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Labour Market Reform in Germany: How to Improve Effectiveness

Eckhard Wurzel

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by

Eckhard Wurzel

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Abstract/ Résumé

Labour market reform in Germany: How to improve effectiveness

High levels of unemployment and rising social charges have lead to considerable pressure on labour markets to adjust. Major steps in labour market reform have been implemented over the last three years. These need to be followed up in several respects in order to raise the economy's capacity to generate employment. The present tax and transfer system still implies significant disincentives for labour supply of older people and spouses, which should be eliminated. Unemployment related benefits and active labour market policies can be better geared toward activating the unemployed, while institutional reform of the Public Employment Service should continue. On the labour demand side, there remains scope to raise the efficiency of Germany's employment protection system. Also, provisions should be made to allow for a higher degree of wage flexibility across qualifications and regions to fight unemployment. Regulatory conditions in other parts of the economy interact in important ways with labour market performance, underlining the need for a broad based reform approach.
This Working Paper relates to the 2006 *OECD Economic Survey of Germany* (www.oecd.org/eco/surveys/Germany).

JEL classification: J22, J23, J26, J31, J32, J33, J48, J52, J65, J68
Keywords: Germany; employment; unemployment; labour market reform; unemployment benefits; labour force participation; activation strategies; public employment service; minimum wage; wage rigidities; wage determination; employment protection legislation; policy synergies.

La réforme du marché du travail en Allemagne: Comment améliorer l'efficacité

Face à un chômage élevé et à un alourdissement des charges sociales, des ajustements sont devenus de plus en plus nécessaires sur les marchés du travail. D'importantes réformes du marché du travail ont été mises en œuvre ces trois dernières années. Elles doivent être poursuivies dans plusieurs domaines afin de permettre à l'économie de créer davantage d'emplois. Le système actuel de prélèvements et de transferts dissuade encore dans bien des cas les personnes âgées et les conjoints de travailler, situation à laquelle il y aurait lieu de remédier. L'indemnisation du chômage et les politiques actives du marché du travail pourraient être conçues de manière à favoriser davantage le retour à l'emploi des chômeurs, et la réforme institutionnelle du service public de l'emploi doit être poursuivie. S'agissant de la demande de main-d'œuvre, l'efficience du système de protection de l'emploi pourrait être améliorée. Par ailleurs, il y aurait lieu de prendre des dispositions pour permettre une plus grande flexibilité des salaires en fonction des qualifications et suivant les régions, afin de lutter contre le chômage. Les conditions de réglementation dans d'autres secteurs de l'économie interagissent de façon importante avec la performance du marché du travail, soulignant le besoin d'une approche globale des réformes.
Ce document de travail se rapporte à *l'Étude économique de l'OCDE de l'Allemagne* (www.oecd.org/eco/etudes/Allemagne).

Classification JEL: J22, J23, J26, J31, J32, J33, J48, J52, J65, J68
Mots clés: Allemagne; emploi; chômage; réforme du marché du travail; allocations chômages; activité des personnes sur le marché du travaille; stratégie d'activation; services publics de l'emploi; salaire minimum; rigidités salariales; détermination des rémunérations; législation de la protection de l'emploi; synergies des politiques

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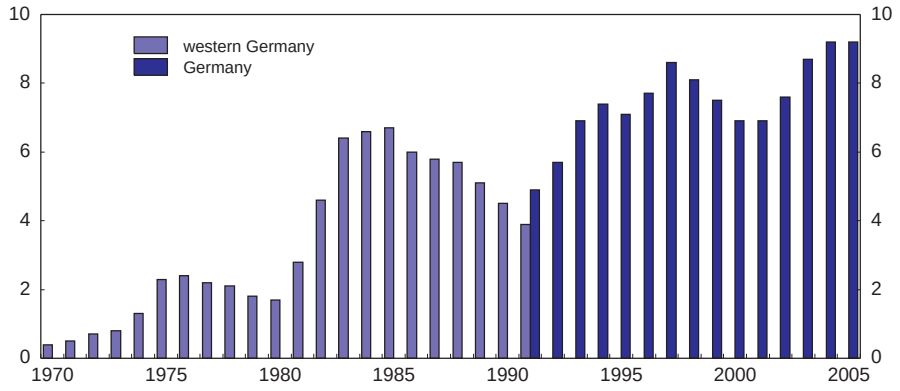
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LABOUR MARKET REFORM IN GERMANY: HOW TO IMPROVE EFFECTIVENESS

by
Eckhard Wurzel[1]

1. High levels of unemployment and rising social charges have lead to considerable pressure on labour markets to adjust. Indeed, unemployment has been drifting upward since the first half of the 1970s and into the present decade (Figure 1), with unemployment rising when adverse shocks to economic activity occurred and falling only partially as the shocks subsided. The trend increase in unemployment was accompanied by a rising share of long-term unemployment, with unemployment extending over 12 months or more accounting for about half of total unemployment. Moreover, since the middle of the 1990s a sizeable gap has opened up between employment measured in terms of persons and the volume of hours worked, which is trending down over the same time span (Figure 2).

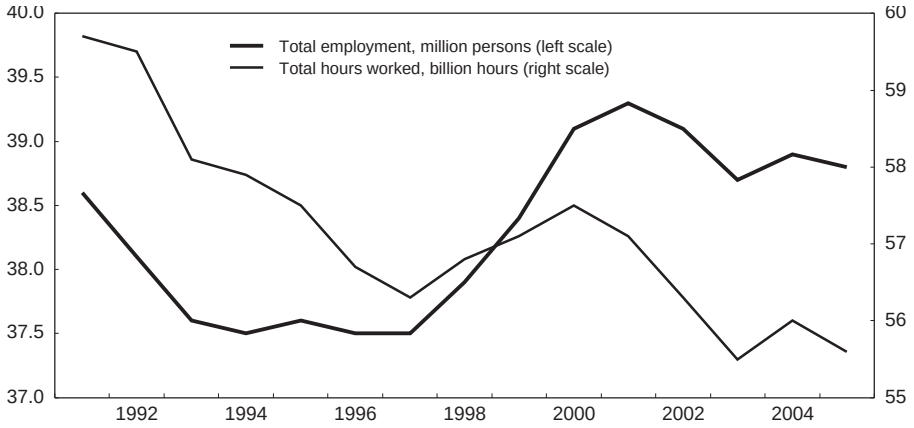
Figure 1. **The development of unemployment**[1]
Unemployment as per cent of labour force



1. National Accounts concept.
Source: German Federal Statistics Office, National Accounts.

1. Most of this paper was originally prepared for the OECD's 2006 *Economic Survey of Germany* under the responsibility of the Economic and Development Review Committee. Eckhard Wurzel works at the OECD Economics Department as a senior economist. The author is grateful for the valuable comments received on earlier drafts of this text from Andrew Dean, Andres Fuentes, David Grubb, Herwig Immervoll, Val Koromzay, Christopher Prinz, Peter Tergeist and Andreas Wörgötter. This paper has also benefited from valuable discussions with officials from the German government and researchers. Special thanks go to Margaret Morgan and Susan Gascard for technical assistance.

Figure 2. **Employment: persons and hours**



Source: German Federal Statistics Office, National Accounts.

2. In response, aggregate wages moderated and work conditions agreed between employers and employees became considerably more flexible over the last years. On the policy side, major steps in labour market reform have been implemented over the last three years. The thrust of reform focused on reducing disincentives in unemployment-related benefits to accept employment, and better activation strategies for the unemployed. Policies comprised: organisational reform of the Federal Labour Office; the introduction of new active labour market measures; the introduction of tax preferences for small jobs with only a few hours worked; deregulation of fixed term and temporary employment contracts; and an easing of dismissal protection. At the beginning of 2005 a new income replacement scheme for the long-term unemployed was introduced, replacing former unemployment assistance and social assistance benefits. As has been outlined in the 2004 OECD *Survey* on Germany, the thrust of reform is an important step in the right direction.[2] However, reform is incomplete yet, and demands have come up in the public debate to implement complementary measures some of which risk impairing the effectiveness of what has already been achieved. This note considers major issues that are important for increasing the capacity of the economy to generate employment, and makes suggestions for further reform. The present tax and transfer system still implies significant disincentives for labour supply, which should de remedied. Activation strategies for the unemployed can be improved, and this includes further institutional reform of the Public Employment Service (PES). On the labour demand side, there remains scope to raise the efficiency of Germany's employment protection system, and provisions should be made to allow for a higher degree of wage flexibility across qualifications and regions. Moreover, making growth more employment intensive requires that labour market reform is linked to policy initiatives in other areas.

Reducing disincentives to labour force participation of older people and spouses

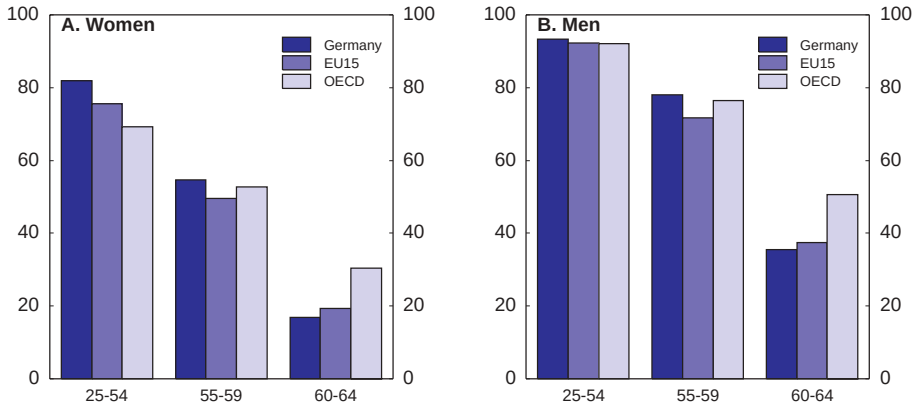
3. Labour force participation of older workers in Germany is still low by international comparison (Figure 3). While there is still a perception in the society that economic growth is not high enough to prevent higher labour supply from translating into higher unemployment, abolishing disincentives for labour force participation and reducing impediments for higher labour demand impacts positively on employment and growth. In OECD countries where participation rates of older workers are high, so are their employment rates, suggesting that there are few inherent barriers to employment at an old age.[3]

2. See OECD (2004a).

3. See OECD (2004a).

4. Since the second half of the 1990s channels into effective early retirement outside the pension scheme have gained importance. The main channels utilised for withdrawal from the labour force prior to retirement are extended periods of unemployment insurance benefits for older unemployed and a subsidised part-time employment scheme for older employees (*Altersteilzeit,* AT). The former allowed unemployed workers aged 58 and older to receive unemployment insurance benefits for up to 32 months without obligation to search for a job. In February 2006 the maximum eligibility period for the new unemployed in this age group was cut to 18 months. Also, extended eligibility periods for medium age groups were cut to the standard duration of 12 months. However, persons aged 58 and older are still exempted from the job search requirement. The AT scheme replaces part of earnings foregone if older employees decide to reduce full-time employment by 50%. Participants are allowed to choose how to distribute part-time employment over a maximum period of 10 years from the age of 55 onwards, subject to a collective agreement between the employer and a union and the hiring of a replacement worker. Most employees decide to work full-time in the first half of the period and not to work in the second half. Subsidies for new entries into the AT scheme will be terminated in January 2010. Both schemes have been used at increasing rates by employers in agreement with employees to terminate employment for workers at older age, thereby by-passing the provisions of employment protection legislation, which, in turn, shifts part of the costs of reducing the workforce from firms to the social insurance system.[4] Once the benefits under either scheme are exhausted, they might be followed up by early retirement pensions, although these will be completely phased out by 2016.[5] In 2004 the number of recipients of AT and extended unemployment insurance benefits was almost 4 times as large as the number of participants in active labour market measures designed to foster the hiring of older employees (Figure 4).[6]

Figure 3. **Labour force participation**
Labour force as per cent of population, by age group, 2004



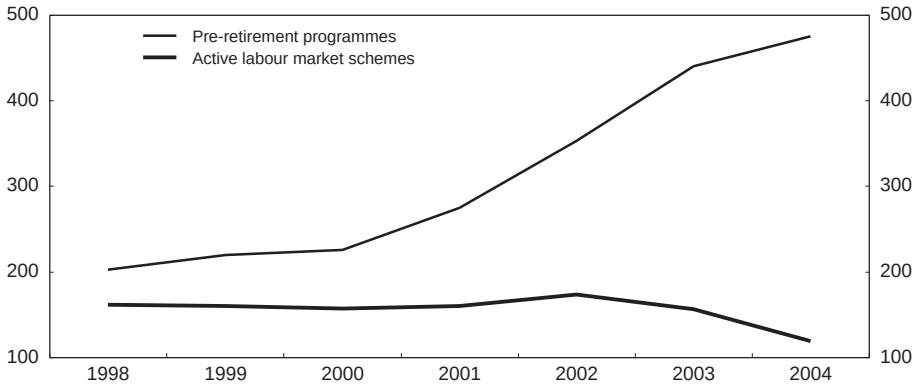
Source: *OECD Employment Outlook*.

4. In the case where workers are made redundant, current employment contracts are terminated in mutual agreement between the employer and the employee *via* a "work-termination" contract (*Aufhebungsvertrag*). Often, employers bridge the difference between the last net wage and unemployment insurance benefits by special compensation payments (*Abfindungen*).

5. Both early retirement schemes – following receipt of AT benefits or of extended UI benefits – are subject to phasing out regulation. Between 2006 and 2008 the minimum retirement age will be increased to 63 years. As the birth cohort 1951 will be the last one eligible the schemes will come to an end by 2016. For comprehensive analysis of retirement policies see OECD (2005a).

6. See Eichhorst and Sproβ (2005).

Figure 4. **Older people participating in pre-retirement programmes and active labour market schemes**[1]
Thousands



1. Considered in the pre-retirement programmes are recipients of unemployment insurance benefits of extended duration without obligation to search for a job, and participants in the subsidised part-time employment scheme for older people (*Altersteilzeit*).

Source: Eichorst and Spross (2005).

5. This shows that policies to improve employment chances for older workers are undermined as long as effective early retirement is financially attractive. The abolition of extended eligibility periods for unemployment insurance benefits marks considerable progress in reducing incentives for older workers to drop out of the labour force. However, the fact that employees aged 58 and older continue to be exempted from job search obligations, in contrast to original plans by the government, suggests that employers will continue to offer pre-retirement packages that are effectively subsidised by the Federal Labour Office, followed up by early retirement pensions on account of unemployment as long as these are not completely phased out. Hence, the exemptions from the job search requirement should not be prolonged further. Subsidies for the AT (*Altersteilzeit)* scheme should be removed. Moreover, consideration should be given to phasing out the associated early retirement schemes in the pension system more quickly than presently scheduled or to make utilisation more costly by raising the discounts for retirement below the statutory retirement age. Germany's pension system offers various options for gradual retirement, which are hardly utilised at present. These options are likely to be exploited more fully, when subsidisation of early withdrawal from the labour force is abolished.

6. The new government has announced plans to increase the statutory retirement age in annual steps between 2012 and 2029 to 67 years of age. This measure, which speeds up the phased increase in the statutory retirement age that was envisaged earlier, would be an important step toward raising labour force participation of older people. Even then, the financial burden of Germany's pension system caused by the ageing of the population will imply a substantial increase in social charges.[7] In the public debate, following the announcement of this plan, suggestions were made to exempt certain occupational groups with above average physical stress from the increase in the retirement age. These have been rejected by the government. Indeed, empirical evidence for OECD countries suggests that life expectancy differs across social groups by several years.[8] While it is appealing to account for this fact in the pension system, there are obstacles that could outweigh the benefits from such an approach. Empirical evidence on life expectancy by occupation is sparse. Assessments would have to undergo continuous adaptation as occupational characteristics are changing and new professions come into play. Incentives for professional

7. See OECD (2006).

8. See OECD (200b).

groups to put pressure on the government for awarding them special treatment might pose a risk of permanent lobbying that could result in gradual extension of the occupations covered, undermining policies to curb early retirement.

7. In fact, persons with limited or no capacity to work are in principal covered by the pension scheme for reduced earning capacity (*Erwerbsminderungsrente*, EMR), which provides full or partial pension benefits depending on the degree of reduced capacity to work. However, persons, with partially reduced earnings capacity receive a full EMR pension if they cannot find a part-time job. In particular, for older persons with reduced earnings capacity it is assumed that such jobs are unavailable and thus they are automatically entitled for a full EMR pension. This exemption should be dropped, as suggested in the OECD *Report on Ageing and Employment Policies* for Germany.[9] Instead, persons with partially reduced earnings capacity should be obliged to register with the Public Employment Service (PES) in order to be placed in part-time employment. As this is likely to reduce outlays for EMR pensions, there is scope to reduce the present transfers from the unemployment insurance system to the pension system.

8. The plans by the federal government to raise the minimum retirement age to 67 years should be implemented, without exceptions for occupational groups. At the same time, there is a need to harmonise the minimum entitlement age for preferential income taxation of pensions obtained from private (*Riester*) and occupational pension schemes with the statutory minimum age in the general public schemes. For the former schemes, income tax advantages accrue from the age of 60 onwards, providing further incentives outside the public pension system for early withdrawal from the labour force. These should be terminated for activation policies to be effective. Moreover, special pension rules for civil servants, such as linking pension entitlement to seniority wages, discourage labour supply of civil servants over the life cycle, and should be terminated as well.[10]

9. While female labour force participation in Germany is above the OECD average for those aged between 25 and 54 years (Figure 3) there are a number of features in the tax and transfer system providing disincentives for the labour supply of spouses. Policies designed to improve the compatibility of child rearing and labour force participation of spouses should rank high on the policy agenda, given that birth rates in Germany are very low, averaging 1.3 children per female, while the deterioration in age distribution of the population is projected to be more severe than in most other OECD countries. To address this issue, the new government has tabled legislation which substantially increases the ceiling up to which child minding expenses are deductible from the income tax bill. Also, the new regime widens eligibility to couples with a single working spouse – although at less favourable conditions than for working couples – while at present tax concessions are only granted to families with two working spouses and single parents. Moreover, a new income replacement scheme (*Elterngeld*) is being introduced that replaces over one year two thirds of earnings foregone due to reductions in labour supply after childbirth. This supersedes the present income replacement scheme (*Erziehungsgeld*), which provides flat benefits for up to two years after childbirth subject to an earnings ceiling.

10. Empirical work suggests that fixed costs of work, both monetary (notably fees for child care facilities) and non-monetary (such as commuting times) can be an important impediment to parents' labour force participation.[11] As fixed costs of work are higher for the second working spouse, and in view of the budgetary constraints to be observed, financial support for child minding outlays should be more focused on families where both spouses are working. Child care facilities are also likely to be better suited for providing some degree of formal education to children than personal child minders, who are normally

9. OECD (2005a).

10. OECD (2005a) and OECD (2004a).

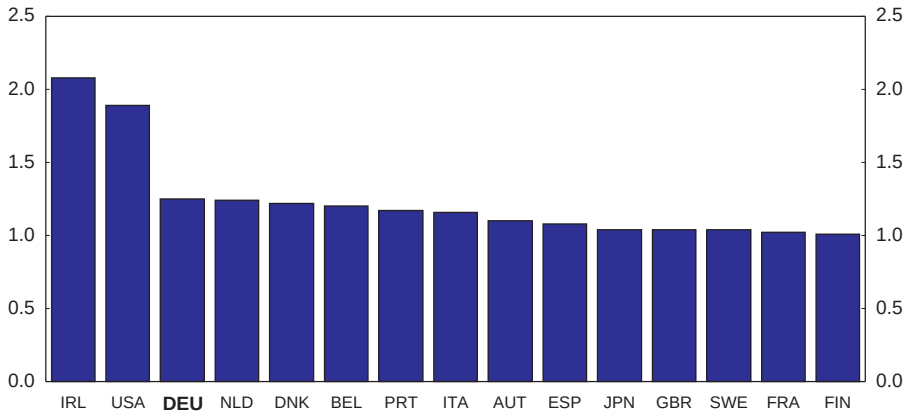
11. See OECD (2004a), also Jaumotte (2003).

lacking the relevant training. In Germany, the supply of kindergarten places falls significantly short of demand, while the important role kindergartens can play in pre-school education has not yet been sufficiently explored. Hence, financial benefits for child minding should give a preference to early education and child care institutions. Giving financial support to the users rather than the providers of services would help improve the efficiency of the child care sector. In the same vein, a voucher scheme might be more effective than tax deductibility as it would increase benefits for families with low income tax liabilities. Moreover, opportunities for full-day schooling should be extended.

11. The impact of the new income replacement scheme (*Elterngeld)* on labour supply is ambiguous. For families with lower income the scheme would improve incentives to expand labour supply beyond the present earnings threshold as it cuts the very high marginal implicit taxation of additional earnings at the threshold and shortens the maximal eligibility period by 50%. On the other hand, the high rate of envisaged income replacement would provide incentives to reduce labour supply for highly qualified persons with earnings in the upper tail of the earnings distribution who do not consider the lower income replacement by the present scheme as a relevant option.

12. In this context the present system of income tax assessment should be reconsidered. The system is based on the spouses' joint income rather than individual incomes, providing disincentives for labour force participation of second earners. Indeed, taxation of second earners relative to single earners is higher than in many other OECD countries (Figure 5). Simulation studies for Germany suggest that employment rates of spouses would substantially increase if the system moved from joint assessment to individual assessment.[12] Hence, given that financial support for child minding is scheduled to be extended, average effective tax rates on labour income of second earners in households should be reduced. For this end it should be examined whether it is feasible to replace the joint income tax assessment of spouses by individual tax assessment. There are also disincentives for the labour supply of second earners in the financing of health insurance. Spouses are entitled to full health insurance benefits regardless of their labour market status, but are only required to pay health insurance contributions if taking up a job. Hence, introducing contributions for health care co-insurance of non-working spouses should be considered. Such reform has been implemented in Austria.

Figure 5. **Ratio of average tax rate on family earnings: two earners relative to a single earner[1]**



1. 2004. Tax rates are computed as average income tax plus employee and employer contributions less cash benefits as % of labour costs. The numerator is for a two-earner household (earning 100% AW, 67% AW) with 2 children. The denominator is for a one-earner household (earning 100% AW) with 2 children. AW denotes the average gross wage earnings of adult full-time workers in the manufacturing sector.

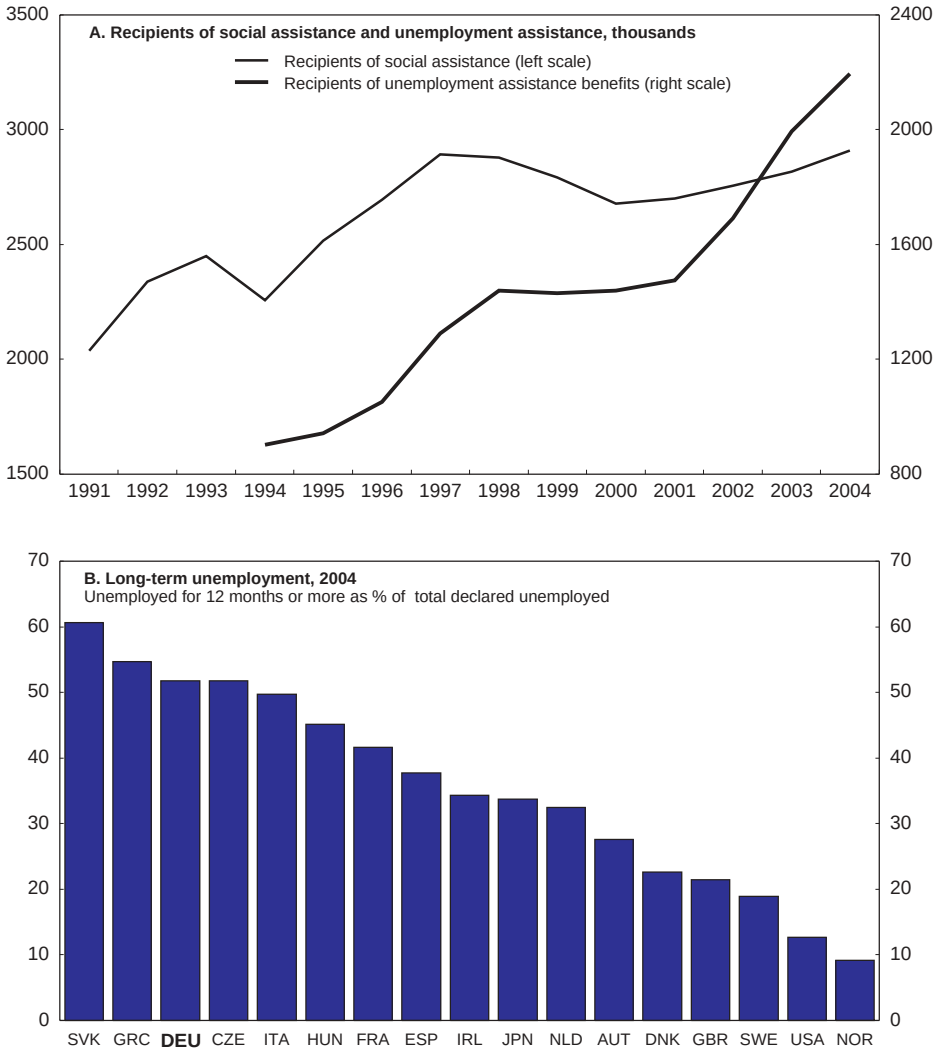
12. See Steiner and Wrohlich (2004) for Germany and Immervoll and Barber (2005) for comparisons across countries.

Toward more efficient employment policies

Work incentives for welfare recipients need to be further increased

13. The Unemployment Benefit II (ALG II), introduced in January 2005, replaces the former unemployment assistance benefits (UA) and social assistance benefits (SA) by a single means-tested income replacement scheme for persons in need, who are able to work. The fact that the two predecessor schemes of ALG II were subject to different rules and administered by different administrations posed various problems that hampered efficient activation of recipients. With the number of recipients of UA and SA benefits steeply rising, largely on account of increasing long-term unemployment, reform of the system became increasingly urgent (Figure 6).

Figure 6. **Recipients of unemployment related benefits and long-term unemployment**



Source: Federal Labour Office, "Amtliche Nachrichten der Bundesagentur für Arbeit 2004"; Federal Statistics Office; *OECD Employment Outlook*.

14. OECD Economic *Surveys* on Germany have argued that the indefinite duration of UA, high replacement ratios of SA for certain groups of low qualified workers and the high marginal implicit

taxation of earnings due to rapid withdrawal of SA all reduced effective labour supply of benefit recipients and hampered wages from spreading out at the low end of the wage distribution that would induce higher labour demand for the low-skilled.[13] This appears to be of particular importance in view of the fact that unemployment rates among the low qualified are very high and have increased in recent years. Indeed, recent econometric research suggests that on average the long-term unemployed in Germany with low pre-unemployment earnings expect significant improvements in earnings in their next job, while reservation wages fall short of previous earnings if pre-unemployment earnings were relatively high. Moreover, reservation wages in Germany do not decline much over the unemployment spell.[14] In the same vein, several empirical studies, both for Germany as well as for other OECD countries, point to fact that predictable reductions of replacement ratios over the unemployment spell raise re-employment probabilities.

15. Hence, the scrapping of the open-ended UA scheme marks progress toward more employment friendly income support. Indeed, the introduction of ALG II appears to be associated with a drop in replacement ratios for most long-term unemployed who would have been eligible for UA in the old system.[15] Also, means testing for this group is stricter now than it was before.[16] However, simulations indicate that the new ALG II scheme leads to higher income replacement for a large share of persons who would have received SA or UA in the old system. Mainly, this arises because supplementary and one-off benefits in the old system, which were not paid automatically, are now integrated into ALG II.[17] Simulations also indicate that there are significant socio-economic groups where the new benefit regime implies income replacement that is close to or exceeds market wages.[18] This was already the case in the previous SA system, and is particularly relevant for low qualified persons living in households with children. Moreover, adult children, aged up to 25 years, receive full ALG II benefits even if they live with their parents in one household. In this respect, new legislation came into force in 2006 which reduces the generosity of the system. Unemployed workers whose eligibility for unemployment insurance (UI) benefits is reaching exhaustion receive for a period of two years' supplementary benefits, the level of which depends on the difference between the former UI claim and the level of ALG II. While supplementary benefits fall after one year, this provision cushions the drop in replacement ratios at the UI exhaustion point.

16. For transition into full-time employment, the implicit taxation of additional earnings due to benefit withdrawal is important. The main argument is that high transfer withdrawal rates over a considerable gross income band make work at low wages not worthwhile, thereby preventing a spreading

13. See OECD (2003).

14. See Christensen (2005).

15. See Blos and Rudolph (2005).

16. One might also note that the reform brings Germany close to the OECD main line. While about half of the OECD countries have no intermediate assistance scheme between unemployment insurance benefits and social assistance there is almost no country with the level of UA benefits being related to the level of former earnings *via* fixed replacement rates as was the case with the German UA.

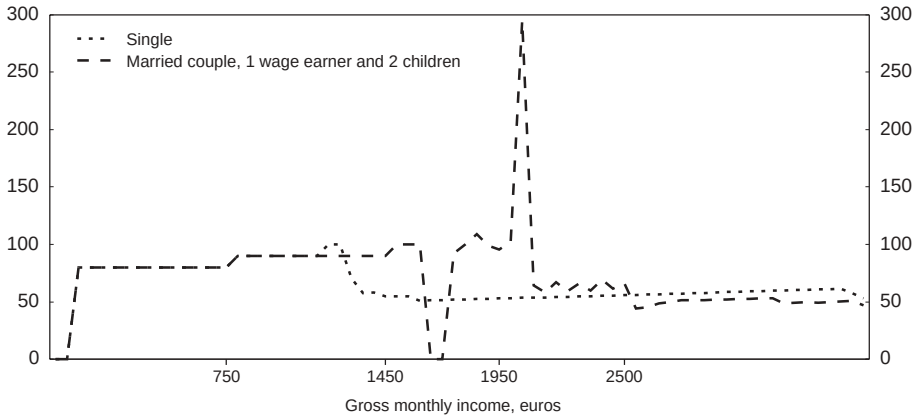
17. See Blos and Rudolph (2005).

18. Boss, Christensen and Schrader (2005).

Given the short period that elapsed since the introduction of ALG II, few empirical evidence of the impact of the new scheme on the transition into employment is available. Prior to the implementation of ALG II inflow into temporary work agencies appears to have increased. This might reflect an early response to the anticipated switch in the benefit regime, as the timing for this switch was known already in spring 2004. Experience from other OECD countries also suggests that announcement of new activation strategies can be associated with significant labour supply responses prior to the actual implementation of the new regime.

out of the wage distribution at the low-earnings tail that would induce higher labour demand. In the previous social assistance scheme withdrawal rates rose quickly to between 85% and 100% of additional earnings.[19] In the new ALG II scheme the marginal implicit taxation of gross earnings still amounts to around 80% to 90% over a broad income band (Figure 7). Also – due to a complicated interaction between the income base, supplementary benefits for children, and housing benefits – for families with children net income steeply increases at a certain level of gross income while net income falls back at a higher level of gross income.[20] To compensate for this income loss would require sizeable increases in gross wages.

Figure 7. **Marginal implicit taxation of gross income under unemployment benefits II**[1]
Marginal implicit tax rate, per cent



1. Taken into consideration unemployment benefits II (*Arbeitslosengeld II*), housing benefits (*Wohnkostenzuschüsse, Wohngeld*), child benefits (*Kinderzuschlag, Kindergeld*), income taxes, social charges for employees. Regulation for western Germany as of fourth quarter 2005. For a married couple with gross monthly income between € 1 600 and € 1 700, the marginal implicit tax rate is strongly negative.

Source: ifo Institute for Economic Research.

17. Overall, this suggests rebalancing the parameters of income replacement in the ALG II scheme in order to improve work incentives and support the spreading out of the wage distribution in favour of workers with low qualification. One option of reform is to lower ALG II withdrawal rates. Spikes in the provision of ALG II benefits for families with children should be abolished. Replacement rates should be revisited to preserve incentives to take up employment. In the same vein, the supplementary benefit layer between UI and ALG II should be phased out in order to raise the digressiveness of income support when UI reaches exhaustion. Moreover, income support should be concentrated on the needy. At present this is not generally the case. In particular, for "mini jobs", paying up to € 400 per month, workers are exempted from the obligation to pay social charges and income taxation is reduced. The subsidies for social contributions are gradually phased out over a range of incomes up to € 800 (*Midi jobs*). These jobs are hardly taken up by the unemployed but mainly by working spouses. Second earners benefit most from the income tax concession, in contrast to employees with no other source of family income for whom the basic tax-free zone of the personal income tax system applies. The government has already decided to reduce preferential taxation of mini-jobs. Preferential tax and contribution treatment of mini and midi jobs might be terminated as part of a policy package that reduces withdrawal rates of ALG II benefits and lowers the income taxation of second earners. Action along this line would also be required for fiscal reasons as isolated reductions in benefit withdrawal rates are fiscally costly, at least in the transition phase. This reinforces the case to tighten sanctions in cases where ALG II recipients do not conform with job search rules (see further below). Furthermore, reform of the ALG II scheme would need to be combined with

19. See OECD (2003).

20. See Sinn *et al.* (2006).

further regulatory reform designed to reduce wage rigidities in the lower tail of the wage distribution (see further below) and enhance enterprise foundation.

Activation strategies for the unemployed have improved but need amendment

Job search requirements have been strengthened …

18. 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.

19. 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.[21] 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.[22] 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.[23] 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 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.

20. 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.[24] Empirical evidence elsewhere indicates, however, that credibility of the sanctioning regime is important for its success.[25] 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.[26] Hence,

21. For an overview see OECD (2000).

22. 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).

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

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

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

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

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

21. 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.[27]

22. 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 are now scheduled to 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.[28] A comparable examination of the *Ich-AG* – after programme participation has terminated – is not available as the scheme has been introduced only recently. Later evaluation of the costs and the benefits of the instrument for setting up a business out of unemployment should take into consideration the costs and the benefits of other programmes that give financial aid for starting a business.

23. 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.

24. 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.[29] Similarly, while

27. Econometric studies on the effectiveness of ALMPs in Germany have been summarised in previous OECD *Surveys* on Germany. On the international experience see Hagen and Steiner (2000), Martin and Grubb (2001), OECD (2005c) Chapter 4, and Careillo and Grubb (2006).

28. See Caliendo and Steiner (2006).

29. 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.

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.

25. 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

26. 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.[30] 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.

27. 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

30. See Bundesregierung (2006).

efficiency of service provision.[31] 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.[32] 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.[33] 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.[34] 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.

28. 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.

29. 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

31. See Bundesregierung (2006).

32. See Schütz (2005).

33. 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).

34. See Grubb (2005b).

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.

30. 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.[35] 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 in which the municipalities take over financial responsibilities, thereby providing incentives for the municipalities to engage in efficient job placement.

31. 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, 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.

32. 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

35. See OECD (2005c) Chapter 5.

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.

Employment protection remains in need of reform

33. Strict employment protection legislation (EPL) tends to increase unemployment duration for the low qualified and marginal groups on the labour market.[36] Reaping the benefits of deepening international integration in goods and factor markets also reinforces the need to allow for more flexible labour force adjustment. Up to now, efforts to ease EPL for regular employment contracts, which is relatively strict by international comparison (Figure 8), were quite modest.[37] Instead, regulatory initiatives to increase the flexibility of labour contracts relied to a large extent on regulatory changes and financial support for non-regular forms of employment. This has contributed to the strong increase in a-typical contracts over the last years, such as employment *via* temporary work agencies (TWAs) or – quantitatively much more importantly – employment in mini-jobs with only a few hours worked per week.[38]

34. To some extent this might increase the chances of the unemployed in finding jobs and ease transition into regular employment. Empirical analysis points to the fact that a substantial share of temporary employees move on to regular employment. However, there is empirical evidence for Germany and other OECD countries that strict EPL for regular employment provides incentives for firms to resort to more atypical forms of employment contracts such as fixed-term or temporary employment and minor employment with only few hours worked per week.[39] Hence, single-sided deregulation of EPL in favour of highly protected regular employment contracts risks creating a dual labour market with an increasing share of marginal or unstable jobs. Also, the rise in financially supported mini jobs in Germany is reducing revenues of the social insurance system, putting upward pressure on labour taxation. Dualisation of the labour market might also have adverse incentives for the development of skills for the low qualified. Not least, this would be counter-productive in view of the fact that the relative demand for skilled labour is increasing. Some empirical studies for the 1990s have argued that low-skilled workers in Germany tend to be more skilled than in some other countries such as the US.[40] This, in turn, can reduce the degree to which

36. See Brandt, Burniaux and Duval (2005); OECD (2004c).

37. See OECD (2004a).

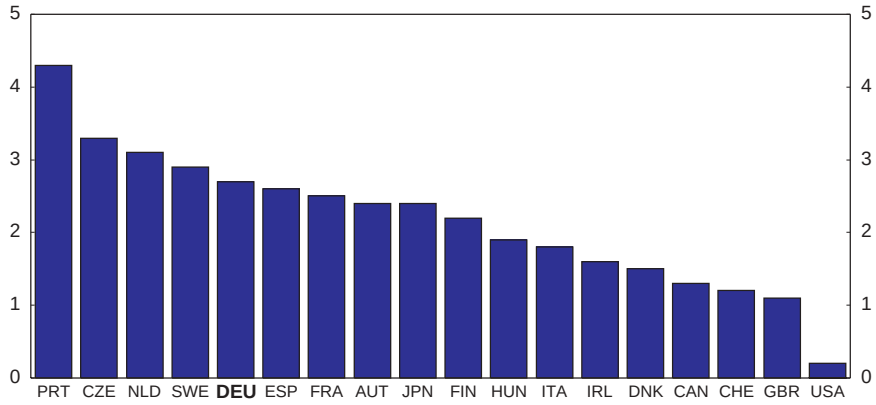
38. Concerning temporary work agencies (TWAs) the previous government implemented two regulatory reform measures with opposite implications for the profitability of TWAs. Since January 2004 employees on loan need to be subject to the same wages and employment conditions than regular employees, restricting profit margins of TWAs. At the same time, the "prohibition of synchronisation" provision (*Synchronisationsverbot*) was dropped, which required that the contract period between TWA and the worker had to differ from the sub-contracting period from the worker's first assignment. The regulation implied that after the termination of the first temporary work assignment the TWA had to pay salaries for another quarter of the year to a worker who could not be placed with another borrowing firms. As was argued in the 2002 *Survey* the regulation, which appears to have been unique for Germany, implied a squeeze of profits of TWAs that hampered the evolution of the market for temporary employment. The fact that loan employment accelerated 2004 points to the importance of the deregulation.

39. For Germany, Bookmann and Hagen (2001) found a significant positive relationship between the institutional redundancy costs for regular workers and the demand for fixed-term contracts. See also Brandt, Burniaux and Duval (2005); OECD (2004c) Chapter 2.

40. See Nickell and Bell (1996); Freeman and Schettkat (2001); Blau and Kahn (2001). There is some evidence that German firms invest more than US firms in training the low-qualified relative to the high qualified. See Pischke (2005).

low-skilled labour is affected by adverse labour demand shocks, such as technology shocks that reduce demand for low-qualified labour while favouring demand for high-qualified labour.

Figure 8. **Employment protection for regular employment**
Index of 0 to 6 from least to most restrictive legislation, 2003



Source: OECD (2004), *OECD Employment Outlook*.

35. The government plans to drop dismissal protection for the first two years of a regular employment contract. In exchange, the plans are to abolish the present option to offer fixed term contracts for the first two years of an employment spell. This initiative is welcome as it is likely to increase the flexibility of permanent employment contracts and contribute to reducing labour market segmentation.

36. At present, dismissal protection is subject to complex and non-transparent procedures. This is reflected in the fact that there are around 250 000 terminated court cases annually relating to dismissals. Legislation designed to simplify dismissal procedures became effective in 2004. *Inter alia*, complaints to the courts are subject to stricter time limits. Employers can offer a payment equivalent to half a month's salary per year of job tenure to dismissed workers, which workers can choose to accept instead of challenging the dismissal in court. However, it is questionable that this will lead to a significant reduction of uncertainty, as the present system is strongly influenced by case law, and provides few incentives to employees to co-operate with employers to terminate employment contracts in mutual agreement. Employees co-operating in their dismissal run the risk that they will be subjected to a waiting period for unemployment benefits. Hence, consideration should be given to modify the legislation that gives employers and employees the option to trade off severance pay against the right to challenge the dismissal in court. Workers and firms could be given an option to open work contracts after the probationary period to specify severance pay for workers in case of redundancy in return for a less stringent dismissal protection.

37. Economic analysis suggests that firms need to face some dismissal costs in order to avoid free-riding on the provision of unemployment benefits.[41] In the present unemployment insurance system, the uniformity of the employers' contributions to the scheme across enterprises contains an element of cross-subsidisation of employers with high dismissal rates by those with low dismissal rates. This could be internalised, at least partially, by linking the firms' current unemployment insurance contribution to their dismissal record over some period in the past. Reformed financing of unemployment insurance along this line, by better internalising the costs of redundancies, actually provides more employment protection,

41. See for example: Fath and Fuest (2005).

hence allowing some weakening of other aspects. Hence, introduction of experience rating should be considered as another option.

Toward more flexibility in setting wages and work conditions

38. Since the first half of the 1990s there is a trend toward more decentralisation in the determination of wages and work conditions. To a large degree this reflects a response to steep increases in collectively bargained wages after reunification and exits of enterprises and workers from employers' associations and unions, respectively. Collective agreements between the employers' associations and unions are increasingly incorporating opening clauses that give some scope for agreements on the firm level between the firm's management and the work council, although exercising these clauses often depends on the approval of the collective bargaining partners.[42] Moreover, over the last 15 years the share of firms with firm-specific agreements negotiated between the management and a union has substantially increased, as has the share of enterprises that are not covered by collective agreements at all.

39. Firm-level agreements – based on opening clauses from multi-firm collective contracts, single-firm collective agreements or individual contracts – have been a main driver for a higher degree of flexibility in work conditions and wages. According to an enterprise survey conducted by the German chamber system, in 1993 some 15% of enterprises had started to introduce some form of flexible working time arrangements. By 2004 such arrangements were adopted by two thirds of the enterprises.[43] While international comparisons are sparse, there is some evidence that firm-based working time flexibility is high in Germany relative to the EU average.[44] In particular, a large share of enterprises has established working time accounts that allow for compensating periods of overtime by reduced hours worked within a period that can extend up to several years. Econometric research indicates that arrangements on working time flexibility and working time prolongation had a significant positive impact on job creation among firms with firm-specific determination of wages and work conditions. This is similarly true for firm-specific agreements on training. By contrast, agreements on employment guarantees, which usually trade off guarantees against employees' concessions in wage increases, were estimated to have a negative influence on job creation.[45] Indeed, depending on the comprehensiveness of employment guaranties, reductions in a firm's workforce can only be brought about *via* voluntary separations, causing higher

42. For an overview over different types of opening clauses from collective contracts by sector and bargaining area see Bispinck and WSI-Tarifarchiv (2005a); see also OECD (2003). For a comprehensive account of plant level agreements by type of agreement and firms' economic conditions and characteristics see Seifert and Massa-Wirth (2005).

43. Deutscher Industrie- und Handelskammertag (2004). For an account of different types of working time regulations across collective bargaining areas see: Bispinck and WSI-Tarifarchiv (2005b). A large share of collective contracts contains opening clauses that allow firm-specific agreements on working time variations. However, achieving a higher degree of working time flexibility was also a major motive for employers to exit the employers' association. According to a study by Kölling and Lehman (2001) based on 13 800 companies in the IAB firm panel 22% of the firms, which left the collective wage agreement between 1996 and 1999 increased the weekly working time by at least 1 hour, 15% by more than 1 hour. On the other hand, some 11% of the companies decreased the weekly working time. This response was largely confined to west German enterprises. Surprisingly, there was no empirically significant time lag between the date of quitting the employer's association and the change in regular working time. This indicates that employers were able to quickly arrange the terms of employment with workers' representatives, sometimes avoiding statutory waiting periods. See Kölling and Lehmann (2001).

44. According to a study of the EU Commission in 1999 85% of German industrial enterprises have the option to vary the working time within a given year, as opposed to 80% in EU-15 average. Quoted according to Spitznagel and Wanger (2004).

45. See Hübler (2005).

severance payments than would have to be paid otherwise. Recent developments suggest that such agreements might well add to the costs of labour adjustment in times of falling product demand or rapid structural change requiring rapid adjustment in the firms' work force.[46]

40. Wage rigidities would need to be reduced further to fight unemployment, notwithstanding the fact that there has been considerable aggregate wage moderation for a number of years in a row. Empirical research indicates that the responsiveness of real wages to local unemployment rates is low in Germany by international comparison.[47] While the wage dispersion among full-time employees has increased since the middle of the 1990s, reflecting to a large extent lower entry wages for new hirings, some studies indicate significant wage rigidities across qualifications.[48] Deficiencies in the benefit and placement system to activate the unemployed and make work pay might go some way in explaining wage rigidities. Also, econometric analysis for Germany suggests that the wage distribution by qualification is the more compressed at the lower end of the wage distribution the higher the union density by sector.[49] There is some indication that the difference in the inter-firm wage dispersion between industry-wide collective contracts and firm-specific contracts has declined in the 1990s. This is consistent with the observation that opening clauses in industry-wide wage settlements have become more common over the period.[50] Empirical work indicates that higher wage flexibility by qualification could generate significant employment effects.[51] This calls for institutional reform supporting such adjustment.

41. Some government provisions in support of collectively bargained contracts contribute to insulating collectively bargained wages from labour market conditions. Specifically, power of the federal government to impose the collective bargain outcomes on all firms reduces the scope for firm-level agreements outside collective bargains, notably in the construction industry. Some states have adopted legal provisions on public procurement which aim at eliminating contractors paying wages which are substantially below competitors wages or do not meet quotas for the employment of women. These legal provisions increase the cost of public procurement, raise transaction costs and reduce competition. Administrative extension of collectively bargained contracts should only be applied if negative consequences for the labour market can be avoided. Policies linking public sector procurement to collective wage agreements should be given up. Current labour law gives a preference to collective wage bargaining, which hampers firm-specific determination of wages and work conditions. Consideration should be given to widening the scope for wage determination at the firm level so as to better align collective wage contracts with labour market conditions, as has been suggested in OECD Economic Surveys on Germany. In such a system collective bargaining outcomes would continue to serve as the default if firm-based agreements do not come about. Indeed, the importance of collective bargaining is

46. In summer 2004 the management of Daimler-Chrysler in Germany and the IG Metall union agreed on a contract that excluded dismissals until 2011. In return, the employees' side agreed to wave pay rises of some 2.8% for 2005 that had already been agreed upon, and to accept partial working time extensions that were not compensated by proportionate increases in remuneration. Overall, concessions by the employees were estimated to generate savings of some € 0.5 billion. One year later, Daimler-Chrysler announced plans to reduce its workforce in Germany by several thousand employees. The costs of severance payments for voluntary quits are estimated to total some € 1 billion.

47. De Galdeano and Turunen (2005); Montuenga, Garcia and Fernandez (2003).

48. See *e.g.* Steiner and Wagner (1998),and Möller (1999) for investigations on the evolution of the wage distribution until the middle of the 1990s; More recent investigations include Fitzenberger and Franz (2001), Möller (2005), Pfeiffer (2004), Fitzenberger and Garloff (2005), Gernand and Pfeiffer (2006), Kohn (2006), and Fitzenberger and Kohn (2006).

49. See Gerlach and Stephan (2005).

50. See Gerlach and Stephan (2005).

51. See *e.g.* Fitzenberger and Franz (2001); Fitzenberger and Kohn (2005); Pfeiffer (2004).

apparent from the fact that a significant share of enterprises apply the provisions negotiated collectively between the social partners although they are not members of the employers association.[52]

42. New demands came up in the policy debate to prevent wages from falling to levels considered to be socially unacceptable by introducing legal minimum wages for the economy overall. The proposition was reinforced by the perception that increasing international competition on labour and product markets could result in non-acceptable downward pressure on wages. Indeed, empirical work suggests that the firms' option to offshore production has had a damping impact on German wage settlements. However, to the extent that minimum wages become binding, they risk to counteract policies that aim at increasing labour demand for the low qualified and raising employment chances for new labour market participants. Indeed, experience indicates that minimum wages too often started a slippery slope toward higher rates that cause labour market exclusion.[53] Increasing pressure to outsource labour intensive goods and services abroad reinforces the argument.

43. In the policy debate it has been proposed to base legally binding minimum wages on collective bargaining outcomes. According to this approach unions and employers associations would determine nation-wide sector specific minimum wages, which would be declared legally binding for all enterprises in each sector, independently of whether the enterprises are subject to collective bargaining outcomes, *via* administrative extension by the Federal Minister of Labour. However, this approach runs the risk to aggravate potentially adverse effects of minimum wages on employment creation as it would allow the social partners to set minimum wages at levels favouring "insiders" – workers that are already in employment – and reducing the chances of outsiders to enter employment. Indeed, facing packages of wage demands by the unions, employer associations may find it preferable to trade-off more modest increases in wages above the minimum level against higher growth in minimum wages. Moreover, to the extent that large enterprises have a larger weight than small enterprises in shaping bargaining outcomes there is a risk that administrative extension of minimum wages will hurt the competitiveness of small enterprises.[54] Also, nation-wide minimum wages would reduce the responsiveness of wages at the low end of the wage distribution to differential development of regional labour demand and supply conditions, hampering labour market adjustment across regions. In particular, this would adversely affect the new states.

Reaping the benefits from reform in related fields

44. Reform efforts should not be restricted to institutional features of the labour market in a narrow sense, such as unemployment related benefits or the design of work contracts, to improve the economy's capacity to create employment in a durable way. Regulatory conditions in other parts of the economy interact in important ways with labour market performance, underlining the need for a broad based reform approach. The final section of this note highlights a few areas where this aspect is of particular relevance.

The tax wedge on labour needs to be reduced

45. Within the OECD Germany belongs to the group of countries with high tax wedges between gross wages paid by employers and the workers' take home pay net of personal income taxes and social

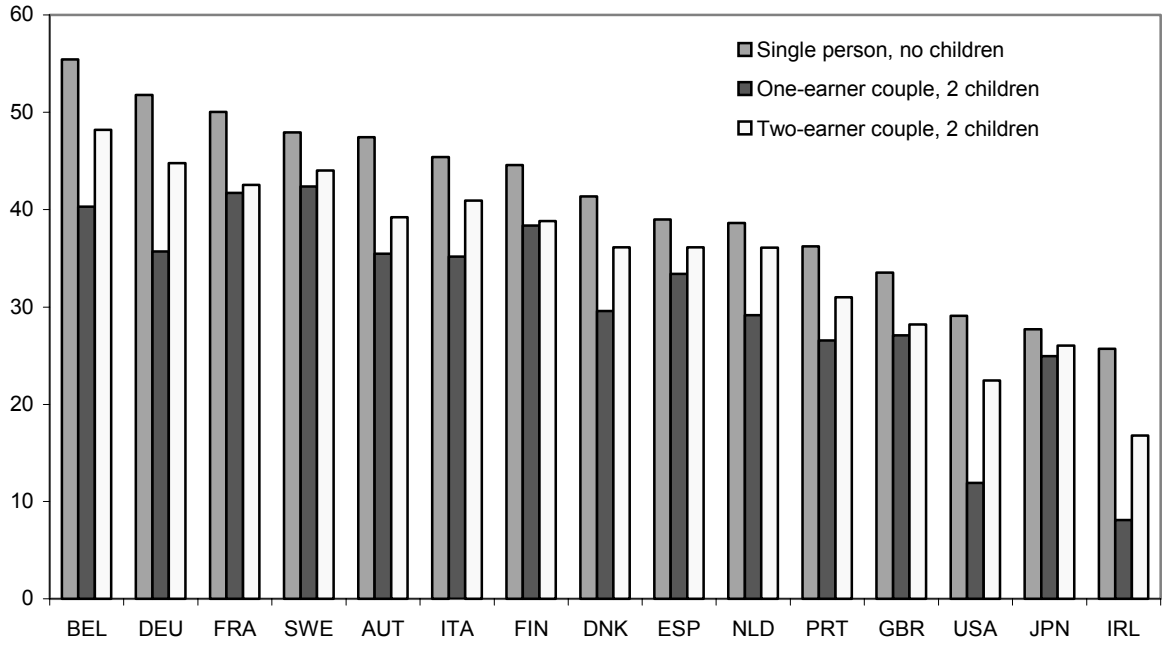
52. Survey based investigations by Franz (2001) and Franz and Pfeiffer (2005) indicate that efficiency wage considerations prevent a large share of enterprises to exercise opening clauses in collective agreements giving some discretion in firm-specific wage setting.

53. OECD (2005b). Also: Abowed and Kramarz (2000).

54. Empirical research shows that the probability of a firm being subject to multi-firm collective agreements is positively related to firm size and age. See, for example, Hohaut and Schnabel (2003).

charges. This is true for a wide wage band around the pay of an average worker. For a single person without children the tax wedge is higher than in almost any other OECD country, although effective taxation is more favourable for families with single earners (Figure 9). High social charges are mainly responsible for this outcome. High tax wedges discourage both labour force participation and the firms' labour demand. Given the high reliance of the German tax system on social security contributions, reductions in social charges are required to generate significant reductions in tax wedges.

Figure 9. **Effective taxation of an average worker**[1]
% of labour costs, 2005



1. Average worker's gross wage for first earner, 67% of this wage for second earner. The ratio is income tax plus employee and employer social security contributions less cash benefits as a % of labour costs ("tax wedge").
Average worker's gross wage is average gross wage earnings of adult full-time workers in the manufacturing and services sectors.

Source : OECD, *Taxing Wages 2004-2005* (2006 edition).

46. The beneficial effects of reductions in social charges that are financed *via* other tax increases, notably a rise in the value added tax (VAT), are limited as tax increases are associated with adverse effects as well. An increase in the VAT tax rate reduces incentives to work by reducing the purchasing power of wage income, although the tax base of VAT is somewhat broader than that of social security contributions, encompassing non-labour income as well.[55] Hence, refinancing measures of this type can be no substitute for more fundamental reform in social security systems, such as the health care and the pension systems, that generates the scope for reductions in social charges.[56]

55. While the tax wedges shown in figure 9 are confined to the effect of income taxation, including social charges, a broader definition of the tax wedge includes the value added tax as well.

56. For reform options in Germany's health care, long-term care and pension systems see OECD (2004a), OECD (2005a) and OECD (2006).

The education system needs to be made more efficient

47. An important aspect influencing demand for labour, labour force participation and the growth of labour productivity is how training and skills provided by education institutions contribute to the human capital of workers. The challenge in this respect is to improve regulations so as to raise the efficiency of the education system overall and to improve its capacity to respond swiftly to skill requirements of the economy. There is much scope for significant improvements in Germany's education system, ranging from pre-schooling over secondary education and vocational training to the university system, as has been discussed in subsequent OECD *Surveys* on Germany.[57]

48. Institutional reform in the education system is often complicated by the fact that responsibilities are dispersed across different authorities. For example, responsibilities for secondary education are allocated at the level of the federal states, which has made it difficult to arrive at nation wide standards to evaluate schooling performance.[58] The existence of significant regional spill-over effects of policies affecting the education system poses serious challenges for policy makers, involving issues of federal fiscal relations. University construction stands as an example. Freedom of students to choose their university without obligation to pay fees implies a regional divergence between the costs for the provision of tertiary education and the returns associated with this provision. The latter can consist of returns from research or income tax receipts of high-income workers. Given the fact that the states can appropriate only a small fraction of the returns from education, there are incentives to react to extensions in another state's supply of tertiary education by curbing own spending for universities. Consequently, if the externalities remain uncompensated, the equilibrium outcome of the states' individual actions is under-provision of tertiary education services, as the return from extending the supply of tertiary services or improving their quality falls short of the overall return.[59]

49. University construction by the states is co-financed by the federal government, which provides incentives to extend the supply of universities. However, the co-funding instrument is sub-optimal as allocation of funds is not closely linked to the size of inter-regional spill-overs and subject to both bargaining between the federal government and the various states as well as sizeable co-ordination costs. Hence, the instrument is unlikely to provide efficient internalisation of inter-regional externalities that are involved in university education. Indeed, empirical research for Germany indicates that spending on tertiary education of neighbouring states are significantly negatively correlated, pointing to the existence of significant inefficiencies in the present university financing system despite federal co-financing.[60] By contrast, introduction of study fees whose returns accrue to the universities would internalise spill-overs as the universities would receive funding of those who utilise their services. In the same vein, coupled with a sufficient degree of autonomy of the universities to shape the services they offer, fees would provide incentives for quality improvements that attract students. A majority of states still reject the notion of charging study fees, and direct accrual of fees by universities is not envisaged. The states should give the universities the right to charge study fees that accrue to them. However, as this will not suffice to finance the university system public sector funding will remain necessary. In view of the externalities involved, funding should be provided by the federal government rather than the states. This would have to entail a re-allocation of responsibility for universities from the states to the federal level.

57. See the chapter on education in OECD (2006), and OECD (2004a) for the apprenticeship system.

58. See OECD (2006) and OECD (2004a).

59. Büttner and Schwager, (2004).

60. Büttner and Schwager (2004).

Synergies from product market reform need to be exploited

50. Labour market reform can be particularly difficult to implement, especially as there is a risk of impacting negatively on household confidence. Reform will be more effective in generating new employment if it is combined with regulatory reform that reduces barriers to entry for new firms and impediments to the growth of enterprises. Structural reform in favour of product market competition reduces the rents of incumbents, implying a redistribution of real incomes in favour of consumers. This, in turn, contributes to strengthen domestic demand and can increase the acceptability of reforms in other areas, notably the labour market. There is considerable scope for product market reform along these lines. Barriers to entry in the craft sector have been recently reduced but warrant further deregulation. Regulation of enterprise-near professional services, such as architects and engineers, is very restrictive by international comparison. Fostering competition in network industries, such as in telecommunication, energy supply and in postal services, should also rank high on the policy agenda, notwithstanding the significant progress that has already been made in recent years. Streamlining administrative regulation in a number of fields is called for, which would promote firm entry, as administrative costs are particularly burdensome for small enterprises.[61]

61. See the special chapter on competition in OECD (2006).

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