



Reforms of the German Labor Market: Finally Overcoming Structural Weaknesses?

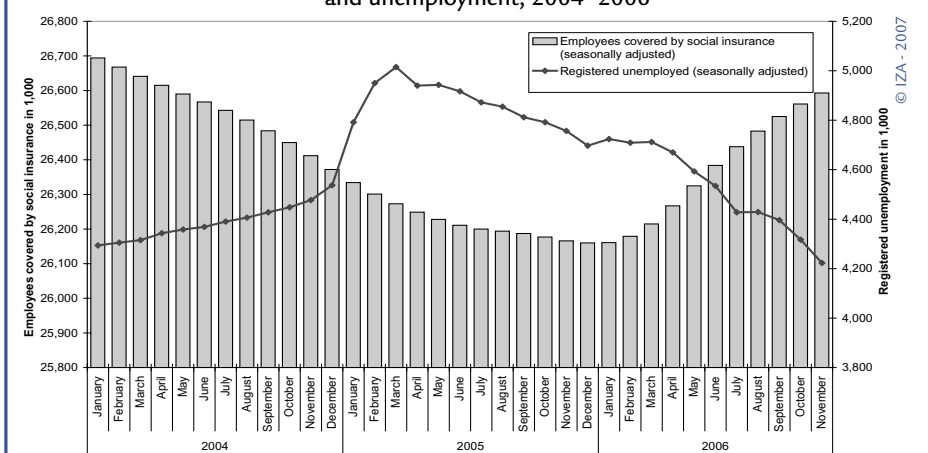
The recent recovery of the German labor market is largely due to a favorable business cycle and increasing growth prospects. It is uncertain whether the positive development can also be attributed to institutional changes as part of the labor market reforms that have been started over the past years. Has the German labor market really become more flexible and adaptable? Have the Hartz reforms – despite rather ambiguous findings from scientific evaluations of their effectiveness – contributed to this outcome? And are the vast amounts of money that Germany spends on active labor market policy really well invested? A number of recent IZA Discussion Papers address these issues and provide a preliminary assessment of the German labor market reforms. The fight against structural unemployment must remain the top priority of policymakers. To achieve fast results, the current growth phase must be used for a consistent modernization of the labor market structure.

Reforming a Continental European Labor Market: Why and How?

Germany fits into established typologies of welfare states and national employment sys-

tems, making it perhaps the best example of a conservative “Bismarckian” welfare state. Competitive industrial production is facilitated and stabilized by an elaborate system of vocational training and industry-wide collective bargaining, as well as by status and skills-protecting employment regulation and a high level of unemployment compensation. Whereas institutional preconditions are conducive to manufacturing in larger firms, the German employment system is ill-equipped for the transformation to a service economy. Part of this adjustment problem is due to policy measures during the 1980s and after the reunification which, as a response to decreasing economic growth, aimed at keeping unemployment down by reducing labor supply. This resulted in a significant increase in non-wage labor costs, as high benefit dependency automatically results in a higher burden of contributions to the German social insurance system, which is particularly harmful to employment in non-tradable services – a field of potential future employment expansion. Hence, whereas the German system is conducive to high productivity and competitiveness in manufacturing, it is less capable of achieving a high level of employment in services.

Seasonally adjusted data on employment and unemployment, 2004–2006



Source: Bundesagentur für Arbeit



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Continental European “welfare states without work” therefore risk their own sustainability as the generation of resources is tied to labor while not providing the institutional prerequisites for employment stability or growth through service sector jobs. To reduce the burden of benefit dependency, opening up employment opportunities in services and a less selective pattern of access to employment is crucial. This implies changes to the overall labor market regime by easing labor market regulation, allowing for more flexible wages, an overhaul of active and passive labor market policies and a reconsideration of welfare state funding via contributions, which would make the institutional arrangement more employment-friendly. To what extent have recent reforms contributed to overcoming these structural problems in the German labor market?

Passive and Active Labor Market Policies: The Shift Toward Activation

For many decades, labor market policies in Germany were predominantly oriented toward passive income maintenance and the reduction of open unemployment, which led to increasing fiscal pressures on unemployment insurance and the federal budget. For this reason, the Kohl government, which was in power until fall 1998, introduced some benefit cuts and increased formal availability and entitlement criteria. These changes, however, were revoked by the incoming Red-Green coalition. The first period of the Schröder government was characterized by an ad-hoc program addressing youth and by experimental pilot projects on better cooperation between the Federal Labor Agency (the body in charge of unemployment assistance) and municipalities (which are responsible for social assistance). Without a general consensus on the role of low-wage employment, the government opted out of general reforms, favoring instead regional experiments and various pilot projects. The basic structure of labor market policies was left untouched, although critical assessments of the performance of active labor market policy schemes became available. Additionally, international experiences from other European countries pointed at the crucial role of activation on making the receipt of benefits conditional upon the accepting of job offers or other active schemes.

In 2002, a report from the Federal Audit Office showed massive misreporting in placement statistics. This led to the Hartz Commission's blueprint for a complete overhaul of active and passive labor market policies. It aimed at a threefold goal: strengthening job placement and reintegration capacities,

activating the unemployed through effective “demanding and supporting” policies and a partial liberalization of the labor market.

The core of the Hartz reform package resulted in major internal restructuring of the Public Employment Service and the introduction of performance-related monitoring in active labor market policies. At the same time, however, the range of active labor market policy schemes was modified considerably. Active measures, which had already been used for many years (e.g. direct job creation schemes or wage subsidies), were supplemented by new and partially innovative programs such as temporary agency work for the unemployed (“Personal-Service-Agenturen”), a new start-up grant (“Ich AG”, literally “Me Inc.”) and different instruments to mobilize the job counseling and placement potential of private service providers, most notably a placement voucher. The established model of organizing publicly-funded training was replaced by allocation via training vouchers. Together with a series of ad-hoc programs addressing the young unemployed and the low-skilled, this increased the complexity of the active labor market policy toolbox even further. For the first time, though, a systematic evaluation of active labor market policies modified by the Hartz reforms was commissioned by the federal government.

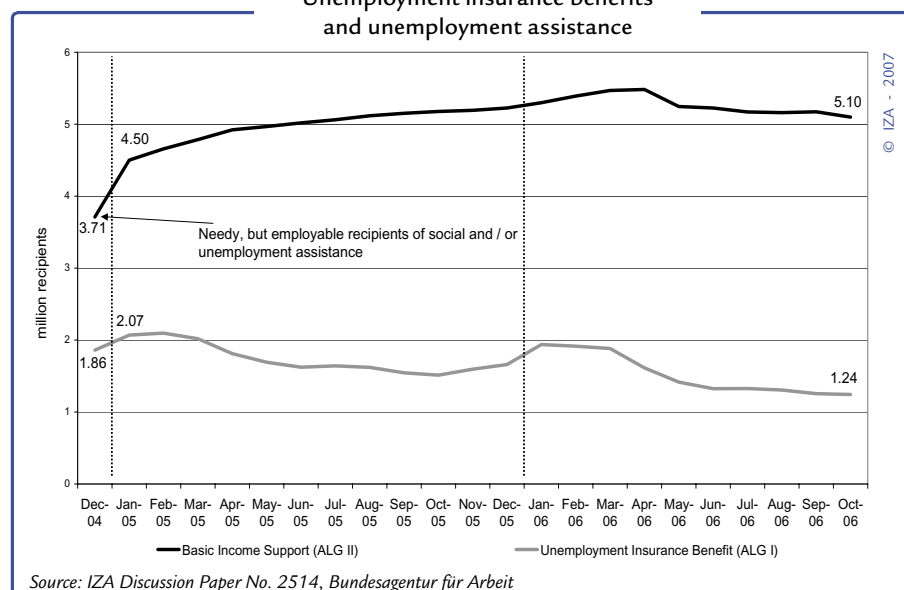
Regarding unemployment benefits, the Hartz reforms left the level of unemployment insurance benefits unchanged, while tightening the availability and entitlement criteria and abolishing annual adjustments of benefits. Through supplementary reforms, the duration of maximum unemployment insurance benefits for older workers was reduced.

The major change, however, was the fourth pillar of the reform package (“Hartz IV”): both earnings-related and means-tested unemployment assistance paid after expiry of unemployment insurance benefits and social assistance for employable people were replaced by a flatrate and means-tested unemployment assistance scheme – without taking into account prior earnings (“Arbeitslosengeld II”). This meant that status protection of the long-term unemployed was abolished in favor of a flat-rate benefit for all jobseekers not entitled to unemployment insurance benefits (▼ Figure).

Hartz IV was conceived as a measure to reduce benefits for the long-term unemployed with high earnings-related unemployment assistance in order to reduce their reservation wage and increase job search intensity. It also aimed at reducing unemployment duration through a more activating approach, which is based on closer monitoring of the long-term unemployed, strict availability criteria and enhanced counseling for jobseekers.

Regarding work incentives, while Hartz IV only reduced benefits for some households, it actually increased benefits for former social assistance recipients and those recipients of low unemployment assistance who did not apply for supplementary social assistance. Incentives to earn more than the income maximum – defined by the earnings disregard clause – are weak as marginal taxation reaches 80 to 90%. This leads to a virtually stagnant net income in spite of higher earnings or longer working time. In addition, public employment opportunities lasting for six to nine months provide additional net earnings of 1–2 euros per

Unemployment insurance benefits and unemployment assistance



hour, which are not deducted from benefits (“one-euro jobs”).

Both public employment opportunities and earnings disregard clauses create strong incentives to work part-time and not search for full-time employment. Net income from unemployment assistance, particularly when combined with earned income from part-time work, is close to or higher than market wages, especially in the case of low-skilled persons. Hence, Germany now clearly has a general and easily accessible in-work benefit scheme.

While activation of the long-term unemployed is at best reluctant in practice, reforms aiming at a better labor market integration of older workers have also been hesitant and contradictory in recent years. Incentives to leave the labor market before the statutory retirement age, such as old-age part-time work (open until end of 2009), still exist. However, the Grand Coalition announced raising the statutory retirement age for the younger generation of workers from 65 to 67.

Systematic evaluation of active labor market policies to address the long-term unemployed under “Hartz IV” is still in its early phases, meaning that no conclusions can be drawn on the effectiveness of measures such as “one-euro jobs.” The commissioned research on active labor market policies within the framework of unemployment insurance, however, has now resulted in the first comprehensive assessment of the effectiveness of a major segment of active measures in Germany and of the changes induced by the Hartz reforms with respect to established instruments and the creation of new programs.

In 2006, nearly 15 billion euros were spent on 60 to 80 major active labor market policy schemes. Within the framework of the evaluation completed in 2006, programs representing slightly less than five billion euros were analyzed systematically with regard to their effects on individual re-employment by comparing program participants with comparable non-participants. For these schemes, the Hartz evaluation studies now facilitate a more stable and robust assessment (► Table).

Positive effects could be found for active labor market policies amounting to 4.2 bil-

lion euros. Four schemes were identified as the most effective: (1) hiring subsidies for employers, (2) publicly-funded training schemes, (3) start-up grants to support business creation and (4) the placement voucher. The period under scrutiny, however, was too short to assess the long-term effects of these measures. At the same time, considerable deadweight losses might lead to an overestimation of employment effects triggered by wage subsidies and start-up grants. Other active labor market policy schemes either did not show any clear effect (e.g. contracting-out of services) or had negative effects on individual labor market careers, such as direct

Increasing the Tax Share of State Funding for Welfare

Attempts at lowering non-wage labor costs have been a recurrent topic in recent reforms. The Red-Green Coalition, for instance, aimed at reducing the burden of non-wage labor costs through an increase in the share of social expenditure. This was financed through taxes by introducing an additional tax on fuel, gas and electricity in 1999.

Public health insurance and old-age pension systems are moving toward a basic protection system, which could possibly reduce non-wage labor costs over time. At the same time, general tax revenues are more heavily used to subsidize social security and private pension schemes. The share of taxes in the funding of social expenditures rose from 33.1% in 1992 to 39.1% in 2003, not only due to a long-term increase in the share of unemployment insurance and active labor market policy and pensions, but also due to health insurance expenditures funded through taxes. This trend has been further amplified by the Hartz IV reform. The most recent changes resulted in a cut in unemployment insurance contributions (to be financed by lower expenditures in this scheme) and a VAT increase of three percentage points effective January 2007. At the same time, though, contribution rates for pension insurance and many health care funds were raised, which prohibited an effective cut in non-wage labor costs.

This, however, is only true for regular employment, as part-time jobs below a certain earnings level benefit from lower social insurance contribution rates. The so-called “marginal jobs” were exempt from social insurance and only subject to lump-sum taxation. Employees can now earn of

up to 400 euros per month without the deduction of income taxes and employee contributions, whereas the employer must pay contributions of 30% (slightly higher than the regular rate) and a lump-sum wage withholding tax (2%). So-called “mini-jobs” in private households benefit from even lower employer contribution rates.

Regulation of the Labor Market: Continuing Partial Deregulation

As in other continental European countries, reforms of labor market regulation were

Expenditure and evaluation

	2002		2006	
	billion €	%	billion €	%
Total expenditure on active labor market policies	22.1	100.0	15.0	100.0
Not evaluated, includes:	9.7	43.7	10.2	68.4
Programs for the disabled	3.1	14.1	2.4	16.3
Programs for the young unemployed	3.2	14.5	1.7	11.2
Old-age part-time work	0.7	3.1	1.3	8.4
Active schemes for the long-term unemployed (Hartz IV)	-	-	3.8	25.6
Evaluated, includes:	12.4	56.2	4.8	31.7
Positive effects, includes	1.4	6.1	4.2	28.1
Hiring subsidies	1.4	6.1	0.3	1.9
Publicly funded training	-	-	1.3	11.4
Start-up grant I	-	-	1.5	9.8
Start-up grant II	-	-	1.0	6.9
Placement voucher	-	-	0.1	0.7
Negative effects, includes:	3.2	14.4	0.2	1.5
Direct job creation	2.3	10.6	0.1	0.7
Structural adjustment schemes	0.8	3.7	0.1	0.5
Temporary agency work for the unemployed	-	-	0.0	0.3
No or unclear effect, includes:	7.9	35.7	0.3	1.9
Publicly funded training	6.7	30.4	-	-
Start-up grant	1.0	4.6	-	-
Contracting-out	0.2	0.8	0.0	0.2
Transfer schemes	-	-	0.2	1.4

Source: IZA Discussion Paper No. 2605

job creation schemes and similar structural adjustment schemes or temporary agency work for the unemployed. With respect to expenditures in 2006, only 28 percent of all resources triggered a clearly positive effect.

More than two-thirds of all expenditures are not yet covered by appropriate evaluation. This holds true for 3.8 billion euros spent on active measures within the Hartz IV framework, as well as for programs addressing young unemployed and the disabled as well as for old-age part-time work. These programs amount to nearly 5.4 billion euros.

limited to flexible jobs and marginal changes in dismissal protection. We can observe a long-term trend toward progressive flexibility at the margin by easing restrictions on fixed-term contracts and temporary agency work. However, an approach by Red-Green in 1999 allowed fixed-term contracts only in the case of newly hired employees. The Hartz reforms lowered the age threshold for fixed-term employment to 52, which, combined with other measures, meant that dismissal protection was neutralized for newly hired older workers.

Temporary agency work was largely liberalized within the Hartz context in order to facilitate job placement via commercial temporary work agencies. At the same time, though, collectively negotiated wages were established in this sector, leading to some reduction of the wage differential between regular and temporary employment.

Dismissal protection, finally, was maintained without major changes. In 2003, the Red-Green coalition revoked a prior reform and raised the size threshold for the application of statutory dismissal protection for new hires.

Wage Setting, Working Time and Collective Bargaining: Flexibility on the Inside

With regard to wage setting, we cannot see a general change of the industrial relations system. Collective bargaining coverage and membership in unions and employers' associations has been declining in recent years. This implies that collective agreements have less influence on enterprise-level arrangements regarding working time and wages. At the same time, flexibility inside the system has grown due to wider

provision and use of opening clauses and frequent experiences with enterprise-level concession bargaining in industries where international competition has become more intense. As a consequence, over the last years, both collectively-agreed and effective wages increased only moderately, with Germany being one of the countries with the lowest level of wage growth and declining unit labor costs.

As with wage setting, working time is mostly influenced by the social partners and by enterprise-level bargaining. Collective and enterprise-level agreements have allowed for the more widespread existence of highly-flexible working time arrangements in the late 1990s. However, most recent trends in collective agreements and enterprise-level bargaining point in the opposite direction, with agreed and effective working time growing again. This development was triggered by businesses aiming for higher competitiveness, which could not only be realized by wage cuts but also by longer working hours at given wage levels – all of which would result in lower unit labor costs. Together with the newly gained flexibility of wage setting, this has strengthened the flexibility and competitiveness of German industry in global markets.

Legal interventions in wage setting and working time are rare in Germany. In 1999, however, the Red-Green government changed the posted workers law which allowed the Minister of Labor to make minimum wage agreements in the construction sector generally binding. Prior to this reform, generally binding collective agreements depended upon the consensus among peak associations of employers and unions. This led to a subsequent increase in minimum wages in the construction sec-

tor. Currently, the trade unions and Social Democrats are considering either the introduction of a general statutory minimum wage or making collectively agreed minimum wages generally binding through the expansion of the posted workers law.

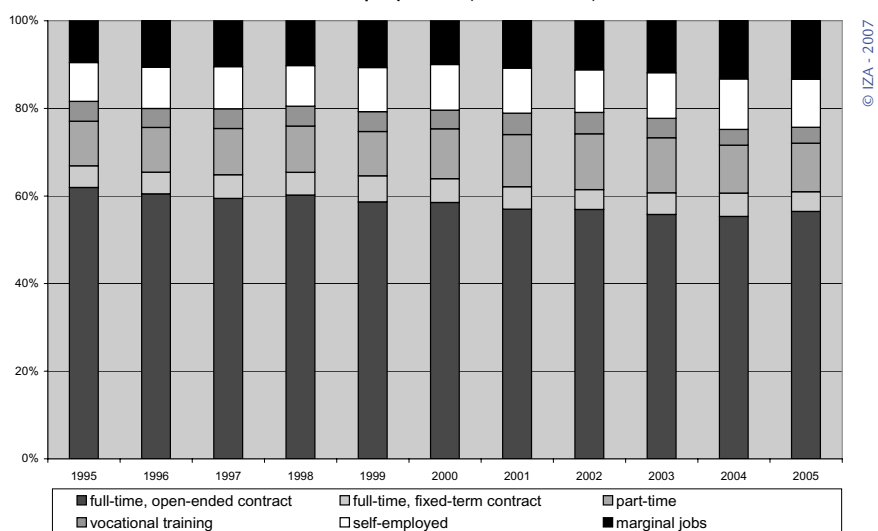
Has the Adjustment Potential of the German Labor Market Increased?

Institutional change of the German employment system is both gradual and fundamental in the sense that established core elements of the labor market (such as unemployment insurance, strict dismissal protection and reliance on social insurance as well as collective bargaining) are still in place. Hence, path dependence and stability are significant features. At the same time, though, fundamental change has taken place. In both public pensions and health care – but even more clearly in benefits for the long-term unemployed – a shift away from status-related (Bismarckian) benefits to basic protection schemes (Beveridge) was initiated. An increasing share of welfare state funding has come from general taxation. This is not only due to benefit cuts in social insurance, but also due to the move toward a more tax-based labor market policy for the long-term unemployed.

However, the benefits of activation strategies and policies to reduce benefit dependency are not clear yet. Therefore, social expenditure could not be reduced significantly so far, which is also true for non-wage labor costs. As part of a pattern of marginal flexibility, however, part-time work with lower contributions, employment subsidized by in-work benefits and self-employment have grown (◀ Figure). Core regular employment is still charged with high taxes and contributions and strict dismissal protection, but the core of the labor market has benefited from regained competitiveness due to higher flexibility in wages and working time.

While the German labor market has become more adaptable, the dual character of the employment system – shrinking but competitive regular employment and growing, flexible employment – also means that transitions are problematic. The cost of introducing low-wage jobs and high flexibility through the backdoor in order to avoid “Americanization” is the limited mobility to the core of the labor market and continued high burden of taxes and contributions need to subsidize people outside of the labor market or with only partial labor market attachment. This approach of gradual reforms or “institutional layering” means higher flexibility, but also new segmentation.

Regular and flexible employment in % of all employment (1995–2005)



Source: IZA Discussion Paper No. 2215, Socio-Economic Panel

However, growth of flexible jobs tends to crowd out standard employment. The challenge now is to continue activation and to complement this with higher labor market flexibility. What is necessary in economic terms, though, involves controversial issues such as the role of higher wage dispersion and higher inequality within the regular labor market and not only in carefully segregated compartments of the labor market, as the current debate on in-work benefits and minimum wages shows. Yet, what would be more efficient in economic terms requires a fair amount of political courage. Policymakers are therefore well-advised to take advantage of the recent economic upswing in order to implement further reform steps.

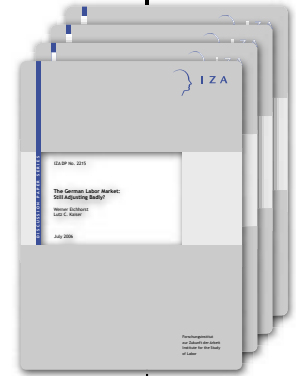
IZA Discussion Papers on the topic:

IZA DP No. 2605: Werner Eichhorst/Klaus F. Zimmermann:
Dann waren's nur noch vier: Wie viele und welche Maßnahmen der aktiven Arbeitsmarktpolitik brauchen wir noch?
► <http://ftp.iza.org/dp2605.pdf>

IZA DP No. 2514: Werner Eichhorst/
Maria Grienberger-Zingerle/Regina Konle-Seidl:
Activation Policies in Germany: From Status Protection to Basic Income Support
► <http://ftp.iza.org/dp2514.pdf>

IZA DP No. 2505: Bernhard Ebbinghaus/
Werner Eichhorst:
Employment Regulation and Labor Market Policy in Germany, 1991–2005
► <http://ftp.iza.org/dp2505.pdf>

IZA DP No. 2215: Werner Eichhorst/Lutz C. Kaiser:
The German Labor Market: Still Adjusting Badly?
► <http://ftp.iza.org/dp2215.pdf>



IZA DISCUSSION PAPER NO. 2574

Are Older Workers Really More Risk-Averse and Less Adaptable to Change?

Most European labor markets are facing the same dilemma: While the baby-boom generation is approaching retirement age, many industries are experiencing a shortage of skilled workers. This is why strategies of reintegrating older workers in the labor market through activation and training play an important role. As IZA Research Report No. 6 has shown, most German employers are insufficiently prepared to fill this gap since they often underestimate the benefits of having older workers in the workforce.

Against this background, a recent IZA Discussion Paper by Gary Charness (University of California, Santa Barbara) and Marie-Claire Villeval (CNRS-GATE and IZA) seeks answers to the questions brought about by the 'graying' of society, including, most importantly, the question: How can these senior members of the workforce – and those who have already retired – continue to benefit the economy?

Folks over fifty years of age are plagued by a number of misconceptions – most commonly that aging is synonymous with a decline in ability and performance, or that they are overly cautious and less willing to learn. Despite laws against it, 'gray-hair discrimination' is a real problem facing the baby-boom generation.

A 2003 survey of French employers, for instance, cited "lower adaptability to techni-

cal change" as the most common reason for not employing people over the age of 50. Furthermore, research in Sweden – the country with the highest rate of participation for seniors in the workforce – showed that half of all employers believed that seniors were "less flexible and less willing to change." Discrimination rooted in these misconceptions has edged 'seniors' out of the workforce and replaced them with a smaller generation of younger workers, clearly having serious implications for the sustainability of pension systems and the economy at large.

Charness and Villeval's research shows, though, that it may well be "inadvisable to exclude seniors from the labor force." Their report, which provides important insights into the behavior and performance of both older and younger workers in France, not only debunks many misconceptions about so-called senior (aged 50+ years) workers, but also analyzes the manner in which juniors (under 30 years old) and seniors interact with each other at the workplace.

In order to better understand these interactions, Charness and Villeval conducted on-site field research at two large French firms, where junior and senior employees were given a series of tasks aimed at measuring cooperation, risk and effort. Additionally, the authors repeated the exercises in a conventional laboratory environment, where the juniors and seniors were represented

by students and retirees, respectively. The purpose of the laboratory experiments was to expand the age dispersion in their observations, and to observe potential workers who were either not yet or no longer employed.

One of their first conclusions is that older workers, contrary to the conventional stereotype, are not more risk-averse. In fact, the study shows that seniors are less likely to underestimate their abilities than their junior colleagues.

Their on-site experiments also showed that seniors "react to incentives and the competitiveness of the working environment as strongly as juniors" and that there is "no significant difference in performance across the generations."

Perhaps most importantly, Charness and Villeval's research also yields interesting results with regard to the concept of an intergenerational workforce. According to their observations, cooperation among employees was highest in groups comprised of a balance between juniors and seniors – suggesting that there is, indeed, a compelling reason to maintain a workforce with diversity in age. Working seniors, for instance, cooperate the most in an age-balanced group, as if to teach juniors the benefits of teamwork. Another telling observation shows that both groups seem to anticipate

the advantage of being in a heterogeneous group, as though there were a distinct preference for such hybridity.

Besides increases in productivity, the opportunity for knowledge transfer should also be an attractive benefit for employers. An age-balanced workforce presents young employees with the opportunity to share their fresh ideas and knowledge of new technologies, while also providing senior employees with the chance to share their experiential knowledge. In short, the study concludes that workplaces with more heterogeneous skill levels are more productive.

All of these considerations suggest that it is worthwhile to include seniors in the workforce, and to develop incentive schemes toward this end. This issue is particularly relevant in countries such as France and Germany, although the preva-

lent age discrimination in the United States makes it clear that this is a real problem there as well. In both the United States and Europe, the demographics indicate that pension plans and retirement systems are in serious peril.

Some governments have begun to realize the gravity of this problem. For example, after previously legislating early retirement for older workers, France has changed course in recent years by ending these programs. Some companies have also started to care about diversity management and seem aware of the benefits of such a policy.

Nevertheless, participation rates for older workers remain low and it is still un-

usual for a senior worker to be replaced by another senior worker. Much of the problem seems to stem from the demand side, despite the introduction of penalties against the firing of seniors. Will jobs be available, given the misconceptions surrounding older workers? Clearly the first step for employers will need to be a change in mindset and the realization that both older and younger workers have vital skills, attitudes and experience to offer.



IZA WORKSHOP

IZA Workshop: EU Enlargement and the Labor Markets

What is the labor market impact of EU enlargement? Will east-west migration and the differences in national regulations concerning freedom of movement for potential migrants have positive or negative effects on the domestic labor markets of old EU member states? These questions were addressed by an IZA project group led by IZA Director *Klaus F. Zimmermann* and IZA Research Associate *Martin Kahanec* at a workshop on November 30, 2006, during which international experts in the field presented the most recent country studies. In particular, topics of interest included the magnitude of the migration flows from the new member states and its effect on the three countries that have opened up their labor markets (the UK, Ireland and Sweden). The impact on Poland, the largest sending country, as well as the public perception of migration in Europe and the overall effects of European integration were also addressed by the researchers.

Gerard Hughes (Trinity College, Dublin) presented evidence of a large increase in labor migration into Ireland from the new member states after 2004. The author concluded that this immigration was largely demand-driven, while there was no aggregate evidence on the effects of displacement on unemployment figures, since Irish workers moved to better-paying jobs. *Eskil Wadensjö* (Swedish Institute for Social Research and IZA) arrived at similar results for Sweden. While immigration from the new member states to Sweden has also increased, it still constitutes a very small proportion of overall immigration. Based on household data from Statistics Sweden, he found a wage penalty of around 10 percent for these immigrants. Despite Sweden's strong growth rates, overall immigration remains at a low level, which can be largely attributed to language barriers.

Jonathan Portes (Department for Work and Pensions, UK) also acknowledged a large increase in immigration from the new member states, but found no econometric evidence that these immigration flows have contributed somehow to the rise in unemployment within the UK. Thus none of the researchers found evidence of "welfare tourism." Social problems, however, did arise from a regional concentration of Eastern European immigrants, who are overrepresented in the agricultural sector. This has prompted the British government to restrict the freedom of movement for EU citizens from the new member states Bulgaria and Romania.

According to *Krystyna Iglicka* (Leon Kozminski Academy of Entrepreneurship and Management, Warsaw), Poland is experiencing substantial problems due to its twin status as a large emigration and immigration country. While the emigration of more than 300,000 skilled workers between 2004 and



Gerard Hughes

Eskil Wadensjö

Jonathan Portes

Krystyna Iglicka

Marcel Canoy

Michael C. Burda

2006, mainly to the UK and Ireland, has contributed to lowering the Polish unemployment rate (and led to increased remittances sent to Poland), the country has suffered from a shortage of workers in some sectors despite substantial return migration. The government responded by opening parts of the domestic labor market to migrants from the Ukraine and allowing more freedom of movement for new EU citizens from Bulgaria and Romania. The effects of this policy, however, are expected to be rather small since

Poland is not yet sufficiently attractive for potential immigrants in sectors where the demand is particularly strong.

The second part of the conference focused on the public and scientific perceptions of migration and in Europe. *Marcel Canoy* (Bureau of European Policy Advisers, European Commission) emphasized the need for effective migration management policy to improve the generally negative public perception of migration and migrants. *Michael C. Burda*

(Humboldt University, Berlin and IZA) quantified the overall positive effects of migration using the example of German reunification. *Anzelika Zaiceva* (IZA) underscored the positive aggregate effects of EU enlargement and started a lively discussion on the preliminary assessments and future prospects of this process. All studies and presentations from this highly policy-relevant workshop are downloadable from the IZA website.

► <http://www.iza.org/EULaMa2006>

NEW IZA BOOK

Immigration Policy and the Labor Market: The German Experience and Lessons for Europe

German and European immigration policies have only recently begun to cope with the inevitable: growing labor demand in the face of high unemployment and a shrinking labor force due to demographic change. Despite the implementation of Germany's first immigration act, other initiatives on the national level of western EU member states, and efforts towards legal harmonization at the EU level. An actively controlling immigration policy, which would be needed to master the challenges ahead, is not yet in sight.

In the light of first experiences with the new German immigration and integration law, a new IZA book, authored by *Klaus F. Zimmermann, Holger Bonin, Holger Hinte* (all IZA) and *René Fahr* (University of Cologne and IZA), provides a comprehensive account of the immigration situation in Germany. Moreover, it develops future perspectives that are not confined to Germany but can be applied to many other European nations as well. It thus lays the foundation for a joint European immigration strategy.

The passing of the first comprehensive immigration law in German history in January 2005 marks a historical turnaround after this crucial policy field had been dangerously neglected over the past decades. Since German policymakers previously focused on strategies to curb immigration, effective integration programs were rare. While the new immigration law still has deficiencies (which are analyzed in this IZA volume), its implementation raises hopes that a strategic immigration policy accounting for economic criteria could well be established over the medium term. This prospect becomes all the more important as many industrialized nations and the European Union as a whole are increasingly moving issues of immigration, integration and the labor market

toward the top of their agenda. Against this background and the growing competition among aging western societies in filling shortages of high-skilled labor, Germany – despite the new law – still lags far behind other nations in terms of immigration policy.

German competitiveness in this field is still limited and may even further decrease if policymakers were to take a break now rather than continuing on the new path after painfully pushing the bill through parliament. The fact that Germany is still a leading European immigration country based on the annual inflow of foreigners is by no means contradictory to these findings. One of the key problems is that Germany remains an attractive receiving country for those who would be unable to meet the immigration requirements of other nations.

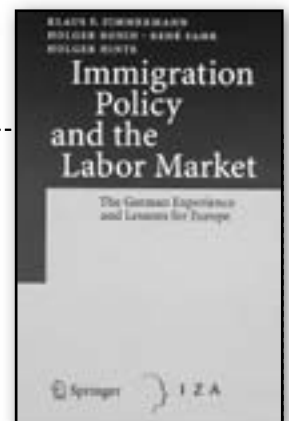
Germany negligently forgoes the enormous welfare gains associated with an active “quality control” of immigration. The analysis of the inevitable trend towards a shrinking and aging population shows that an immigration policy based on economic demand – although it cannot single-handedly solve the funding problems of the social security systems – must become an integral part of any larger strategy to deal with the challenges of demographic change.

This volume is the first book that combines a scientific evaluation of the situation in Germany before and after the implementation of the new Immigration Act with concrete policy proposals for a comprehensive future migration and integration policy at the national and European level. The study

Klaus F. Zimmermann/Holger Bonin/René Fahr/Holger Hinte

Immigration Policy and the Labor Market: The German Experience and Lessons for Europe

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209 pages



is based on intensive research and advisory activities by IZA in the field of migration policy. At the core of the IZA analyses is the deep conviction that an immigration policy consistently geared towards economic needs is the best guarantee for a successful integration of immigrants into society and the labor market.

“Western Europe, and in particular Germany, have come to realize that they are regions of substantial net immigration. This book develops prospects for future trends in German and European immigration policies. It is an essential input into any serious public policy discussion of European immigration issues.”

Barry Chiswick
(University of Illinois at Chicago)

“Legal migration should be managed rather than endured. To show policy makers and citizens under which circumstances legal migration can be beneficial, research is needed and puzzles need to be solved. Which criteria should be applied? What can we learn from traditional migration countries? What role is there for Europe? This book is a valuable contribution to these pertinent questions.”

Marcel Canoy
(Bureau of European Policy Advisers, Directorate General of the European Commission)

IZA / World Bank Workshop on Informal Labor Markets in Developing and Emerging Economies



The economic progress of developing countries is often impeded by the problematic structures of their labor markets, which are marked by substantial shadow economic activity and large informal sectors. At the same time, these activities undermine efforts to provide social security for the citizens of these countries. A thorough analysis of the particular characteristics and mechanisms of developing and emerging economies is therefore a prerequisite for more efficiency in international development assistance and for the economic success of these countries. Against this background, IZA joined forces with the World Bank in bringing together academic and applied researchers who presented their research on "The Informal Economy and Informal Labor Markets in Developing, Transition and Emerging Economies." The two-day workshop in Bertinoro, Italy (January 26–27, 2007), was sponsored by the Fondazione Cassa dei Risparmi di Forlì and organized by *Hartmut Lehmann* (University of Bologna and IZA Program Director for Labor Markets in Emerging and Transition Economies), *Riccardo Rovelli* (University of Bologna and IZA) and *Stefano Scarpetta* (OECD and IZA).

From the scientific debate on informality, three paradigms about informal employment and its role in the broader context of labor markets in the developing countries have emerged. The traditional paradigm sees segmentation as the characterizing feature of labor markets in developing countries and informal employment as the secondary and involuntary ("bad") segment, as some workers are crowded out of the primary ("good") segment of the labor market. The second, "revisionist" paradigm – in its pure version – sees informal employment as coming about because of a voluntary choice of workers. In essence, workers choose this state because they are better off than if they remained formally employed. The third paradigm is a hybrid: here the labor market is segmented into formal and informal sectors, but within the latter there is further segmentation. On the one hand, there is a minimum of rationed "good" jobs that workers voluntarily take up. Meanwhile, a surplus of "free entry" jobs exists, which workers do not like but must take because they are kept out of the formal sector and the "upper tier" jobs in the informal sector.

Gary Fields (Cornell University and IZA) has been closely associated with this last paradigm. He presented a general paper on "Modeling Labor Market Policies in Devel-

oping Countries," emphasizing that "sound labor market policies require sound labor market models." He pointed to three important aspects of such models: 1) adopting a welfare economics point of view and clearly stating the objective function; 2) developing rigorous theoretical models that could incorporate multiple sectors; and 3) having proper empirical evidence using micro, aggregate and qualitative data.

Much of the recent work that supports this second model on informality has been done by *William Maloney* (World Bank), who presented a paper on "Informality and Gross Worker Flows in Latin America." The evidence on worker flows in Mexico, which was presented in detail by the author, seems to provide support for the second paradigm. The evidence for Brazil, on the other hand, is less clear and leads one to wonder whether the results from Maloney's empirical work over the last decade – which has focused almost exclusively on Mexico – can also be applied to other developing countries.

The paper presented by *Hartmut Lehmann* on "Informal Employment and Labor Market Segmentation: Evidence from Ukraine" provided strong evidence for the applicability of the third model in this transition country. Using information from the Ukrainian Longitudinal Monitoring Survey on the voluntary nature of informal employment, the evidence suggests that one third of workers freely choose informal employment, but that two thirds queue in the informal sector for formal sector jobs.

Andrey Launov (University of Würzburg and IZA) also provided evidence for the third paradigm in his paper on "Competitive and Segmented Informal Labor Markets," which included an econometric model for the analysis of the dual structure of the informal labor market that integrates Heckman's sample selection model. Using data from Côte d'Ivoire, the main estimation result indicated that the informal labor market had a heterogeneous latent structure with both "free entry" and rationed segments.

Stefano Scarpetta, in his presentation of the paper "For Better or for Worse? Job and Earnings Mobility in Nine Developing and Emerging Economies," looked at the challenging task of providing evidence on workers' transitions between labor market states (including the informal sector) and the consequences on earnings in

a large cross-country study that included six transition and three Latin American developing economies. A fundamental challenge arises because of the difficulty to define informality in a uniform fashion given the non-uniformity of the data sources. The main findings of the paper are the high mobility of workers across labor market states in all countries, the higher turnover in the informal sector and the fact that moves from formal to informal employment result in earnings losses in the three developing countries while the evidence is less clear with regard to the transition countries.

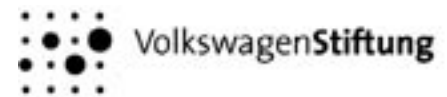
The paper "Developing a Statistical Instrument for Assessing Informality," presented by *Valeria Perotti* (University of Rome Tor Vergata), opened some insights into the laborious first stages of a research project on informality. The paper describes the development of a household questionnaire module that assesses the links between informality and social protection, and also provides some descriptive analysis of data derived from a pre-test in Bulgaria and Colombia. In the presentation, the main emphasis was on the link between employment status and subjective beliefs, as well as attitudes towards different social security systems. The preliminary evidence from the pre-test showed a substantially higher incidence of informality in Colombia.

A very different perspective on informality was taken in the theoretical paper "From Formal to Informal: The Role of Capital Accumulation in Senegal," which was introduced by *John Bennett* (Brunel University and IZA). In the model of the paper, formal sector entrepreneurs are reluctant to reinvest all their profits into their own firms. If they did this and their enterprises grew accordingly, large parts of the profits might be "captured" by members of the extended family for consumption purposes. This argument could explain the size distribution of formal firms in West Africa in general – and in Senegal in particular – and the stylized fact that many formal firms provide capital to start up informal businesses.

All papers presented at this workshop are downloadable from the IZA website.

► <http://www.iza.org/link/bertinoro2007>

IZA Interethnic Practitioners' Meeting on Naturalization and Citizenship



IZA's third Interethnic Practitioners' Meeting was held in Bonn on January 15, 2007 as part of the IZA research project "The Economics and Persistence of Migrant Ethnicity." This project is supported by the Volkswagen Foundation and led by IZA Director *Klaus F. Zimmermann* and *Amelie Constant* (IZA and Georgetown University). The exchange of ideas and experience between IZA researchers and experts in the field surrounded the topic of naturalization and citizenship. Among the invited guests were naturalized and non-naturalized immigrants to Germany, as well as representatives of government agencies and major NGOs dealing with citizenship issues. They discussed possible motives for or against naturalization, as well as the legal framework and the economic determinants of the decision to apply for German citizenship.

Following the introduction by Klaus F. Zimmermann, IZA Research Fellows *Don J. DeVoretz* (Simon Fraser University) and *Pieter Bevelander* (Malmö University) led the discussion with the invited migrants. The exchange yielded important insights into complicated motivational issues that will be highly relevant



3rd IZA Interethnic Practitioners' Meeting – January 15, 2007

for future research. Another important aspect discussed by the participants of the meeting was the recent decrease in the German naturalization rate. The next IZA Inter-

ethnic Practitioners' Meeting will focus on the issue of interethnic marriages.

► <http://www.iza.org/link/iepm3>

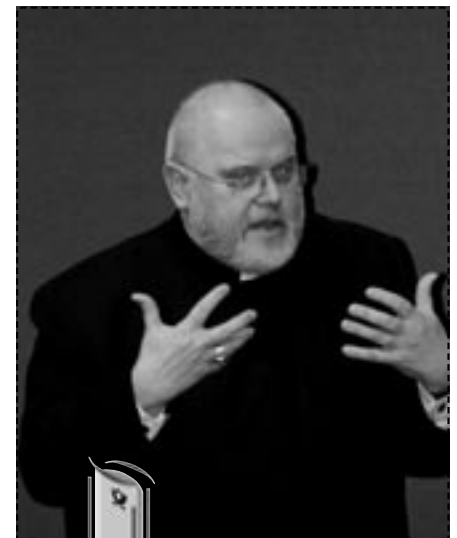
Bishop Reinhard Marx at IZA Tower Talk: A Social Market Economy Based on Ethical Principles

Reinhard Marx, Bishop of Trier, was the guest speaker at the 16th IZA Tower Talk, where he spoke before a crowd of 300 invited guests on the relationship between labor and capital in the age of globalization. Marx, who is chair of the German Catholic Bishops' Conference's Commission for Society and Social Affairs, outlined the basic principles of Catholic social teaching and commented that "freedom in responsibility" must be the goal of economics. To that effect, the bishop rejected any form of collectivism and mapped out his idea for a "social market economy based on ethical principles," which would need to be strongly aimed at (global) welfare.

Marx warned that methodological individualism in economics – in the form of "*homo oeconomicus*" – cannot be the only valid view of the world, and said that he viewed politics and economics as responsible to hinder boundless global capitalism. Furthermore, Marx criticized noticeable tendencies toward a "rent-seeking society," in which short-term profit maxi-

mization are the paramount principles. Capitalism and the free market economy, stressed Marx, will only be ethically maintainable through a binding, universally-accepted legal framework. Even the Catholic social teachings explicitly speak out on the concept of free market economy – though "material prosperity is not the only goal." Competition must be understood as a means – not the end. The free market economy requires a long-term period of dependability, along with a state-run framework, in order to strengthen the trust of the people.

The matter of how such a state-run framework could look in the age of globalization served as the topic of a lively audience discussion, led by IZA Director of Labor Policy *Hilmar Schneider*. According to Marx, the WTO could play a key role in developing a framework that would prevent "degrading labor conditions," and take to heart the notion of minimum working standards at the international level.



IZA
Tower Talk

Reinhard Marx has served as Bishop of Trier since 2002. He is head of the "Commission for Society and Social Affairs" of the German Bishops' Conference and chairman of the "German Commission for Justice and Peace."

Enrico Moretti Receives IZA Young Labor Economist Award

On January 6, 2007, IZA Director *Klaus F. Zimmermann* presented the first IZA Young Labor Economist Award to *Enrico Moretti* (University of California, Berkeley) during an IZA reception held at the Annual Meetings of the Allied Social Science Associations (ASSA) in Chicago. This newly established prize is awarded for an outstanding paper published by young labor economists under the age of 40. The selection committee – consisting of *Klaus F. Zimmermann*, IZA Research Director *Armin Falk* and six IZA Program Directors – chose Moretti's paper "Estimating the Social Return to Higher Education: Evidence from Longitudinal

and Repeated Cross-Sectional Data" (*Journal of Econometrics*, 2004) from a large number of nominations submitted by IZA Research Fellows.

During the award ceremony, Zimmermann stated the selection committee was impressed by the "scientific originality, methodological rigor and policy relevance" of the paper, which provided evidence that the social return to education may in fact exceed the private return. In his acceptance speech, Moretti declared he felt extremely honored to receive this inaugural award from an "institute that



has in just a few years established itself at the forefront of international research in labor economics."

IZA Director Klaus F. Zimmermann Becomes Honorary Professor at Renmin University of China

In a festive ceremony on December 20, 2006 in Beijing, *Richard B. Freeman* (Harvard University, NBER and IZA) and IZA Director *Klaus F. Zimmermann* have been appointed Honorary Professors of Renmin University of China in recognition of their outstanding contributions to labor economics. Both economists were awarded this high honor from the hands of *Tianquan Cheng*, Chair-

man of the University Council of Renmin University, in front of a larger number of distinguished Chinese labor economists, government officials, and many research students. The laudations were given by *Xiangquan Zeng*, Dean of the School of Labor Relations & Human Resources of Renmin University and Director of its China Institute for Employment Research (CIER).



Call for Papers: Research in Labor Economics

IZA encourages its Research Fellows and Affiliates as well as all other interested labor economists to submit papers to the Research in Labor Economics (RLE) series, a well-established scientific series consisting of a collection of refereed research papers in the field of labor economics. Started in 1977 by *Ronald Ehrenberg* (Cornell University), the series has been edited by *Solomon Polachek* (Binghamton University) 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. Since 2006, the RLE series has benefited from the contribution of IZA. It was extended to two volumes per year with one volume remaining in the tradition of the series with empirical and theoretical papers in labor economics and a second volume being more policy-oriented, in the spirit of IZA's focus on policy aspects of labor economics.

IZA Research Associate *Konstantinos Tatsiramos* serves as co-editor of the series

which is characterized by high-quality research papers focusing on empirical, theoretical and policy-oriented topics, a fast refereeing process, and special issues concentrating on highly relevant individual topics. General information on RLE submission guidelines can be found at

► <http://www.iza.org/rle>

Papers submitted before August 31, 2007 will receive priority for publication in the 2008 volumes.

IZA Guest Researchers

From January 2007 until March 2007 the following renowned economists stayed at IZA to discuss issues of labor market research and policy:

Avner Ahituv (University of Haifa); *Christian Belzil* (CNRS, GATE and IZA); *Pieter Bevelander* (Malmö University and IZA); *Michael Bognanno* (Temple University and IZA); *Lex Borghans* (University of Maastricht and IZA); *Espen Bratberg* (University of Bergen); *Don J. DeVoretz* (Simon Fraser University and IZA); *Markus Frölich* (University of St. Gallen and IZA); *Bart Golsteyn* (University of Maastricht); *Peter T. Gottschalk* (Boston College and IZA); *Anton Hemerijck* (WRR Netherlands Scientific Council for Government Policy); *Thomas Hintermaier* (IHS - Institute for Advanced Studies, Vienna); *Helena Holmlund* (CEP, London School of Economics); *Robert I. Lerman* (Urban Institute and IZA); *Mariapia Mendola* (University of Milan and Centro Studi L. d'Agliano); *Mark Schaffer* (Heriot-Watt University, Edinburgh and IZA); *Uta Schönberg* (University of Rochester and IZA); *Olmo Silva* (London School of Economics and IZA); *Kjell Vaage* (University of Bergen).

IZA Research Fellow Riccardo Faini Died Unexpectedly

The community of IZA Research Fellows lost an exceptional scholar when *Riccardo Faini* died suddenly on January 20, 2007 at the age of 55. Among economists he was well known for his fundamental contribution to the theory underlying the “new economic geography” (*Economic Journal*, 1984) and his influential work in the economics of migration, finance and development, trade and development. He was also directly involved in economic policy, first at the World Bank, then serv-

ing as Executive Director for Italy at the International Monetary Fund, and in the Italian Treasury over the past several months.

Faini was an IZA Research Fellow since November 2001 and collaborated with IZA mainly on migration topics. In 1999 he co-edited a volume on “Migration – The Controversies and the Evidence” with IZA Director *Klaus F. Zimmermann*. Riccardo Faini was a great colleague and person, as

everybody found who met him. He will be sorely missed.



Riccardo Faini

Gerard J. van den Berg Appointed as Top Professor at Free University of Amsterdam

As of January 2007, IZA Program Director *Gerard J. van den Berg* has been appointed as Top Professor at the Free University of Amsterdam. Deemed pivotal for the university, Top Professors receive special means to stimulate their research activities. Currently, the Free University of Am-

sterdam has three Top Professors. Van den Berg's appointment is well-tuned to his role as IZA Program Director for the evaluation of labor market policies and will strengthen further research initiatives at IZA as well as facilitate future collaboration between the institute and van den

Berg's research team at the university.



Gerard van den Berg

Armin Falk New EEA Council Member

Armin Falk has been elected as a Council Member of the European Economic Association (EEA) for a five-year period starting January 1, 2007. EEA Secretary *Ian Walker* (University of Warwick and IZA) congratulated Falk on the vote result and thanked him for his continuous support of the EEA in its work.

John T. Dunlop Award for IZA Research Director

In January 2007, IZA Director of Research *Armin Falk* received the John T. Dunlop Scholar Award from the Labor and Employment Relations Association (LERA) for his work on international labor issues. According to *Morris M. Kleiner* (University of Minnesota), Chair of the LERA Awards Committee, the committee members were “most impressed with his research on experimental econom-

ics dealing with labor issues.” Kleiner also lauded Falk's role in establishing IZA as the “best research center for studying labor issues in Europe.”



Armin Falk

Book Recommendation: Reshaping the American Workforce

What directions should workforce policy in the U.S. take over the next few decades in light of major labor market developments that will likely occur in this period – such as the retirements of “baby boomers” and continuing globalization? A new volume edited by IZA Research Fellow *Harry J. Holzer* (Georgetown University and Urban Institute) and *Demetra S. Nightingale* (Johns Hopkins University and Urban Institute) presents fresh thoughts on this topic.

Essays by Richard Freeman, Burt Barnow and Demetra Nightingale review the rel-

evant labor market and policy contexts that will likely exist over the next few decades; those by Robert Lerman and Sarah Turner review career education and higher education for youth; while Paul Osterman, Dan Bloom and David Butler discuss training for less-skilled adults. Essays also appear on immigration and retirement policy, written by George Borjas and Alicia Munnell; and on insurance for workers and family workplace issues, by Gary Burtless and Jane Waldfogel. Together, these essays provide a set of policy discussions that are firmly grounded in strong research and that

address the most critical workforce issues over the coming years.

Harry J. Holzer, Demetra S. Nightingale (eds.), *Reshaping the American Workforce in a Changing Economy*, Urban Institute Press: 2007.



Forthcoming IZA Workshops:

July 2–3, 2007

September 28–29, 2007

IZA-EUI Workshop: Firm Dynamics, Labor Markets and Growth

IZA Workshop: Long-Term Care

Deadline: March 26, 2007

Deadline: March 27, 2007

Active Labor Market Policy: Why Less Is More

In Germany, the field of active labor market policy has turned into an impenetrable jungle of various programs and measures. Depending on the definition used, there are now between 60 and 80 different policy instruments, which have cost German taxpayers 15 billion euros in 2006 alone.

Less would definitely be more in this case. But while there is already an abundance of proposals to cut away the thicket, there is still a lack of political courage to actually swing the axe. Caught up in red tape, even the agents who are engaged in counseling jobseekers have trouble keeping track of all the existing programs and regulations. As a result, it is often impossible to provide quality service and select the best solution for each individual participant. Those who suffer most from this unfortunate situation are the unemployed.

But the poor transparency of the available policy toolkit is merely the quantitative dimension of the problem. On the qualitative side, German government agencies have only recently allowed program evaluation, a systematic evaluation through scientific research. Consequently, a reliable cost-benefit assessment is only available for one-third of all expenditures for active labor market policy. The results are alarming: No more than four instruments have stood up to scientific analysis as effective and successful. Among these programs are hiring subsidies for employers, publicly-funded training schemes, placement vouchers and business startup grants. More than two-thirds of active labor market policy expenditures have yet to be critically assessed by independent research. It is not to be expected that this evaluation will yield a more favorable result.

According to the available findings, less than 30 percent of all funds for active labor market policy are invested effectively. In many cases, however, it remains completely unclear whether the vast sums of money poured

into these programs have any positive impact at all on the labor market. Even the measures that receive a favorable assessment are prone to be taken advantage of by those who would have been able to find employment without state assistance.

Policymakers must realize that discontinuing some of the existing programs – even those found to be successful – may yield aggregate welfare gains if it turns out that the public funds are better spent for other purposes.

So what needs to be done? The long overdue strategy of allowing an independent scientific evaluation of labor market programs must be continued and expanded. Without a comprehensive assessment of all existing instruments, the fog that surrounds the plethora of policy programs will not lift. While long-term studies are indispensable to arriving at reliable results, the preliminary assessment is sufficiently clear to warrant a concentration on the four instruments that have proven effective. A market-oriented solution should replace overambitious bureaucratism. If the agents who are involved in implementing the programs are given more room to experiment, detailed regulations to thin out the program jungle will be redundant. This would require, however, that the responsibility for a success-oriented allocation of funds is clearly defined. Under such a system, the most effective programs will automatically prevail. This would best serve the interests of the unemployed.



For a detailed account of this topic, see also IZA Discussion Paper No. 2605:

► <http://ftp.iza.org/dp2605.pdf>



Klaus F. Zimmermann



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