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## **ABSTRACT**

### **The Petersberg Declaration<sup>\*</sup>**

Against the background of the worldwide financial market and economic crisis, leading German economists urge policymakers to maintain the reform course in labor market policy. The experts warn not to jeopardize the clearly positive effects of the recent reform efforts. The “Petersberg Declaration” also proposes an economic orientation of German immigration legislation and an improvement of the market for social services, which has so far been dominated by voluntary work. Moreover, the welfare state should encourage risk-taking as a key factor for mobility, innovation, and growth.

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<sup>\*</sup> Upon an initiative of IZA, the “Petersberg Declaration” was originally published in German language on the occasion of IZA’s 10<sup>th</sup> anniversary on December 1, 2008.

## **The Petersberg Declaration Guidelines for a Future-Oriented Labor Market Policy**

The German labor market has experienced many far-reaching changes in recent years as a result of various labor market reforms. There has been a move away from the policy of rewarding non-work, a deregulation of temporary work, and an efficiency-enhancing organizational reform of the employment administration. For the first time in three decades, structural unemployment has been successfully reduced. The labor market reforms have been accompanied with consistent corporate restructuring efforts and appropriate union wage moderation. Altogether, this has led to a drop of 1.5 million in the number of unemployed since 2005, and an increase in the participation rate of older people by almost 15 percentage points to a total of 50%.

Still, policymakers need to face a number of unsolved problems in the coming years. Those most heavily affected by the structural problems are the long-term unemployed, who have not profited enough from the recovery of the labor market. The current shortage of skilled labor could well develop into a serious obstacle to growth in view of the impending demographic change. Moreover, governments are putting past achievements at risk by once again increasing benefit transfers at the expense of the social security system. This is particularly problematic for German companies whose global competitiveness will also suffer from rising employer contributions due to demographic change.

### **1. Encouraging work instead of financing unemployment**

One of the key problems of the German labor market is the work disincentives inherent in the current tax-benefit system. Low-skilled workers in particular have become a problem group in the labor market because regular employment is often not worthwhile for them. Furthermore, many married women are discouraged from working due to a high marginal burden on extra earnings, with the exception of the otherwise problematic “mini-jobs.” Finally, older employees still find early retirement an attractive option to exit the labor force. This leaves an important employment potential unused while at the same time imposing high costs on society that result in lacking funds for education and other measures to promote equal opportunity.

The labor market would profit substantially from a systematic abolishment of various indirect subsidies for permanent exits from the labor force. This would also require the implementation of workfare principles in social security, which means that government benefits are tied to the participation in work, vocational training and other programs. This creates incentives for low-skilled workers to take up low-paid work, turning benefit recipients into tax and contribution payers.

### **2. Promoting pre-school education and lifelong learning**

With demographic change in full swing, knowledge and education have become the key sources of growth and prosperity. The German education system has been put to the test, particularly with the publication of the results from the PISA study carried out by the OECD. German education institutions have fallen behind in the face of increasingly

globalized labor markets. When compared internationally, education is still not being used enough as a key to the labor market. For instance, there are few childcare places with qualified teaching programs; educational outcomes vary greatly from region to region; the time to complete degrees and other vocational training is on average too long; and the share of unskilled workers in the labor force is still too large.

Among the most pressing problems are the need for more nursery school places; increased quality and equal opportunity in the school system; more external evaluations of schools; the introduction of uniform final exams; more competition between schools; more independence for schools in hiring and performance pay strategies; later entry into the different types of secondary school, and easier movement between them; independence for colleges and universities in setting tuition fees; as well as a general reorganization of tuition fees through a graduate tax. In addition, further training must become more attractive for older workers. This can be achieved partly by removing early retirement incentives, which have made investment in further training unattractive for workers over 50.

### **3. Making social services marketable**

Social services continue to be provided on an honorary basis, or by those who perform community service as an alternative to military service, or a voluntary year of social service. While social commitment of these individuals is without a doubt of great importance to society, it should be clear that the impending demographic problems cannot be solved on the basis of voluntary service alone. Many households are already forced to rely on long-term care services provided by illegal workers from Eastern Europe. Market entry barriers in the form of regulations or monopolies still exist particularly in work-intensive service sectors, such as healthcare, care for the elderly, or childcare. These barriers must be removed to legalize existing employment and to exploit the vast potential for growth. Unequal competition between public and private service providers further adds to the market distortions. In many areas of social service, the privileged treatment of non-profit organizations should be reassessed.

Fairness considerations also suggest that social services should be more marketable. A voucher system would ensure sufficient purchasing power for social services. At the same time, it would have a socially desirable distributional effect. Finally, publicly funded service agencies could provide an important contribution to the organization of the market.

### **4. Bringing immigration policy in line with Germany's economic interests**

With the implementation of the Immigration and Integration Act of 2005, Germany has achieved important progress in migration policy by providing a foundation for an economically motivated control of immigration. At the same time, the EU Bluecard initiative is evidence of a changing attitude towards migration on the European level. There is a growing consensus that the economy as a whole will benefit from controlled immigration, particularly from admitting high-skilled foreign workers to the German and

European labor markets. However, the current German immigration law does not fully meet the challenges of skilled labor shortage and demographic change.

The full potential of permanent immigration can only be exploited with a combined point and quota system. While the universities should be generally more open to foreign students, labor market access for foreign graduates must also be facilitated. Improved curricula can help attract and integrate the high-skilled workers of the future.

### **5. Separating redistribution from social security in the tax-benefit system**

Due to substantial progress in capital taxation over the past decade, Germany has again become attractive to foreign investors. This came, however, at the expense of consistency in the tax system. While capital and corporate taxation should remain on the agenda, the most urgent need for action is in the area of labor taxation. When accounting for the co-payments introduced in the statutory health insurance, social security contributions have de facto increased. Demographic change will put additional pressure on the social security system over the next years. A decreasing number of contributors will have to finance an increasing number of benefit recipients. Demographically induced labor shortages could be aggravated by the negative work incentives inherent in higher social security contributions. As an important step toward solving these problems, social insurances must be relieved from redistributive tasks. Benefits not related to insured risks ought to be financed primarily through taxes.

To promote the employment of low-skilled workers, consumption taxes should be preferred over taxation of production and social security contributions. This would reduce labor costs and thus also discourage shadow economic activities. Redistributive tasks should be handled through direct transfers.

### **6. Enabling risk-taking through social security**

The German welfare state has reached its limits. It was an illusion to believe that the challenges of globalization could be met by rewarding labor force exit. The modern welfare state has to support its members to actively master the structural changes. It cannot take away all individual risk. On the contrary, people must be encouraged to take risks because this is a prerequisite for individual mobility, innovation and growth. Social security is still necessary, but it is no substitute for the potential benefits of risk-taking. Without insurance against certain individual risks, economically useful investment, e.g. in human capital, will not be undertaken if it seems too risky or uncertain. Risk-averse individuals will only make this investment if they are protected against failure. Therefore, active incentives must complement the passive risk-taking incentives of the welfare state.