Activation versus Other Employment Policies – Lessons for Germany

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In the last two years, Germany has embarked on a path of labour market reforms to fight its high and persistent unemployment. The reforms have come in two rounds. The first set of reforms, based on the report of the Hartz Commission (2002), aimed mainly at increasing the efficiency of the federal employment service. The second round of reforms, the Agenda 2010, went further and involved also reforms of the unemployment benefit system.[1]

The reforms to raise the efficiency of the employment services have involved a number of measures: the establishment of integrated job centres, attempts to extend the access of the unemployed to various training programmes (for young people in particular), subsidised employment for elderly unemployed, and the creation of temp work agencies. Other ingredients are "activation measures" in the form of increased requirements on the unemployed regarding active job search, availability for work, and acceptance of work conditions in new jobs, as well as stronger sanctions if these requirements are violated. One way of characterising these reforms is as an attempt to adopt active labour market policies of the type used in the Scandinavian countries, where these policies have been employed on a large scale.

This article discusses what contribution to lower unemployment such active labour market policies can give. This is done against the background of experiences from other countries, mainly Sweden. Based on this, I give an outsider's evaluation of Germany's labour market reforms and draw conclusions on which other policies are required if unemployment is to be permanently reduced.

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[1] See e.g. EEAG (2003, 2004) for brief accounts of the reforms. More detailed accounts are given in e.g. Collier (2004) and Siebert (2004).

[2] The figures refer to 2000 or 2001 and are from the *OECD Employment Outlook* (2003).

[3] This literature originated with Layard et al. (1991). The most important of these studies are listed in Calmfors et al. (2001, 2004) and EEAG (2004, Ch. 3).

The conventional wisdom on active labour market policy

There appears to be a broad consensus that the major part of unemployment in Germany is structural, reflecting a high rate of equilibrium unemployment (see, for example, Sinn, 2003; or EEAG, 2003, 2004). Although the current recession has certainly added a substantial cyclical element, the fact that unemployment in Germany has over the last three decades ratcheted up from recession to recession must be interpreted as a successive rise in equilibrium unemployment.

It has for many years been a standard recommendation from international organisations, such as the OECD and the European Commission, that in such a situation there are large gains from re-allocating resources from passive unemployment benefits to active labour market policies. This recommendation has to some extent been followed in many countries. The average EU country today spends nearly 1 percent of GDP on active labour market programmes. Germany spends even more, around 1.2 percent, although this is a smaller fraction of total expenditures on the unemployed (39 percent) than in the average EU country (42 percent).[2]

The recommendation to channel more resources to active labour market policies is underpinned by a large empirical research literature, which has tried to explain differences among countries and over time in equilibrium unemployment with differences in *labour market institutions*: a standard result in these studies is that higher expenditure on active labour market policies tends to reduce unemployment.[3]

However, there are reasons to be sceptical about these results since they only measure the effects of active labour market policies on *open unemployment:* it is not surprising that open (registered) unemployment falls when openly unemployed persons are enrolled in various labour market programmes of long duration (training programmes, public-sector job-creation programmes, and subsidised employment in the private sector) and are then no longer counted as unemployed. It also turns out that if one recalculates the results in the studies it is no longer clear whether or not active labour market programmes reduce unemployment in total (that is if we add *open unemployment* and *programme participation*). According to some studies they do, according to others they do not (Calmfors et

al. 2001, 2004).[4] The flip side of this is that it is also unclear whether or not programmes increase *regular employment.*

The Swedish experience with active labour market policies

One can probably learn more about the effects of active labour market policies from the experiences of individual countries than from the aggregate studies using data from many OECD countries that have been undertaken. The experiences from Sweden are particularly illuminating.

Sweden has a long tradition of active labour market policy with large placements of unemployed in various training, practice or subsidised employment programmes (usually of about half-a-year length). These labour market programmes were gradually expanded in the post-war period. They reached a peak during the Swedish unemployment crisis in the first half of the 1990s. In that period, Sweden spent more on active labour market policies than any other OECD country, almost 2 percent of GDP. At a time, nearly 5.5 percent of the labour force participated in various training or subsidised employment programmes. Subsequently, programme volumes were reduced to 2 to 3 percent of the labour force.

The Swedish active labour market policies in the 1990s can be seen as a giant experiment. Afterwards, the policies were subjected to a large number of rigorous evaluation studies.[5] One can summarise the results as follows:

- Looking at the outcomes for individuals participating in various training programmes, results are very disappointing: training programmes appear either to have had *no effect* at all on future employment opportunities or a *negative effect.*
- In contrast, some types of subsidised employment seem to have increased employment probabilities of participants substantially also after programme completion: not very surprisingly the results are the better the closer such a programme has been to regular employment.
- But, unfortunately, subsidised employment seems also to cause a large displacement of ordinary jobs: estimated crowding-out effects on regular employment are often of the order of magnitude of 60 to 70 percent.
- As expected, training programmes do not seem to be associated with displacement of ordinary jobs.
- The results are particularly bad for youth programmes. It is unclear whether such programmes have increased the employment prospects of participants. At the same time, the subsidised employment schemes for young people seem to have caused particularly large crowding-out effects.
- Both training and subsidised employment programmes seem to have reduced rather than increased labour mobility.[6]

These results are indeed very dismal. Some types of subsidised employment have been good for the individual, but have had a high price in terms of reducing regular employment. Training programmes have not suffered from such crowding-out problems, but have been inefficient or even damaging to the individual participants.

Is there nothing good to say about Swedish active labour market policies in the 1990s? It is possible that policies – by keeping the long-term unemployed attached to the labour market – helped maintain labour force participation. There are studies indicating this, but we do not know to what extent it was *effective* labour supply that was maintained or just the measured labour supply, because programme placements were to a large extent used to re-qualify the unemployed for unemployment benefits. Programmes may also have kept the unemployed "happier" than would otherwise have been the case: survey results indicate that the experienced welfare of programme participants was significantly higher than the experienced welfare of openly unemployed (Korpi, 1997).

Lessons to learn from the experiences of Sweden and other countries

A first lesson to learn from the Swedish experience has to do with the scale of programmes. With such large programme volumes as undertaken in Sweden, huge inefficiencies are bound to arise. Especially

[4] In the studies the size of labour market programmes is measured in terms of expenditures and not in terms of the number of persons enrolled. This means that a number of assumptions have to be made in order to calculate the effect of an increase in the number of programme participants on total unemployment (the sum of open unemployment and programme participation).
[5] See Calmfors et al. (2001, 2004) for an overview of the evaluation studies performed.

[6] See Fredriksson and Johansson (2003) in addition to the studies surveyed in Calmfors et al. (2001, 2004).

training and practice schemes tend to become of low quality.[7] The same happens with various schemes of public job creation and subsidised private-sector employment if one tries to regulate them in such a way that they only encompass "tasks that would not otherwise have been carried out", which one is in effect forced to do with large volumes in order to reduce crowding-out effects.

Equally serious – but often not realised – is that large placements in long-duration programmes of the Swedish type have very negative effects on the core matching activities of the public employment services. The task of matching unemployed and vacancies in as efficient a way as possible is to a large extent crowded out by the administration of large programme placements.

The obvious conclusion is that programme placements should be carefully targeted. This will automatically reduce programme volumes and increase efficiency. If one can target subsidised employment programmes on those that are, or run the largest risks of becoming, long-term unemployed, displacement of ordinary jobs is much less of a problem: to the extent that such displacement is the result of increased competition for jobs for "insiders" in the labour market from "outsiders" supported by labour market policies, there will be downward pressure on wages that generates a net employment creation effect.

At the same time, there are limits to the extent to which programmes should be targeted. The reason is the risk of "stigmatisation": if programme participation is reserved only for those with the largest difficulties in the labour market, programme participation may come to serve as a negative screening device for employers. So there is a delicate balance between targeting too little and targeting too much.

One conclusion that has been drawn in Sweden, and many other countries, is that the focus of active labour market policy should shift from placement in various training and subsidised employment programmes of long duration to *activation measures* designed to directly improve the matching process. Such measures include intensified counselling, more frequent contacts between employment offices and job seekers, higher demands on job-search activity, individual action plans for the unemployed, tougher requirements on which jobs to accept, more benefit sanctions when job offers are not accepted, and "workfare" requirements for receiving long-term income support instead of passive benefits.

Several countries have moved in this direction; for example, Australia, Denmark, Ireland, the UK, the Netherlands, and Sweden. Changes of this type are also part of the German reforms.[8] According to studies, such measures can increase outflow rates from unemployment substantially (say in the range of 15 to 30 percent).[9] This has led to quite some optimism on what can be achieved through activation policies.

Although I share this judgement to some extent, one should, however, also be aware of the risk that the positive effects may be overrated. This seems to be a risk that active labour market policy is constantly exposed to.[10] Improved matching can increase unemployment in two ways. First, labour demand increases if hiring costs of employers fall. Second, there is less wage pressure to the extent that employers can fill their vacancies more quickly. But it is difficult to believe that any of these effects is large in a situation with very high unemployment. As vacancies then tend to be filled quickly anyway, both employers' hiring costs and wage pressure are already low.

To the extent that activation has been limited to particular groups, better labour market outcomes for these groups have probably come at the expense of other groups, so that one cannot generalise the results to the whole labour market. And where activation measures have been claimed to have positive aggregate effects – such as in Denmark, Ireland, the Netherlands, and the UK – it has often been difficult to disentangle these effects from the effects of other institutional changes in the labour market (Grubb and Martin, 2001).

A general problem is that successful activation policies are quite resource-demanding on the part of the labour market administration. This problem is, of course, most serious when unemployment is high.

[7] It is interesting to note that the labour market outcomes for participants in training programmes appear to be considerably more favourable in the new EU states than in the old, according to a number of studies (Leetmaa and Võrk, 2003). A possible explanation is that the programmes in the new EU states have been of very limited size. It also appears that training programmes in the U.S., which have also been much smaller than the Swedish programmes, show more favourable results, even though they are not better than those for programmes of subsidised employment (Blank, 2003).

[8] See e.g. EEAG (2003, 2004).
[9] See e.g. Grubb and Martin (2001).
[10] See e.g. Calmfors (1995) and Saint-Paul (1996).

Indeed, *multiple equilibria* are likely to exist. If unemployment is low, as it was in Sweden in the 1970s and the 1980s, close monitoring of the unemployed can help maintain such an equilibrium. But when unemployment is high, close monitoring is no longer possible. In such a situation, monitoring efforts also often tend to focus on formal search methods, like the number of written job applications, rather than on more informal and probably more efficient methods. Also, in high-unemployment situations, caseworkers may shun applying sanctions against unemployed with low search intensity if the sanctions are regarded as too harsh.

My overall conclusion is that we cannot expect too much from active labour market policy. It is probably most effective as a complement to other measures. Activation measures are likely to work best when vacancies increase and unemployment is falling anyway. Activation efforts can reinforce such a process. This may be what happened in countries like Denmark, Ireland, the Netherlands, Sweden, and the UK in the 1990s (Grubb and Martin, 2001).

At the same time, it is clear that the efficiency of active labour market policies and activation measures can be raised in various ways:

- Proper evaluations of various programmes are crucial. This is so not least because active labour market policy is one of the areas with the highest turnover of policies: new programmes are invented all the time and old ones are constantly being disguised under new names.[11] This process usually takes place based on far too little evaluation. This is a strong argument for institutionalising evaluation procedures, for example, by setting up an independent national evaluation body that can accumulate both institutional knowledge about policies and apply academic evaluation techniques. This was done in Sweden in the late 1990s when the Office for Labour Market Policy Evaluation (IFAU) was established: the office has produced a number of qualified evaluation studies, which have been quite important in influencing policies.
- Statistical methods for the ex-post evaluation of programmes can also be used to obtain better ex-ante criteria for programme selection for individuals. These methods can be used either for predicting at an early stage which individuals run the greatest risk of becoming long-term unemployed (profiling) or for estimating which programmes are likely to give the largest improvement in future labour market outcomes per resources invested for a given individual (targeting).[12]
- It is very important to avoid confusing various objectives of labour market programmes. A certain recipe for bad results is to confound objectives of income support and activation. The Swedish experience is that when the same programmes are used both to provide income support and to activate the unemployed, the former objective has a strong tendency to take over and weaken the incentives for using the programmes in an efficient way for enhancing the future employment prospects of participants.[13] This is a strong argument for keeping activation and "workfare" programmes apart.
- There may also be a lot to be gained from introducing more incentive schemes (incentive pay linked to performance) in the public employment service and to open it up for competition, or at least "quasi-competition", among different providers of employment services (job brokering, activation measures, training etc.). Australia provides an interesting example of how this can be done (Grubb and Martin, 2001), but overall it is very hard to assess the potential gains from such a system without much more experimenting. It is clear though that any such system must be backed up by solid evaluations, so as to counter any incentives for employment officers to select programme participants from groups with very favourable employment prospects from the start in order to show good results.[14]

General knowledge of labour market reforms

Even if efficiency can be increased substantially, active labour market policies and activation measures can only be one ingredient of many in a successful employment policy. It may even be very harmful to expect too much of active labour market policies, because too much of a focus on them may weaken the incentives to pursue other policies. There is always a risk that active labour market policies are

[11] See e.g. Calmfors (1995), Saint-Paul (1996), and Calmfors et al. (2001, 2004).

[12] See e.g. Fröhlich et al. (2003).

[13] See Calmfors et al. (2001, 2004) and Forslund et al. (2004).

[14] For example, in Sweden it has been found that training programmes with a high degree of goal achievement in terms of subsequent employment have a lower share of participants with unfavourable labour market characteristics than other programmes: there are lower shares of immigrants, low-educated, long-term unemployed etc. (Martinsson and Lundin, 2003).

used as an excuse for not taking other more efficient – but politically also more controversial – policy action.

The consistent lesson from the large research literature trying to explain differences in unemployment both across OECD countries and over time within them is that there are a number of important determinants of structural unemployment (besides active labour market policy): these include unemployment benefit levels, the duration of benefits, the requirements for obtaining benefits, the way wage setting occurs (which is determined by such factors as the degree of unionisation, the coverage of collective bargaining, and the extent of co-ordination in collective bargaining), and possibly also tax levels and the degree of employment protection.[15]

In general, we seem to have good knowledge of which factors work in which direction, but rather insufficient knowledge about the magnitude of the exact effects of individual factors. There is, however, a general presumption that the more factors ("labour market institutions") are changed in an employment-friendly direction, the greater is the chance that unemployment is reduced. This has recently been illustrated by Nickell (2003), who showed that there is indeed quite some correlation across the OECD countries between the (net) number of labour market institutions changed in an employment-friendly direction and reductions in unemployment between the 1980s and the late 1990s: with an excess of employment-friendly movements in countries that succeeded in reducing their unemployment rates substantially, such as the Netherlands, Ireland, Denmark, and the UK, but with little change or an excess of employment-hostile movements in less successful countries like France, Italy, and Germany.

German labour market reforms

Against the background of the above discussion, how should one look upon the current labour market reforms in Germany? These are my reactions as an outsider to the German debate.

As to active labour market policy and activation measures, the attempts to move in the Scandinavian direction by increasing the efficiency of the employment services through various reforms are steps in the right direction. However, in view of the very limited success of, for example, Swedish active labour market policy, one should not expect very large effects from these measures alone. To put it rudely and only with a slight exaggeration, Germany may be moving from *very bad* active labour market policies to *bad* such policies. If so, it is an improvement, but not a very impressive one.

The limitations of active labour market policies and activation measures imply that much greater reliance must be put on other labour market reforms. According to both microeconomic studies of the unemployment spells of individuals and macroeconomic studies of aggregate unemployment, the generosity of unemployment benefits is a crucial determinant of unemployment. Against this background, it is difficult to avoid the conclusion that if labour market reforms are to achieve a significant reduction in unemployment, they must involve substantial reforms of unemployment benefits. Such reforms are now being implemented in Germany, involving a reduction in the duration of unemployment insurance benefits for elderly workers and some reductions in the level of unemployment assistance benefits for long-term unemployed (with unemployment assistance being merged with social assistance).[16] But the changes are rather limited and may not be enough to have a major impact on unemployment.

If reductions in benefit generosity are to make a maximum contribution to employment generation, they must be translated into lower real wage costs as efficiently as possible. It is therefore a step in the right direction that the unemployed may now have to accept jobs that pay less than the jobs they had before. But the current stipulation that unemployed workers are not required to take jobs at wages below the prevailing ones in the local market means in effect a support for collectively bargained wage levels, which reduces pay flexibility. For this reason, it is

[15] Recent such studies are Nickell and Layard (1999), Blanchard and Wolfers (2000), Belot and van Ours (2001), and Nickell et al. (2003). See also EEAG (2004, Ch. 3) for a more complete list of relevant studies.

[16] Unemployment insurance benefits *(Arbeitslosengeld I)* are 67 percent of the previous net income after tax (for an unemployed with at least one child). Before 2003, the duration of benefits was up to 32 months for those older than 44. From 2003, the maximum duration is 12 months except for those older than 55, for whom it is 18 months. Earlier, unemployment assistance benefits *(Arbeitslosenhilfe)* was 57 percent of the earlier net wage for unemployed with at least one child. Unemployment assistance for new recipients is as of 2005 decoupled from the previous income and aligned with social assistance *(Arbeitslosengeld II)*, which in most cases means some reduction. Social assistance levels are not, however, reduced. See e.g. EEAG (2003, 2004) for brief accounts of the reforms. More detailed accounts are given in e.g. Collier (2004) and Siebert (2004).

important that the plans to remove this stipulation for the long-term unemployed next year are indeed carried through.

If labour market reforms are to succeed in reducing real wage levels, it is also necessary for the pay-setting system to be responsive enough. Existing research does suggest that the present pay-setting system in Germany, with a high coverage of collective agreements and where the main locus of collective bargaining is the sectoral level, is not conducive to real wage moderation and relative wage flexibility (EEAG, 2004: Ch. 3). Instead, it appears that the systems most conducive to low unemployment are either those with a high degree of co-ordination of wage bargaining at the national level (producing very substantial aggregate wage moderation) – like in Ireland, the Netherlands, and Sweden – or those with very decentralised bargaining at the level of the firm and low coverage of collective agreements (producing a combination of aggregate wage moderation and substantial wage differentials among skill groups) – as in the U.S., the UK and most of the new EU member states.

Highly co-ordinated wage bargaining at the national level in order to achieve real wage moderation does not seem to be a feasible option for Germany. Nor is such a system likely to achieve larger relative wage flexibility, for which there is a great need in Germany in view of the compressed wage structure and the concentration of unemployment among the low-skilled and in east Germany.[17] More decentralisation of pay setting to the level of the firm would seem necessary in order to create larger possibilities to adjust wages to the local employment situation. This could be achieved through more liberal opening clauses in sectoral collective agreements and possibly, as has occurred in Sweden, also through collective agreements that leave the determination of the margin for wage increases entirely to the local level (EEAG, 2004: Ch. 3).

There is also great merit in moving towards the Anglo-Saxon approach of restrictive unemployment benefits combined with generous tax credits for income from employment for low-wage earners. Such a shift provides social protection at the same time as it strengthens the incentives for employment and facilitates a downward adjustment of real wage levels. This can be done through general employment income tax rebates for all low-wage earners as in the U.S. *(Earned Income Tax Credit)* and the UK *(Working Family Tax Credit)*.[18] Alternatively, such tax rebates can be limited to the long-term unemployed or earlier welfare recipients (similar to what was tried with the *Self-Sufficiency Project* in Canada).[19] An advantage of employment income tax rebates as compared with employment subsidies to employers within the framework of traditional active labour market policy is that the employment support can be given directly to the targeted group without involvement of the employer. As a consequence, the risk of "stigmatisation" is much smaller than when employers are induced to hire long-term unemployed with extra wage subsidies that identify the unemployed as problem cases.

An "internal devaluation"

Finally, one must not forget about demand policies. Because nominal wage levels are sticky downwards (it is even difficult to reduce annual nominal wage *growth* below 1 to 2 percent), it will take time for any labour market reforms that put downward pressure on real wage levels to produce results in a situation with low product demand and low inflation. This is a strong argument for speeding up the adjustment process through policies increasing aggregate demand. Without EMU, such a demand increase would in all likelihood have been achieved through a devaluation of the D-mark relative to the other European currencies and a more expansionary monetary policy in Germany than in the rest of Europe. Or put differently, the real exchange rate depreciation (relative price reduction for German products) necessary for creating the demand to match the increase in equilibrium output associated with labour market reforms would have been achieved through a nominal currency devaluation.

With EMU, there is no longer any D-mark to devalue. Then there is only one option left to achieve a fast reduction of real labour costs and a real exchange rate depreciation boosting Germany's international competitiveness. That is a radical cut in payroll taxes (social security contributions) paid by employers (say by 10 percentage points). If such a

[17] See e.g. the German Council of Economic Experts (2002), EEAG (2004, Ch. 3) or Siebert (2004).

[18] See Ochel (2001) or Blank (2003) for discussions of the US system. Sinn et al. (2003) develop such a proposal for Germany.

[19] See e.g. Lyndon and Walker (2004). Germany has taken a small step in this direction by allowing recipients of *Arbeitslosengeld II* to retain a fraction of the unemployment assistance benefit (15 to 30 percent) if they find a market job (see Siebert, 2004).

tax cut is not to increase the budget deficit, it must be fully financed. To the extent that this cannot be done through reductions in government expenditures, taxes paid by employees would have to be raised. This could be the VAT, social security contributions paid by employees or income taxes. Such a tax shift – or *internal devaluation* as it is sometimes labelled – is a policy measure that has been used in the Nordic countries as a substitute for nominal exchange rate devaluations.[20]

The point of an internal devaluation is to achieve the same adjustment of the real labour cost and the real exchange rate as with a nominal exchange rate devaluation in a situation with an own currency. The theory is that the equilibrium real labour cost (and real exchange rate) is determined by the fundamental labour market institutions, but that a rapid adjustment to the equilibrium levels is prevented by downward money wage rigidity. Just as nominal exchange rate devaluation can speed up adjustment to equilibrium in such a situation, so could a tax shift from employers to employees. Under some assumptions, the effects of such a tax shift and a nominal exchange rate devaluation are equivalent.[21]

Concluding remarks

As an outsider, I am surprised that the option of speeding up real wage adjustments and boosting aggregate demand through an internal devaluation does not seem to have played any role in the German economic-policy discussion. To me, such a tax shift would seem an obvious complement to labour market reforms. As far as I can judge, such reforms need to go much further than they have done so far, involving more substantial cuts in unemployment benefits, reforms of the pay-setting system, and an introduction of generous employment income tax credits. A two-handed approach, combining demand policy with thorough labour market reforms, seems to be required to lift Germany out of its present stagnation. In such a policy package, there is a place for active labour market policy and activation measures for the unemployed. But experiences from other countries, especially Sweden, suggest that such policies can only play a limited role. They can be a complement – but not more – to other policy measures.

[20] See, for example, Calmfors et al. (1997), Calmfors (2003a,b), or EEAG (2003).
[21] The argument is elaborated in Calmfors (1993) and Calmfors (1998).

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