" (*Review of Economic Studies*, 1994) develops the famous Mortensen and Pissarides model of equilibrium unemployment, which has been at the core of much theoretical work during the past decade. Dale Mortensen's and Christopher Pissarides's equilibrium search framework is widely used in theoretical work, particularly because it can generate cyclical fluctuations in job flows. At the same time it is flexible enough to accommodate a host of alternative mechanisms of wage determination, ranging from ex post bargaining and various forms of union bargaining to efficiency wage theory and wage posting by employers. Their model is also a powerful tool for assessing labor market policies, which they substantiate in their joint article "Unemployment Responses to 'Skill-Biased' Technology Shocks: The Role of Labour Market Policy" (*Economic Journal*, 1999). In this contribution they demonstrate that skill-biased shocks can explain why and how different unemployment insurance and employment protection policies can lead to the differential employment and wage outcomes that are observed in practice.

Dale Mortensen and Christopher Pissarides have jointly presented the essence of their ideas and the insights of the immense literature that was stimulated by the search and matching framework in two state-of-the-art articles that are the prime references for researchers interested in the field: "Job Reallocation, Unemployment Fluctuations and Unemployment Differences" (in *Handbook of Macroeconomics*, 1999) focuses on the macroeconomic implications of the flows approach while "New Developments in Models of Search in the Labor Market" (in *Handbook of Labor Economics*, 1999) centers on the implications of search decisions at the individual worker level.

The IZA Prize in Labor Economics 2005 honors the pioneering work of these two exceptionally creative scholars, who have revolutionized theoretical and empirical labor market research.

### IZA Prize Committee

**Prof. Dr. George A. Akerlof**  
University of California, Berkeley  
**Prof. Dr. Richard Portes**  
London Business School; CEPR  
**Prof. Dr. Joseph E. Stiglitz**  
Columbia University, New York  
**Prof. Dr. Armin Falk**  
IZA; University of Bonn  
**Prof. Dr. Klaus F. Zimmermann**  
IZA; University of Bonn

# IZA Research on “Economics and Persistence of Migrant Ethnicity”

## Volkswagen Foundation Funds Eight Study Groups

### First Successful Workshop on Migration and Integration

In December 2004, the Volkswagen Foundation (VolkswagenStiftung) granted five million Euros to eight research groups to study “Migration and Integration” for the next three years. By means of integration policy research projects the initiative of the Volkswagen Foundation focuses on a productive accompaniment of the forthcoming internationalization processes of societies. IZA, as one of the funded study groups, started its project on the “The Economics and Persistence of Migrant Ethnicity” in April, 2005 ([www.iza.org/ethnicity](http://www.iza.org/ethnicity)). It thereby aims at defining migrant ethnicity, measuring ethnic capital, and identifying the parameters for immigrants’ success or failure in the field of economy and society.

The need for additional knowledge about the costs and benefits of ethnicity and migration has further increased as a result of the effects of globalization, the upcoming demographic burden, and the sluggish economic development in many parts of the world.

A major topic of the IZA project therefore is to identify the forces which determine immigrant ascension to major indicators of success like citizenship, interethnic marriages and self-employment, as well as to define and measure immigrants’ ethnic capital. The IZA project group is headed by IZA Director *Klaus F. Zimmermann* and IZA Senior Research Associate *Amelie Constant*, in collaboration with IZA Program Director on Migration *Barry R. Chiswick* (University of Illinois, Chicago) and IZA Research Fellow *Don J. DeVoretz* (Simon Fraser University, Burnaby).

On October 6-7, 2005, the Volkswagen Foundation held its first workshop on Migration and Integration, organized and hosted by the Social Science Research Center (WZB) and the Programme on Intercultural Conflicts and Societal Integration (AKI) in Berlin. The workshop raised questions on theoretical and methodological issues, the institutionalized inter-disciplinarity of migration studies, and the applicability of scientific results to the reality of culturally and ethnically diverse societies. It offered a platform for discussion and

further cooperation between the eight study groups sponsored by the Volkswagen Foundation to research the issues of migration, the Foundation’s board and committee members, as well as practitioners.

IZA was represented by *Klaus F. Zimmermann*, *Amelie Constant* and Research Affiliate *Holger Stichnoth*. The team presented its project on the “Economics and Persistence of Migrant Ethnicity.” Their presentation gave an overview of the project’s three sub-themes: interethnic marriages, ethnic entrepreneurship, and citizenship. They also talked about the measurement of ethnic capital. The other study groups presented their projects on: “Cultural Capital in Migration,” “Diversity, Integration, and the Economy,” “Home Start before School Start,” “Individual Integration Efforts and Societal Preconditions for the Integration of Immigrant Youth in Germany and Switzerland,” “The Integration of the Second-Generation of Migrants in Several European Countries,” “Cultural Diversity in the Health Care System,” and “Migrants in the Organizations of Law and Order.”

The workshop ended with fruitful and productive discussions between the Volkswagen Foundation members, the funded research groups and practitioners from organizations working on issues of integration and diversity. These discussions indicated the importance of further cooperation between scientists and practitioners and also among the study groups. Such a synergy will enhance the quality of results and ensure the successful operation of the Volkswagen initiative. Volkswagen board members were pleased with the strong international comparative nature and interdisciplinary approach of the research groups. A pledge to continue with a series of smaller workshops and a second conference was made.

For more information on the workshop program and all projects of the study groups funded by the Volkswagen Foundation, refer to the special webpage set up by IZA:

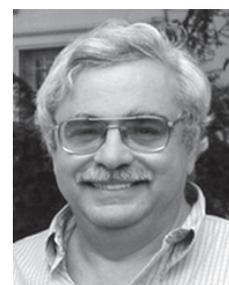
<http://www.migration-integration.de>



Klaus F. Zimmermann



Amelie Constant



Barry R. Chiswick



Don J. DeVoretz

## New Services for Labor Economists: IZA Virtual Data Service Center and Remote Data Processing

As part of a project supported by the Federal Ministry of Education and Research, IZA has developed an extensive virtual data service center that for the first time facilitates the search for and within datasets relevant for labor economics. The IZA "meta-database", which will be expanded continuously, contains by now ten of the most important datasets on labor market research (e.g. European Community Household Panel, German Micro

Census, German Socio-economic Panel, European Labor Force Survey), identified by the IZA Research Fellow Network. All these datasets are available with technical and content information. They are easily searchable in a standardized way, e.g. for questions and variables. Another advantage of the IZA data service center is that documentation previously only available in German has been translated to English.

In addition to this publicly accessible service, authorized researchers can now analyze several datasets by means of controlled remote data processing. The jobs are submitted online or via e-mail to IZA, which performs the analyses in a timely fashion and sends the results back to the submitter. These unique services are now available for labor economists around the world.

<http://metadata.iza.org>

Third Workshop of the **DFG Priority Program at IZA**

## Potentials for Increasing Flexibility on Heterogeneous Labor Markets

On October 6-7, 2005, about 50 representatives of the 18 study groups of the DFG (German Research Foundation) Program on "Potentials for Increasing Flexibility in Heterogeneous Labor Markets", which was established in summer 2004, met at IZA for their third semi-annual workshop. In the face of globalization, research in this field is increasingly gaining relevance. The key objective of the program is to find out whether it is necessary and possible to remove or reduce the institutional labor market rigidities that have developed over the past decades.

The IZA project group headed by IZA Directors *Klaus F. Zimmermann*, *Armin Falk* and *Hilmar Schneider* analyzes the "workfare" concept. As the German social security system in the form of unemployment insurance and social welfare generates implicit minimum wages, it provides negative incentives to employees in the low-wage sector. An economic solution to this incentive problem is to restrict social benefits in the way that the full amount of basic assistance is granted only if the transfer recipient is willing to accept employment (workfare). Compared with the status quo, this would increase the attractiveness of low-wage

employment above the minimum income. Workfare therefore is an important instrument for employment in the low-wage sector and for increasing labor market flexibility. Nonetheless, workfare is met with resistance by many parts of society, which is problematic because a lack of political acceptance may stand in the way of any economically reasonable concept. The project therefore aims at an empirical evaluation of the incentive effects by analyzing both field data as well as experimental laboratory data. Additional experiments will be conducted to assess the acceptance of the workfare concept.

IZA Director Appointed to the **Group of Societal Policy Analysis**

## Klaus F. Zimmermann New Advisor for the President of the European Commission

IZA Director *Klaus F. Zimmermann* has been appointed to the Group of Societal Policy Analysis (GSPA) of the Bureau of European Policy Advisors (BEPA). On October 6, 2005, the GSPA met in Brussels for the first time under the chairmanship of the EU Commission President, *José Manuel Barroso*, in order to discuss the sustainability of the European social models.

The Group of Societal Policy Analysis is one of three newly established advisory groups of the BEPA and deals with such topics as labor market and social

reforms in the EU Member States, as well as science, technology, European values and culture.

As a department of the European Commission, the Bureau of European Policy Advisors reports directly to the President of the Commission and advises him and other members of the Commission on the fields of economics, politics and society. The recommendations of the BEPA have a strong influence on the policy decisions of the Commission and the President. Zimmermann will participate in this expert group as an

independent and internationally renowned economist.



Klaus F. Zimmermann

# Is the Private Sector an Adequate Provider of Social Protection?

In 2001 public expenditure reached 43% of GDP on average across the OECD. Social spending constituted over half of public spending in almost all countries. Against the background of high budget deficits in some OECD countries, and aging populations almost everywhere, social policies and their funding are coming under unprecedented pressures for radical reforms.

One option is to cut social spending, but this would be unpopular and indeed undesirable in many cases. A second option is the privatization of some parts of public social spending, which would follow the example of privatization activities in many fields of the public sector over the past two decades. The issue of whether to rely on more private social expenditure is analyzed in a recent IZA Discussion Paper by *Mark Pearson* (OECD) and *John P. Martin* (OECD and IZA). Based on recent OECD studies, the paper describes the current extent of social spending in different countries and assesses the various claims that have been made as to the advantages of private social expenditures. To that effect, it looks in more detail at the practical experiences of private social spending in the areas of health insurance, provision of income in retirement, and care for children and the elderly (↪ *M. Pearson / J. Martin, Should We Extend the Role of Private Social Expenditure?, IZA Discussion Paper No. 1544*).

## The Roles of Public and Private Social Spending

Due to matured social insurance schemes - particularly for old-age pensions - and extended social provision between 1960 and 1980, public social expenditure doubled in nearly all OECD countries. At the end of the 1990s, public social spending on average accounted for 21% of GDP for the OECD area and 24% for the EU. In the future, demographic trends are expected to exert upward pressure on public expenditures, especially by increased spending on old-age pensions and health. Unless a sustained economic upswing is able to stabilize public spending, policymakers will need to consider other instruments to control social expenditures.

Besides the restriction of public benefit programs and benefit cuts, greater private provision of social benefits is a possible alternative. In the mid-1990s, for example, the Dutch government followed this track. As a result, public social spending in the Netherlands decreased sharply as a

percentage of GDP over the period 1993-2001. However, most social support is still publicly provided. In most European countries the share of public social spending in total social expenditure is around 95%, whereas private social benefits are more abundant in countries where public provision is limited, e.g. in the United States, where they constitute about one-third of all social expenditures. Across the OECD, private social expenditures have increased since 1990, but these increases have been small, except in the Netherlands and the United States.

## Privatization Effects in Theory

Many policies of privatization in the energy and telecommunication sectors have been moderately successful, encouraging policymakers to look for additional areas where such reforms may yield benefits. Consequently, attention has turned to the provision of social spending. Despite this trend, the arguments for a greater reliance on private sector provision are not always convincing.

One group of arguments for making greater use of the private sector to either provide or finance social benefits refers to a more efficient economy. It is argued that the current social system has a lack of transparency as to the true costs of social protection because workers only see their employee contribution. By confusing individuals about the true costs, social programs may be expanded beyond their optimal size, leading to a higher tax wedge which can, in turn, damage employment and output. Instead, the private sector is assumed to make the true costs and benefits of a program more transparent to those involved. However, there are some obvious ways of increasing the system's transparency within a publicly-financed and managed system. The Netherlands, for instance, has shifted responsibility for social insurance payments from employers to employees, at the same time raising gross wages to compensate workers in order to demonstrate to them the true costs of social programs.

Furthermore, supporters of privatization argue that greater use of private alternatives to public provision involves greater use of financial markets, which could have beneficial economy-wide effects. Greater flows through financial markets will increase the pool of saving available for investment. For example, by reducing public provision of pensions and requiring individuals to save for their own

retirement, investment would increase and growth rates would rise accordingly. However, risk reduction by diversifying investment is important for private pension provision. As this is only possible at the cost of reducing expected returns, the case for privatizing pensions becomes less compelling. There is also evidence that such effects can only be realized in an appropriate regulatory framework to avoid financial losses and to ensure that the public interest of quality service does not fall victim to private sector concerns about cutting costs or spending too much on advertising.

It is thus difficult in purely theoretical terms to make a strong case that most social spending should be either public or private. It is rather an empirical question, which hinges around whether it is possible to design a regulatory package that both meets the legitimate public interest in social protection, but also encourages those aspects of private sector behavior which might encourage greater efficiency and choice in service delivery. These aspects refer to genuine advantages of the private sector provision such as the flexibility of products and practice as well as efficiency in administration. The public sector is not very good at promoting innovation and novelty since governments are intrinsically risk-averse and innovation inevitably comes with a risk of failure that politicians dislike. In addition, the private sector's profit motive is a powerful tool to cut costs in order to achieve a higher degree of efficiency in administration, even though regulation may be necessary to make private provision feasible. In theory, private provision of social benefits could lead to efficiency and welfare gains for individuals and societies, but such outcomes are not inevitable.

## Practical Experience with Privatization

Various OECD countries have made different privatization experiences in the area of social system reforms. There is little doubt that [private health insurance](#) (PHI) has the potential to yield welfare gains by facilitating greater individual choice and innovation, but it also involves significant risks. For example, insurers have an incentive to "cherry-pick" young, healthy individuals and price high-risk individuals out of the market. Regulations to remove incentives for cherry-picking have been introduced in some countries where PHI is significant (e.g. Australia, Ireland, the Netherlands, and Switzerland), in part

mitigating the problems. But following such an approach sharply reduces the scope for private insurers to respond to individual wants and to innovate in the package of services they offer. Furthermore, PHI creates higher administrative costs. In theory, these might be offset by greater efficiency, but the record to date shows that PHI has not proved effective in restraining the growth of health spending - witness the U.S. experience.

Coverage and adequacy of **private pension arrangements** are not easy to ensure. This is due to a fundamental dilemma: on the one hand, policymakers are trying to introduce more flexibility into existing pension systems by moving more responsibility into the private sector; on the other hand, coverage and adequacy of such private contracts cannot be ensured without a high degree of compulsion and regulation. Even the regulation of administrative costs and organizational structures may eventually be counterproductive since they may become excessively complex and increase the administrative burden. There is also the fact that many countries offer tax incentives in order to encourage workers to make their own pension provisions. These represent a considerable burden on the public purse: recent OECD estimates put the tax concessions for pensions as equivalent to 1-2% of GDP in many countries. To strike the balance between proper regulation, protection of pension plan participants, and a sufficient degree of flexibility in private provision, represents a considerable challenge to policymakers, and it is arguably one to which no country has yet found an appropriate solution.

The **provision of care for children and elderly** is of growing importance and leads to an increased demand of care services. Whether care services should be public, private non-profit institutions or private firms matters for care providers because being at arms' length from political interests may allow more flexibility and help organizations focus more on the quality and costs of the service they provide. However, the profit motive of private firms may imply incentives to reduce costs which are too strong and may be counterproductive in care services. Apart from the ownership question, other aspects such as introducing competition in care provision and allowing users more choice may play an important role. User choice is quite effective at focusing the attention of care providers on the different needs of individual users, and this flexibility makes users more satisfied. Competition and less static funding schemes may also facilitate a swifter reallocation of activity and ca-

capacity adjustment in response to changing demand and care needs. Again, the key challenge appears to lie in developing the appropriate regulation of markets for care services. It is therefore of high priority for countries to evaluate and draw the lessons from ongoing reforms in this sector.

**Private Social Protection is Not a Magic Wand**

It is right to be cautious about many of the sweeping assertions that are often made about the economy-wide effects that might result from a greater reliance on the private sector in financing and delivering social protection. Social programs do utilize a substantial proportion of economic output, but merely moving them to the private sector does not magically reduce the burden. People want high-quality provision of social protection and will devote

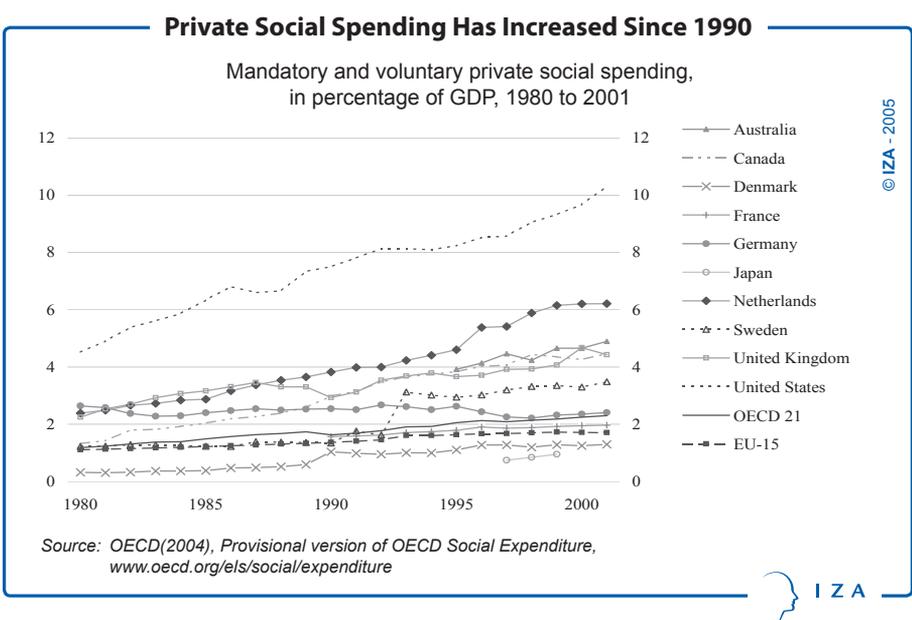
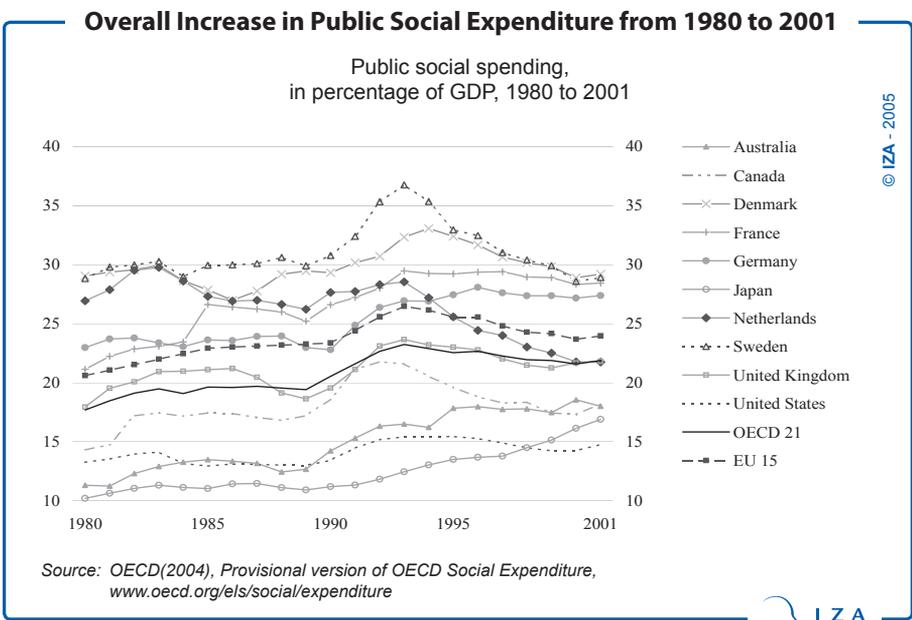
resources to this purpose, if not through the tax system, then through private sector alternatives. While private provision may help address structural problems and may stimulate growth, there are other routes to achieving such goals. In many cases, a reformed public system could solve the problems, and a badly-designed move towards greater private provision could perpetuate them.

Mark Pearson  
John P. Martin

**Should We Extend the Role of Private Social Expenditure?**

IZA Discussion Paper No. 1544  
<ftp://ftp.iza.org/dps/dp1544.pdf>





# Do Adverse Macroeconomic Conditions Favor Job Persistence?

Policymakers sometimes find it difficult to choose between subsidizing existing jobs and funding start-up programs. A recent IZA Discussion Paper endorses the second alternative. *René Böheim* (University of Linz and IZA), *Alfred Stiglbauer* (Austrian National Bank) and *Rudolf Winter-Ebmer* (University of Linz, Institute for Advanced Studies Vienna, CEPR and IZA) focus on job persistence and show that the survival of new jobs depends on (i) the state of the business cycle at the time of job creation, (ii) the number of jobs created, and (iii) firm age.

By looking at a large dataset covering 21 years, the authors investigate the relationship between economic circumstances and the survival of newly created jobs in Austria. The dataset originates from records of the Austrian social security system ("Hauptverband der Österreichischen Sozialversicherungsträger") and covers all employees in the Austrian private sector and all non-tenured public sector workers. The authors estimate the hazard rates of new jobs using a Cox proportional hazard model.

Focusing on the labor side of firm expansions, the persistence of job creations can be used as an indicator of the persistence of overall capacity expansion (although a given technology may require fewer workers over time, as soon as learning effects materialize). Job creation is thus considered a lower bound of the persistence of productive capacity.

## Jobs created in large job creations survive longer

Dynamic labor demand theory and analogies from investment (i.e. the amount and the form of adjustment costs and the option value of investment), serve as initial points for the evaluation of productive capacity. The analysis identifies that for continuing establishments a large relative expansion is related to long-lasting jobs, but the quantitative effect is small. For new firms, the effect is mixed: A large expansion raises the volatility of the first job compared to a similar job created in a small expansion, but increases the survival chance of average jobs (or all jobs). The opposite is true for re-entering firms: Larger job creations are estimated to result in shorter durations of the average job.

In general, the results indicate that larger expansions are more successful than smaller ones since more jobs are created by continuing and new establishments than by re-entering establishments. Furthermore, the estimated hazard rates specify that the creation of a single job is short-lived, hence a typical newly created job survives the longer, the larger the job creation.

## A job lasts longer if created in adverse macroeconomic conditions

Irrespective of their extent, the timing and persistence of expansions over the business cycle is of great importance. Whereas job creation is strongly procyclical and job destruction is countercyclical, the cyclical properties of total job reallocation (the sum of job creation and destruction) are less clear-cut. The state of the business cycle at the time of job creation shows a strong statistical relationship with the survival chances of the job. Intuition suggests that a job creation is more consistent if started in an expansion because the firm can profit from better demand conditions. However, low interest rates will also make investment projects of a more risky type viable and increase competition for continuing firms - at the expense of job persistence. The job thus survives longer if it was created in a downturn, i.e. when the sectoral unemployment rate was high. For example, increasing the sectoral unemployment by 1% is estimated to lower the hazard rate by between 1% and 5%. The regional unemployment rate, however, does not affect the survival of newly created jobs.

This survival may relate to the quality of the expansion because higher real interest rates in recessions lead to a selection of only the most promising investment opportunities. In addition, the average skill of the unemployed is greater than in a boom, which may affect the project positively. Alternatively, the association of the business cycle with the survival of jobs may be caused by the momentum of the business cycle, given that economic conditions improve soon after job creation. In contrast, jobs created in a boom will face adverse economic conditions relatively sooner. The comparison shows that the hazards are consistently greater when unemployment was low at the time of job creation. A new job therefore has a considerably longer duration if created when unemployment was high.

## Jobs created by entering establishments last considerably longer

Structural characteristics of these job creations show a statistical association with their survival. Jobs in new firms are more persistent, especially if they are filled by prime-age, female, or white-collar workers. The hazard rate of a typical job in a new firm rises by 22% if the job is filled by a worker younger than 25. It is still 7% higher if the worker is over 50. It also increases by 22% if the job is filled with a blue-collar worker. In contrast, the hazard lessens by 16% if the new employee was female rather than male. The effects are similar for continuing firms.

From a policy perspective, it is important whether job creation is more permanent in newly founded firms or in continuing firms: Establishment births account for a large fraction of these newly created jobs. Growing establishment age lowers the persistence of new jobs. An increase in age by one year raises the hazard ratio by more than 2%. Consequently, job creation in new firms (and in re-entering firms) is more persistent than in continuing firms. The hazard rate for jobs created in new firms is approximately 45% lower than corresponding hazards for jobs in continuing firms. For re-entering firms, the effect is somewhere in between.

## When and how to create a job?

On the basis of these results, it becomes easier to decide when and how to create a job. The policy conclusions from the study are the following:



René Böheim  
Alfred Stiglbauer  
Rudolf Winter-Ebmer

### When and How to Create a Job: The Survival of New Jobs in Austrian Firms

IZA Discussion Paper No. 1602  
<http://ftp.iza.org/dps/dp1602.pdf>

As jobs created by entering establishments last considerably longer than new jobs in continuing establishments, the removal of entry barriers is a clear priority for economic policy. If policymakers are hesitant to choose between subsidizing new jobs in already existing firms or funding start-up programs, the money is better spent on new enterprises. They tend to do business in new sectors (jobs in the service sectors are among the most

persistent), possibly hire highly skilled workers, and create jobs that last on average almost 50% longer than those created in pre-existing establishments.

If new jobs created during economic upturns are less stable because projects are riskier and the pool of available workers is smaller, then an argument for dampening the business cycle can be made. Reducing business cycle volatility

could yield social gains in terms of more stable jobs.

As the negative correlation between the business cycle and the duration of newly created jobs can be extended to the persistence and profitability of business investment, stockholders and creditors can base their investment decisions on this information.

Marieluise Beck at IZA Tower Talk

## Federal Migration Commissioner Calls for Better Educational and Labor Market Integration of Immigrants

At the 10th IZA Tower Talk on August 23, 2005, the Federal Government Commissioner for Migration, Refugees and Integration, *Marieluise Beck*, MP (Green Party) delivered a speech on the topic "Integration Policy Is Modernization Policy". She emphasized the need to eliminate the historically developed shortfalls of German immigration and integration policies. In view of the impending demographic changes, Germany ought to have a substantial self-interest in improving its ways to control immigration and, most importantly, in realizing a long-term integration policy. Beck attributed a central role to the education system, which should enable young immigrants "to catch up on education and training." In order to remove the serious disadvantages still experienced by immigrants, pre-school education and improved language acquisition should receive a larger weight. So far, Germany has negligently failed to utilize the full potential of young immigrants.

In this context, the migration commissioner criticized the deficits of

the immigration law finally enacted in the beginning of 2005. Apart from the short-sighted rejection of a "point system" to select immigrants and the high entry barriers for foreign investors and entrepreneurs, Beck deplored the work permit regulations for foreign students living in Germany: Employers

*"the issue of immigration must be placed at the center of society"*

are only allowed to hire foreign university graduates in the absence of native job applicants. According to Beck, it would be in Germany's best interest to replace this protectionist policy with a substantially easier labor market entry for foreign graduates.

Beck applauded the growing interest among immigrants in Germany to participate in the language and integration courses that have been established in accordance with the new immigration law. This great response proves all those wrong who accuse immigrants of lacking the willingness to learn Ger-

man, she said. Beck also drew hope from the efforts initiated in the wake of the PISA Study to improve the pre-school integration of immigrants. She warned, however, that many years of hard work will be necessary to make up for the omissions of the past. The success of an improved integration policy will ultimately hinge on its ability to overcome the prejudices that still exist among the native population. In light of these prejudices, *Hilmar Schneider*, IZA Director of Labor Policy, called for a stronger focus on economic aspects in shaping immigration policy and convincing the native population of the need for immigration. After all, only an enhanced public awareness of the social benefits of controlled immigration and consistent integration will generate widespread acceptance of immigration. Commissioner Beck agreed that "the issue of immigration must be placed at the center of society."



**Marieluise Beck** is Federal Government Commissioner for Migration, Refugees and Integration and Parliamentary State Secretary at the Federal Ministry for Family Affairs, Senior Citizens, Women and Youth (since 2002). Previously she was Federal Government Commissioner for Foreigners' Issues (since 1998). Marieluise Beck is a member of the Green Party (Bündnis 90/Die Grünen, since 1980) and a member of the German Parliament (Bundestag, since 1994).



New IZA Researchers

### New IZA Research Associates



Werner Eichhorst

Werner Eichhorst joined the IZA Research Team in July 2005. Eichhorst studied sociology, political sciences, psychology, and public policy and administration at the universities of Tuebingen and Constance, after that joining the Max Planck Institute for the Study of Societies in Cologne as a doctoral and post-doctoral fellow. Following his doctoral degree from the University of Constance, he became project director at the Bertelsmann Foundation, a private think tank in Germany, where he was responsible for comparative analyses of the German labor market and related policy areas ("Benchmarking Germany"). At last he worked for the Institute of Employment Research (IAB) in Nuremberg. His main research area at IZA is the comparative analysis of labor market institutions and performance as well as the political economy of labor market reform strategies.



Konstantinos Tatsiramos

In September 2005 Konstantinos Tatsiramos became a Research Associate at IZA, which he already joined as a Research Affiliate in January 2004. After completing his Bachelor's and Master's degree in Economics at the Athens University of Economics and Business and the University College London, Tatsiramos received his Ph.D. in Economics at the European University Institute in Florence. His main research interests lie in Applied Micro-Econometrics and Labor Economics, with a particular emphasis on labor-geographic-residential mobility, unemployment dynamics, and with a growing interest in Economics of Aging and Housing Economics.



Martin Kahanec

Martin Kahanec is another researcher, who took up his work at IZA in September 2005; he is also member of the IZA Migration Program. Kahanec earned his Master's degree from the Central European University in Budapest as well as from Comenius University in Bratislava, where he also earned his Bachelor's degree. In August he completed his Ph.D. at the Center for Economic Research (CentER) at Tilburg University. Among his main research areas labor economics, ethnicity, migration, and technological change are counted.

### IZA Scholarships for Young Researchers



Ulf Rinne



Marc Schneider

Within the scope of its Scholarship Program, IZA currently promotes two young researchers, who are at the same time integrated as Resident Research Affiliates into the institute's research activities. In August respectively September 2005 Ulf Rinne and Marc Schneider received an IZA Scholarship. The latter this year successfully completed his study of political economics at the University of Bonn and is now preparing his dissertation. In 2005 also Rinne, who in addition spent an academic year at the University of Lisbon, finished his economics diploma in Bonn. At present he works on his dissertation at the Free University of Berlin. Both young labor economists are offered the possibility to promote their research work at IZA, thereby benefiting from the institute's manifold resources and the cooperation with experienced IZA researchers.

### New Visiting Research Fellow



Xavi Ramos

Xavi Ramos is currently staying at IZA for six months as a Visiting Research Fellow. In 1998 he received his Ph.D. in economics from the University of Essex. He is now associate professor of economics at the University of Barcelona. His main research interests are in the area of labor economics and income dynamics as well as the economics of inequality and poverty. At present he is working on multidimensional measurement of living standards, the impact of subjective expectations on income risk, and attitudes toward income distribution aspects using questionnaire based methodology.

### New IZA Research Assistant



Liliya Gataullina

Another face at IZA is Liliya Gataullina, who joined the IZA Migration Program as a Research Assistant in August 2005. Gataullina received her B.A. from Bryn Mawr College, graduating with High Honors in Economics from Haverford College and Honors in Political Science. She also attended Tashkent Financial Institute in Uzbekistan and American University in Kyrgyzstan.

## IZA to Co-edit Renowned Research in Labor Economics Series (RLE) Outstanding Publication Platform for Labor Economists

The Research in Labor Economics (RLE) series is a well-established scientific series consisting of a collection of refereed research papers in the field of labor economics. The series was started in 1977 by *Ronald Ehrenberg* and JAI Press and has been published by Elsevier since 1999. *Solomon Polachek* (Binghamton University) has been editor since 1995. Recent volumes have hosted papers by economists such as *D. Acemoglu*, *J. D. Angrist*, *D. Card*, *H. Farber*, *A. Krueger*, *E. Lazear*, *G. Field*, and *J. Mincer*, among others.

The Research in Labor Economics series is characterized by

- high-quality research papers focusing on empirical, theoretical and policy

oriented topics

- a fast refereeing process (first editorial decisions are usually made within 4 months after paper delivery)
- special issues concentrating on highly relevant individual topics.

With active support of IZA from 2006 on Research in Labor Economics will be extended from one to two volumes per year. While the first volume remains in the tradition of the series with empirical and theoretical papers in labor economics, the second volume will be more policy-oriented, in the spirit of IZA's focus on policy aspects of labor economics. As co-editor IZA Research Associate *Olivier Bargain* will be integrated in the conceptual and textual planning of the series.

All labor economists are highly recommended to submit their papers for publication in the RLE series. Proposals for special issues (e.g. from workshops or sessions of international conferences) and symposia are also considered. An electronic submission system to make the publication process even faster and more convenient will be available soon. Please note that papers received before **December 1, 2005**, will receive priority for publication in the 2006 volumes.

General information on RLE submission guidelines can be found at:

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

## Fifth IZA/SOLE Transatlantic Meeting of Labor Economists

**Call for Papers: January 10, 2006**

The IZA/SOLE Transatlantic Meetings are a joint initiative of IZA and the Society of Labor Economists (SOLE) to underline the prominent role of international labor market research in Europe as well as the US. The Fifth IZA/SOLE Transatlantic Meeting will be held at

the Ammersee Conference Center in Bavaria/Germany on May 18-21, 2006.

Abstracts of papers can be submitted to IZA until January 10, 2006, by using our online application form. The program committee consists of *Daniel S. Hamer-*

*mesh* (University of Texas at Austin and IZA) and *Armin Falk* (IZA). Decisions of acceptance or rejection by the program committee will be announced no later than February 10, 2006.

[http://www.iza.org/conference\\_files/TAM2006/call\\_for\\_papers](http://www.iza.org/conference_files/TAM2006/call_for_papers)

### IZA Guest Researchers

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

*Heather Antecol* (Claremont McKenna College and IZA); *Avner Ahituv* (University of Haifa); *Subhayu Bandyopadhyay* (West Virginia University and IZA); *Christian Belzil* (CNRS, GATE and IZA); *Uri Ben-Zion* (Ben Gurion University and IZA); *Sumon Bhaumik* (Brunel University and IZA); *David G. Blanchflower* (Dartmouth College and IZA); *Hans Bloemen* (Free University of Amsterdam); *Tilman Börgers* (University College London); *Tito Boeri* (Bocconi University, Milan and IZA); *Deborah Cobb-Clark* (Australian National University and IZA); *Rachel Croson* (University of Pennsylvania); *Stefano DellaVigna* (University of California, Berkeley); *Olivier Donni* (University of Cergy-Pontoise and IZA); *Francesco Drago* (University of Siena); *Gil S. Epstein* (Bar-Ilan University and IZA); *Gustav Feichtinger* (Vienna University of Technology); *Guido Friebel* (Université de Toulouse I and IZA); *Nicola Fuchs-Schündeln* (Harvard University); *Ira N. Gang* (Rutgers University and IZA); *Christina Gathmann* (Stanford University and IZA); *Lorenz Götte* (University of Zurich and IZA); *Charles Grant* (University of Reading); *David A. Jaeger* (College of William and Mary and IZA); *Spyros Konstantopoulos* (Northwestern University and IZA); *Peter Kuhn* (University of California, Santa Barbara and IZA); *Astrid Kunze* (Norwegian School of Economics and Business Administration and IZA); *Marco Leonardi* (University of Milan and IZA); *Robert I. Lerman* (Urban Institute and IZA); *Edwin Leuven* (University of Amsterdam); *Ulrike Malmendier* (Stanford University and IZA); *Shoshana Neuman* (Bar-Ilan University and IZA); *Ronald L. Oaxaca* (University of Arizona and IZA); *Kristian Orsini* (Catholic University of Leuven); *Jan C. van Ours* (Tilburg University and IZA); *Simon C. Parker* (University of Durham and IZA); *Daniele Paserman* (Hebrew University, Jerusalem and IZA); *Miguel Portela* (Tinbergen Institute and IZA); *Julien Prat* (University of Vienna and IZA); *Xavi Ramos* (Universitat Autònoma de Barcelona and IZA); *Michael R. Ransom* (Brigham Young University and IZA); *Uta Schönberg* (University of Rochester and IZA); *Matthias Schündeln* (Harvard University); *Massimiliano Tani* (University of New South Wales and IZA); *Antonella Trigari* (Bocconi University, Milan); *Rudolf Winter-Ebmer* (University of Linz and IZA); *Hendrik Wolff* (University of California, Berkeley); *Kenneth Wolpin* (University of Pennsylvania)

## Is Germany a “Bazaar Economy”?

It takes a thorough analysis to explore the causes of Germany’s economic stagnation. Globalization is easily held responsible for the current crisis. Many critics claim that Germany has turned into a “bazaar economy”, which assembles imported parts into products “Made in Germany” rather than generating truly domestic output. As a consequence, the argument goes, the economy is struggling and the labor market crisis is aggravated. The export boom, on the other hand, is said to be a mere consequence of Germany’s weak domestic growth. Driven by the excesses of the welfare state, German manufacturers

first switch to capital-intensive production and then to exports, before they eventually move their entire operations abroad. This is why the export boom is sometimes seen as an economic supernova about to swallow the entire country.

Let’s get the facts straight. Germany has traditionally been an exporting nation despite the inevitably resulting net capital exports. The wage level in Germany remains high even after the moderate wage increases of the past ten years. In the area of goods exports, Germany has again earned the title of “world champion”. But when it comes to services, we are still light-years behind other nations. While Germany follows the international trend in shifting the employment structure from manufacturing to services, there is not yet an abundance of new jobs in the service sector. This is partly due to our generous welfare state and the collectively bargained

wages for low-qualified workers. The lack of employment among this group of workers is turning into a millstone around the neck of those who are (still) employed.

Technological progress and the economic laws of the division of labor are forcing the world to shift the demand for labor away from the low-qualified and towards high-qualified workers. As this new trend is becoming more relevant than the notion of comparative advantage, which holds that increased trade is mutually beneficial especially for industrial nations and will lead to rising imports and exports, it is not surprising that intermediate products are also affected. It is true, for instance, that the automotive industry is increasingly importing parts from abroad. But this is by no means a one-way street. German automotive suppliers are exporting more parts than the country is importing. The bazaar is indeed a global one. Just imagine how much “Germany” is driving around inside foreign-built cars!

Our imports are dominated by goods that clearly compete with products made in Germany. If they are less expensive because they have been produced with cheap foreign labor, product competition will displace our domestic labor. The likely consequence, it is argued, will be stagnation. But according to a number of international studies, this hypothesis fails to explain the high unemployment rates.

Each increase in exports based on imported intermediate goods reduces the competitive pressure that imports exert on German products. In fact, imports of finished products - discounting primary/intermediate goods and foodstuffs - are substantially lower than Germany’s exports of these products. In recent years, imports of finished products have even stagnated, partly due to the sluggish growth of the German economy. At the same time, domestic sales of locally produced goods have risen.

Ultimately, we must weigh changes in the level and structure of imports and exports against each other. It is true that parts used in the production of German exports are increasingly acquired abroad. Nonetheless, the volume of strictly German output exported to other countries is growing every year while the import competition that threatens domestic production is stagnating. As net exports will likely continue to rise in the future, there is no reason to be alarmed.

We must instead look elsewhere for the causes of Germany’s economic stagnation. The goods export sector is not part of the problem because it is dominated by high-tech industries that rely on qualified labor - and are able to pay adequate wages. It is much rather the service sector that is in trouble. In the United States, for instance, the deindustrialization process has been much more radical than in Germany. But the Americans have succeeded in mitigating the negative consequences by consistently developing the service sector. In Germany, a relatively high wage level for low-qualified labor, the generous welfare state, and government regulations in many areas are the main impediments to an appropriate response to globalization. It is up to our policymakers now to remove these obstacles by implementing effective reforms rather than calling for explicit or implicit forms of protectionism.




Klaus F. Zimmermann



Institute for the Study of Labor



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