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ECONOMIC SURVEY OF GERMANY 2006:

TOWARD MORE EFFICIENT EMPLOYMENT POLICIES

This is an excerpt of the OECD Economic Survey of Germany, 2006, from the section on labour market reform in chapter 4.

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Activation strategies for the unemployed have improved but need amendment

Job search requirements have been strengthened…

Job acceptability requirements for ALG II recipients were tightened. In principle, the long-term unemployed receiving benefits cannot refuse job offers, irrespective of pay and occupational characteristics. In practice, however, the range of job offers considered suitable is narrower. Wage offers some 30% below the standard for comparable occupations appear to be considered the limit for acceptability. Rejection by benefit recipients of acceptable job offers are to be sanctioned by the PES. Moreover, PES counsellors have some discretion in defining suitable work. In case of repeat rejections the sanctioning can result in a complete withdrawal of ALG II benefits.

PES monitoring of job search activities and imposition of sanctions in the case of non-compliance of benefit recipients with the job search rules are increasingly used among OECD countries as activation strategies.[1] For example, regular reporting requirements to the Labour Office and telling the benefit recipients that the reported contacts with employers would be verified were found to have had a positive impact on transition rates into employment. This is also true for other measures activating job search, such as search training courses.[2] In the same vein, empirical work indicates that reemployment rates can be substantially increased if conditions for job search are tightened *via* imposition of sanctions in case of non-compliance with job search requirements.[3] In particular, monitoring of job search activities was found to be important to reduce unemployment duration for persons with adverse socio-economic characteristics whose chances to find a job are relatively low, such as the long-term unemployed and low-skilled workers. This is consistent with evidence that workers with unfavourable labour market characteristics rely much more on formal channels of job search offered by the PES, which are relatively easy to monitor, rather than on informal channels of job search, which are hard or impossible to monitor, and which are often highly relevant for high-qualified job searchers. Imposing job search requirements and monitoring also act as a sorting device to separate those willing to seriously search for a job from those who do not. Empirical

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evidence for OECD countries suggests that some share of individuals who have been referred to a job search course respond by dropping their benefit claim rather than participating in the activation measure.

Available information indicates that until the recent PES reform counsellors of the Federal Labour Office rarely decided to impose sanctions, and the sanctions advocated were often not executed.[4] Empirical evidence elsewhere indicates, however, that credibility of the sanctioning regime is important for its success.[5] More recently, the rate of sanctioning has increased, but the dispersion in the application of sanctions between local labour offices appears to have been large and to have increased as well.[6] Hence, allocation of benefit recipients to profiling and monitoring schemes should be guided by socio-economic characteristics of the unemployed, and programme participation of benefit recipients, once assigned, should be strictly compulsory.

… and new active labour market measures have been introduced

There has also been a re-orientation of active labour market policies (ALMPs). Traditional ALMPs have been reduced. More emphasis is being put on short training spells and job search assistance. Indeed, several empirical studies for traditional large-scale work provision and training schemes in Germany concluded that the schemes were either ineffective or even reduced re-employment probabilities of participants. Evidence from other OECD countries also points to large scale work provision schemes, which are not geared toward the individual characteristics of job searchers, being inefficient instruments to foster transition into employment.[7]

However, there is much scope to improve the design of ALMPs, and some changes to newly introduced measures have already been made. The *Ich-AG* support scheme granted unconditional subsidies to the unemployed who decide to set up their own business. The scheme was associated with very high take-up rates, and in the introduction phase of ALG II beneficiaries appear to have used it to a large extent as an instrument to prolong the effective duration of higher-level income replacement when unemployment insurance benefits ran out. The instrument has been modified since; in particular eligibility is now conditional on the presentation of a business plan. However, the scheme co-exists with a similar one (*Überbrückungsgeld*, UG), diminishing the focus of the activation strategy. The two schemes should be merged. Empirical evaluation of the UG scheme indicates that participants are less likely to re-enter unemployment after programme termination than former unemployed who did not receive support.[8] A comparable examination of the *Ich-AG* – after programme participation has terminated – is not yet available as the scheme has been introduced only recently. Later evaluation of the costs and the benefits of the instrument should take into consideration those of other programmes that give financial aid for starting a business.

Recipients of ALG II can be assigned to employment schemes in the secondary labour market ("Work Opportunities", WOs, *Arbeitsgelegenheiten*), lasting 6 months as a rule. The schemes, which have expanded rapidly, are offered by municipalities or welfare associations, and aim at easing the transition of long-term unemployed into the primary labour market. It has also been suggested that WOs can serve as a test for the readiness of benefit recipients to work ("workfare"). Refusal to accept participation in a WO is considered as a signal that there is a lack of willingness to co-operate with the Labour Office, triggering a reduction in benefits as a sanction.

Persons on WO retain the full amount of ALG II benefits. In addition, they receive a supplementary payment of between € 1 and € 2 per hour, paid by the Labour Office, which is considered as a compensation for additional outlays an individual incurs when he is working. While the size of the total remuneration associated with participation in WOs depends on the participant's family situation, personal disposable income under the assumption that the individual works 30 hours or more totals an amount that appears to be hard to realise on the primary labour market for low-qualified employees.[9] Similarly, while

ALG II recipients who are not on a WO face very high marginal implicit tax rates when they expand their labour supply on the primary labour market, this is not the case for recipients on WO schemes. Hence, financially WOs are associated with disincentives for participating long-term unemployed to accept and expand employment on the primary labour market. Moreover, as municipalities and welfare institutions obtain a transfer from the Federal Labour Office if they offer WOs, they might have an interest in keeping WO workers on their scheme rather than fostering their transition into the primary labour market.

Willingness-to-work tests rest on the presumption that benefit recipients who are not seriously willing to work under market conditions will not participate in activation programmes since the disutility associated with programme participation is as big as the disutility associated with working under market conditions, while programme participation pays less than the market wage. WOs do not appear to be well geared for this purpose, given their financial generosity. Pay for participation in WOs should be revisited so as to preserve incentives for the low-qualified to accept jobs on the primary labour market while securing a subsistence level of income replacement for those in need that do not find work. Rather than giving a transfer to municipalities and welfare institutions that offer WOs, institutions should bear part of the costs of the income replacement for WO workers. In the policy debate it has been suggested to lengthen the duration of WOs for older long-term unemployed to up to several years. This proposal should not be implemented as it would very likely establish a new channel into non-participation of older people in the primary labour market. More generally, keeping benefit recipients in work provision schemes for many months or even years can significantly reduce the participants' available time and capacity for job search activities in the primary labour market. Empirical evidence suggests that this factor can be important in reducing employment chances. Moreover, care needs to be taken that no new industry of work provision schemes will be created, which would contradict the down-scaling of Germany's large-scale work-provision programmes. Instead, activation measures should be based on the persons' socio-economic characteristics as established in profiling exercises. The effectiveness of measures in raising employment chances and as willingness-to-work tests should be strictly evaluated, and instruments should be modified or dropped accordingly.

Further institutional reform in Public Employment Services is necessary

A major element of the reform of the Public Employment Service (PES) so far has been to give more scope to outsourcing. Private placement agencies are allowed to operate without licensing, the Labour Office can contract out placement services, and subsidies were given to Temporary Work Agencies (*Personalserviceagenturen*, PSA) that agreed placement activities commissioned by regional branches of the Labour Office. Up to now, Contracts between the Employment Agencies and PSAs specify both placement targets and the PSA's remuneration. However, according to independent evaluation studies, transition rates into normal employment were lower for unemployed workers utilising a PSA as an entry channel into employment than for unemployed workers who did not.[10] More recently, regional Employment Agencies have therefore been reducing their links to PSAs. Indeed, regional Labour Offices should not be obliged to establish a PSA. More generally, outsourcing of employment services should be based (as in Australia, the Netherlands and the UK) on the allocation of batches of unemployed clients to contracted providers, making tender decisions and payments on the basis of placement rates that different providers achieve.

First steps have been made in favour of internal organisational changes. In particular, computation of unemployment insurance benefits has been simplified and reception of clients reorganised so as to be better able to allocate resources in favour of placement activities rather than benefit administration. First evaluations by economic research institutes indicate significant improvements in the efficiency of service provision.[11] Also, there are agreements of goals between the different regional levels of the Federal Labour Office, referring to indicators such as reintegration or activation ratios. Incentive structures on how to reach a consistent set of targets are not yet established, however.[12] Until 2004 caseloads of job searchers

per counsellor appear to have been very high by international comparison, which probably has been a serious brake for successful application of activation and placement strategies. Indeed, analysis for 2004 points to low levels of profiling activities. More recently, hiring of placement officers and reallocation of staff has led to considerable improvements in client-to-counsellor ratios. Yet, while new legislation foresees lower client-to-counsellor ratios for the long-term unemployed, further administrative reform is required to free resources for activation and placement within the first year of an unemployment spell.[13] Lacking significant progress in raising placement rates has lead to demands in the German policy debate for more radical PES reform, including the abolishing of the Federal Labour Office in its present form and the privatisation of placement and employment services. Experience in other OECD countries indicates that outsourcing of PES services can contribute to more efficient employment policies. However, only a few countries have extensively outsourced the placement and counselling roles. With or without outsourcing, the results depend on the management framework for employment services and benefit provision and the impact of employment services on labour market outcomes should be the driver of PES activity.[14] According to this criterion there are still serious obstacles in the organisation of the German PES that need to be addressed to be able to reap the benefits of recent reform initiatives.

A major goal of combining unemployment assistance and social assistance benefits in one single means-tested income replacement scheme for persons that are able to work was to reduce the administrative overhead inherent in the old system and to arrive at more coherent activation strategies for all persons on welfare benefits that are able to work. However, financing and decision powers with respect to employment policies remain dispersed in important respects. In most regions a new layer of administrations – associations between the local agencies of the Federal Labour Office and the municipalities – has been created that is in charge of administering ALG II and designing employment services for benefit recipients. The staff of the Associations remains employed by different public sector entities – the Federal Labour Office and the respective municipality – with differing contractual employment conditions, and this has lead to frictions in the administration of the Associations. Moreover, difficulties in harmonising activation targets across regions became apparent when the municipalities complained that the Federal Labour Office would hamper efficient job placement by centralistic ordinances. In response, an agreement was made between the federal government, the Federal Labour Office and the municipalities that leaves the determination of operational targets for the Associations to their governing council. However, the fact that the Federal Labour Office is responsible for the financing of ALG II and related employment services while the municipalities hold equal decision powers on ALG II related policy targets poses the risk that the municipalities can free-ride in their decisions at the expense of the Federal Labour Office.

Moreover, some 69 municipalities obtained the option to provide ALG II benefits and related services on their own responsibility. This option, allocated to a fixed number of municipalities, was the outcome of a compromise in the second chamber of Parliament, as the government envisaged assigning responsibility for ALG II policies to the Federal Labour Office while a majority of states wanted to assign responsibilities to the municipalities. While the "option municipalities" pay for ALG II benefits, the compromise between the two chambers of Parliament entailed compensatory transfers to the municipalities out of the federal budget. This arrangement further aggravates the segmentation of employment services. Impediments to exploiting economies of scope in administering the new benefit system became already visible as the option municipalities provided basic statistics on benefit recipients after the introduction of the new ALG II system only with a delay of several months.

Overall, consideration should be given to concentrating responsibilities for benefit and employment policies at one level of administration. Experience in other OECD countries suggests that the division of responsibilities between national and local government makes it difficult to measure the impact on labour market outcomes achieved by employment services and to implement changes in employment policies on this basis.[15] Full allocation of responsibilities to the Federal Labour Office would have the advantage that it

could re-enforce coherent activation strategies over the entire duration of unemployment spells – that is for recipients of unemployment insurance benefits as well as for the long-term unemployed receiving ALG II. Moreover, this approach would align spending and financing responsibilities for both types of benefits in one hand, reducing the risk that some actors will adopt labour market policies that are not geared toward improving employment outcomes. On the other hand, it is sometimes argued that the municipalities dispose of better knowledge of regional labour markets and should therefore be given the responsibility for ALG II related policies. Postulating a sustainable advantage of the municipalities over the regional branches of the Federal Labour Office does not appear entirely convincing, however, given both the need for regional branches of the Federal Labour Office to develop efficient placement technologies in regional labour markets for recipients of unemployment insurance benefits and a higher involvement of private sector agencies in placement and activation services. Nevertheless, if responsibilities for ALG II related policies are assigned to the municipalities – either directly or *via* decision rights in Associations with the Federal Labour Office – this should be accompanied by a financing mechanism for ALG II that provides incentives for the municipalities to engage in efficient job placement.

Against the background of adverse incentives for efficient employment policies associated with the risk of financial free-riding, some OECD countries have designed incentive systems that better align both aspects. In several OECD countries regional administrations that are in charge of administering unemployment assistance benefits are also responsible for their financing. Basing the co-financing of the municipalities on the right base is important so as to minimise the risk of involuntary overruns that could trigger compensation demands from the federal government. Whatever the exact model used, it is important that regional ALG II budgets do not benefit from compensating transfers by the federal government in case of benefit over-runs. Indeed, as considered in more detail in Chapter 2 above, in a recent policy dialogue between the federal government and the states on options to reform federal fiscal relations there was general agreement that a higher degree of congruency between spending and decision powers at the different layers of government would be desirable. In line with this proposition, policy makers at the federal and the states' level should work to prevent new disparities between financing and decision responsibilities from opening up in the important area of institutional reform in the employment administration.

Effective management of employment policies also requires efficient separation of welfare recipients who are able to work from those who are not. As was the case in the past, the municipalities maintain the financial responsibility for income support for persons who are not able to work (social assistance). Given that the Federal Labour Office is responsible for the financing of income support for the needy who are able to work (ALG II and two thirds of housing benefits), the municipalities have an incentive to shift costs by classifying persons as being able to work who would otherwise obtain municipal social assistance benefits. Indeed, after the introduction of the new ALG II benefit system, cases have been reported where municipalities shifted persons, who could not be considered as being able to work, into the sphere of the Federal Labour Office. Hence, to exclude the risks of cost shifting arising from incentives to misclassify the earnings capacity of benefit recipients, it is important that the federation issues clear classification standards for the assessment of work ability and the Federal Labour Office maintains some control over the assignment of welfare recipients to ALG II benefits.

Notes

1. For an overview see OECD (2000).

2. For various examples from OECD countries see OECD (2005b), Chapter 4. In particular, for empirical evidence on job search assistance courses in Austria see Weber and Hofer (2004).

3. See Van den Berg, Van der Klaauw and van Ours (2004); Ashworth *et al*. (2004).

4. See Gray (2003); Gerhard (2004); Wilke (2003). According to this study, in the majority of cases where sanctions were advocated they were not executed.

5. See for Switzerland: Lalive, van Ours and Zweimüller (2002).

6. See Oschmiansky and Müller (2005). For empirical analysis on the decision to temporarily suspend payment of unemployment benefits see Mosley *et al.* (2005).

7. Econometric studies on the effectiveness of ALMPs in Germany have been summarised in previous *Surveys*. On the OECD see Martin and Grubb (2001) and OECD (2005c), Chapter 4.

8. See Caliendo and Steiner (2006).

9. See Boss and Elender (2005). For the types of families considered by the authors personal disposable income totals between € 926, – and € 2 143, – for a WO with 30 hours working time and an hourly supplement of € 2.

10. See Bundesregierung (2006).

11. See Bundesregierung (2006).

12. See Schütz (2005).

13. For the long-term unemployed, receiving the new "Unemployment Benefit 2, counsellor to – client ratios of 1:75 and 1:150 for young and older, respectively, recipients are targeted. In mid 2005 counsellor to – client ratios stood at around 1:200 on average. This marks substantial progress over past ratios, which were much more unfavourable, see Schütz (2005).

14. See Grubb (2005b).

15. See OECD (2005c), Chapter 5.

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