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Growth Aspects of Labor Market Policy – Learning from the Neighbors

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Preface

The following IZA Research Report marks the conclusion of the “Growth Aspects of Labor Market Policy – Learning from Our Neighbors” research project, which was commissioned by the Federal Ministry of Economics and Technology and took place from January to April 2007.

By comparing the clearly more effective labor market policies of three neighboring countries with those of Germany, the goal of this project was to collect evidence of effective employment policy reform strategies. Central to this evaluation were questions of labor law regulations, active labor market policies, unemployment benefits as well as wage policy and tax burdens. The following studies on Denmark, Switzerland and Austria show that a well-functioning labor market can in fact be reconciled with a generous social security system if there is sufficient flexibility in terms of labor market regulation and if unemployment benefits are deployed hand-in-hand with a consistent re-activation strategy.

IZA completed this research report with the cooperation of a group of renowned foreign economists. The analysis of the Danish employment system was composed by Professor Per K. Madsen (Aalborg University), the report on Switzerland was written by Professor Michael Gerfin (University of Bern), and the study on the Austrian labor market by Professor Rudolf Winter-Ebmer (Johannes Kepler University Linz and Institute for Advanced Studies, Vienna) and Dr. Helmut Hofer (Institute for Advanced Studies, Vienna).

The results of this cooperative endeavor between IZA and the foreign researchers were presented to the public during an international conference at the Federal Ministry of Economics and Technology in Berlin on March 20, 2007. At the conference, the conclusions of this report were discussed by academic experts as well as policymakers from Germany and abroad. The documentation from this conference is available on the ministry’s website.

IZA wishes to thank the Federal Ministry of Economics and Technology for commissioning this report. We are also grateful to the team of foreign researchers for their participation in this joint project.

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Labor Market Policy in Switzerland

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1. Introduction

By international comparison, Switzerland has a high labor force participation rate, a low unemployment rate and a high wage level. At the same time, Switzerland has had one of the lowest economic growth rates of all OECD countries over the past 20 years. What characteristics of Swiss labor market policy are responsible for the favorable situation despite weak growth? We will show that the key to success is the flexibility of the Swiss labor market, which is mainly due to decentralized wage negotiations (often at the firm level), minimal layoff protection, and comparably low non-wage labor costs. What adds to this flexibility is an unemployment policy (consisting of unemployment insurance and social assistance) according to the principle of “providing support and making demands” (*Fördern und Fordern*). Interestingly, the implementation of this policy is also decentralized within a framework designed by the federal government.

In addition to the direct factors of labor market policy, there are also a number of indirect factors that play an important role, e.g. relatively low corporate and wage taxes, immigration policy and the decentralized organization of politics, economy and society. This decentralization is reflected by the tax system (only one-sixth of all taxes are collected by the federal government) and a corporate structure dominated by small- and medium-sized firms. 99% of all firms have fewer than 250 employees, and 75% of all workers are employed by a small- or medium-sized firm. For a more detailed discussion of the political and economic background, see Straubhaar and Werner (2003).

The following Sections 2 and 3 illustrate the employment and unemployment trends in Switzerland. Section 4 outlines the Swiss unemployment insurance system, particularly with regard to labor market programs and their evaluation. Section 5 describes the social assistance system. While Swiss wage policy is analyzed in Section 6, the subse-

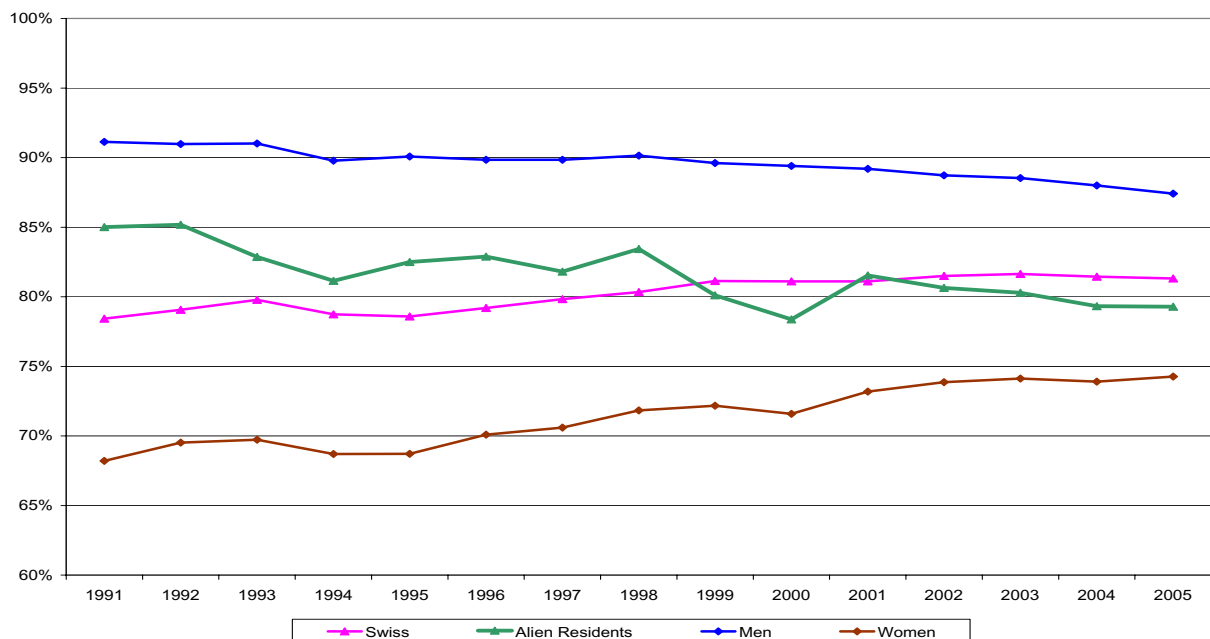
quent section is devoted to the tax system. Immigration policy is discussed in Section 8. Finally, Section 9 provides a summary of the determinants of success in Swiss labor market policy.

2. Employment in Switzerland

In 2005, the labor force participation rate among 15 to 64-year-olds in Switzerland stood at 80.9%.¹ While male participation averaged 87.4%, female participation reached 74.3%. Most notably, about 55% of all women work part-time. The share of foreigners in the workforce amounts to 21%. Self-employment accounts for 15%. Figure 1 illustrates the development of the labor force participation rate.

¹ Unless noted otherwise, all statistical data are taken from the Bundesamt für Statistik (BFS).

Figure 1: Labor Force Participation Rate in Switzerland



Source: Bundesamt für Statistik

3. Unemployment in Switzerland

The recession of the early 1990s triggered an unprecedented rise in Swiss unemployment (see Figure 2). Between 1990 and 1993, the unemployment rate rose from 0.5% to 4.5%. In the subsequent years until 1997, unemployment remained clearly above 4%. Between 1998 and 2001, the rate fell again from 3.9% to 1.7% until the 2002 recession caused another increase. For 2004, the State Secretariat for Economic Affairs (SECO) reports an average unemployment rate of 3.9%. Since then, the rate has remained relatively constant. Figure 2 is comprised of both unemployed and jobseekers, with the latter including participants of labor market programs who are not registered as unemployed. This differentiation does not become relevant until the revision of the unemployment law in the mid-1990s.

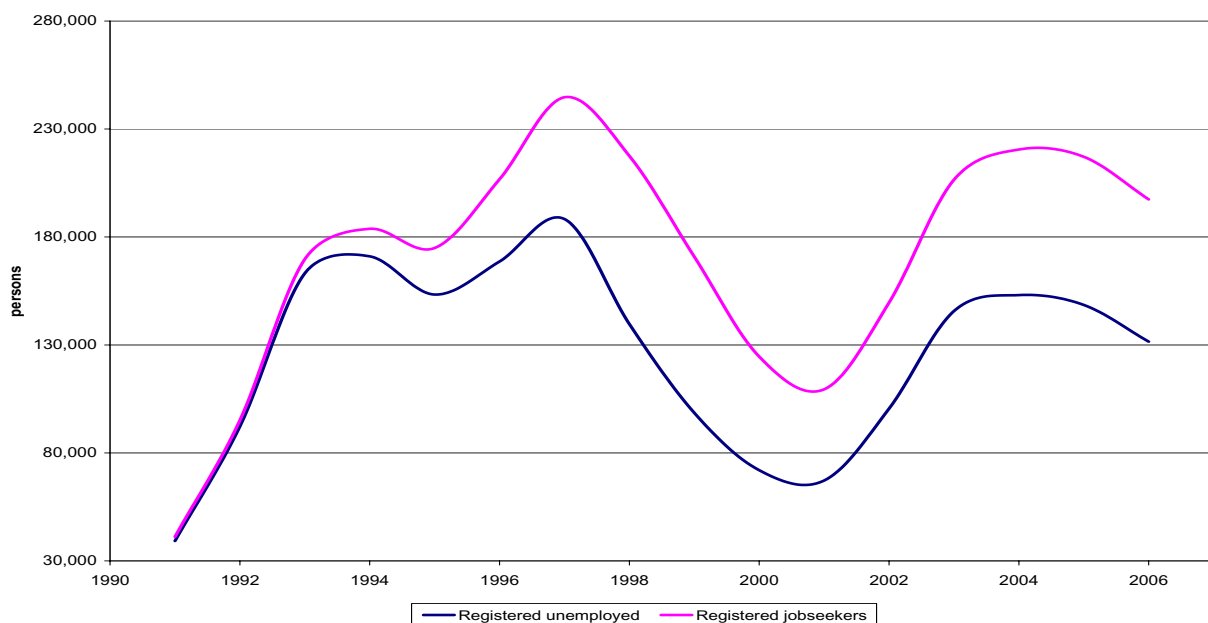
The highest unemployment rate by age is found in the group of 20 to 24-year-olds (6.1%), while unemployment is lowest among 50 to 54-year-olds (2.8%). The unemployment rate of foreigners is relatively high (6.1%) compared to Swiss natives (2.9%). This is partly due to Swiss immigration and integration policy, which mainly attracted

low-skilled foreigners until the early 1990s. The unemployment rate is also above average for western Switzerland (the non-German speaking part) at 5.1%. These structural differences can be observed for most nations and are not a particularity of the Swiss labor market.

The share of long-term unemployed has varied strongly over time. When unemployment peaked in 1997, long-term unemployment accounted for 31%. This share fell to 12% in 2002 and rose again to 20% in 2005. Within the age group above 50 years, long-term unemployment is above average at 34%. Accordingly, this age group has a below-average unemployment rate but a higher probability of becoming long-term unemployed.

These numbers, however, do not reflect the dynamic labor flows in Switzerland. Lalive et al. (2006) estimate that the probability of exiting unemployment during the next quarter averaged 34% between 1998 and 2003, with peaks above 40%. This implies an average expected unemployment duration of nine

Figure 2: Unemployment Trends in Switzerland, 1991–2006



Source: Bundesamt für Statistik

months.² As with exit probabilities, the risk of becoming unemployed is dependent on the business cycle – it varied between 0.8% in 2000 and 1.6% in 2002.

² Under specific assumptions, the expected duration of unemployment is inversely related to the exit rate.

4. Evolution of Unemployment Insurance and Active Labor Market Policies

4.1 Legal Background

The Swiss unemployment insurance (UI) is governed by federal law through the mandatory insurance against unemployment and bankruptcy (AVIG). According to AVIG, each insured member receives unemployment benefits (A-LE) amounting to 70% or 80% of the insured income if certain conditions are met (e.g. minimum contribution period, gainful employment). The benefit duration under AVIG is limited to two years. Until the end of 1996, the maximum benefit duration depended on the contribution period, which had to start at least two years before the conditions for benefit receipt were met.

During the second revision of AVIG, effective January 1997, the system of passive insurance of income risk was transformed into a system of active support for jobseekers. The key elements of the revision are the concentration of municipal job centers in so-called regional placement centers (RAV), the improved exchange between RAV and firms, the creation of labor market programs, the duty of all cantons to offer a minimum number of program slots, and the duty of jobseekers to participate in the labor market programs assigned to them. The cantons play a central role in implementing active labor market policies (Art. 76 Abs. 2 AVIG).

The second revision of AVIG, effective July 2003, changed key aspects of the passive elements of the insurance scheme. First, the maximum benefit duration was reduced from 520 to 400 daily allowances, except for jobseekers above 55 years of age who have contributed for at least 18 months. Second, cantons disproportionately affected by unemployment can ask for an extension of benefit receipt to 520 daily allowances if they bear 20% of the additional costs and the extension does not exceed six months. Third, the contribution period requirement was expanded from 6 to 12 months during the two years before unemployment. Since 2003,

SECO has also required a target agreement between program providers and the canton governments. The cantons have the power to decide on all programs with estimated costs of CHF 5 million (€ 3 million) or less. More expensive projects are SECO's responsibility. Figure 3 summarizes the evolution of the unemployment law.

4.2 Labor Market Programs

The cantons are responsible to provide an adequate supply of labor market programs (Rz. A11 *Kreisschreiben arbeitsmarktliche Massnahmen* (KAMM)). According to a directive from 19 June 2003, cantons have the power to decide on all collective measures with projected costs below CHF 5 million (€ 3 million; Rz. A12 KAMM). Decisions on projects above this threshold are made by the UI Central Equalization Board. The cantons reach a service agreement with the providers of each labor market program with regard to duration, objectives, target values, and indicators, as well as the size of the subsidy (Rz. A13 KAMM). The providers create an individual target agreement with each program participant (Rz. A14 KAMM). The RAV counselors are continuously informed about the participants' progress. Non-attendance or discontinuation of the program is sanctioned with termination of the daily allowance (Rz. A26-A29bis KAMM).

Training programs are meant to substantially increase the actual placement prospects of the jobseekers (Rz. C32 KAMM). This goal is reached, for example, by teaching key qualifications. The educational measures of the Swiss system focus mainly on personality-related qualifications, language competences, IT skills, business knowledge, vocational training and qualifications for healthcare and other social occupations (Rz. A2 KAMM). Retraining for industries with an oversupply of labor is not subsidized. The same applies to qualifications that are not immediately relevant for the labor market (e.g. college prepa-

ration courses). Course participation can either be mandated or granted upon request (Rz. C39 KAMM). The duration and intensity of training programs may vary. Participants are exempt from the employment requirement for the duration of the program.

Programs for temporary employment aim for the fast and lasting reintegration of jobseekers. This is to be achieved by selecting tasks that are close to the occupation for which the participants have been trained and by educational components tailored to the individual and to labor market demand (Rz. G1 KAMM). Program duration is limited to six months, during which jobseekers must continue their search efforts. Participation in this program is usually mandated by the RAV.

Subsidized temporary employment (“Zwischenverdienst”) compensates for lost income while the jobseeker accepts temporary but inadequate employment. A job is considered inadequate if, for example, the wage income is less than 70% of the insured income (Art. 16 Abs. 2 lit. i AVIG). The UI pays an applicable wage replacement rate to compensate for part of the forgone income, i.e. the difference between the monthly income received and the insured income (Art 24 Abs. 1 and 3, AVIG). The entitlement to wage replacement is limited to the first 12 months (Art. 24 Abs. 4 AVIG). Individuals over 45 years of age with dependent children or other family members may receive the subsidy for up to 24 months. Income from the inadequate job and the interim wage subsidy are counted toward the insured income (Art. 23 Abs. 4 AVIG). Likewise, the subsidized period counts toward a new contribution period if income is generated for which contributions are due. While participating in this program, jobseekers must continue to search for regular employment. Under this scheme, the achievable income is higher than regular unemployment benefits but lower than the insured income, thus providing incentives for further job search.

The following example illustrates how this subsidy works. Assuming that an unemployed individual has an insured monthly income of CHF 5,000 (€ 3,086), the UI benefit then amounts to CHF 3,500 (€ 2,160) (70% of insured incomes). The individual now receives a job offer that pays CHF 3,200 (€ 1,975) per month. Under the *Zwischenverdienst* scheme, the insured earns the wage income of CHF 3,200 (€ 1,975) plus the wage replacement of 70% of the difference between the insured income and the *Zwischenverdienst* wage, i.e. 70% of CHF 1,800 (€ 1,111)– or CHF 1,260 (€ 777). Accordingly, the unemployed earns CHF 4,460 (€ 2,753) in total. It is obvious that the *Zwischenverdienst* solution is financially worthwhile for both the unemployed worker and the unemployment insurance.

How are the participants distributed across the different programs? In 1999 the participation rate for the employment programs was close to 10% but has meanwhile fallen to 5%. About 16% of jobseekers participated in training programs in 1999. Today this share is close to 25%. The *Zwischenverdienst* scheme was applied to 20% of jobseekers in 1999. This share rose to 25% in 2001 and since then has fallen again to about 20%. Overall, at least 50% of all jobseekers participate in at least one active labor market program. The Swiss system of active labor market policy is thus almost equal in size to the world’s largest system in Sweden (cf. Lalive et al. 2006).

The primary goal of the RAVs is to support the reintegration of the registered unemployed. While fast reintegration and lasting reemployment are equally important objectives, some RAVs focus more strongly on the former, others on the latter.

The RAV strategies to reach their goals are not explicitly defined. It is safe to assume, though, that the RAVs issue only general guidelines to their job counselors with regard to organizational, structural and instrumental procedures. Counseling of jobseekers is

clearly a priority, followed by cooperation with employers and supplemented with inter-institutional collaboration and the exchange with private placement agencies.

Thus, there is no uniform active labor market policy in Switzerland. The federal government creates the framework within which the cantons, and even the regional placement centers, have considerable freedom to shape their own unemployment policies.

4.3 Evaluation of Labor Market Programs

The study by Gerfin and Lechner (2000) analyzes the effects of labor market programs on the employment rate using a sample of individuals who were registered as unemployed on December 31, 1997. The authors find that basic courses, language courses and employment programs significantly reduce the probability of being employed one year after the program start. A strong negative effect on the exit probability during program participation is followed by a weak positive effect after the end of the program.

Gerfin and Lechner (2000) also point to the effect of the *Zwischenverdienst* scheme on employment probabilities one year after the program start. According to their findings, the employment rate of program participants is about 6.4 percentage points higher than for non-participants. This positive assessment of *Zwischenverdienst* is supported by Gerfin et al. (2005). Lalive et al. (2002) show that program participants' exit rates are seven percentage points higher than for non-participants. Overall, *Zwischenverdienst* does not seem to lower the probability of finding regular employment when compared with labor market programs. This is remarkable, as individuals with *Zwischenverdienst* employment have less time available to spend on the search for an adequate job. This means that the search effectiveness may be positively affected by the *Zwischenverdienst* job, which may be due to (i) better contact to the work-

ing world or (ii) direct employment by the company which has offered the *Zwischenverdienst* job.

Lalive et al. (2006) examine the aggregate economic effects of the various labor market programs. The main results are:

- Employment programs reduce the unemployment rate (by 0.4 percentage points) as well as the rate of jobseekers (by 0.4 percentage points). This may be explained by the threat effect, i.e. the unemployed increase their search efforts to avoid having to participate in an employment program. Even if the program effect as such is negative (as found by microeconomic studies for Switzerland), aggregate unemployment is lowered. Studies on comparable programs in the U.S. confirm that the threat effect may in fact play a large role.
- *Zwischenverdienst* substantially lowers the unemployment rate to 3.5% - compared to 4.4% in the (hypothetical) absence of such a program. The rate of jobseekers (including those temporarily employed in *Zwischenverdienst* jobs), however, rises to 5.1% as regular jobs are displaced by *Zwischenverdienst* jobs. Accordingly, aggregate employment (*Zwischenverdienst* plus regular jobs) would increase by 0.9 percentage points while the number of persons employed in regular (full-time) jobs would decrease by 0.7 points.
- Evidence on training programs suggests, in accord with existing microeconomic evaluation studies for Switzerland, that program participation does not necessarily accelerate the individual job finding rate.

Employment programs are also mandated by the RAVs to test the willingness of the unemployed to work. This may help understand the results. *Zwischenverdienst* jobs, on the

other hand, are not used for this purpose, but mostly result from the initiative of the unemployed (Lalive et al. 2006, p. 36).

4.4 Evaluation of the RAV

Because of numerous evaluations of the public employment service system by external experts in 1998 and 1999, the existing service order from the federal to the cantonal authorities was replaced with a results-oriented agreement (first enacted on 1 January 2000, revised 1 January 2003). This reform stipulated that the RAVs would be evaluated neither on the quantity and quality of used services nor the resources used for such services, but rather that the success of the RAVs should be measured by their achieved results. How quickly and effectively did the RAVs integrate their clients into the labor market? Furthermore, this results-based agreement established that the effects of the RAVs should be based on a system of benchmarks, which would be published for the general public. The system of benchmarks was intended to provide the RAV with incentives to aim for the highest-possible effects. An additional method of introducing incentives – part of the original agreement of 2000 – was a rewards-based system for the above-average RAVs and, on the other hand, a system of penalties for RAVs with lower-than-average performance (Malus). This reward/penalty system was removed in the 2003 agreement.

The effects of the RAVs are judged based on four goals:

- Goal 1: Expeditious reintegration
- Goal 2: Avoidance of long-term unemployment
- Goal 3: Avoidance of labor force exit
- Goal 4: Avoidance of reenrollment

According to the agreement, the four criteria are weighed differently. Goal 1 is the most heavily weighed (50%). Goals 2 and 3

are weighed at 20% and Goal 4 at 10%. This arrangement reflects the RAVs emphasis on expeditious integration (Goals 1–3), as opposed to enduring integration into the labor market (Goal 4).

Egger and Lenz (2006) evaluated the performance of the 137 RAVs according to these four goals from 2000–2004, controlling for exogenous differences between the RAV (share of foreign jobseekers, region, etc.). Their results are as follows:

Discounting the “best” and “worst” 10% of the RAVs, the effects of RAVs on the average duration of job searches (Indicator 1) – after controlling for exogenous factors – differ by +/- 10%. With regard to entry into long-term unemployment, the rates of rejection and the rates of reenrollment, the corresponding differences in RAV effectiveness are larger: For these factors, the effects of the RAVs vary by +/- 30%. These relative differences in effectiveness between the best and worst RAVs have remained largely constant over the past few years.

The new regulations have not led to an equalization of effectiveness between some of the worst and best RAVs, but, rather, have led more or less to an overall improvement by all RAVs. Those RAVs at the top of the rankings have worked their way to the top by showing a comparatively greater improvement over other RAVs.

Furthermore, the study identified the following success factors:

- Early and effective activation of jobseekers. Particularly necessary are a quick start into the process of reintegration and an effective attitude by RAV counselors with regard to the jobseekers, as well as goal-oriented support and demand through labor market programs.
- Placement activities and contact with employers. Through personal contact with

employers, the counselors can improve their knowledge of the labor market and industries. Another important aspect of this contact with employers is the opportunity to make employers aware of the RAVs programs.

Another current evaluation of the RAVs (Frölich et al. 2007) had the following results, which largely correspond to the results listed above. Job counselors can increase the employment chances of their jobseekers by having a demanding attitude and clearly focusing on the goal of a quick reentry into employment. The activation and placement of jobseekers seem to be more important for success than the deployment of qualification-building efforts. Empirical analysis generally indicates that a cautious, conflict-free approach to jobseekers is, on average, less beneficial, and that a more straight-forward attitude can be more reasonable.

Swift reemployment is especially important for low-skilled jobseekers. Counselors who place less emphasis on quick reintegration generally achieve a lower rate of employment for their clients. A strategy that prioritizes qualification programs is generally less effective than the forceful adherence to the goal of reemployment that also keeps temporary solutions like interim jobs in mind. Forceful activation and possible compulsion to look for (and take) a job seem important. Sanctions or the threat of sanctions can also function supportively.

5. Social Assistance

When the claim to unemployment benefits has been exhausted, unemployed individuals are disqualified. At this point, social assistance is responsible for their financial support. The cantonal Social Assistance Laws regulate the minimum subsistence income and determines the available income for recipients of social assistance. The regulations published by the Swiss Conference for Social Assistance are recommendations given to the cantons and municipalities in order to harmonize the practice of social aid throughout the cantons (SKOS Regulations 2005). A third of all social aid recipients over 15 years of age have no labor income, while nearly a third of recipients have either a full- or part-time job (Bundesamt für Statistik 2006). In total, the welfare rate is 3.0%. Table 1 provides an overview of the key statistics.

The largest group of social assistance recipients is singles (58%), followed by single parents (22%) and couples with children (14%). Single parents are most affected by welfare dependency – 13% of this group receives some form of welfare benefit. Particularly noticeable is the increasing number of 15–24 year-olds in welfare, which is currently at 4%.

The SKOS guidelines, which were revised in 2005, set the groundwork for an activated

social policy under the motto “providing support and making demands” (Fördern und Fordern). Important components of these guidelines build a sophisticated system of incentives, which materially honor the acquisition of a job and the maintenance and expansion of gainful employment. The SKOS guidelines recommend, therefore, an earnings disregard range of CHF 400–700 (€ 247–432) per month depending either on hours worked or income received.³ The activities of non-employed individuals, from whom an improvement of occupational and/or social integration is expected, should also be supported through a specific cash benefit of 100–300 francs (€ 62–185). According to the SKOS guidelines, people who make an effort to integrate despite specific life situations preventing them from enrolling in an appropriate integration activity or not being offered an appropriate activity in their communities can receive a minimum integration allowance of 100 francs (€ 62) per month. Because these incentives are given on an individual basis, multiple individuals within a household can qualify to receive integration allowances and/or non-deductible income according to the earnings disregard clause. In this respect, these efforts could be categorized as activating social assistance. Additional benefits in the form of exemptions

³ A non-deductible income of CHF 500, for instance, means that these 500 francs are disregarded in the calculation of welfare benefits.

Table 1: Social Assistance Recipients by Nationality and Sex

	Recipients of social assistance in %	Total rate of social assistance receipt
Total	100	3.0
Swiss	56.3	1.9
Alien residents	43.7	5.8
Swiss		
Men	48.5	2.0
Women	51.5	1.9
Alien Residents		
Men	52.3	5.7
Women	47.7	6.0

Notes: Includes all social assistance recipients in the period under study, without counting double instances on the canton level. If family members receive social assistance benefits, only basic income support is counted. The social assistance rate is defined as the percentage of social assistance recipients in the resident population. Source: BFS, Sozialhilfestatistik 2004, Volkszählung 2000

or integration allowances are only granted in connection with a particular trade-off. Due to the lack of studies, the amount of incentive these benefits actually provide still remains unclear.

A framework for sanctions was also established for cases when recipients are uncooperative (e.g. turning down job offers or refusing to take part in an integration program). The minimum level of support can be reduced by up to 20%. Rulings by the federal court have supported the reduction of all benefits except emergency assistance, should there exist a demonstrable lack of cooperation.

The SKOS guidelines are non-binding. Correspondingly, the concrete forms of social assistance differ considerably among the cantons. Take the situation in Zurich, for example. Social assistance recipients who are employed receive income disregards, the amount of which is dependent on the level of employment. Recipients working at a rate up to 17% may earn a non-deductible monthly income of 100 francs (€ 62). Higher levels of employment proportionally increase the amount of the benefit relative to the amount for full-time employment (CHF 600 or € 370 per month). In order to qualify for the integration allowance, recipients must regularly take part in a social integration project, an employment and qualifications program, a motivational seminar, occupational/vocational training scheme or a self-organized volunteer program. Childcare or school attendance can also qualify recipients for the integration benefit. The benefit amounts to 100 francs (€ 62) for activities of less than 14 hours/week or 300 francs (€ 185) for full-time integration activities, as well as the cor-

responding portion for activities between 15 and 40 hours/week. The prerequisites to receive a minimum integration allowance include a demonstrable, supervised job search (in cooperation with Team Arbeit), an approved form of self-employment, cooperation with the RAV, cooperation with disability insurance (Invalidenversicherung, IV), utilization of medical treatment as necessary in proven cases of illness and waiting periods due to internal difficulties in providing access to integration programs.

Besides the canton-specific incentive systems, the social assistance systems also differ depending on how the particular canton has defined the subsistence level. These definitions are based on the SKOS guidelines on the basic need for a means of subsistence, living costs, basic medical costs and essential costs including food and childcare costs.

The costs for rent are taken on by social assistance, provided that they do not exceed the maximum rent established by rent regulations. The BFS-established median rent is used by the authorities in most cases and cities at least until the next possible date of cancellation. Basic medical costs are taken on by social assistance in all cantons.

Table 2 shows the level of basic support in Zurich for three types of households. Clearly, the level of basic support is relatively high in Switzerland. The median wage, by comparison, of a full-time employee is nearly 67,000 francs (€ 41,358) per year.

From an economic perspective, the rates generated by the applicable tax structure are of central importance. Two key figures are par-

Table 2: Level of Basic Support in Zurich

	Single	Single, 1 Child	Couple, 2 Children
CHF	30,576	39,496	55,650
EURO	18,957	24,488	34,503

These values are based upon the income available to a household without income from a job in order to pay SKOS-determined basic expenses such as rent and health insurance premiums.

Source: Gerfin et al. (2007)

ticularly important: the participation tax rate and the marginal tax burden. The participation tax rate measures the tax burden (income tax plus the reduction of welfare benefits) produced when a previously non-working individual becomes gainfully employed and, therefore, achieves a specific gross income. This rate is formally defined as one minus (available income from employment minus the available income without employment) divided by the gross income. A participation tax rate of 0.8 means, for instance, that the available household income only rises to 20% of the gross income when the aid recipient takes on a job. 80% is either spent on taxes or used to offset the discontinuation of welfare benefits.

The marginal tax rate, on the other hand, determines how much of the additionally

earned funds are taken by the tax authorities and used to offset the reduction in welfare benefits. In contrast to the participation tax rate, which expresses the average burden of taxes and the reduction in welfare benefits for a given gross income, the marginal tax rate reflects how much of the additional hourly earnings will not be reflected in the income received by the worker. The marginal tax rate is, thus, an indicator of the incentives to expand an existing occupation.

The tables make clear that the tax burden on low incomes is very high in Zurich (and also in most other cantons). The high participation tax rates are a direct result of the high level of basic income support. The high tax burden on low incomes occurs where the respective households still qualify for substantial welfare benefits.

Table 3: Participation Tax Rates and Marginal Tax Rates in Zurich (in%)

Gross Income	Single	Single Parent	Couple with 2 Children
Participation Tax Rate			
12000	0,97	0,92	0,97
24000	0,91	0,87	0,91
36000	0,9	0,88	0,79
48000	0,75	0,71	0,86
60000	0,65	0,75	0,95
Marginal Tax Rate			
26000	1,03	1,05	1
36000	0,21	0,19	1,06
48000	0,22	0,22	1,09
60000	0,5	0,25	0,37
100000	0,31	0,28	0,26

Source: Gerfin et al. (2007)

6. Wage Policy

In principle, a wage or collective bargaining policy does not exist in Switzerland. The state stays out of the wage determination process and delegates this responsibility to social partners (employers' associations and unions). Furthermore, firms are left largely free to negotiate their own wages with their employees. This leads to a particularly decentralized wage negotiation process.

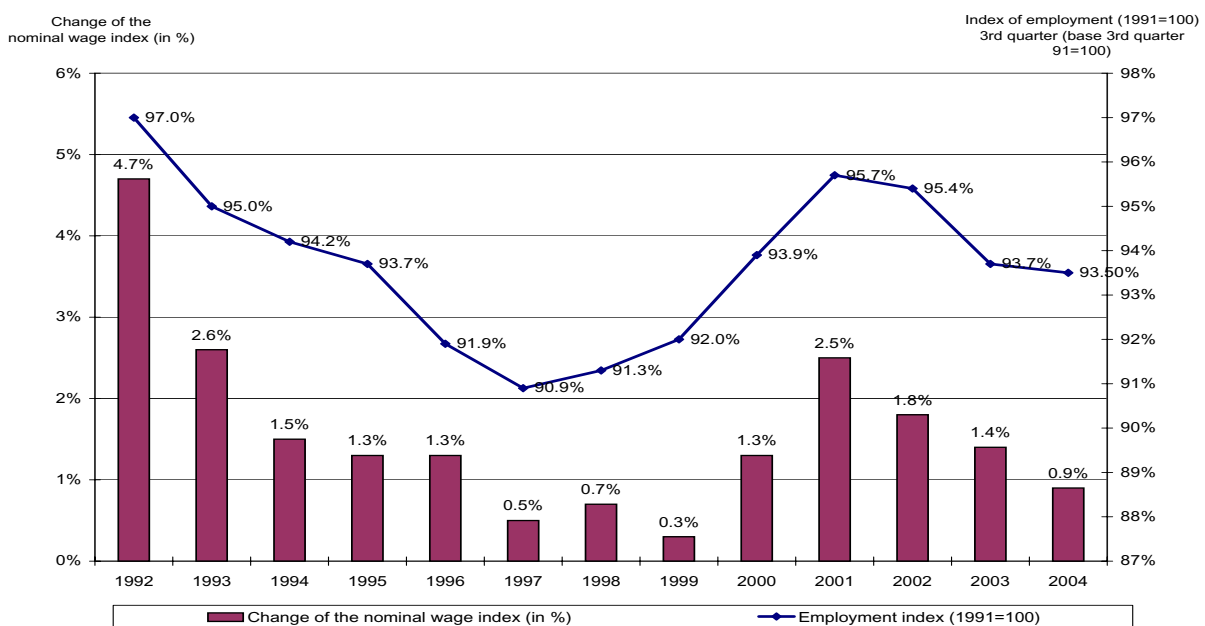
Generally binding collective wage agreements exist neither for industries nor regions. There are, however, "collective employment contracts" (Gesamtarbeitsverträge, GAV), which somewhat resemble the collective agreements on working conditions (Manteltarifverträge) in Germany. In 2005, there were a total of 611 GAVs, which were applicable to nearly 1.5 million employees (nearly 37% of Swiss employees). Some of the GAVs are generally binding (for instance in the construction and hotel and restaurant industries). Generally-binding GAVs account for nearly 550,000 workers.

Minimum wages are established in 480 GAVs, impacting nearly 1.2 million employees.

These minimum wages vary considerably depending upon the industry for which they are established. The lowest minimum wages for unskilled laborers amount to CHF 2,281 (€ 1,408) or CHF 2,520 (€ 1,555) in the clothing or hotel and restaurant industries while the minimum wage for unskilled laborers in the construction industry is CHF 4,110 (€ 2,537) per month. The median wages for these industries are CHF 3,727 (€ 2,300), CHF 3,825 (€ 2,361) and CHF 5,411 (€ 3,340) per month, respectively. The differences in the minimum wages reflect the general differences in wages between the industries. So far, no empirical analyses of the labor market effects of minimum wages in Switzerland exist.

The decentralized wage negotiation process provides businesses with a relatively great deal of flexibility to affect labor costs – even over the short term. This possibility is widely used, which is expressed in the relatively high flexibility of wages. This flexibility is illustrated in the chart below, which shows the development of nominal wages and the employment index. It is clear that both indicators develop virtually parallel to one another.

Figure 3: Development of Nominal Wages and the Employment Index



Source: Bundesamt für Statistik (2005)

Decentralized wage negotiations have also resulted in a much lower influence on the part of unions in Switzerland as compared to Germany, for instance. This influence is largely restricted to the overarching themes of labor market policy. The series of employment problems in the 1990s did not increase, but rather decreased the relevance of unions. While around 960,000 workers were unionized in 1990, only 770,000 were members of unions in 2005.

Despite this decentralized wage setting process, the dispersion of wages in Switzerland is not higher than in neighboring countries. According to OECD analyses, the proportions of the ninth and first deciles of wage distribution in Switzerland and Germany are practically the same size (OECD 2004). A clearly higher dispersion is noticeable in countries like the United States and the United Kingdom. Moreover, there is no evidence to suggest that the dispersion in

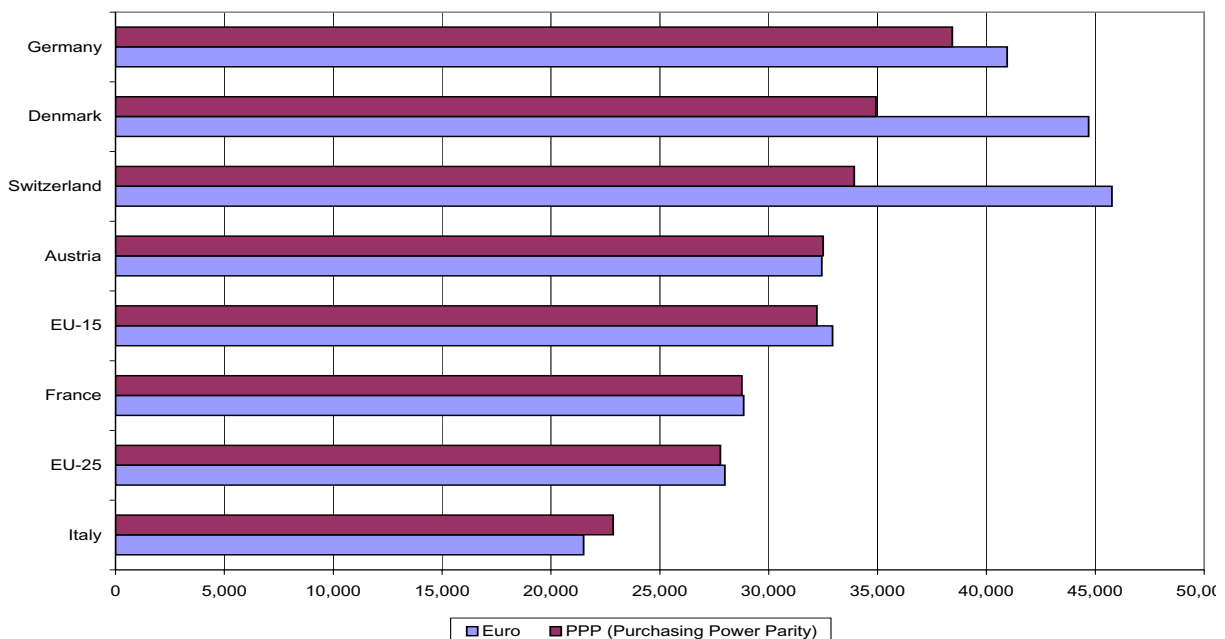
Switzerland has increased over the last 10 years.

An important consequence of wage policy for the design of social policy is an increasing accentuation of the problem of poverty among the working population. According to analyses of the Federal Statistical Office, the proportion of workers whose available income falls below the poverty line is nearly 7%.⁴ This development has been watched with concern, particularly because so far no suitable social policy instrument exists. The existing social assistance is, according to experts, not ideal for the financial support of the working poor. This problem is taken up again in the next section.

Another noteworthy aspect concerning wages is their level, which seems at first to be quite high. After taking into consideration the level of prices, though, the wage level in Switzerland is relative. This is shown in Fig-

⁴ Considered for the analysis were workers who work at least 36 hours/week. The poverty line defined by the welfare regulations was used.

Figure 4: International Comparison of Wage Levels



Source: Bundesamt für Statistik (2006b)

Figure 4. While the Swiss wage level (in Euro) is clearly higher than in neighboring countries, the adjusted purchasing power is comparable to the wages in Austria and clearly lower than the level in Germany.

7. Tax Burden in Switzerland

Switzerland has a federal tax system. Only about 28% of income taxes are levied at the federal level. In contrast, sales tax (generally 7.5%) is levied exclusively by the federal government. The canton taxes vary dramatically and can even differ within each canton. This means that one cannot speak of a Swiss income tax system. Table 4 shows the average income tax burden for three different incomes in Zurich. The mean tax rate on an average income is 10.7%. In addition, wages are assessed a total of 11.1% in social taxes (unemployment insurance 1%, old-age and survivors' insurance (AHV) 5.05%, the second pillar of the old-age insurance (pension fund) 5%),⁵ the amount of which is independent of income and uncapped. In addition, it becomes clear that the employer contributions are also 11.1%, meaning that the employers and employees formally share the contributions to social security. The national old-age and survivors' insurance (AHV), which is a pay-as-you-go scheme and subject to redistribution, can only provide for a relatively modest level of basic coverage. The second pillar exists in a fully-funded private old-age retirement provision without social policy components. A third elective coverage takes the form of a tax-privileged private old-age savings scheme.

In this system the tax wedge (i.e. the combined burden on employers and employees relative to the labor costs) in Switzerland is 30% – a relatively low figure when compared

to other nations. In Austria, the wedge is 47%, in Denmark 41% and in Germany 52% (OECD 2006).⁶

The costs for health insurance are borne exclusively by the employees, who must buy obligatory basic coverage from one of about 80 insurance firms. The premiums for basic coverage are independent of individual income. The premiums have increased dramatically over the past years (on average 6% per year). This has made health insurance a financial problem for many households. Because of this, over 30% of the population currently receive financial support in the form of premium reduction (i.e. the state takes on part of the premium).

An important aspect of Swiss income tax is the taxation on married couples. Currently, the total income is taxed without the possibility of Ehegattensplitting (a system in which husband and wife each pay tax on half of the total household income). This has resulted in a comparatively high marginal tax burden for the second wage-earner (normally the wife). Possible reforms are currently underway to adopt a system of individual taxation or the splitting model.

The average income tax burden for a gross income of CHF 70,000 (€ 43,209) varies by canton anywhere from 6.9% to 15.9%. This difference in tax burden is seen by many as one of the advantages of the Swiss economy

⁵ These figures are taken from the OECD. Contributions to the pension funds vary by canton.

⁶ Calculated in each case using the country's average income

Table 4: Average Tax Burden, Zurich

Earnings in % of Average Labor Income	67%	100%	133%
Federal Taxes	0.50%	1.20%	2.10%
Canton and Municipality Taxes	7.00%	9.50%	11.30%
Total	7.60%	10.70%	13.50%
Employee Social Security Contributions	11.10%	11.10%	11.10%
Total Tax Burden on Employees	18.60%	21.70%	24.50%
Employer Social Security Contributions	11.10%	11.10%	11.10%

Source: OECD (2006)

in terms of tax competition. The difference also expresses itself – perhaps more importantly – in corporate taxation, which is also low compared to other nations (see Eichler et al. 2005), meaning that Switzerland enjoys a considerable level of attractiveness for foreign investment.

There are a series of empirical studies on the influence of taxes on the labor supply in Switzerland (e.g. Gerfin et al. 2002, Nyffeler 2006). These studies find that only married women experience significant labor supply elasticity – and even this is still relatively small. On the whole, empirical evidence does not suggest that the tax system results in appreciable disincentives to work.

A further reform option, which is currently being examined, is the introduction of earned income tax credits modeled after the U.S. EITC or the Working Tax Credit in the United Kingdom. Such models could, on the one hand, serve to strengthen the incentives to get a job and, on the other hand, secure the earnings of workers with low incomes. The expected effects of these tax credits in Switzerland are analyzed by two simulation-based studies. Both studies allow for the possible behavioral changes by affected households and, by extension, the incentive effects of the tax credits. Gerfin et al. (2002) analyze the effectiveness of earned income tax credits to combat poverty among workers. The main result of this analysis showed that, while these tax credits can rather effectively reduce poverty among the employed, they have negative effects on labor supply – and would require substantial public expenditures.

Gerfin et al. (2007) expanded this analysis by using not only partially analytical simulations but also simulations in a general equilibrium model in order to take into account the dependencies between the labor market and the rest of the economy. The results support the previous conclusions in Gerfin et al. (2002): even in a general equilibrium, earned

income tax credits in Switzerland would have negative effects on employment.

Besides earned income tax credits, Gerfin et al. (2007) also analyzed a wage subsidy model. The analysis stipulated that the employer's portion of social security contributions for monthly wages under CHF 3,000 (€ 1,851) would be completely taken on by the state, resulting in a 15% reduction of the labor costs for businesses. For wages between CHF 3,000 and CHF 4,000 (€ 1,851 and € 2,469), the amount of wage subsidy decreases progressively to zero. This program would theoretically raise labor demand for low-wage jobs. The results of the general equilibrium simulation suggest, however, that the program would have no effect on the rates of employment and growth, combined with an additional tax burden of 2.6%.

8. Immigration Policy

Immigration policy plays a central role in the functioning of the Swiss labor market. Since 1970, immigration has been regulated through quotas. Since the ratification of the bilateral agreement between Switzerland and the EU, the focus of immigration policy has only been on non-EU/EFTA member nations. The right to freedom of movement exists between the nations of the EU and the EFTA, which allows citizens of these countries in possession of a job contract to stay in Switzerland. Regarding citizens of non-EU/EFTA states, the policy states that work permits may only be issued when a suitable worker from Switzerland or the EU/EFTA zone cannot be found. This means that only high-skilled workers from non-EU/EFTA states are taken into consideration.

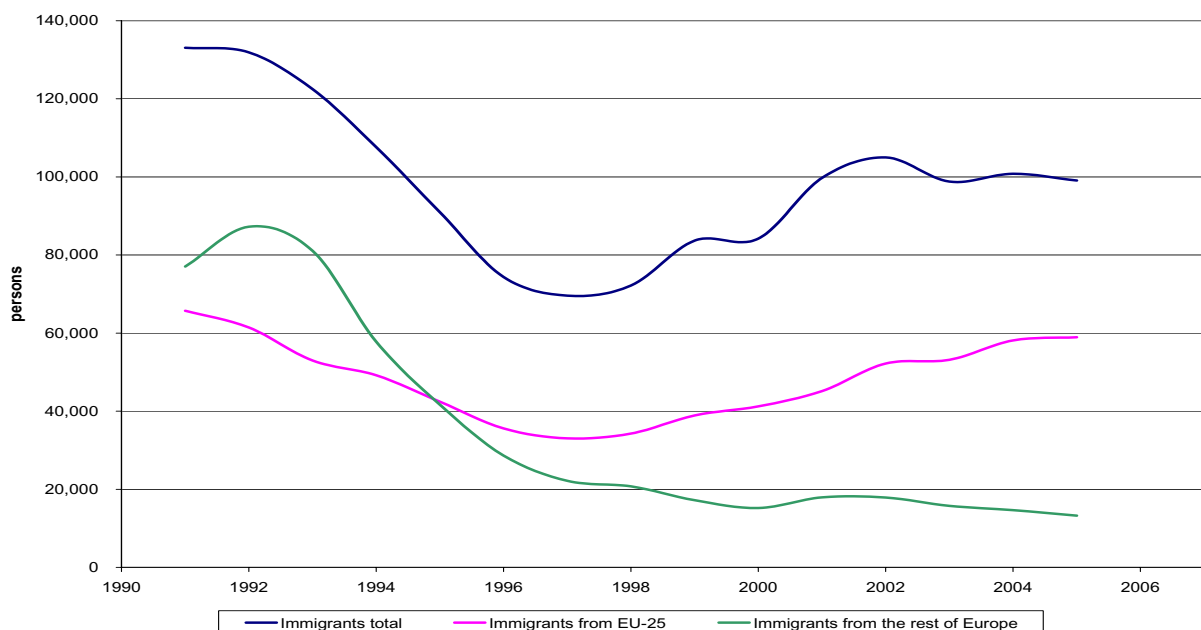
Figure 5 shows the development of immigration between 1991 and 2005. It is clear that immigration has closely followed economic development and declined during the recessions of 1991–1997 and 2002. Furthermore, the shift in immigration policy is clearly evident. Immigration from outside the European Union has continued to decline, while

immigration from within the EU has steadily increased since the mid-1990s.

The shifts in immigration policy have slowly become evident in the qualifications of the immigrants. In 2000, a total of 18.5% of the foreign population had a post-secondary education (Flückiger and Falter 2004). In the 1980s and 90s, this figure was constant at 12%. These policy shifts are especially clear in the percentage of foreigners with post-secondary education among those who arrived in Switzerland over the last five years. While only 15% had a post-secondary education in 1990, this share has risen to 39% in 2000.

This development is reflected in the decline of the number of low-skilled immigrants, which decreased from 62% in 1980 to 52% in 2000. This decline is due to the fact that the percentage of low-skilled workers among immigrants arriving in Switzerland during the five years before 2000 amounted to 39%. At 60% in 1980 and 1990, this figure was clearly higher. It needs to be mentioned, however, that the number of low-skilled immigrants

Figure 5: Immigration, 1991–2005



Source: Bundesamt für Statistik (2006c)

in 2000 was nearly twice as high as the corresponding figure for Swiss workers (29%). Furthermore, the percentage of low-skilled new immigrants (39%) is still clearly higher than the figure for the native Swiss. This shows that the ability to control immigration is quite limited. First of all, the Swiss Federal Council (Bundesrat) is only able to govern immigration from non-EU/EFTA nations – from which only about 40% of immigrants came in 2000. Secondly, 43% of immigration results from the family reunification.

This descriptive analysis of migration shows that Swiss immigration policy has led to structural problems in the labor market until the beginning of the 1990s. Among permanent residents, the group of low-skilled workers is disproportionately large. This has resulted in a disproportionately large percentage of unemployed foreigners and foreigners collecting welfare. This problem, which will only slowly decrease in the future, presents one of the greatest challenges for Swiss labor market and social policy.

9. Conclusions

What follows is a summary of the essential determinants of success for the Swiss labor market. These determinants account for the ability of the Swiss labor market to adapt to structural changes.

Decentralized Wage Setting

The process of decentralized wage setting provides Swiss firms with considerable room to influence their labor costs – even over the short term. Establishments are largely free to negotiate wages with their employees according to firm-specific conditions. Decentralized wage negotiations also mean that labor conflicts are regulated first within the company. Multi-level, external settlement takes place only when the internal solution fails. First in line are the associations, then a dispute settlement body and, finally, an ombudsman is called in.

Short Notice Periods

Swiss notice periods have a maximum length of three months, depending on job tenure. The employer does not usually need a further reason to dismiss an employee. Drawn-out legal processes and high severance payments are the exception in Switzerland. Severance pay is only awarded to longtime employees on the basis of a clear legal precedent. In the OECD rankings on the level of job protection, Switzerland was listed among the most liberal countries. This also applies to the other indicators of employment protection that were evaluated by the OECD. There are, for instance, no legal limitations on fixed-term contracts and temporary work agencies (OECD 2004).

Low Non-Wage Labor Costs

In Switzerland, the responsibilities of the welfare state are financed directly through contributions according to the insurance principle. This means that wages are used less often for the basis of calculating social

security contributions than in other nations. More often, individuals must pay out of their own pockets for private insurance policies, including old-age, health, disability and accident coverage. This leads to low non-wage labor costs. The side effect of this, though, is that these insurance premiums have become an extreme financial hardship for many households over the last years.

“Providing Support and Making Demands”

The reforms of unemployment insurance, job placement and the design of labor market policy efforts all apply the principle of activating the unemployed. The level of unemployment benefits is high, compared to other nations. But these benefits are only awarded unconditionally for 6 months, after which recipients must either take on a subsidized job or enroll in a qualifications program in order to continue receiving unemployment benefits (for a maximum of 18 months). Since 2006, this principle of “providing support and making demands” has also been increasingly used by the welfare program.

In summary, it is evident that the Swiss labor market functions to a large extent according to market principles. Wage determination takes place largely decentralized at the establishment level. With regard to social security, the principle of equivalency is used (i.e. there is a clear separation between socially fair redistribution and insurance objectives). Fairness objectives are to be achieved through direct, tax-financed benefits for the needy, while security objectives are more closely achieved through individual contributions to private insurance policies. Recently, though, this has led increasingly to social problems. Costs for health insurance, for instance, have been taken over (in part) by the government for over 30% of the population.

On the whole, Swiss labor market policy is based on the principle that the labor market should be regulated as little as possible. At

the same time, the state's responsibility to support those who are either unemployed or without sufficient income has remained relatively unchallenged. This characteristic has contributed considerably to the successful balance of the Swiss labor market.

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Regulation of the Austrian Labor Market

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1. Introduction

The persistently high European unemployment figures have, since the 1980s, placed the labor market at the center of economic policy. This shift notwithstanding, the last decades have shown that not every European country has been affected by the so-called “European unemployment problem” in the same way. Countries like the United Kingdom, the Netherlands and Denmark have become models of nations that have been able to dramatically reduce their once high unemployment figures. Austria, likewise, is one of the nations with a comparatively favorable labor market performance. In contrast to the other countries, Austria (as well as Switzerland) has been able to keep its unemployment at a continuously low level.

In the following report, we will discuss the institutions of the Austrian labor market and their contributions to the rather favorable situation of the labor market. The report will not explicitly deal with the general economic conditions (macroeconomic stabilization of the economy, internationally competitive tax policy, etc.), which have led to the growth and development of the labor market. Likewise, we do not wish to get into the cyclical reactions of the labor force with regard to changes in employment opportunities, which over the course of time have waned but, in comparison to other nations, still remain quite high (Hofer 2006a).

When compared to other nations, Austria distinguishes itself with its high-quality labor relations, which contribute significantly to the low rate of unemployment (cf. Blanchard and Philippon 2006). The strong involvement of the social partners, which is reflected particularly in wage policy as well as labor market policy, is typically Austrian. While fundamental reforms of the labor market have not taken place, smaller steps (including the new severance payment scheme “Abfertigung Neu,” tightening of the conditions under which job offers must be accepted, intensified activation of the unemployed, efforts to raise the

retirement age, etc.) have been the hallmark of Austrian policy. When viewed collectively, there exists a good balance between necessary flexibility and security in the labor market (cf. European Commission 2006).

Besides the wage setting process, we will discuss the structure of employment protection regulations, active and passive labor market policies, as well as the tax burden on labor. Due to the unfavorable situation of older workers in Austria, we will also deal with pension reforms. In the last section of this report, we will summarize the successful components of the Austrian labor market as well as the possible lessons these successes may have for other nations.

2. The Austrian Labor Market from an International Perspective

Austria has a highly-developed economy with a 2004 gross national product of € 27,666 (purchasing power adjusted), placing Austria among the top nations of the European Union. Since the mid-1990s, Austria has grown more rapidly than the Eurozone average (see Figure 1). Internationally, Austria's current labor market situation also proves to be favorable. Using Austria's 2006 average unemployment rate of 4.8% (Eurostat) as an indicator, the figure is clearly lower than the average for EU nations. Table 1 compares selected indicators for labor market conditions in 2005 for Austria with the average for the EU-15. With just under 69%, the employment rate is nearly 5% above EU average. The rate of employment for older workers, though, is comparatively unfavorable.

Due to apprenticeship training programs, unemployment among Austrian youth has been kept traditionally low. Over the last several years, though, there have been increasing problems for youth in the labor market. This is partly caused by the economy, but also reflects weaknesses in the structure of the edu-

cation system, as well as related integration problems with immigrant workers and people from immigrant backgrounds. The number of apprenticeship sites – despite substantial government subsidies – is declining, and companies are complaining about deficits with regard to the personal and professional qualifications of the young workers.

Long-term unemployment also presents a problem for Austria, even though the rate of long-term unemployment is only 1.3%. The percentage of long-term unemployed among all unemployed workers is nearly 25%, compared to the EU-average of 41%. Efforts concerning labor market policies have clearly helped to keep the comparatively low rate of long-term unemployment stable.

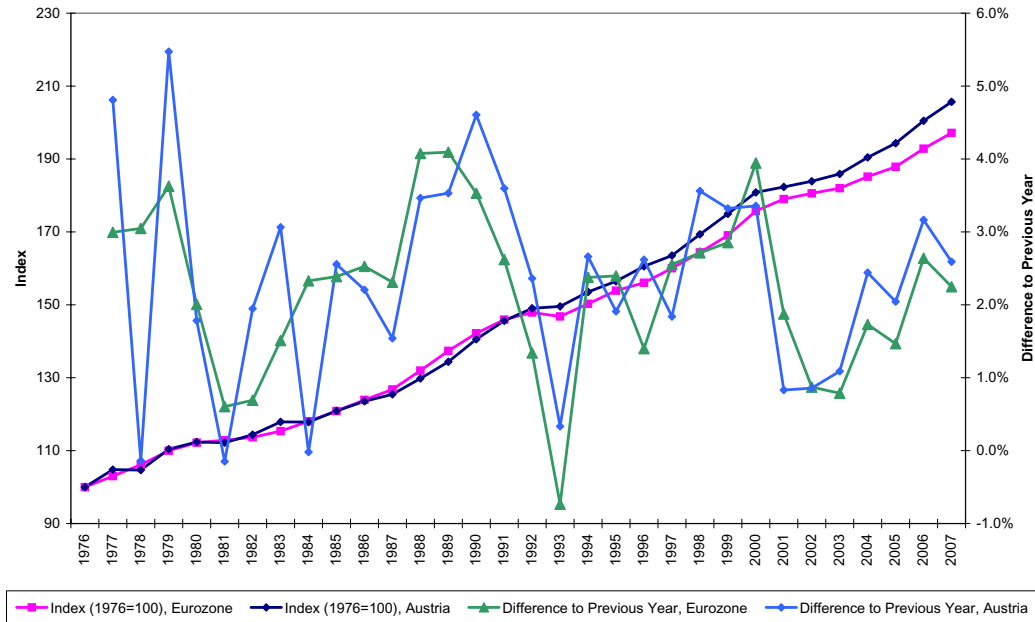
In accord with international evidence, the situation in Austria shows a clearly negative connection between employees' qualifications – measured by the highest-attained level of education – and the risk of unemployment. Over the long term, the rate of unemployment has decidedly increased for

Table 1: Labor Market Indicators for Austria and the EU-15

	AUT		EU-15	
	1995	2005	1995	2005
Unemployment Rate	3.9%	5.2%	10.1%	7.9%
-Youth 15-24	5.6%	10.3%	21.1%	16.7%
Participation Rate	71.4%	72.4%	67.2%	71.0%
Employment Rate	68.8%	68.6%	60.1%	65.2%
- Seniors 55-64	29.7%	31.8%	36.0%	44.1%
Part-Time Employment Rate	13.6%	21.1%	15.8%	20.2%
Long-Term Unemployment Rate	1.0%	1.3%	4.9%	3.3%
Women				
Unemployment Rate	5.0%	5.5%	12.0%	8.9%
-Youth 15-24	6.8%	9.9%	23.5%	17.1%
Participation Rate	61.7%	65.6%	56.6%	63.2%
Employment Rate	59.0%	62.0%	49.7%	57.4%
- Seniors 55-64	18.2%	22.9%	25.3%	35.4%
Part-Time Employment Rate	26.8%	39.3%	31.0%	36.2%
Long-Term Unemployment Rate	1.5%	1.4%	6.1%	3.7%
Men				
Unemployment Rate	3.1%	4.9%	8.7%	7.0%
-Youth 15-24	4.5%	10.7%	18.9%	16.4%
Participation Rate	81.1%	79.3%	77.8%	78.9%
Employment Rate	78.5%	75.4%	70.5%	72.9%
- Seniors 55-64	42.2%	41.3%	47.2%	53.1%
Part-Time Employment Rate	3.8%	6.1%	5.2%	7.7%
Long-Term Unemployment Rate	0.7%	1.3%	4.1%	2.9%

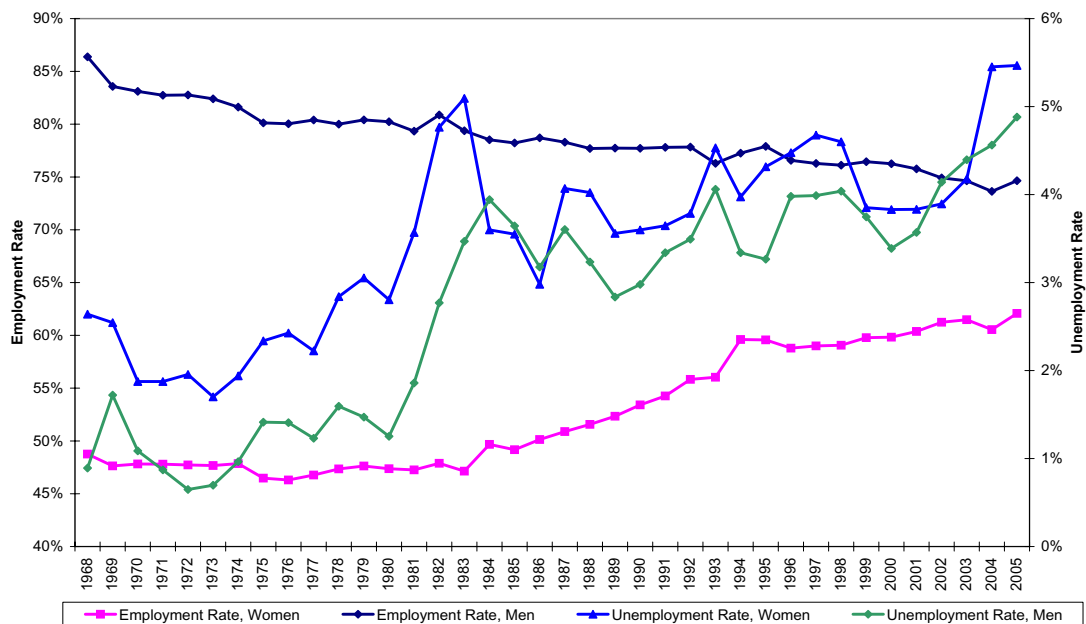
Source: Employment in Europe 2006

Figure 1: Economic Growth in Austria and the Eurozone



Source: OECD Economic Outlook, own calculations

Figure 2: Employment and Unemployment by Gender

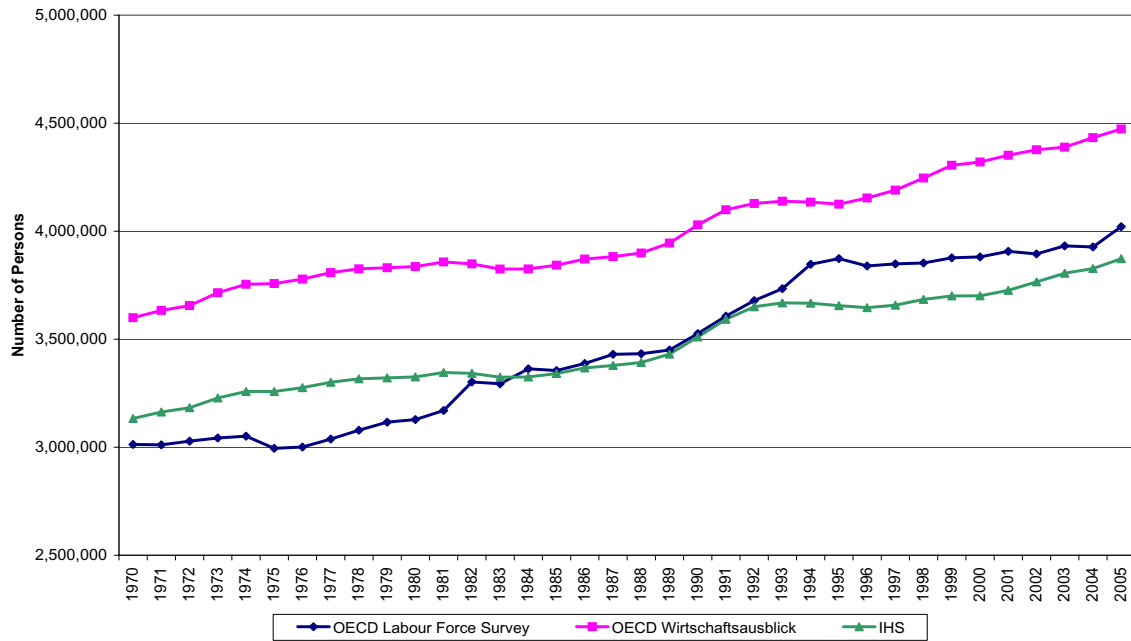


Source: OECD Labor Force Statistics database

individuals with low levels of qualification (cf. Hofer 2006a).

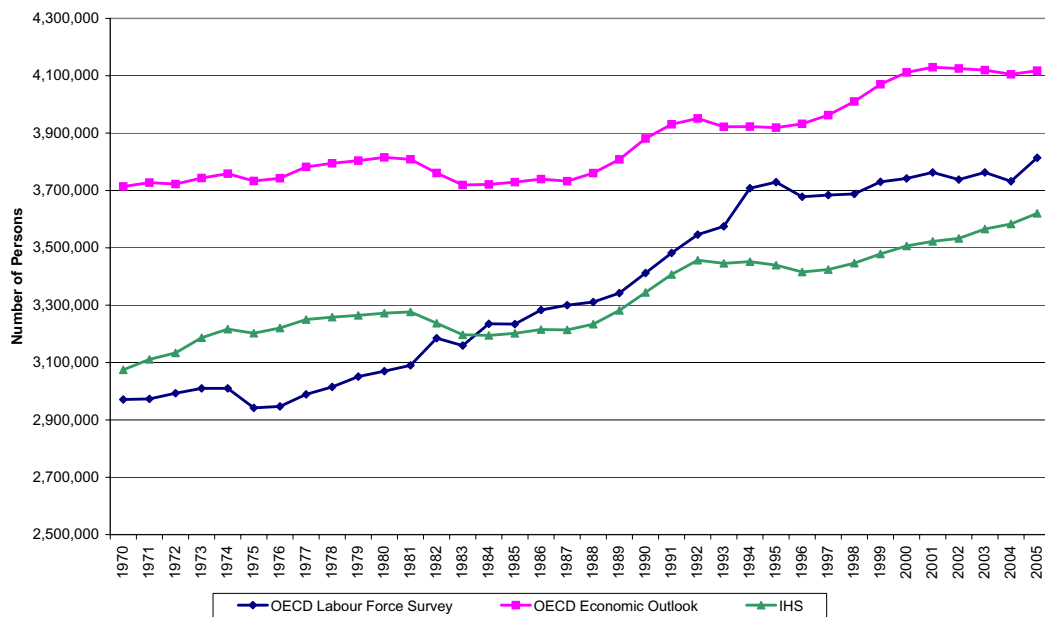
With regard to gender, one notices a marginally higher rate of unemployment for women, while the rate of employment for women clearly falls behind men (see Figure 2). From a long-term perspective, women's rate of employment has dynamically expanded, while the rate for men has stagnated (cf. Hofer et al. 2005). The newly-created positions occupied by women are found to be predominantly part-time jobs in the service industry.

Figure 3: Development of Labor Supply (According to Different Sources)



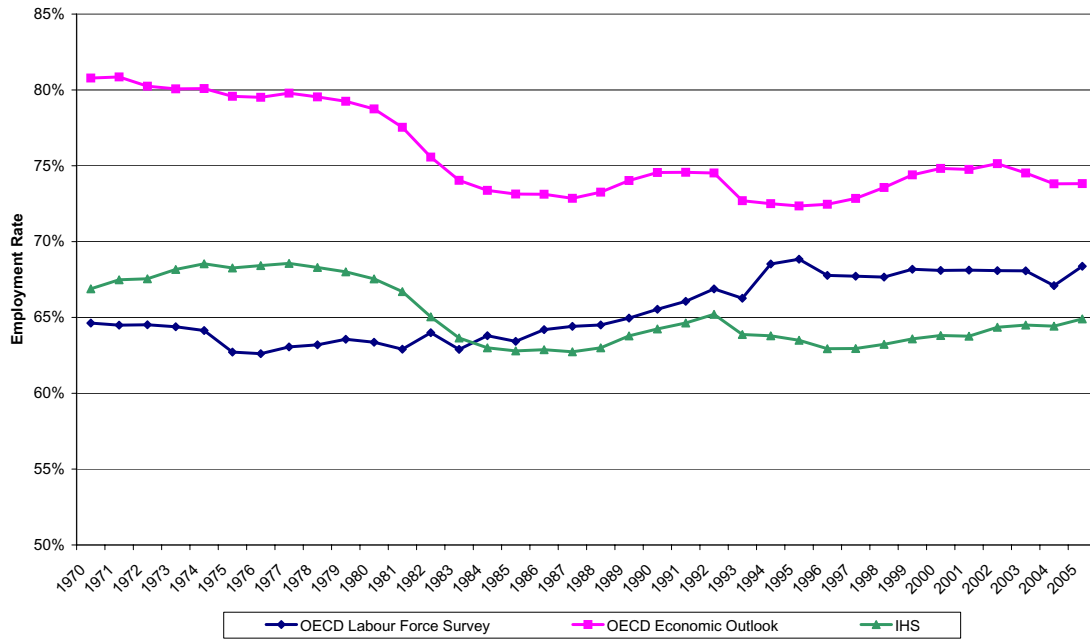
Source: OECD Labor Force Statistics, OECD Economic Outlook, own calculations

Figure 4: Development of Employment



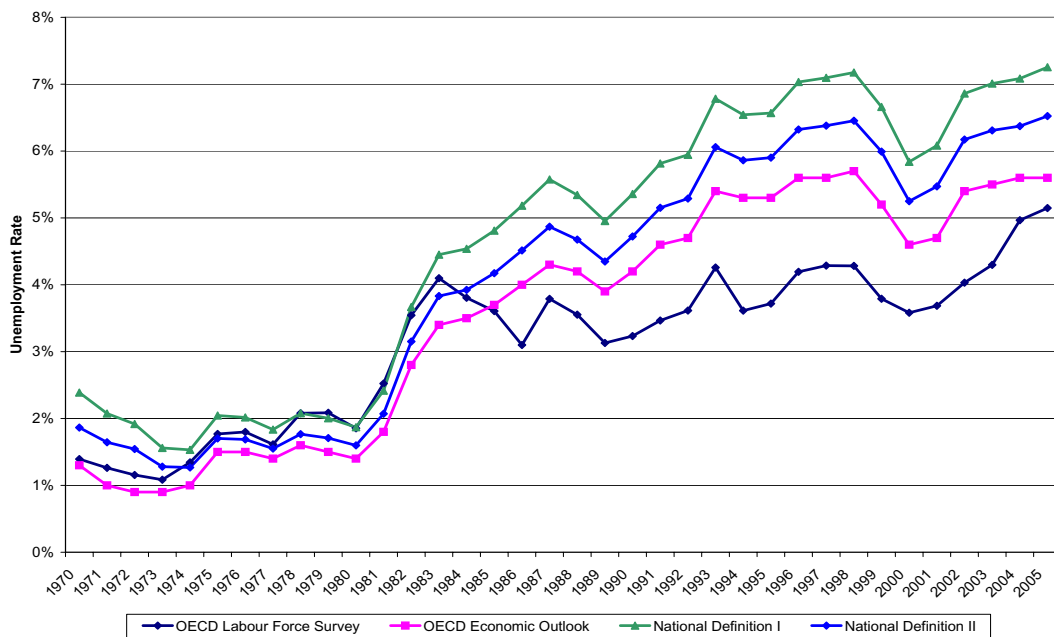
Source: OECD Labor Force Statistics, OECD Economic Outlook, own calculations

Figure 5: Employment Rate



Source: OECD Labor Force Statistics, OECD Economic Outlook, own calculations

Figure 6: Unemployment Rate



Source: OECD Labour Force Statistics, OECD Economic Outlook, own calculations

3. Institutions of the Austrian Labor Market

3.1 Wage Setting in Austria

Austrian wage policy is geared strongly to the macroeconomic conditions and can only be understood with regard to its foundation in the social partnership. The wage policy is influenced on both the employee and the employer sides by large, centrally-organized interest groups with a comprehensive right to representation.

Wage negotiation occurs at the sectoral level, where employees are represented by their particular division of the Austrian Federation of Trade Unions (Österreichischen Gewerkschaftsbundes, ÖGB) and employers are represented by their relevant section of the Austrian Federal Economic Chamber (Wirtschaftskammer). Wage negotiations generally take place yearly, not only an increase of the collective wage contract but also an increase in the so-called “Ist-Lohn” (the actual wage paid to employees) is negotiated. Collective wage contracts are binding for all firms as well as for all employees. They are binding for an estimated 98% of the private sector (cf. Eiro 2002).¹ Within firms, further increases (overpayments) of the Ist-Lohn can be negotiated either individually or between the works council and management. Due to the close bound between works councils and the unions, a certain coordination of wage policy takes place even at the firm level. While there is no legal minimum wage in Austria, the agreed-upon wages in collective agreements cannot be undercut.

Collective bargainers have traditionally taken into account the overall growth in economic productivity as well as the development of inflation. The current conditions of the labor market and international competitiveness, though, have also drawn their attention. Although nearly 400 collective agreements are made yearly (Pollan 2005), Austrian wage policy remains de facto highly coordinated.

The relatively uniform nature of collective agreements can be explained by the informal coordination that takes place at the ÖGB- and economic chamber-levels, as well as the leadership of the metalworkers’ union with regard to wages. The metalworkers’ contract serves as an informal guideline for other industries during the regular wage negotiations in the fall.

In contrast to the Scandinavian countries, Austria does not follow a solidary wage policy. There are clear differences in wages according to gender, age and education. From an international perspective, these wage differences in Austria turn out to be relatively high (cf. Pollan 2005).

The flexibility with which an economy’s real wages react to external or internal supply shocks constitutes an essential determinant of the macroeconomic performance of an economy. From an international perspective, Austria stands among the nations with the highest degree of macroeconomic real wage flexibility (cf. Pichelmann and Hofer 1999). Flexible wage and income policies that are based on the consensus of the social partners have traditionally been an important cornerstone of Austrian efforts to combat unemployment. While real wages rose in harmony with the rate of productivity though the mid-1990s, wage growth has since then remained clearly behind productivity (see Figure 7). The moderate increase in unit labor costs has helped maintain the competitiveness of the Austrian economy. One could, however, regard the relative rigidity of wage structures (returns to education, gender-specific and inter-industry wage differentials, etc; cf. Hofer et al. 2001) and the low level of wage mobility with an amount of skepticism. Furthermore, the large role seniority plays in wages has added significantly to the problems of older workers in Austria.

¹ Within the 30 different OECD countries, Austria is ranked eighth with a 37% concentration of trade unions. Austria also shows the highest degree of universally binding wage agreements (cf. CESifo DICE Report 4/2004).

3.2 Employment Protection Regulations

Open-ended employment contracts are the norm in Austria. The percentage of temporary employment contracts is under 10% (cf. Statistics Austria 2006), of which nearly half are apprenticeship contracts. If a temporary employment contract is extended after its expiration, it becomes an open-ended contract by default. If several temporary contracts are strung together, they become a so-called chain contract (Kettenvertrag). These types of repeated limitations are only allowed when they are factually justifiable; otherwise they are regarded as open-ended employment contracts. One should note that temporary employment contracts can only be terminated amicably or in special situations. During the one-month probationary period, the contract can be terminated by either the employee or employer immediately and without cause.

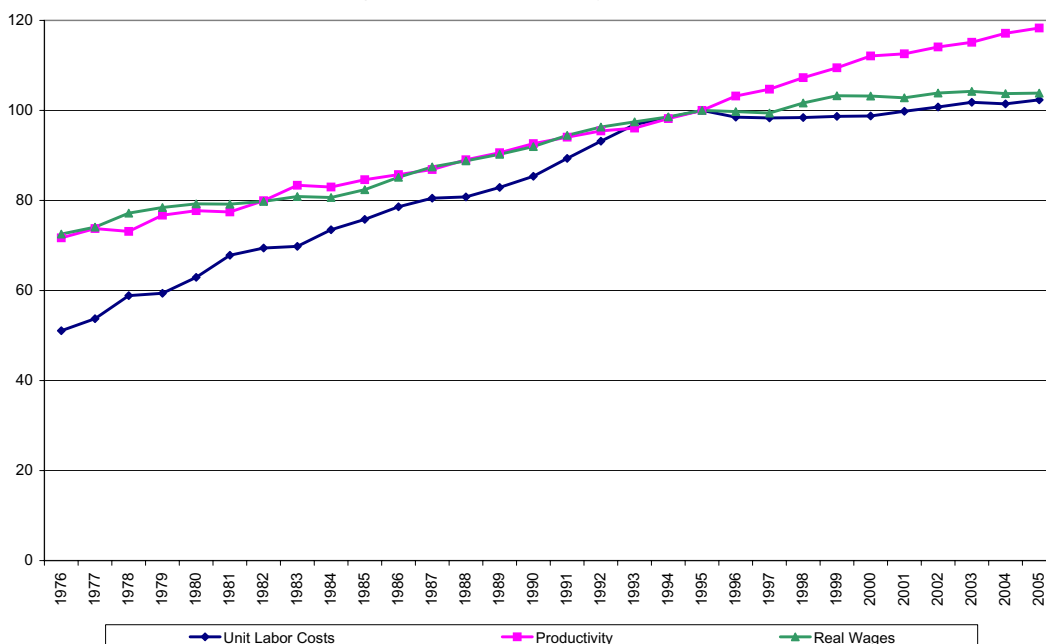
Dismissals can only be challenged when the cause is either discriminatory (e.g. gender-specific terminations or because of union membership) or socially unfair, e.g. when the

dismissed employee would be more negatively affected than a colleague in a similar position. Should the works council agree with the reasons for dismissal, a contestation based on social injustice is no longer possible.

The works council must be notified before an employee is dismissed. Within five days the council must agree to the termination, decline to issue an opinion or lodge a formal complaint. After these five days, the employee in question is informed. In the case of mass layoffs, Public Employment Service Austria (Arbeitsmarktservice, AMS) must be informed within 30 days, during which a social plan must also have been worked out.

Notice periods differ between blue- and white-collar workers. White-collar workers can be given notice at the end of every quarter, at which point the notice period can range from six weeks to five months, depending upon the length of job tenure. The notice period for blue-collar workers is regulated by the collective contract. Should the period not be defined in the contract, it becomes 14 days by default.

Figure 7: Unit Labor Costs, Real Wages and Productivity (1995=100)



Source: Statistics Austria, own calculations

According to OECD assessments of the intensity of employment protection, Austria is ranked in the middle of the OECD member countries. The partial indicator for regular employment relationships measures the relevant notice periods, the amount of possible severance pay, the estimated legal charges and indemnity expenses in the event of an unjustifiable termination, as well as any possible legal difficulties that would accompany the implementation of the termination. Due to the relatively long notice period for white-collar workers (not for blue-collar workers, however), Austria ranks in the middle of OECD members for this indicator. This is noteworthy, as recent labor market literature has ascribed the loss in employment to the procedural costs of dismissing workers in positions with particularly strong job protection (i.e. insecurity about long court proceedings, problems with the possible obligation to reinstate the worker, etc.).² High procedural costs as well as the associated higher insecurity among companies can have a negative effect on employment. Severance pay can, however, already be allowed for in the terms of wage negotiations.

The severance pay reform of 2002 drew international attention (cf. OECD 2006, European Commission 2006). In the former system, employees became entitled to severance pay after having worked three years for a company. The level of severance pay depended on the length of job tenure (from two months' salary to a year's salary after 25 years of service). In cases of retirement, premature termination and dismissal, the severance pay was to be paid by the employer. In the event that employees voluntarily resigned, they had no claim to severance pay (cf. Card et al. 2006 for the labor market effects). In the new system (Abfertigung Neu), the employers pay 1.53% of the gross wage into a so-called severance account (Abfertigungskasse), which is invested in the capital market. Upon retirement,

employees have the choice between receiving a pay-out of the severance pay or having the funds transferred into a pension. Should they move to a different company, they take the right to severance pay with them. After three years of service, employees can choose to have their severance be paid out in cash in cases of dismissal as well as amicable termination. The new severance system implies smaller severance payments and raises the mobility incentives for workers (cf. Koman et al. 2006, Hofer 2006b).

Empirical findings about the impact of Abfertigung Neu are not yet available. Based on theoretical deliberations, it follows that the new severance regulations raise mobility in the labor market. From the viewpoint of the employers, the (expected) costs of dismissal – which are lower than with the previous regulations – are already known at the start of employment. For employees, the mobility-hampering loss of severance pay in cases of resignation ceases to exist. One can, however, criticize the fact that the manner in which the employment is canceled has no influence on the amount and form of the employees' right to severance pay – in other words, Abfertigung Neu includes no elements of a lay-off tax.

The second partial indicator of the employment protection regulations includes the rules regarding the use of temporary employment contracts and temporary work. Special justification for a temporary contract is not required in Austria, and temporary work is principally allowed in all economic sectors. The third partial indicator concerns the regulation of mass layoffs. Strict criteria, defining the termination of multiple employment relationships already as mass layoffs, account for Austria's comparatively high ranking according to this indicator.

The Austrian labor market, at first glance,

² Cf. Büttner et al. (2006) and the sources cited in their text.

exhibits a high rate of job turnover (cf. Stiglzbauer 2006). In 2004, 1,422 million employees were dismissed and 1,336 million new employees hired (BMWA 2005b). This dynamic can be explained in large part by the comparatively high seasonality of employment in Austria (Del Bono and Weber 2006). The dominating industries are construction (35%) and tourism (24%), which also experience the most dramatic seasonal fluctuation in demand.

This seasonal dynamic is strengthened even more through the design of the unemployment insurance system. In the absence of experience rating, unemployment insurance premiums are the same for every sector of the Austrian labor market. As a result seasonal industries are heavily subsidized with a corresponding increase in seasonal fluctuations and a higher job turnover. According to the Austrian Ministry for Economy and Labor (Bundesministerium für Wirtschaft und Arbeit, BMWA, 2005c), nearly 40% (576,000) of all positions taken in 2004 were reinstatements within the same company. If this is understood more narrowly and one considers only the instances with the direct sequence of employment, unemployment and reemployment with the same employer, there still exist 170,000 cases. Aggregate numbers also suggest that job turnover in Austria parallels American rates. Controlling for sectoral composition and the clearly smaller establishment size in Austria, however, and takes into account, the figures for Austria are much lower (Stiglzbauer et al. 2003).

While employment protection regulations seem relatively strict on paper, actual practice is a different story. According to labor lawyers,³ only a relatively small number of cases are brought before a labor court – most of them end with a settlement consisting of severance pay. These kinds of appeals mainly occur when older employees at a firm with

a works council are given notice of termination – besides these cases, challenging is very uncommon. When viewed against the background of the dynamic Austrian labor market, one can assume that these labor regulations seem flexible enough to keep the necessary processes of reallocation from being burdened with prohibitively high costs. For the affected employees, the consequences of firm closures are extremely high: In the first five years after a closure (due to bankruptcy), the former employees show a 20% lower employment rate and a nearly 5% lower income (Ichino et al. 2007). These high losses indicate that the labor market may not be flexible enough in terms of reservation wages and the types of jobs sought by workers.

3.3 Labor Market Policy

According to the Labor Market Promotion Act (Arbeitsmarktförderungsgesetz), the Ministry for Economy and Labor (BMWA) must contribute to the attainment of full employment and optimal functioning of the labor market (cf. BMWA 2005a). The institution primarily responsible for labor market policy is the Labor Market Service (Arbeitsmarktservice, AMS), which executes the legal basis of the Public Employment Service Act (Arbeitsmarktservicegesetz). The BMWA outlines labor market policy goals for the AMS. Furthermore, social partners are integrated into the majority of committees responsible for the development and implementation of laws and political measures. One characteristic of the Austrian labor market policy is, moreover, the decentralization of decision-making authority. The most visible example of this is the 1994 separation of the Labor Market Service from the Labor Market Administration (Arbeitsmarktverwaltung). The AMS is composed of a federal office, nine state-level and 104 regional organizations and currently employs around 4,500 people.

³ Personal interview with Prof. Reinhard Resch (University of Linz).

The AMS is responsible for the following tasks (cf. BMWA 2005a):

- Placement of workers;
- Support with the elimination of placement barriers;
- Implementation of measures to raise labor market transparency;
- Reduction of qualitative imbalances through training and retraining programs;
- Securing the livelihood of the unemployed through unemployment insurance

The responsibilities for the placement of workers and disbursement of passive unemployment insurance benefits within the context of a functional and institutional unit should secure the effectiveness of the principle of “activation before passive benefit receipt.” The Austrian labor market is in accord with the employment strategy of the European Commission as well as the Lisbon Strategy.

The costs of labor market policy have risen from one percent of the gross domestic product at the beginning of the 1990s to the current figure of two percent. In specific terms of active labor market policy, the figure is around 0.6% of the GDP (OECD 2006). This increase primarily reflects the rise in unemployment, although since the end of the 1990s the expenditures for active labor market policy have also clearly risen (cf. Hofer and Weber 2006). From an international perspective, the percentage of the GDP Austria spends on passive benefits ranks above the (non-weighted) average of other OECD nations, while the amount spent on active labor market policies parallels the OECD average. When one normalizes the percentage of ALMP expenditures to a 1% rate of unemployment, Austria moves to the upper half of all OECD nations (BMWBA 2005a).

3.3.1 Passive Labor Market Policies

According to OECD data, Austria spent nearly 1.1% of its GDP on passive labor market policies in 2004. The majority (0.94%) went to expenditures for unemployment benefits and hardship assistance (cf. OECD 2006).

In terms of wage replacement benefits, the unemployed receive benefits for the duration of unemployment and, subsequently, in cases of hardship, additional hardship assistance. The general entitlement requirements are (besides the existence of unemployment): employability, availability and willingness to work, as well as a minimum previous contribution period as a non self-employed worker.

In order to receive unemployment benefits, the individual must have worked a minimum of 52 weeks during the last two years in a position covered by unemployment insurance (when claiming benefits for the first time). For the youth (under 25), the required length of employment is reduced to 26 weeks in a year. In cases of repeated claims, the required length is 28 weeks within the last year or 52 weeks over the last two years. The maximum duration of unemployment benefit receipt depends both upon the previous length of employment and the age of the claimant. In principle, unemployment benefits are awarded for 20 weeks, which increase to 30 weeks when the individual has worked for 156 weeks over the last five years. This length of coverage increases to 39 weeks when the unemployed individual is over 40 years old and has worked 312 weeks within the last ten years. After the age of 50 and having worked 468 weeks in the last 15 years, the unemployed individual is entitled to 52 weeks of coverage.

The rate of unemployment assistance is dependent upon both the previously earned income and the possible addition of a family benefit, and is composed of a basic benefit, family benefit and a supplement. The net replacement rate amounts to 55% of the net in-

come and is capped at €39.31 per day (basic benefit). Should this calculated monthly benefit be less than the equalization supplement reference rate (Ausgleichszulagenrichtsatz), the individual is entitled to receiving the remaining amount in form of a supplement. The amount of the unemployment benefit must not be higher than 60% of the net income, or 80% adding family benefits. As an incentive for repeatedly-unemployed individuals over the age of 45 to also accept positions paying less, the amount of unemployment benefits is always calculated using the highest previous income.

When the right to unemployment benefits has been exhausted, one can apply for hardship support, which is awarded for one year at a time and can be renewed as long as the requirements are met. Besides the ability and willingness to work and the state of unemployment in general, the individual must prove to be in a situation of hardship. During the evaluation of the individual's situation, attention is paid to the economic circumstances of the applicant as well as the total household income of a couple. Based upon these findings, the basic level of emergency assistance may be reduced. The amount of hardship assistance granted is based upon previously-received unemployment benefits and amounts to a maximum of 92% of prior benefits (or 95% for low levels of unemployment benefit). The hardship coverage is capped after six months, depending on the maximum duration of unemployment benefit receipt (which is dependent upon the length of employment and age, see above). When unemployment benefits are awarded for 20 months, hardship assistance is capped at the equalization supplement reference rate (Ausgleichszulagenrichtsatz). With a maximum benefit entitlement of 30 weeks, the amount is raised by about 17%. In cases where an individual has the right to claim unemployment benefits for 39 or 52 weeks, the assistance is not capped. Furthermore, the family benefit is still possible.

Social assistance can be granted in Austria presenting case of need. This encompasses not only monetary but also non-cash benefits and services in order to secure livelihood. Repayment on the part of the recipient is typical for this type of social assistance and takes place once the recipient achieves an adequate level of income and assets (BMSGK 2006). In Austria, the states (Länder) are responsible for social assistance, which is reflected in considerable differences in terms of requirements, types of services and the organizational and financial structures of the respective programs. The monthly cash benefits are determined using standard rates and are granted in the form of either recurring (Dauerunterstützungen) or one-time benefits (Aushilfen). The cash benefits for individual recipients varied in 2005 from €404 (Salzburg) to €630.17 (Vienna). Besides these cash benefits, other benefits were granted, including medical and housing assistance.

Payments to the unemployed exhibit two important characteristics: the duration and the level of awarded benefits (which is frequently based upon the length of coverage). An international evaluation of the structures of wage replacement benefits allows for the comparison of so-called 'net wage replacement rates' for a former industrial worker with an average income (OECD 2004). These net replacement rates vary according to the length of unemployment and the type of household situation. With a net replacement rate of 73% for a single-income household with two children, Austria is ranked midst among OECD nations. Depending on the household situation, the rate varies between 55% (single) and 81% (double-income household with two children). With regard to the awarded length of unemployment benefits (nine months for a 40 year-old employee with a full period of coverage), Austria is ranked in the lower half of OECD nations. It is important here to consider that the rate of benefits drops only slightly over the long term. After nine months of unemployment, the level of benefit drops

to 69% and remains at this rate for the remainder of the coverage period. After five years, this level of support is unbeaten by any EU-15 country (assuming that hardship assistance can be claimed).

The available empirical analysis indicates a positive correlation between the rate and length of unemployment benefits and the unemployment rate. This correlation seems to hold for Austria as well. In these analyses microdata is used to evaluate the impact on employment based on variations in the length and amount of benefits awarded to unemployed individuals who were given a prolonged claim to benefits in regions impacted by the steel crisis in the late 1980s (cf. Lalive et al. 2005 and 2006, Lalive and Zweimüller 2004, Winter-Ebmer 2003). The analysis shows that an extension of the right to claim benefits has a particularly negative effect on older workers. In combination with the (early-) retirement system, the duration of unemployment grew significantly. On the other hand, the negative impacts of an increase in the wage replacement rate (the relationship between unemployment benefits and previously-earned market wages) on the intensity with which unemployed individuals look for jobs and, consequently, the length of unemployment are rather minor (Lalive et al. 2006).

When an unemployed individual is unwilling to return to work, the claims to unemployment benefits and hardship assistance are suspended for six weeks (or eight weeks in cases of persistent refusal). Possible reasons for this include the refusal to accept a reasonable job offer assigned by the AMS, as well as refusal to participate in vocational training or a labor market reintegration program, or a lack of initiative to obtain a new job. In 2004, these reasons accounted for nearly 15,500 sanctions (4.8% of benefit recipients). Within the scope of the Labor Market Reform Law of 2004, lawmakers agreed upon a strengthening of the conditions under which a job offers

must be accepted. The length of career protection (Berufsschutz, i.e. positions that bear no resemblance to the previous occupation can be turned down) was reduced to 100 days. According to the previous regulations, the length of career protection was tied to the right to unemployment benefits, and disappeared altogether in cases where hardship assistance was received. Instead of career protection, a minimum pay guarantee (Entgeltsschutz) was introduced. During an occupational change while claiming unemployment benefits, it is necessary to ensure that the income in the new position amounts to at least 75% (or 80% in the first 120 days) of the previous income. When at least half of the previous income is based on part-time work for less than three-quarters of normal work time, the wage replacement rate is 100%. Also regulated is commute time to and from work, which can be up to two hours (or 90 minutes for part-time jobs). The 2004 reforms also outlined the legal requirement to draw up an individual counseling plan through the AMS. The plan, as far as possible, is meant to be cooperatively developed and should take into account marketable qualifications, their conservation and eventual enhancement of which should also be kept in mind.

In 2005, Hasselpflug developed a comparative indicator to assess the rigidity of regulations governing the availability of labor in 25 nations. This indicator encompasses eight partial indicators: the obligation to search for a position, the availability for employment when taking part in an ALMP scheme, obligation of occupational and geographical mobility, acceptable reasons for turning down a job offer, sanctions in cases of quitting a job, sanctions in cases of unwillingness to work and repeated refusal to accept a job. The indicator and all of its components are rated on a cardinal scale from 1 to 5, where higher values point to more rigid requirements. With an index value of 3.5, Austria is ranked sixth along with Portugal. Ranked higher than Austria are the Netherlands (4.4), the Czech Re-

public (4), Slovenia (3.8), Norway (3.7) and Estonia (3.6). Ranked lower than Austria are, for example, the United States (3.8), France (3.1), Finland and Spain (3), Sweden, Germany and Italy (2.9), Belgium (2.7), Ireland (2.6) and the United Kingdom (2.4). Within the EU-15, Austria takes second place. When one uses partial indicators 1-5 as a gauge for the severity of the conditions under which a job offer must be accepted and partial indicators 6-8 as a measure of the rigidity of sanctions, a different image of Austria emerges. With regard to reasonability, Austria shows the most rigid regulations of all analyzed nations. On the other hand, Austria is among the lower half of the EU-15 with regard to sanctions.

3.3.2 Active Labor Market Policies

In 1994 the AMS was outsourced from the Federal Ministry for Labor, Health and Social Services and constituted as a public body. The duties of the AMS include the payment of livelihood-securing benefits (unemployment benefits, hardship assistance), job placement and the assignment of jobseekers to active labor market schemes. The wages of AMS employees also depend upon the fulfillment of predetermined labor market policy goals. The structure of the AMS is marked by a strong decentralization and the use of modern economic control techniques (“management by objectives”). Target agreements are developed for each regional unit. Region-specific benchmarking is used for the deployment of resources. Provisions to measure and, in particular, to enhance customer satisfaction are in place. The majority of benefit recipients are served under the one-stop

shop principle. The regional units of the AMS are structured corresponding to a three-zone model to ensure that jobseekers can be more or less intensively advised, depending on their individual job prospects. In the info area, jobseekers receive general advice about the job market, open positions and information about professions and training opportunities. Internet access is also available in this area in order to give jobseekers the opportunity to independently search for open positions. The granting of social assistance, placement activities and advice on possible assistance are combined in the service area. Throughout the entire process, jobseekers are served by a personal case manager, who brings together all of the services offered by the AMS. The most intensive form of service takes place in the counseling area, where special counseling is provided to unemployed individuals – including those seeking apprenticeships – who need particular support or have encountered placement barriers. In 2005, individual counseling plans were drawn up for nearly four out of five unemployed. In 2004, the average unemployment duration before the establishment of a counseling plan was 50 days – only 10 days for young people.

Table 2 compares the expenditure structure for ALMPs in Austria with the EU-15. For Austria, there is a clear focus on training, which accounts for nearly 65% of total expenditures – while the EU average is only 40%. The creation of employment initiatives in the private (e.g. integration subsidies and childcare assistance) and public (e.g. direct job creation in socioeconomic firms and non-profit projects) sector, accounted for 13% and 9% of

Table 2: Expenditure Structure for Active Labor Market Policies (Austria and EU), 2004

	AUT	EU-15
Training	64.8	40.6
Employment Programs in the Private and Public Sector	22.4	34.5
Integration of the Disabled	11.9	18.0
Job Rotation and Job Sharing	0.0	0.4
Start-up Initiatives	0.9	6.6

Source: Weber und Hofer (2006)

expenditure, respectively. For the integration of individuals with disabilities, EU-15 average expenditure was 16%, while Austria spent 12%. Only 0.9% of the budget was spent on promotion of self-employment in Austria – dramatically under the EU average of 6.6%. This disregard of business startups is incongruous. It has been shown that jobs created by new Austrian firms last nearly twice as long as jobs created by existing firms (Böheim, et. al 2007). The Austrian expenditures for job rotation and job sharing do not play a role.

Participants in ALMPs are assigned by their AMS case worker to the individual courses. Most of the courses are organized by private companies. The only prerequisite to attend the courses is unemployment, or the risk of unemployment. According to the guidelines, the AMS case manager should actively offer training programs to unemployed individuals lacking qualifications as well as those with placement barriers (school drop-outs, long-term unemployed individuals and those re-entering the job market). For the duration of the program, the participants receive financial support in the amount of their unemployment benefit. The benefit duration is extended by the program duration.

According to Austrian terminology, the expenditures for ALMPs are itemized into qualification, employment and support assistance. Employment assistance primarily comprises wage subsidies in the public and private sector. The support assistance accounts for the promotion of counseling and support efforts, as well as for childcare and business startup assistance. Based on the number of participants, the qualification programs clearly dominate (81% in 2004). 13% were paid wage subsidies and 20% received business startup assistance (Weber and Hofer 2006). Because of the number of individuals participating in more than one program, the figures do not total 100%. By taking a look at the expenditures for the individual programs, a different picture emerges. Qualification schemes still

dominate with a share of 64%, followed by employment schemes with 28%. Support schemes, though, only account for 9% of total expenditures (BMWA 2005a).

From an international perspective, the efficiency of Austrian labor market administration can be viewed favorably (Büttner et al. 2006). The AMS received the best ratings for nine out of 12 indicators in an international study – for instance in terms of rapid entry into employment, rate of employment after participating in qualification schemes, successful and rapid placement through the AMS and with regard to the satisfaction of jobseekers (cf. BMWA 2005a).

The evaluation of Austrian active labor market policies is based primarily on participant interviews focusing on the quality and usefulness of the AMS programs. The BMWA and AMS, furthermore, investigate the effects of selected programs on labor market policy – in particular, they compare the previous and current careers of supported individuals. Important to this comparison was the AMS data warehouse – an instrument for documentation, planning and controlling which supports strategic planning (management by objectives) as well as the gathering of labor market statistics. The relevant labor market data (instances of employment and unemployment, registry of unemployed individuals, information about unemployment assistance programs and passive labor market policy efforts, data on firms and open positions, etc.) are gathered in a databank and are available to all AMS employees in order to allow for quick and standardized analysis (cf. BMWA 2005b).

Although relatively few microeconomic studies are available for Austria, the importance of such evaluations has been recognized by the responsible authorities. The available studies, in short, suggest that the ALMPs have positive – albeit marginal – effects. Echoing international studies, their effects

strongly depend upon program type and participant structure. Efforts to support the active search for employment raise the possibility of finding a job. Due to lock-in effects, qualification programs seem to have little or even negative immediate effects on employment, whereas findings on the long-term effects of qualification programs are not yet available. In contrast to international studies, evidence can be found that public employment programs in Austria can have positive effects on the career chances of individuals who would otherwise be difficult to place (cf. Weber and Hofer 2006). Among the characteristics of Austrian ALMPs are the so-called foundations: In explicit cooperation with social partners and regional governments, social plans are developed in case of mass layoffs (or when the same problem affects the employees of several firms in the region, for example problems facing the transport and food industries during EU expansion). These plans allow for a relatively liberal retraining – ranging from occupational counseling and formal or informal training to placement support and business startup assistance. Winter-Ebmer (2006) found rather positive effects of the Steel Foundation's (Stahlstiftung) activities on the employment situation and income of the affected former steelworkers.

Another characteristic of the Austrian system is that unemployed individuals are allowed to earn up to an income limit of €343 per month without a decrease in unemployment benefits. Weber and Böheim (2006), however, found a negative impact of 'mini-jobs' during unemployment on individual labor market outcomes (higher rate of unemployment, smaller productivity and reduced wages).

3.4. Pension Reform and the Employment Situation of Older Workers

A clearly evident weakness of the Austrian labor market is the low employment rate for older people. The rate for those between age

55 and 64 is currently 31.8%, compared to the EU-15 average of 44.1%. Austria, therefore, is among the countries with the smallest employment rate for older people in the OECD. There are a number of reasons for this. In the 1970s and 80s, early retirement schemes were introduced in order to reduce labor supply – particularly in regions with structural problems. The comparatively high component of seniority in wages worsened the chances older workers had in the labor markets (cf. OECD 2005). Considerable incentives came from the pension system. Austria is among the nations with the highest (official) pension rates in Europe. With a net replacement rate of over 90%, Austria is among the leaders of the OECD. The legal retirement age is 65 for men and 60 for women. There are clear incentives to leave working life as soon as possible (cf. Hofer and Koman 2006). Between the 1970s and the mid-90s, the average retirement age (excluding public servants) declined from 62 to 58 years for men and from 60 to 57 years for women.

Since the mid-90s, the position of the government has changed (cf. OECD 2005): Rather than social security, the focus has been on strengthening employability. A series of reforms have been aimed at securing the financial viability and sustainability of the pension system. The reforms in 2000 and 2003 were targeted at strengthening the connection between individual contributions and pension benefits, as well as raising the effective retirement age. So-called retirement accounts were introduced as part of the 2005 reforms, which also harmonized the pension systems for workers under the age of 50 in the private and public sectors, as well as self-employed and farmers. There were, however, setbacks, including the reintroduction of the early old-age pension (from age 62) – albeit with actuarially correct adjustments – and eased prerequisites for disability pensions.

Traditionally, entry into early retirement has taken place through the early old-age pen-

sion resulting from long contribution periods (as well as long-term unemployment and reduced capacity to work) and through disability pensions. Compared to other OECD nations, Austria has by far the highest concentration of individuals aged 55-59 entering disability pensions, while the rate of entry for younger people is clearly lower than in other OECD nations (OECD 2005). Because of the pension reforms, the significance of early old-age pensions has decreased, while retirement entry through disability pensions has increased. In 2005, nearly 62% of retirement entries were through old-age pensions, of which 56% were before entering the legal retirement age of 60/65, and 38% through disability pensions.

Furthermore, a series of labor market policy efforts to support pension reform were made. Non-wage labor costs, for instance, were reduced for all female and male workers over the ages of 56 and 58, respectively. For workers over the age of 60, non-wage labor costs were reduced by 12.7%. Older workers have also received more attention in the form of active labor market policies. The AMS has developed a long-term strategy for older workers (over 45 years of age) to help raise their employability and prevent long-term unemployment. The AMS has also placed a greater value on the continuing education of older workers, and has provided for intensive consultation in the first months of unemployment, so that, for instance, an individual counseling plan can be produced within the first month. As previously noted, repeatedly-unemployed individuals over the age of 45

receive unemployment benefits according to the highest income they have received.

Despite these reforms, the positions of workers and employers have hardly changed. The former continue to look forward to entering retirement soon after turning 55, while the latter seem to share these expectations. The existing opportunities to enter early retirement – due to disability, for instance – continue to be extensively used. This also explains why, despite the reforms, the average retirement age could not be raised above 59 or 57 years of age. Job prospects in Austria continue to worsen after turning 50. When forced to find a new job after a firm closure, workers over the age of 50 have a 3 percentage points lower chance of finding a job than a younger worker (Ichino et al. 2007).

3.5 Taxes and Social Security Contributions

Table 3 provides an overview of the structure of taxes and contributions in Austria. The data is based on OECD revenue statistics. Altogether, taxes and contributions for 2005 amounted to €100.9 billion, or 42.6% of GDP. One-third was in the form of social security contributions. The greatest tax revenue came from sales tax (€18.6 billion), followed closely by the personal income tax (€18 billion). Corporate income (€5 billion) and petroleum taxes (€3.6 billion) fell far behind. When compared to the EU-15 average, several differences become apparent. In Austria, social security contributions represent a larger share. The amount for payroll taxes

Table 3: Structure of Taxation in Austria and the EU-15 (2004)

	Austria		EU-15	
	% of GDP	%	% of GDP	%
Profit, Income and Capital Gains Taxes	12.5	29.4%	13.4	33.1%
Social Security Contributions	14.4	33.9%	11.3	28.7%
Payroll and Workforce Taxes	2.6	6.1%	0.4	1.0%
Property Taxes	0.6	1.3%	2.1	5.3%
Goods and Services Taxes	12	28.2%	12.1	30.7%
Other Taxes	0.4	0.9%	0.3	0.8%
Total	42.5		39.6	

Source: OECD Revenue Statistics (2006)

is also above average. The amount for excise taxes is 2% short of the EU average. Also below average are the figures for income and, particularly, property taxes.

The business tax component of Austrian tax policy is geared to the retention of international competitiveness. A few reforms have already taken place, including the 1990s repeal of business and property taxes, the introduction of a final tax on interest returns and, as part of the 2005 tax reform, the reduction of the corporate tax rate from 34% to 25%. When measured by effective average tax rates (EATR), the effective tax burden for corporations in Austria is clearly lower than its western neighbors (see Overesch 2005). Lower rates are found only in Ireland and Switzerland. Compared with Austria's eastern neighbors, though, the effective rate of taxation is, in fact, higher.

In Austria, income from dependent employment is subject to income tax. Over time, the tax revenue from this type of taxation has clearly risen. As part of the 2004/5 tax reforms, the average tax burden was reduced and a new system was introduced. Most importantly, the minimum taxable income was raised, meaning that nearly 350,000 low-income individuals no longer need to pay income tax. Incomes of up to € 10,000/year are no longer taxed. One should note that social security contributions are deducted from taxable income. Income between € 10,000 and

€ 25,000 is assessed at a marginal tax rate of 38.3%, from € 25,000 to € 51,000 the rate is 43.6% and income over € 51,000 is taxed at the rate of 50%. Noteworthy is the so-called 13th and 14th monthly salaries (vacation and Christmas pay), which are standard in Austria. These earnings are taxed at an average rate of only 6%. For a non self-employed person with an income of over € 51,000, the effective marginal rate of taxation is 43.7%. Furthermore, a negative tax exists for low-income individuals.

The Austrian social security system primarily covers the risks associated with aging, sickness, accidents and unemployment. Table 4 provides an overview of the rates and structures of the social taxes. These taxes are, above all, supported by non self-employed workers with monthly incomes over the minimum of € 343.26 (2005). The maximum contribution base is € 3,630. Neither the employer contribution to the Family Compensation Fund (Familienlastenausgleichsfonds, FLAF) – 4.5% of the contribution base (uncapped) – nor the contribution to the severance payment accounts (Abfertigung Neu) of 1.53% are included in these figures.

Employee contributions decrease the employees' net wages, while the employer contributions raise the wage costs beyond gross wages. In the majority of cases, a division of equal parts takes place. One exception is the pension insurance, to which the employer

Table 4: Structure and Rates of Social Contributions (White-Collar Workers), 2005

	Employer	Employee
Unemployment Insurance	3.00%	3.00%
Health Insurance*	3.75%	3.75%
Pension Insurance	12.25%	10.55%
Accident Insurance	1.40%	0.00%
Bankruptcy Insurance	0.70%	0.00%
Contribution to the Chamber of Labor	0.00%	0.50%
Building Subsidy Contribution	0.50%	0.50%
Total	21.60%	18.30%

* Blue-Collar Workers: 3.55% and 3.95%, respectively

(12.25%) contributes more than the employee (10.55%). A small difference also exists with regard to health insurance contributions for blue-collar workers, although the total contribution from both sides is the same as the contributions for white-collar workers. Altogether, the contributions sum for employers (21.6%) is noticeably higher than the contributions from employees (18.3%). The total tax burden of social contributions on labor costs is 39.9%. By adding the employer contribution to the Family Compensation Fund and the contributions to Abfertigung Neu, the total tax burden on labor including social security contributions is nearly 45%. Here one should note that the difference between contributions from employees and employers is primarily a legal one. For economic purposes, this difference should play but a limited role, since the actual instances can differ. Over the long term, what matters are the cumulative burdens of labor costs, with consideration, of course, of any possible shifts in the context of wage negotiations.

The tax burden on labor is relatively high in Austria, particularly due to the relatively high social contributions. In Austria, the tax wedge (the sum of income tax and employer and employee contributions to social secu-

rity as a percentage of the labor costs) for an average wage-earner (without children) is 47.4%. In comparison, the average for the EU-15 is 42.1%. Higher values are only to be found in Belgium (55.4%), Germany (51.8%), France (50.1%) and Sweden (47.9%) (OECD 2006b). For individuals earning two-thirds of the income of an average wage-earner, the tax wedge is 42.5% and increases for those making 50% over the average earner to a tax wedge of 50.8%. The marginal rate of taxation amounts to 57.3% for low- and average-income taxpayers and, due to the cap on social security contributions, falls to 41.9% for those with high incomes. Table 6 provides an overview of the tax wedges for low-income individuals and their development since 1997 for the EU-15. Austria is ranked above the average for the studied countries. Furthermore, the table reflects a relatively constant tax burden over time. The offsetting of possible increases in social security contributions through a shift of net wages is decisive for the impact of social security contributions on labor demand. An increase of the tax wedge – that is, the difference between the labor costs for businesses and the net wages for workers – should, according to economic theory, reduce labor demand and raise the structural rate of unemployment. Empirical research on

Table 5: Tax Burden on Labor Costs for Low-Income Earners

	1997	2005
Belgium	49.5	49.1
Germany	47.7	46.7
Sweden	49.2	46.5
Austria	41.1	42.5
Italy	48.8	41.7
France	41.6	41.4
The Netherlands	38.8	41.3
Finland	44.2	39.5
Denmark	41.7	39.3
Spain	34.8	35.7
Greece	35.0	34.4
Portugal	30.8	31.7
United Kingdom	28.4	29.9
Luxemburg	29.7	29.8
Ireland	24.9	19.9
EU-15	40.0	39.4

Source: Eurostat

Austria from the 1990s shows that at least a part of the increase in social security contributions was reflected by rising labor costs, which, besides the increasing rate of long-term unemployment, led to an increase in equilibrium unemployment during the first half of the 1990s (cf. Pichelmann and Hofer 1997). Particularly worthy of scrutiny is the relatively high (marginal) tax burden for low-income earners, above all the social security contributions and the high minimum income tax rate as this burden can negatively influence people with alternative uses for their time (marginal workers, women with child-care responsibilities, students) when choosing whether or not to take a job offer. Since full social security contributions are due above a certain income threshold, which implies a sudden jump in the marginal tax rate, very few jobs are created in this category.

4. Conclusions

What exactly are the strengths and weaknesses of the Austrian labor market, which have allowed Austria not only to survive the structural disruptions of the 1980s and 1990s with a relatively small increase in unemployment, but also to remain among the European economic leaders? In this report, we did not go into macroeconomic stability conditions. Austria coped well with EU eastern enlargement because its companies quickly began to directly invest – investments that helped to secure a sharp increase in Austrian exports. Competition-oriented wage policies have undoubtedly profited from the strong involvement of the social partners in many sectors of economic policy. With particular regard to wage policy, the high degree of unionization on the part of employees – but also on the side of employers – has led to somewhat modest wage increases as well as to, from an international viewpoint, an extremely low occurrence of strikes and labor conflicts. The strong meaning of social partnership has diminished slightly of late. A greater social consensus would have been an advantage for comprehensive efforts to reform labor and social law. Austria has benefited from its combination of strong coordination of wage negotiations and its high degree of unionization, which within the OECD, according to Nickell et al. (2005), has led to lower rates of unemployment.

Flexibility within the labor market is relatively high. Generally, individuals aged 25-50 can easily be dismissed, which is particularly true for blue-collar workers, for whom shorter notice periods are required. An increasing number of temporary workers has also contributed to the level of flexibility. The introduction of “Abfertigung Neu” and the organization of unemployment insurance have also eased job fluctuation. Missing, though, are elements of a layoff tax, which would pass onto businesses the negative external effects of layoffs. In the unemployment insurance law, equal contributions from all branches have led to a stronger cross-subsidization of seasonal la-

bor, which has led to increased seasonal fluctuation. Furthermore, while unemployment benefit levels are rather low compared to other nations, the benefit duration is rather long, which may reduce search efforts. In recent years, labor market policy tried to counteract this trend through training initiatives and stricter requirements for the acceptance of job offers.

The greatest problem for Austria is probably the (formerly) common practice of early retirement. This led to very low employment rates for older workers, even greater problems for older workers who somehow became unemployed, an early-retirement mindset on the part of employees and restrained efforts on the part of companies to better integrate older workers. Several pension reforms over the past years have had limited success in counteracting these trends. In the past, the apprenticeship system contributed to the extremely low rate of youth unemployment. Current developments, however, point to lacking innovation within the system, which, in combination with insufficient basic training and integration problems, has led to worries about an increase in labor market problems for the low-skilled. Austria has, in the last few years, made no fundamental reforms to labor and social law – neither was it compelled to make such changes through substantial macroeconomic disruptions. It has yet to be seen how the Austrian system would deal with a crisis similar to German reunification or the Finnish economic crisis.

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Danish Labor Market Institutions and Employment Outcomes

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1. Labor Market Policies

The Danish employment system features prominently in the international debate on successful labor market models. It is often referred to as a “flexicurity” regime that combines a flexible labor market with generous unemployment benefits and heavy investment in active or activating labor market policies. This contribution analyzes the core elements of the Danish labor markets and shows how they contribute to a high level of employment and an impressive dynamism in terms of labor turnover and low long-term unemployment. In addition, the study addresses the issue of welfare state funding based on taxation, which is conducive to a positive development on the labor market.

Both when it comes to economic support for the unemployed and to active labor market policy, the Danish organization of labor market policies is based on a division between those unemployed who are members collecting funds from unemployment insurance and those who are non-insured. In the case of unemployment, the latter applies to means-tested social assistance (cash benefits) that is administered by the municipalities. Also, when it comes to the active programs, the non-insured unemployed are handled by the municipalities, while the insured unemployed are in the public employment system, which is administered by the central government. However, from 2007, the two systems will be physically integrated into the new local “job-centers”. However, the legal distinction between the insured and the non-insured unemployed will remain, both when it comes to participation in active labor market programs and to economic support during unemployment.

1.1 Economic support for the unemployed

The Danish system of unemployment insurance is based on the so-called Ghent system. It consists of 31 state-recognized unemployment insurance funds, four of which are unemployment funds for both employed and

self-employed individuals. One unemployment insurance fund admits only self-employed people as members. When a person moves from one unemployment insurance fund to another – either due to a shift in occupation or because he or she decides to do so – the right to unemployment benefits are transferred at the same time.

Most of the unemployment insurance funds are affiliated with one or more trade unions. While membership in an unemployment insurance fund is independent of being a member of a trade union, most workers will conceive the membership in the trade union and the affiliated unemployment insurance fund as a package. This is probably due to the long historical bonds between the two kinds of institutions and to the fact that trade unions do little to advertise the formal difference between the two sorts of membership. Also, of course, membership in a trade union offers some advantages, which are unrelated to receiving unemployment benefits like support in local wage negotiations and in conflicts with the employer.

The present version of the system for economic support for the unemployed dates back to the last large reform of the unemployment benefit system in 1970, where the state took over the responsibility for financing the extra costs of unemployment benefits that were caused by increases in unemployment (the principle of public financing “at the margin”). The members of the unemployment insurance funds will therefore only be obliged to pay a fixed membership contribution, independent of the actual level of unemployment.

This mechanism for financing unemployment insurance implies that the share of public funding depends on the total number of unemployed. During periods of high unemployment – as in the early 1990s – the government’s share rises to 80 percent, while it falls to less than 50 percent during economic upswings.

Apart from those having exhausted their right to unemployment benefits, the group of “non-insured” unemployed consist of those unemployed, who do not fulfill the criteria for becoming eligible to unemployment benefits in the first place (cf. the list of criteria presented below). This group of unemployed must apply for cash benefits administered by the local government (the municipalities). As explained in more detail below, cash benefits are means-tested and the amount depends on the family situation of the unemployed.

Membership conditions

- Membership in an unemployment insurance fund is voluntary. Members must fulfill the following criteria:
- A member must stay and reside in Denmark. However, exceptions are made from this rule if the person resides in another EEA country.
- He or she must be between 18 and 63 years of age when they join the unemployment insurance fund. The age limit of 63 years for joining the fund is due to the fact that one must have been a member for one year before being eligible for benefits, which are only paid to people aged less than 65 years (the age for public old age pension).
- He or she must have had employment either as an employed person or as a self-employed person or assisting a spouse in a company owned by a self-employed person.
- A person may also be admitted as a member of an unemployment insurance fund if he or she has completed a vocational training course of at least 18 months when applying for membership, but no later than 2 weeks after completion of the training course.

Both full- and part-time employees may become members of an unemployment insurance fund. Part-time insurance is an option for people working less than 30 hours per week. Both

membership contribution and unemployment benefits are lower for this group. Thus, benefits cannot be higher than two-thirds of the benefits for a full-time insured person.

Membership contributions

The membership contribution amounts to:

- A flat-rate compulsory contribution to the unemployment insurance, which is the same for all members and in 2006 amounted to 3,204 DKK per year (430 €)
- A flat-rate contribution to finance the Labor Market Supplementary Pension Scheme (the so-called ATP-scheme)
- An administrative fee, which varies (considerably) between the individual unemployment insurance funds
- An optional contribution to the Voluntary Early Retirement Scheme. The early retirement contribution in 2006 amounted to DKK 4,668 (626 €) for full-time insured members. Early retirement contributions are payable only if the individual wishes to be covered by the early retirement benefit scheme. The benefits paid under this scheme relate to the level of unemployment benefits and will not reflect the individual amounts contributed by the member, if the member fulfils the eligibility criteria. These call for a certain minimum number of years of having contributed to the scheme (at present 25 years). The member can retire from the age of 60 years.

All membership contributions are tax deductible, which implies that the net cost to the member is about two-thirds of the gross cost.

The amounts are adjusted at the end of each year (according to the wage-index). An important observation is that the membership contribution is not based on actuarial considerations of the risks of unemployment for individuals or groups, but is uniform for all

members, notwithstanding to which fund they belong.

Level of unemployment benefits

To be entitled to unemployment benefits, the unemployed generally must fulfill the following conditions:

- He/she must have been a member of an unemployment insurance fund for at least one year
- For people insured on a full-time basis, the employment requirement means that they must have had employment to such an extent that it altogether corresponds to employment during the full, normal working hours of the trade or profession for a minimum of 52 weeks within the past three years. If the full, normal working hours are 37 hours a week, the employment requirement for full-time insured members would amount to a total of 1,924 hours of work within the past three years.

Furthermore, the unemployed must look actively for work and will be subject to the rules and regulations of active labor market policy (cf. below). In principle, an unemployed person who has been unemployed for more than three months must accept any job offered by the Public Employment Service (PES) for which the individual is capable. An unemployed academic, for example, must be willing to work as a letter carrier. In practice, though, the PES is not very strict about implementing this rule, because of the expected lack of motivation of the unemployed if actually placed in the job.

Taking part in labor market training will not make the unemployed eligible for an extension of the benefit period. The benefit rate is individual and depends, among other things, on the size of the previously earned income. Unemployment benefits can, at a maximum, amount to 90 percent of previous earnings.

The maximum benefit rate in 2006 was 667 DKK (90 €) per day for full-time insured members. Unemployment benefits are paid out for five days a week. The maximum yearly benefit is, then, 173,420 DKK (23,278 €).

Once being eligible for unemployment benefits, an unemployed person may collect them for a total period of four years, provided he or she follows the directions concerning active job seeking and participation in active labor market programs. At the end of the four-year period, the unemployed lose the right to unemployment benefits and must apply for cash benefits as an “un-insured” unemployed, cf. below. The right to benefits is also automatically rescinded at the age of 65 years, when the person will qualify for old-age pension.

Sanctions will be imposed by the funds on individual members that receive unemployment benefits without being eligible (for instance if they are not available for work or do not actively look for work). The standard sanction is withdrawal of benefits for a shorter period of time. Suspension can be for one week and up to 26 weeks. For 2005, the statistics of the Directorate of Labor show that approx. 13,800 persons had their benefits suspended. Of those, 3,200 were sanctioned with a suspension of more than 3 weeks. (Arbejdsdirektoraret 2007a). The number has been relatively stable over the last years.

The non-insured unemployed

Apart from those having exhausted their right to unemployment benefits, the group of “non-insured” unemployed consists of those unemployed, who do not fulfill the criteria for becoming eligible for unemployment benefits in the first place (cf. the list of criteria presented above). This group of unemployed must apply for cash benefits administered by the local government (the municipalities). Cash benefits are means-tested and the amount depends on the family-situation of the unemployed. For example, an individual

aged 25 or more and having children will receive 139,500 DKK per year (18,725 €), while a young person aged 24 or less will receive 67,656 DKK per year (9,081 €). The duration of cash benefits is not capped, but again the person must accept offers from the municipality to participate in active programs. If not, cash benefits may be reduced or withheld altogether. In 2005 a total of 2,700 unemployed recipients of cash benefits were sanctioned (Arbejdsdirektoratet, 2007b).

These benefits are thus considered a part of social policy and regulated by a separate law under the supervision of the Ministry of Employment. Financing is shared between national government and the municipalities.

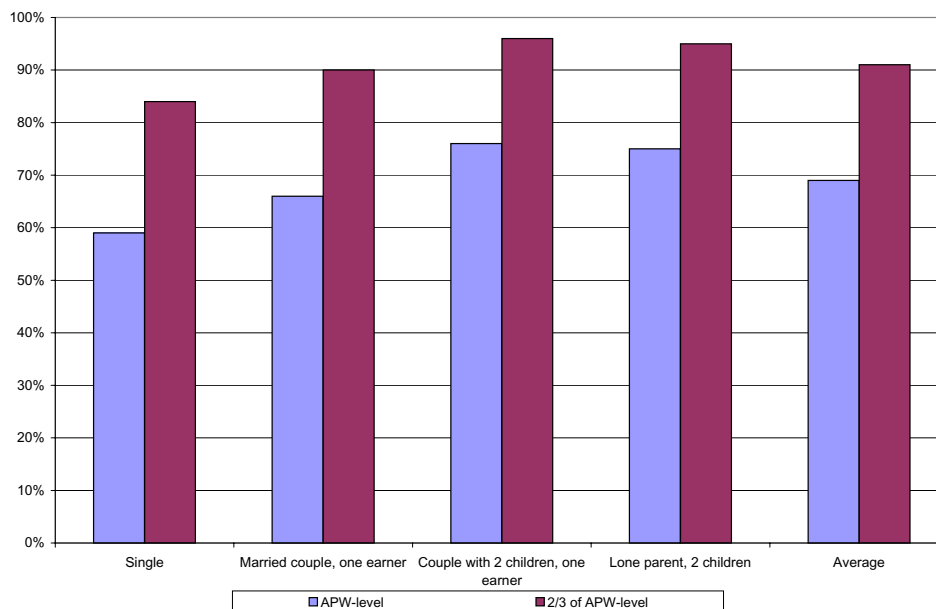
Replacement rates

As presented in the description of the calculation of unemployment benefits, they amount to 90 percent of previous earnings (normally based on the three-month period before becoming unemployed). There is a maximum amount, at present equal to approximately 14,500 DKK (1,946 €) per month. This im-

plies that the gross compensation rates decline rapidly with previous income, when the income reaches a limit of about 200,000 DKK (26,800 €) per year. To give an impression of the groups actually experiencing the different levels of gross compensation, one can mention that a wage earner in the private sector at the lowest income level would get about 175,000 DKK (23,500 €) (excluding pension) per year in 2005, while an average salesperson would get 235,000 DKK (31,500€) per year. A highly-skilled white collar worker would earn 457,000 DKK (61,300 €) per year (Dansk Arbejdsgiverforening, 2006, table 5.28).

OECD calculates net compensation rates for different family types and income levels. As is evident in Figure 1 – and as a consequence of the limit on the UI benefit – wage-earners earning two-thirds of the average production worker (APW) experience a significantly higher rate of compensation than the average worker. Also, the family situation plays a (limited) role, which is not due to the UI-insurance system, but related to other benefits (like housing benefits), which are included in the OECD-calculations.

Figure 1: Net replacement rates for two income levels and four family types in the first month of benefit receipt, 2002



Source: OECD (2004a), tables 3.1b and 3.3b. Note: APW stands for Average Production Worker.

Over last couple of decades, there has been a tendency for the compensation rates to decline, which has been the cause of some debate. The main reason for the decline is a special and rather complicated system for indexing the development of unemployment benefits (and other transfer incomes) according to the increase in average wages. The main element of the indexation involves regulating unemployment benefits with the percentage increase in yearly wages (excluding pensions and paid absence) over the previous two years with a deduction of 0.3 percentage points. This deduction is used to finance targeted measures for special groups among the unemployed and other “weak groups.”

Furthermore, the introduction of collective pension schemes among blue-collar workers has led to a decline in the compensation rates, because contributions to such schemes are not included in the calculation of unemployment benefits. As a result, the compensation rates (including pension contributions) have gradually declined since 1982.

Costs and financing

The majority of unemployment insurance is financed by the state. The total expenditure for unemployment benefits was 20.4 billion DKK (2.7 billion €) in 2005. The other major payments from the unemployment insurance funds are for the voluntary early retirement pay, which amounted to 24.1 billion DKK (3.3 billion €) in the same year. The costs are covered from three sources: the mandatory contributions to UI from the members, the optional membership contributions to the Voluntary Early Retirement Pay (VERP) and the funding received from the state. Table 1 gives an overview.

The administrative costs of the Labor Market Directorate (approx. 180 million DKK, 24 million €) and the administrative costs of the individual unemployment insurance funds (covered by the members) can also be added

to Table 1. In 2004, the total administrative costs of the unemployment insurance funds amounted to 3.3 billion DKK (440 million €) (Arbejdsdirektoratet, 2005, p. 15). One may also add the costs of the active labor market programs for the insured unemployed members of the funds, which adds up to 7.5 billion DKK (1 billion €).

In 2005, the total administrative costs of the UI funds were 3.2 billion DKK (which was covered by the membership contributions. Thus, of the total membership contributions, about 20 percent covers the administrative costs of the funds, while 44 percent is the mandatory membership contribution to the unemployment benefits and the remaining 36 percent are contributions to the voluntary early retirement scheme.

Since the state covers all variations in the expenditures of benefits through the federal budget, no special funds are accumulated. Membership contributions are not regulated according to the general level of unemployment or to the unemployment risks of the individual members or groups of members. The only factor that makes the membership contributions differ between the funds is variations in the administrative costs of each fund.

Approximately 2,000 people are employed by the Public Employment Service. An additional 5,000 work for the unemployment insurance funds. The total number of employees in the social services departments of the municipalities is about 6,200 persons. The total number of full time people working for the administration of employment policy is about 13,000 persons. The number of full-time persons in the target groups for employment policy measures is estimated at 450,000 persons in 2002. (Finansministeriet, 2004, Chapter 6)

1.2 Active labor market programs

The organization of active labor market policies (ALMP)

As mentioned above, an important feature of the present system of labor market policy is its two-tier structure, which follows the dividing lines in the unemployment insurance system. At the individual level, the dividing line is drawn between those unemployed who are members of an unemployment insurance fund and those who are not, and therefore eligible for means-tested social welfare.

Measured in numbers, the municipalities take responsibility for almost half of the total number of unemployed people in active measures and, thus, play a key role in the implementation of active labor market policies. This is also the main reason for current efforts to integrate the state system for the insured unemployed with the activities of local governments, cf. below.

In 2007, the so-called “Structural Reform” will implement major changes to the Danish public sector. The number of municipalities will be reduced from the present level of 271 to 98. The existing 14 labor market regions (each headed by a director and a tripartite council) will be replaced by five labor market regions – each

still with a tripartite council. The councils will, however, have fewer responsibilities than before. The reform thus implements two important changes from to the present set-up:

- The role of local government in implementation of labor market policy will increase
- The influence of the social partners is reduced (probably due to opposition from the present Conservative-Liberal Government and the Ministry of Employment regarding the more powerful role of social partners under the previous system)

At the municipal level, the reform will create new Jobcentres – one for each municipality. The Jobcentres will be responsible for both the insured and the non-insured unemployed and will thus combine the tasks that are now assigned to the social assistance branch of the municipalities and the public employment service. However, apart from 14 pilot Jobcentres, the formal legal responsibility for the unemployed will still be divided between the state- and municipality-branches of each Jobcentre. The model is thus a hybrid between a one- and two-tier system.¹

Programs and participants

Figure 2 shows the participants in ALMP during the period 1995–2005. The figures do not

¹ For an official overview of the reform, see http://www.bm.dk/fremtidig_beskaeftigelsesindsats/default.asp. A more recent detailed description of the tasks of the new job-centres can be found on the homepage of Local Government Denmark: <http://www.kl.dk/336499/> in the publication: “Temaguide om beskæftigelsesområdet – opgaveændring og sammenlægning”, October 13, 2005. For a recent overview of the new organization of employment policy, reference can be made to Arbejdsdirektoratet (2006).

Table 1: Revenue and costs of the Danish unemployment insurance system, 2005

Item	Amount (million DKK)	Amount (million €)
Unemployment benefits	20,405	2,738
Voluntary Early Retirement Pay	24,656	3,309
Total expenditures	45,061	6,048
<i>Covered by:</i>		
Membership contribution to UI (mandatory)		
	7,068	949
Contribution to VERP (voluntary)	5,712	767
State contribution	32,281	4332

Source: Data provided to the author by the Directorate of Labor

include participants in so-called flexi-jobs, which are jobs with a permanent wage subsidy for people with long-term reduced work capacity.

The figures reveal information about the main programs of Danish ALMP:

- Job training with a wage subsidy implies that the unemployed person is paid a normal wage from a public or private employer over a limited period of time (up to one year).
- Special job training is for weaker groups of unemployed, and will typically take place in special projects within the public sector.
- Support for self-employment (a three year subsidy equal to 50 percent of benefits) was phased out from 1998. The program is now closed.
- Education covers a wide range of vocational and labor market training for up to one year.
- Counseling includes job search activities, etc.
- Targeted measures are programs aimed

at special groups like immigrants or older workers.

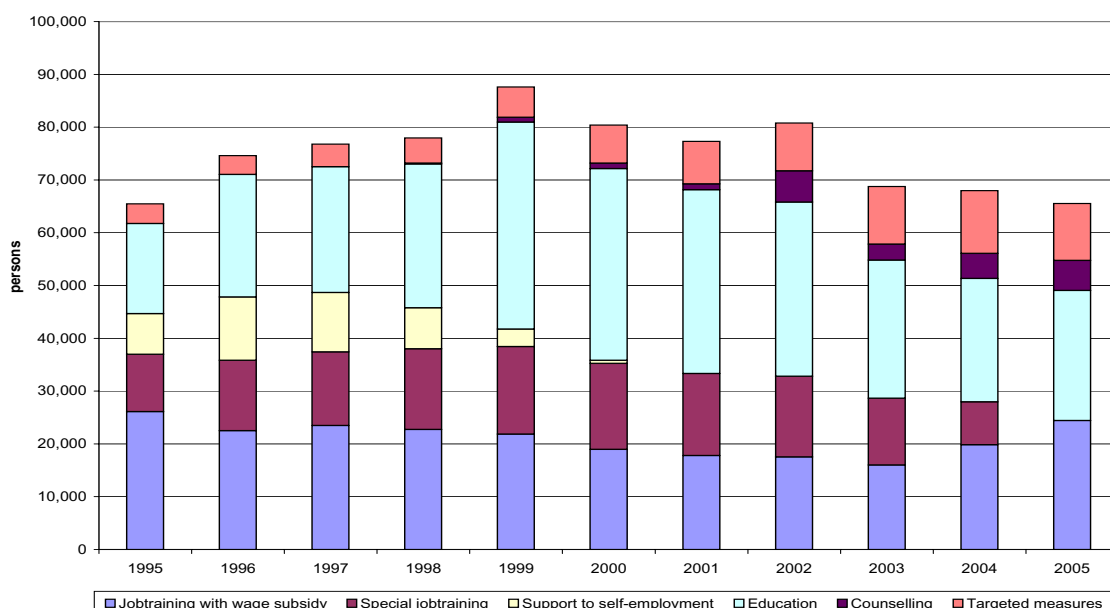
Mainly as a reflection of the improved conditions of the Danish labor market, the number of participants has been falling in recent years. At the same time – and reflecting a deliberate policy shift of the present government – more emphasis has been placed on job training with private employers and on counseling under the slogan “work-first”. Lower priority is given to educational measures. Targeted measures have also grown in importance due to an increased emphasis on the integration of immigrants and descendants.

Effects of ALMP

As in many other countries, the net effects of active labor market policy are disputed. One reason is that active programs have both positive and negative effects on the future employment prospects of the individual participants:

- The motivation effect implies that an unemployed person seeks work more ac-

Figure 2: Number of participants (full-time equivalents) in active labor market policy measures, 1995-2005



Source: Databanks of Statistics Denmark.

tively in the period immediately before he or she has to participate in a mandatory activation program. The strength of the motivation effect is indicated by the change in the probability of leaving unemployment during the period immediately before the person is obliged to take part in an activation program.

- The “locking-in”-effect means that job-search activities are reduced while an individual takes part in an activation program.
- The training (or qualification) effect stems from a rise in the level of qualifications during activation, which should improve the possibilities of finding a job for those who have participated in one of the active programs.

In a study published in 2000, the Ministry of Labor presented some of the first results based on a new database, which it had developed (Ministry of Labor 2000). The database contains information on the labor market situation of all individuals, including their participation in labor market programs and their contacts with the social security system. Advanced statistical methods based on individual labour market histories can, therefore, be applied (fixed effects methods and estimates of hazard rates).

First of all, the study revealed significant motivation effects, measured by an increased probability to take up employment during the period immediately before having to take part in mandatory activation programs. Such effects have been confirmed by later studies (e.g. Geerdsen 2003; Rosholm and Svarer 2004) and play an increasing role for proponents of active programs. However, the specific dilemma posed by such observations should be kept in mind. If the aim is to increase the motivation effect, there may be a temptation to change the content of activation programs in order to make them less attractive to participants. But this would also

probably imply that the quality of the programs themselves would be lowered in terms of their training content and other activities to improve the skills of participants. As a result, the overall outcome might be less positive for those unemployed people who are unable to find a job before entering activation.

Another potential effect for the individuals taking part in activation programs is that they increase their chances of gaining employment due to the improvement in their qualifications and therefore their employability. In the study by the Ministry of Labor, the improvement in employability was measured by the reduction in the percentage of the year for which the people concerned received any form of transfer income (such as unemployment benefits, social assistance or sickness benefits). A reduction in this proportion is a reliable indicator of a real improvement in the employment situation of an individual, either because the individual has found ordinary employment or taken up some form of education.

Such qualification effects of the various types of labor market programs are of considerable interest. In this respect, the largest improvement in the employment situation (measured by an increase in the economic self-dependency of the participant) was in the 2000 study of participants in private job training. For public job training and labor market education the effects are positive, but smaller. These findings are in line with international observations (Martin 2000).

In the most recent study from the Ministry of Employment (Beskæftigelsesministeriet, 2005b), the following conclusions are made concerning the effects on qualification:

- Positive effects from participation in active programs are found for both insured and uninsured unemployed and the estimated magnitude of the effects are rather similar.
- Job training with a wage subsidy yields

the largest effects, especially job training in the private sector.

- Positive effects are also found for educational programs, especially when targeted to job-types with labor shortages.
- Especially for the uninsured unemployed, one observes an increased effect of education when measuring the effect one year after participation compared to measuring the effects after six months, thus pointing to the importance of longer term effects.
- Finally, it is observed that combinations of different programs (for instance education combined with job-training) gives larger effects than just participating in single programs, although this must also be seen in the light of the longer duration of such combined programs.

The authors of some studies have viewed the positive net effects of active programs with skepticism, often pointing to the existence of significant locking-in effects. The Chairmen of the Economic Council, for example, in their report from December 2002, attribute about one third of the reduction in unemployment since 1993 to the improved structural performance of the Danish labor market, part of which is also attributed to improved labor market policy (Det økonomiske Råds formandskab 2002). The report, however, gives a rather critical account of the majority of the instruments applied within active labor market policy, and points in particular to the significant locking-in effects of several measures. Only job training in private firms seems to have large positive net effects and to be cost-effective. Job training in the public sector and many forms of education have dubious or negative net outcomes for the participants. Based on these conclusions, the Chairmen propose improvements in the use of active measures (including giving higher priority to job search and private job training).

2. Regulation of the Labor Market

In recent reports on the Danish employment system (often labeled the Danish “flexicurity-model”), it is generally emphasized that the overall level of employment protection in Denmark is at a low level, which is comparable to liberal labor markets like that of the United Kingdom, cf. Figure 3.

While the general picture is that of a low level of employment protection, in reality the situation is somewhat more complex and implies different levels of protection for different groups.

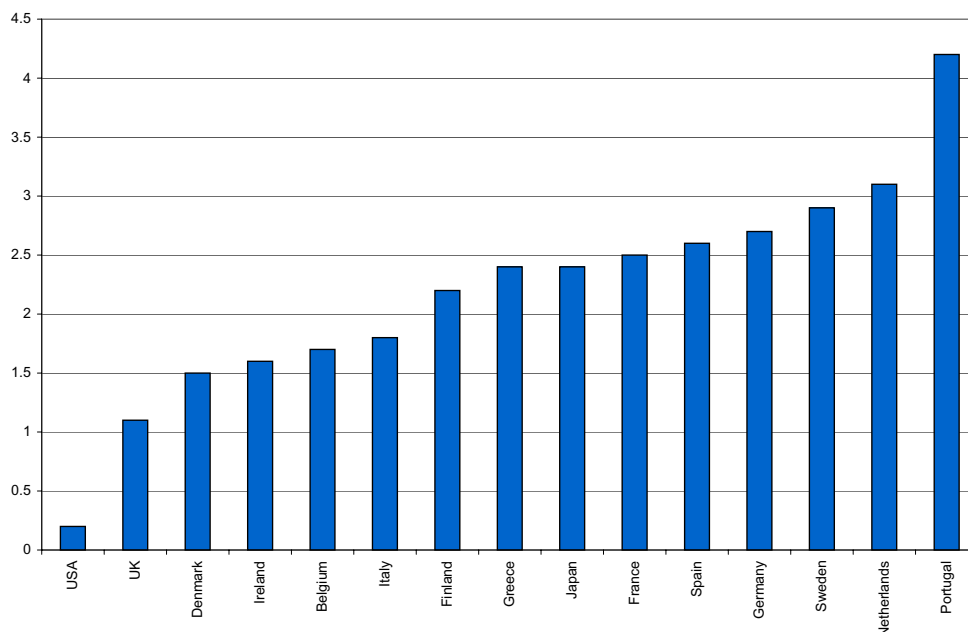
First of all, one should point to the fact that employment protection in Denmark is, to a large degree, seen as an issue to be handled by social partners as part of the general negotiations of work and pay conditions. Therefore, one will find only limited legislation in this field and, at the same time, different rules with respect to employment protection embedded in the various collective agreements.

One important exception is, however, the “Law on Salaried Workers,” which regulates the employment conditions for large groups

of white-collar workers. In the law, a salaried worker is defined as a person who conducts office or clinical work and similar functions or supervises the work of others. Furthermore, in many collective agreements, it is stipulated that those workers covered by the agreement will have the right as defined by the law, even if they are not covered by the definition in the law. It is the assessment that the majority of public employees and about half of the employees in the private sector are covered by agreements or regulations that follow the “Law on Salaried Workers.”

The law outlines, among other things, a set of rules for dismissals, the main content of which is a definition of the employer’s notice period in relation to the duration of employment. An increasing number of non-salaried workers in the private sector have, as part of negotiations between the social partners, been classified as “quasi-salaried workers” and therefore experience a level of employment protection similar to those just described. Employers offending the protection of salaried or quasi-salaried workers will have to pay compensation to the former employ-

Figure 3: Employment protection for regular employees with an unlimited contract (index values)



Source: OECD (2004b), chapter 2, table 2.A2.1.

ees. The employer, however, cannot be forced to reinstate the employee. Apart from these groups, one may find varying rules concerning employment protection in the collective agreements for different groups and sectors. The lowest protection level is found in the construction sector, where one can find dismissal periods of only a few days. This is discussed in more detail in Section 4.b below.

Concerning part-time workers, there are no specific regulations. This means that part-time workers are covered by the same regulations as full-time workers – a situation which is a general feature of the Danish labor market.

Due to the rather low level of employment protection in the Danish labor market, the share of people having a time-limited contract is also rather low. The use of such contracts is now regulated by rules that implement the governing EU-regulations.

An interesting trait is that there are no special regulations for public employees, who are generally subject to the same rules as in the private sector. One exception is the minority of public employees who still have a special status as public servants, although the tendency over the last decades has been to phase out this category of public employees.

Finally, one should mention that legislation has been introduced to ban the discrimination of pregnant women when it comes to dismissals. Employers who dismiss pregnant women will have to prove that the dismissal had nothing to do with the pregnancy or face a fine and payment of compensation to the former employee if this cannot be proven.

Cases brought against employers for offending the regulations with respect to employment protection are handled by the separate legislative system that was established for the labor market.

Table 2 gives some examples of the notice periods for different groups of employees.

As mentioned above, it is the assessment that the majority of public employees and about half of the employees in the private sector are covered by agreements or regulations similar to those of the salaried workers in Table 2.

Similarly, Table 3 shows that severance pay is paid to tenured salaried workers but rarely to blue-collar workers.

Unfortunately, it is difficult to get a statistical overview of the way the EPL-system functions as a whole, because most of the conflicts are

Table 2: Notice period depending on duration of employment for different groups

Duration of employment	1 year	5 years	10 years
Construction worker	3 days	5 days	5 days
Industrial worker	21 days	2 month	3 months
Salaried worker and public employee	3 months	4 months	6 months

Source: Westerlund (2006), Table 5

Table 3: Severance pay depending on duration of employment for different groups

	12 years	15 years	18 years
Salaried workers	1 month's wage	2 month's wage	3 month's wage
Blue collar workers	Found in some collective agreements		

Source: Westerlund (2006), Table 6

solved through arbitration at the firm level, which involves the local trade union representative and the local employers' organization. Therefore, only a few of the dismissal cases reach the Court of Labor (see www.arbejdsretten.dk).

3. Wage Setting and Collective Bargaining

Industrial relations

Of the total number of Danish wage earners (2,656 million people), 2,120 million people were members of a trade union in 2004 – a rate of organization of about 80 percent. Of the organized workers, about two-thirds are members of the Danish Confederation of Trade Unions (LO), while the rest are members of various white-collar unions. In a detailed study of union membership from 2000, the rate of unionization in the public sector was reported as very high (around 90 percent), while the rate in the private sector was 77 percent (Madsen, 2000). The rate is slightly higher for women than for men (83 percent versus 80 percent) and significantly lower for those aged less than 30 years (69 percent versus 85 percent for the older workers). The unionization rate is highest for skilled workers and employees with a short or medium cycle education.

The principle of the “closed shop,” which until recently was a rule for about 10 percent of Danish wage earners, has now been declared illegal. Membership in a trade union is

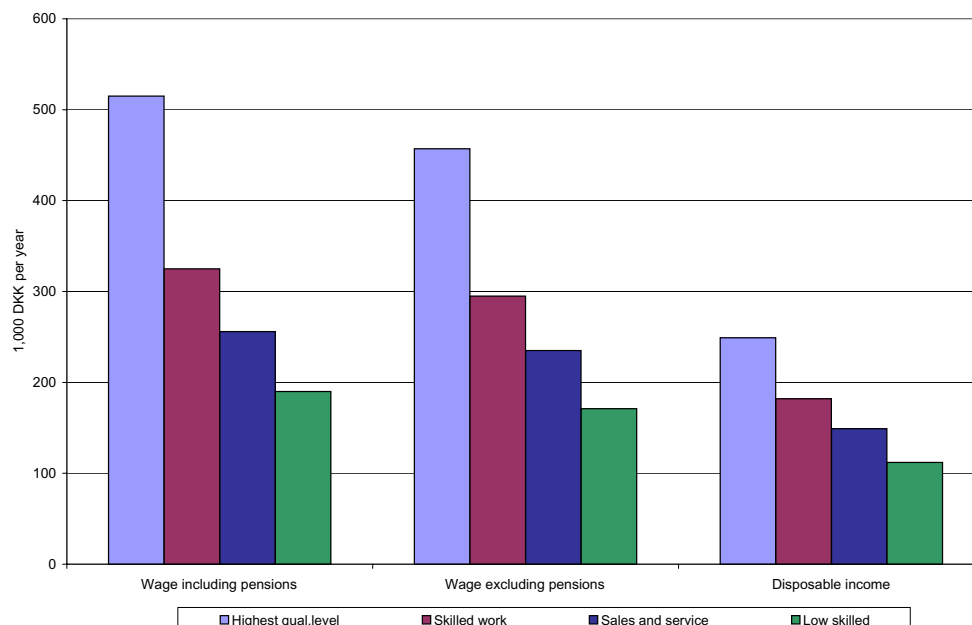
therefore voluntary, but in many workplaces there will still be strong social pressure on the employees to become members. Furthermore, the decentralized character of wage bargaining and the strong role of shop stewards in the bargaining process probably act as strong incentives for members, as does the close relation between the trade unions and the unemployment insurance funds.

The percentage of wage earners covered by collective agreements is 100 percent in the public sector and 77 percent in the private sector (Dansk Arbejdsgiverforening, 2005, table 6.1).

Wage negotiations

In 1987, the social partners issued a joint declaration stating that they would take the overall macro-economic performance into consideration and, therefore, negotiate wage increases below the international wage inflation in order to improve the competitiveness of the Danish industry. This declaration has since laid the foundation for general wage negotiations.

Figure 4: Annual wages for different skill levels, 2004



Source: Dansk Arbejdsgiverforening (2005), table 6.28

Furthermore, Danish wage negotiations have to an increasing degree been decentralized to the level of the individual firms. Thus in 2004, only 16 percent of the collective agreements (measured by the share of workers covered) under the DA/LO-area specified a standard wage rate (so-called “normal wage”). In 62 percent of the agreements, a minimum wage was specified, but actual wages were to be set by local negotiations. Finally, in 22 percent of the agreements, no wage rate was mentioned at all. The latter represents an increase in such “wage-less” agreements from four percent in 1999. There is no statutory minimum wage in Denmark.

By combining the conditions for wage negotiations at the central and de-central level, one could, therefore, point to a shift in the norms for wage negotiations, which implies both a recommendation of wage restraint from actors at the central level and a higher acceptance of the need to keep wages in line with (foreign) competitors at the firm level. Shifts in norms and in the organization of wage formation have overruled the potential inflationary effects of the large reduction in unemployment observed since 1993.

As shown in Figure 4, the largest dispersion is found for gross wages, where the relation between the highest and the lowest level is 2.7. For disposable income the relation is 2.2. Apart from this rather narrow wage dispersion, the Danish labor market shares a number of characteristics with other Northern European labor markets. Thus, there is an unmistakable wage gap between men and women, which can be estimated to be between 12 and 19 percent (Deding & Wong, 2004). In the private sector, about ten percentage points cannot be explained by background factors like age and education. In the public sector, the unexplained part of the gender wage gap is almost nonexistent.

4. Taxation

The most peculiar trait of the Danish tax system, as compared to other EU Member States, is the minor role of social contributions as a source of revenue. About half of the public income from taxes and duties comes from income taxes and about one-third from the VAT and other indirect taxes. In 2005, only 2.2 percent stemmed from social contributions paid by the employers or the employees. Thus the Danish tax and contribution system is characterized by:

- A dominance of direct personal taxation and few social security contributions paid by the employers.
- Rather high average income taxes and especially a high marginal taxation on ordinary incomes.

To some extent, the lower social contributions paid by employers are mirrored by higher direct wage costs, implying that the cost advantage to firms, following the low level of social contributions, is not as pronounced as one might think.

Concern has been expressed that the high rate of marginal taxation, in combination with income-related social benefits (support for child care, housing benefits), may cause serious economic disincentives to labor supply – particularly at the lower end of the income scale. However, the relevance

of this observation as a means of explaining the higher unemployment among low-skilled workers is disputed, since other factors (including changes in the demand for qualifications) may also be involved

Measured as a share of GDP, taxes and duties amounted to 50.1 percent in 2005. This represented a minor increase from 49.0 percent in 2004 and 47.8 percent in 2003.

As in many other countries, the issue of marginal taxation and its influence on labor supply is high on the political agenda. During the last decade a number of tax reforms tried to lower marginal income taxation. Since 1999, there has been a steady reduction in marginal tax rates for all income levels, although the reductions have been modest. For a low-income earner, the marginal tax rate has fallen from 45.5 percent in 1999 to 42.9 percent in 2006. For high-income earners the reduction is a meager 0.3 percentage points, from 63.3 percent in 1999 to 63.0 percent in 2006.

As part of a 2004 tax reform, a special “job-deduction” was introduced, providing for a deduction of 2.5 percent of all earned income – albeit not applicable to transfer income. The maximum deduction is 6,800 DKK (913 €) per year, which equals an average tax value of 2,265 DKK (304 €), because the deduction is only calculated from local and regional government taxes. The purpose of the

Table 4: The Danish tax structure, 2005

	Mio. DKK	Mio. €	Percent
1.1. Personal income taxes	381,469	51,196	48,7
1.2. Corporation tax, etc.	59,275	7,955	7,6
1.3. Real interest tax	37,038	4,971	4,7
2. Social contributions, total	17,138	2,3	2,2
3. Other labor market contributions, total	2,907	390	0,4
4. Taxes on wealth, real property, etc., total	29,955	4,02	3,8
5. Taxes on goods and services, total	254,747	34,189	32,5
6. Other production taxes, total	144	19	0
Taxes and duties, total	782,673	105,04	100

Source: Databanks of Statistics Denmark

“job-deduction” is to increase the incentive to work for low income earners.

A standing issue among labor economists is the effect of this and other tax reductions on the supply of labor. Will tax reductions in the higher end of the income scale have greater or lesser effects than the reductions for low-income wage earners? Given the limited empirical evidence, the answer remains unclear. Some agreement has been reached, however, that the elasticity of labor supply is generally rather low. Thus an often-quoted study from 2002 estimated the elasticity of labor supply with respect to income to be 0.052 and 0.148 for men and women, respectively.

Finally, apart from general efforts to lower marginal taxation, focus has also been placed on the disincentives for specific groups to work. The recent introduction of lower “start-help/introductory benefits” for newly-arrived immigrants as well as a ceiling on social security cash benefits for married couples are examples of such targeted initiatives.

5. Outcomes

This section first takes a look at some of the standard indicators of labor market performance. It then goes on to discuss the interplay between unemployment insurance, active labor market policies and labor market dynamics by applying the framework of the Danish “flexicurity model”.

5.1 Employment rates

One of the characteristic aspects of the Danish labor market is the high employment rate for both men and women in all age groups, cf. Figure 5.

The employment rates for women are almost equal to those for men, except for the age groups between 25 and 34 years, where caring for small children is reflected in a somewhat lower employment rate for women. From a comparative perspective, though, the employment rates for Danish women are still among the highest in the European Union, even when it comes to women with small children.

5.2 Unemployment flows and rates

Another characteristic feature of the Danish labor market is the high volume of flows in and out of unemployment. Figure 6 shows the number of people having been unemployed for a shorter or longer period of time in each of the years from 1995 to 2004.

In 1995, nearly 800,000 people – almost one third of the workforce – was unemployed one or more times during the year. About 323,000 experienced unemployment less than 20 percent of the year, while 114,000 people were unemployed for more than 80 percent of the year,

and thus considered long-term unemployed by the standard definition applied in Danish statistics.² The graph illustrates the reduction in the number of people experiencing unemployment during the upswing of the 1990s and the slight increase in 2003 and 2004. From 2005 the numbers are falling again. The number of long-term unemployed has been falling from more than 100,000 people in the beginning of the period to less than 50,000 people in the most recent years. These figures can be compared to a total workforce of 2,895,950 people in 1995 and 2,854,100 in 2004.

The dominance of short-term unemployment in the Danish labor market is also illustrated in the survival curve. It shows the outflow from unemployment to employment (including state-supported education) or retirement for the 130,000 people who became unemployed for the first time from the third quarter of 2002 to the second quarter of 2003. After six months, about 68 percent were employed, while 80 percent were employed after one year (Beskæftigelsesministeriet, 2005a). The curve also illustrates the difference between the insured and the non-insured unemployed. The latter has a slower outflow during the first weeks of unemployment, but after a year the share left in unemployment is about the same for the two groups.

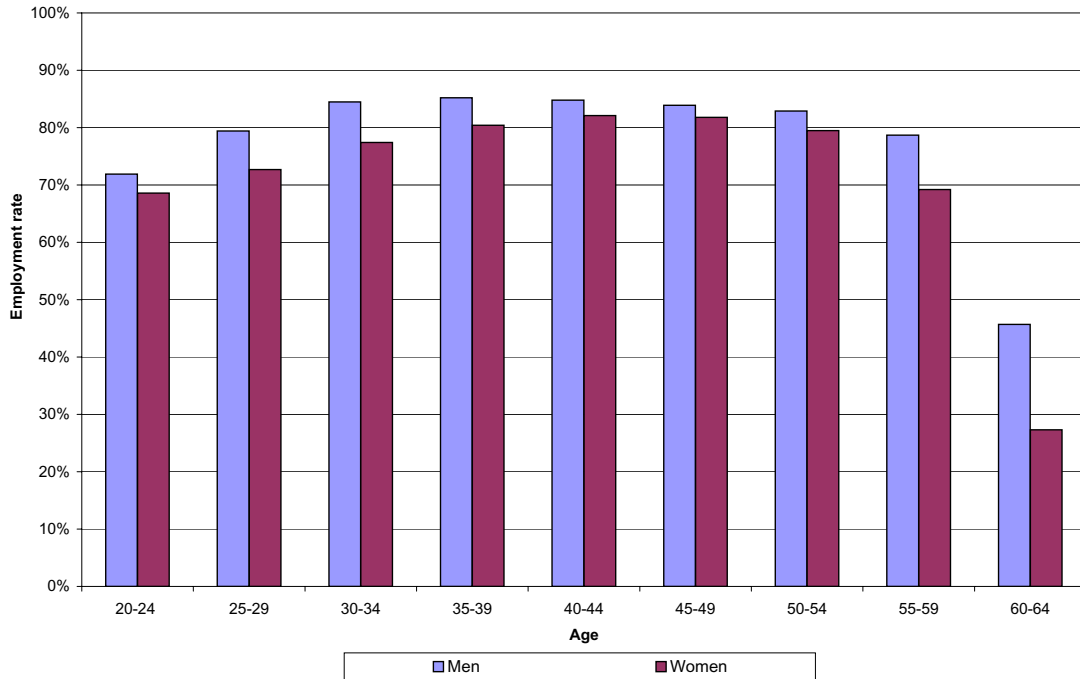
The registered rate of unemployment by sex is shown in Figure 7, which documents a somewhat higher unemployment for women than for men.³ In 2005 the average unemployment rate for men was 5.0 percent and 6.5 percent for women.

Similarly, the unemployment rates for different

² The most important statistical concept in Danish unemployment statistics is the “degree of unemployment,” which measures the percentage of the year during which a person has been registered as unemployed. A long-term unemployed person is defined by this measure as a person having been unemployed for more than 80 percent of a given year. Thus this definition differs from the concept applied in labor force surveys, where a person is considered unemployed when he or she has been unemployed for more than 12 months.

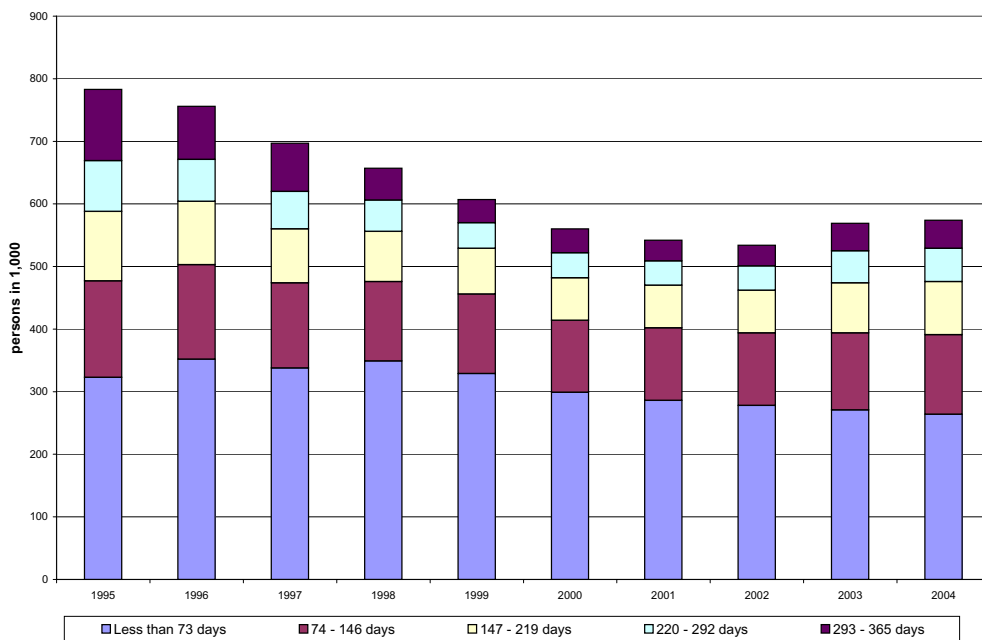
³ The registered rate of unemployment refers to the number of unemployed in the registers of the Public Employment Service and differs somewhat from the rate of unemployment calculated on the basis of labor force surveys.

Figure 5: Employment rates for men and women, 2004



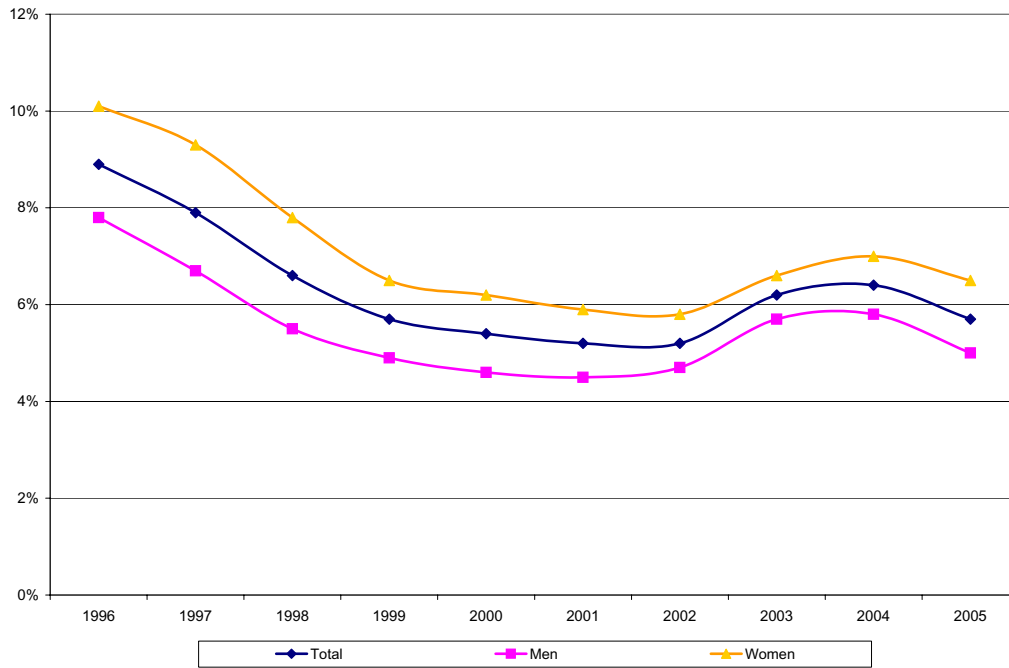
Source: Databank of Statistics Denmark

Figure 6: Number of people having been unemployed for a shorter or longer period of time, 1995 to 2004



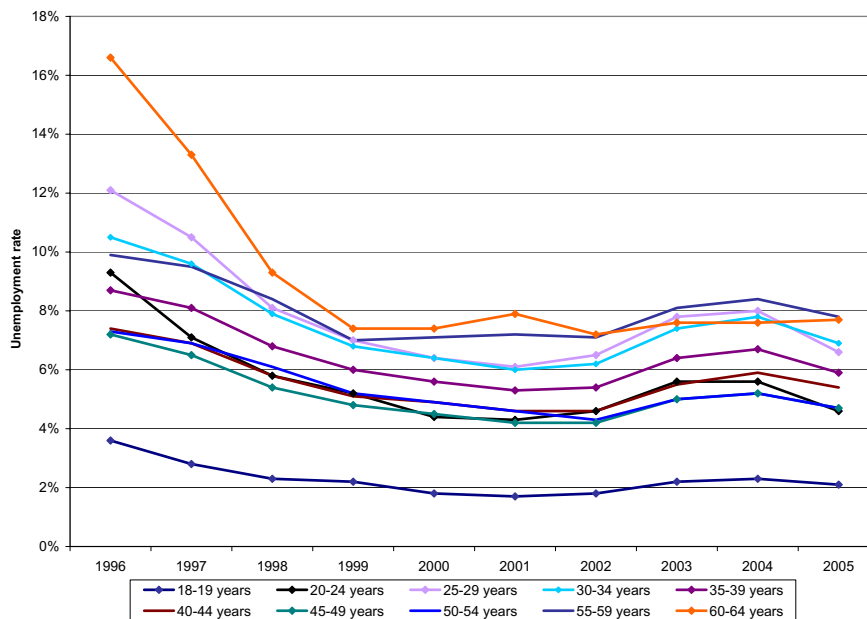
Source: Databank of Statistics Denmark

Figure 7: Unemployment rates for women and men, 1996–2005



Source: Databank of Statistics Denmark

Figure 8: Unemployment rates for different age groups, 1996-2005



Source: Databank of Statistics Denmark

age groups are documented in Figure 8. The relationship between the age groups is rather stable. In 2005, unemployment rates above six percent were found for the age groups 24–34 years and for those aged 55 years and more. A remarkable feature of the Danish labor market is the low youth unemployment rate, which is often attributed to the special youth measures introduced in 1996. The overall purpose of the youth program was to stimulate unemployed, low-skilled youth to take up paid employment or to participate in education. It is, however, disputed whether the decrease of the rate of youth unemployment could also be due to other factors including the general economic upswing since the early 1990s (see Bredgaard & Jørgensen, 2000).

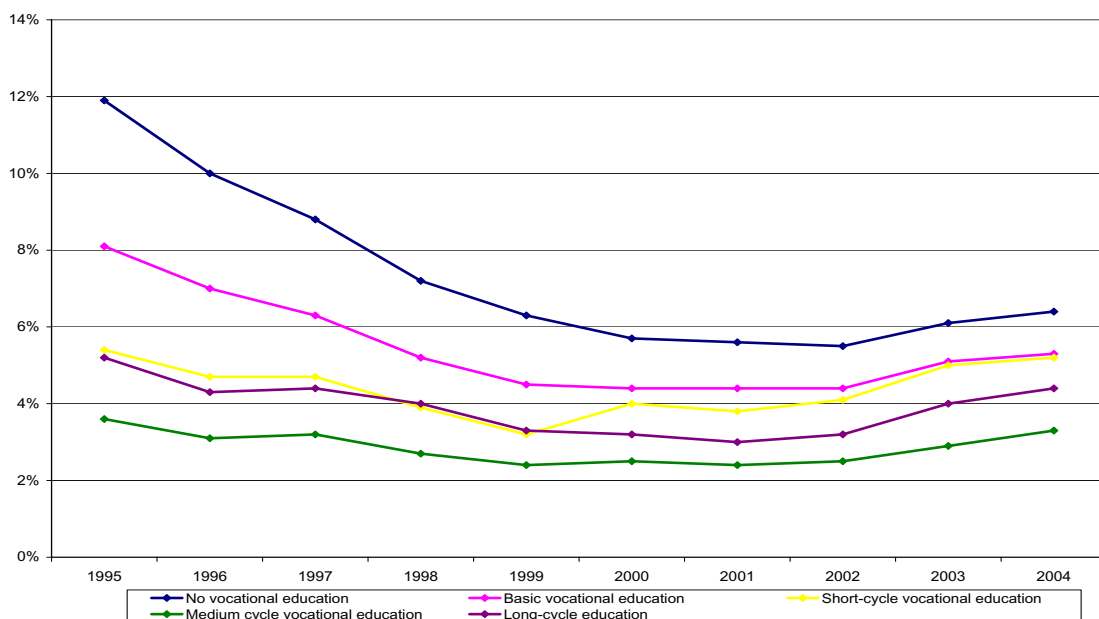
Another important factor related to the unemployment rate is educational background, which corresponds, to some degree, with age and sex. As shown in Figure 9, there is a stable hierarchy, where the highest unemployment rates are found for those groups without any vocational training and the lowest for those with a medium-cycle vocational background.

An important issue for the Danish labor market is the difficult employment situation of immigrants from non-Western countries, which is also illustrated by the unemployment rates shown in Figure 10. First-generation immigrants stand out as having very high unemployment rates.

Several interrelated reasons can be used to explain the barriers that immigrants and descendants from non-Western countries encounter in the Danish labor market:

- Their lower average level of education
- Language barriers
- Discrimination
- The narrow wage dispersion, which makes it difficult for people with very low productivity to enter employment (e.g. unskilled immigrants with insufficient language skills)
- Unemployment traps due to relatively high social benefits (although special low-level benefits have been introduced for some immigrant groups)
- The fact that many non-Western immigrants seek Denmark for other reasons

Figure 9: Unemployment rates for different educational groups, 1995–2004



Source: Statistical Ten-year Survey 2005, Statistics Denmark

than to find a job (political asylum or family reunification).

While the former three barriers will be valid for most European countries, the three latter are probably more dominant in the Danish labor market than in many other Central or Southern European countries.

5.3 Job-to-job mobility patterns over time for different groups⁴

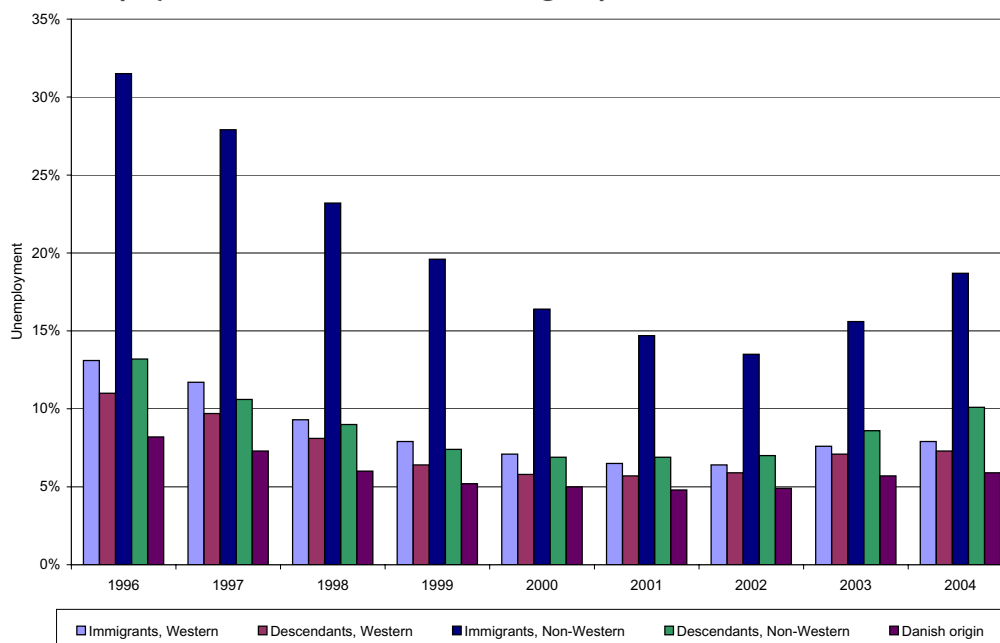
Available registry data provides the possibility to make a detailed analysis of mobility patterns with a long-term perspective (1980–2003).

When we look at the level of job mobility in the Danish labor market from 1982 to 2002, the general picture is one of continuity over time. After one year, almost three quarters of all individuals are still employed at the same

workplace across the three measurement periods (1982, 1992 and 2002). The remaining quarter of all employees change positions within one year. The majority of these employees move to another firm, i.e. numerical flexibility. This numerical flexibility increased slightly during this period (from 10.2 percent in 1982 to 12.9 percent in 2002), which seems to reflect an increase in employment creation since the mid-1990s. While around six percent of all employees became unemployed in 1982 and 1992, only 2.9 percent became unemployed in 2002. During the same period, there was a slight increase in the number of people outside the labor market (from 3.9 percent exiting the labor market in 1982 to 4.8 percent in 2002). This might be related to the increasing collection of early retirement benefits. From these data, two findings emerge. First, there is a surprisingly high continuity over time in the share of employees who either remain employed at the same workplace, or change employment. Second,

⁴ This section draws on results from ongoing research conducted by the author together with associate professor Flemming Larsen and assistant professor Thomas Bredgaard at CARMA. The research receives economic support from the Danish Ministry of Employment.

Figure 10: Unemployment rates for different ethnic groups, 1996–2004



Source: Databank of Statistics Denmark

the level of numerical flexibility (measured as a change to another firm) remains at a relatively high level throughout the period.

As shown in Figure 11, the high level of numerical flexibility in the Danish labor market is found not only for unskilled workers, but also for skilled workers, salaried workers and managerial staff – although mobility is somewhat lower at the higher levels of the job-hierarchy. Using this calculation, there is some variation in the numerical flexibility between groups in the labor market. Flexibility thus depends on position within the job hierarchy; but even among high-ranking employees there is still a rather high mobility between jobs.

From 2002 to 2003, 28 percent of all employees changed their position in the labor market, while 72 percent stayed at the same workplace. The level of mobility is clearly higher at the lower end of the job hierarchy, where around 30 percent of wage earners with either basic qualifications or no qualifications at all changed positions. At the other end of the scale, only 17 percent of senior managers changed positions within a year. It is clear from the data that unskilled and semiskilled workers are more mobile than highly-skilled workers. This means that mobility is also clearly linked to educational status, as illustrated in Figure 12.

Nearly 45 percent of employees with only a youth education change positions the year

after, while this is only the case for around 20 percent of employees with further education (short-term, medium term and long-term).

Despite these variations, the overall impression is one of rather high mobility for the major part of the labor market, irrespective of occupational groups, socio-economic groups or educational groups, and a high degree of continuity over time. It should, furthermore, be noted that there are not any distinct gender differences in the data on job mobility, and only minor differences by company size (where employees in firms with fewer than 50 employees are slightly more mobile than employees in medium- and large-sized companies).

The low employment protection and high numerical flexibility have, nonetheless, varying effects on different groups in the labor market. Young people looking for their first job or mothers returning to the labor market probably find it easier to gain a foothold because of high job turnover. Youth unemployment in Denmark has, in fact, been low in recent years and the employment and participation rates for women are among the highest in Europe. In the figure below we compare job mobility over time by age groups.

Generally speaking, the combination of a flexible labor market and an extensive social security system must be said to be to the advantage of highly skilled, mobile and flexible

Table 5: Job mobility in Denmark (change of employment the year after, percent of all employed)

	Mio. DKK	Mio. €	Percent
1.1. Personal income taxes	381.469	51.196	48.7
1.2. Corporation tax, etc.	59.275	7.955	7.6
1.3. Real interest tax	37.038	4.971	4.7
2. Social contributions, total	17.138	2.3	2.2
3. Other labor market contributions, total	2.907	390	0.4
4. Taxes on wealth, real property, etc., total	29.955	4.02	3.8
5. Taxes on goods and services, total	254.747	34.189	32.5
6. Other production taxes, total	144	19	0
Taxes and duties, total	782.673	105.04	100

workers who are able to switch jobs and job functions easily. When enterprises are able to easily hire and fire workers, employers may be more reluctant to retain certain groups of employees or to upgrade the skills and qualifications of their staffs. It is, therefore, impor-

tant that the public sector steps in and helps remedy the lack of investments in education and training, and encourages firms to retain employees who are at risk of being excluded from the labor market (e.g. older, unskilled or disabled workers, as well as refugees and im-

Figure 11: Still employed at the same workplace the year after by socio-economic groups, 2002

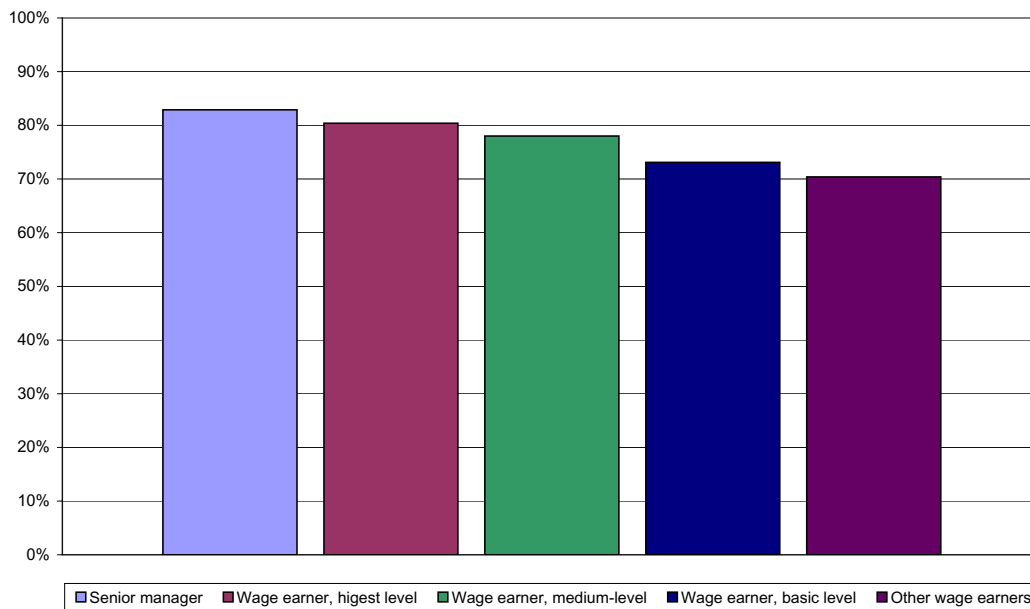
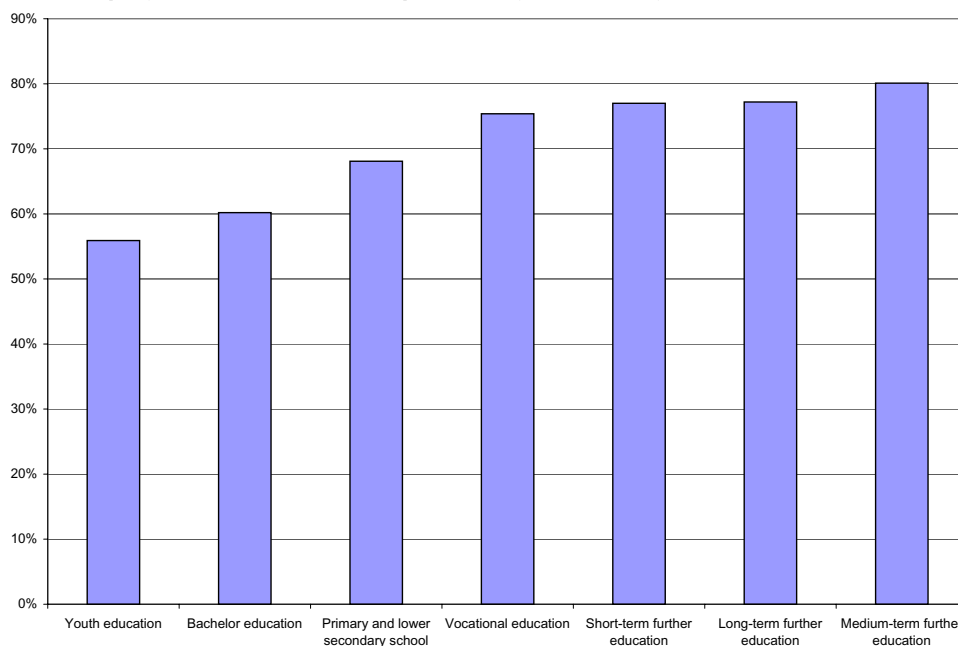


Figure 12: Still employed at the same workplace the year after by educational status, 2002



Source: Databank of Statistics Denmark

migrants), cf. Bredgaard et. al. 2006.

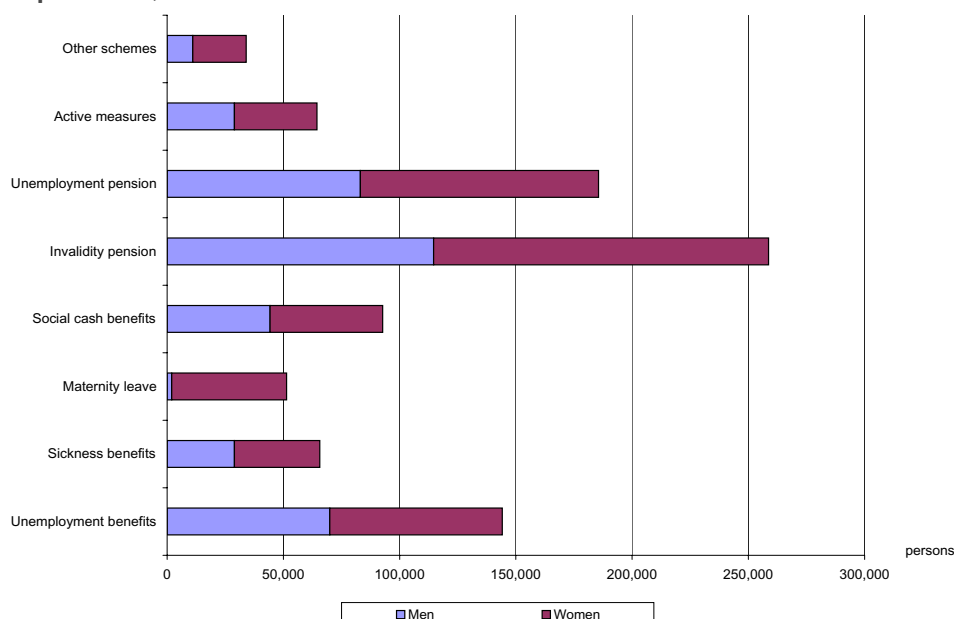
Finally, one can add that available statistics on job creation and destruction also indicate that such indicators of structural dynamics of the labor market are at a rather high level. Estimates from the Economic Council of the Labor Movement point to the level of job destruction and creation of about 12 percent of all jobs (Arbejderbevægelsens Erhvervsråd, 2004). About two-thirds of both newly-created and destroyed jobs are due to expansion or reduction of employment in existing firms. Similar estimates are documented in a 2005 report from the Ministry of Employment (Beskæftigelsesministeriet, 2005c).

conditions, this scheme allows people aged 60-65 years to retire and receive a pension equal to unemployment benefits. The total number of people receiving some form of transfer income in 2004 was almost 900,000 (full time equivalents), or about 25 percent of the adult population aged 15-65 years. Given the fact that the average employment rate in the same year was almost 75 percent, the striking observation is that for adult Danes there are only two alternative positions vis-à-vis the labor market: either to be employed or to be the recipient of public transfer income.

5.4 The economically inactive

The number of registered unemployed tells only part of the story about how many adults are economically inactive. As indicated by Figure 13, the number of unemployed in 2004 was surpassed by both the number of recipients of invalidity pension and the number of people receiving voluntary early retirement pay (unemployment pension). Under certain

Figure 13: Number of adults (aged 15-65 years) receiving some form of transfer income, full time equivalents, 2004.



Source: Databanks of Statistics Denmark

6. Flexicurity in Danish: The Interplay between Unemployment Insurance, Active Labor Market Policy, and Employment Protection

The balance and interplay between unemployment insurance, employment protection and ALMP are often viewed to be the main characteristics of the Danish flexicurity model in the following configuration:

- A flexible labor market with a high level of external numerical flexibility indicated by high levels of worker flows in and out of employment and unemployment;
- A low level of employment protection, which allows employers to adapt the workforce to changing economic conditions, makes the high degree of numerical flexibility possible.
- A generous system of economic support for the unemployed
- Active labor market policies aimed at upgrading the skills of those unemployed who are unable to return directly from unemployment to a new job

It is important to emphasize that, while the term “flexicurity” has only recently been associated with the Danish employment system, its basic characteristics have a long history. While current attention paid to the Danish model stems from the significant reduction in unemployment since 1993 and the correspondingly high employment rate, one should not confuse this recent success with the creation of a fundamentally new version of the Danish employment system over the last decade. On the contrary, one of the fascinating elements of the Danish labor market is the fact that the model has been able to survive since the founding of the modern Danish welfare state in the 1960s and despite the economic turmoil of the 1970s and 1980s. Furthermore, it has been successful in supporting the ongoing structural changes in the economy, which has kept Denmark among the most affluent countries in the world.

The Danish labor market model is often described as a ‘golden triangle,’ cf. Figure 14. The model combines high mobility between jobs with a comprehensive social safety net for the unemployed and an active labor market policy. In fact, mobility in Denmark (measured by job mobility, job creation, job destruction and average tenure) is remarkably high compared to other countries (Madsen 2006a). The high degree of mobility from employer to employer is definitely linked to the relatively modest level of job protection in the Danish labor market. Another reason could also be workers’ increased willingness to take risks due to the comprehensive social safety net and also the low stigmatizing effects of social security in Denmark.

Despite one of the lowest levels of job protection among OECD-countries (OECD 2004b, chapter 2), Danish workers have a feeling of high job security among all subgroups of workers (Auer and Casez 2003). A recent Eurobarometer reported that more than 70 percent of Danes found it a good thing to change jobs every few years.⁵

The arrows between the corners of the triangle in Figure 14 illustrate flows of people. Even if the unemployment rate is low from an international perspective, Denmark almost has a European record in the percentage of employed, which are each year affected by unemployment and receive unemployment benefits or social assistance (around 20 percent). The majority of these unemployed people, though, manage to find their way back into a new job. Those who become long-term unemployed end up in the target group for the active labor market policy, which – ideally – helps them to find employment again. The model illustrates two of the most important effects of this connection (cf. also the discussion in Section 1.2 above). On the one hand, as a result of the active measures, the partici-

⁵ See Eurobarometer Survey on Europeans and Mobility, 2006 (http://ec.europa.eu/employment_social/worker-smobility_2006/uploaded_files/documents/FIRST_percent20RESULTS_Web_percent20version_06.02.06.pdf)

pants in various programs (e.g. job training and education) are upgraded and therefore improve their chances of getting a job. This reflects the “qualification effect” of ALMP.

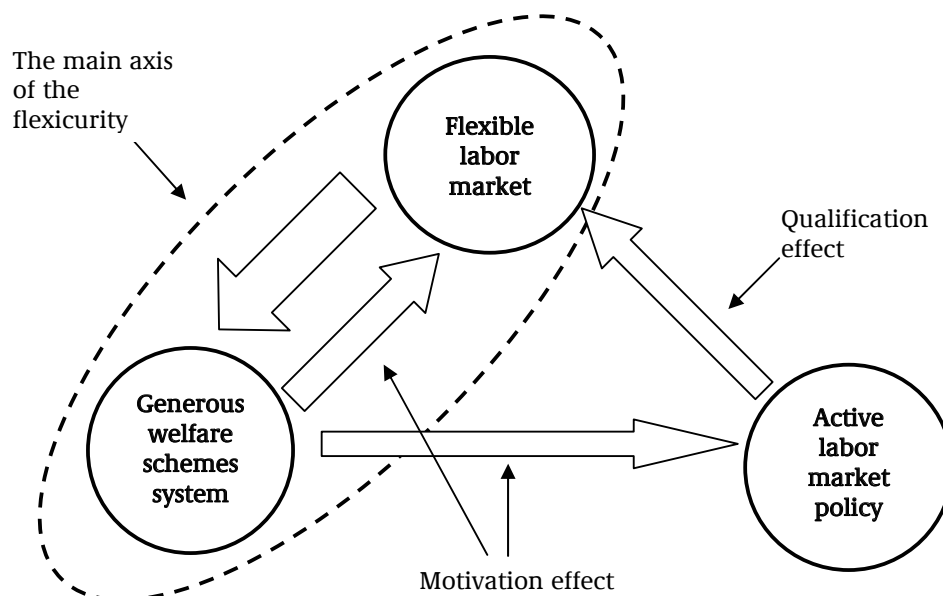
On the other hand, though, the measures can have a motivational (or threat) effect in that unemployed people who are approaching the time when they are due for activation may intensify their search for ordinary jobs, particularly when they consider activation a negative prospect. Thus one effect of labor market policy is to influence the flow from unemployment benefits back to work, as well as for those unemployed who do not actually participate in the active measures. A recent study has, in fact, argued that this motivational effect accounts for the major part of the macro-effect of ALMP (Rosholm & Svarer, 2004).

The social safety net in the shape of unemployment benefits and social assistance for the unemployed, together with the high flex-

ibility form the main axis of the model, in the sense that both elements have been characteristic of the Danish labor market for many years. Recognition of employers’ rights to hire and fire at will date back to the September Compromise of 1899, when Danish labor market parties entered into an agreement that focused on labor market disputes and how to solve them, as well as the appropriate role of organizations in the system. This established centralized negotiations and mechanisms for resolving disputes and, furthermore, laid the foundation for the practice of self-regulation by labor market parties in most matters of importance to the labor market.

As described in detail in Section 1.1, the Danish unemployment benefit system is based on the Ghent-system. It has its roots in the early 1900s, and in its present form dates back to the late 1960s. A generous (by international standards) and primarily government-financed benefit support system was established in 1969 and fairly wide frames for sup-

Figure 14: The Danish “flexicurity” model



port were adopted. Unemployment benefits and the state's role in financing them were increased, eligibility requirements for insurance and unemployment benefits were reduced, and high levels of compensation for lost income were secured. In return, employers were exempted from compensating redundant employees, as this responsibility was taken over by the state. Consequently, employers have never had to secure employment and pay for redundancies, and the hiring and firing costs of Danish businesses have remained very low. On the other hand, the presence of active labor market policy that stresses the upgrading of skills and job training is relatively new. In its present form, it originates from the labor market reform of 1993-94 and subsequent initiatives (Madsen, 2006a).

The Danish development of the welfare state and labor market points toward an interesting hybrid between the flexible, liberal welfare states, which are characterized by high numerical flexibility (liberal hiring-and-firing rules), and the generous Scandinavian welfare schemes of high benefit levels. The hybrid model manages to reconcile the dynamic forces of the free market economy with the social security of the Scandinavian welfare states. This model is a result of a long evolutionary development and is supported by relatively stable institutions and class compromises.

Table 6 below sums up the main traits of the Danish system and its specific development in the 1990s.

Both in international as well as Danish debate there has, from time to time, been a tendency to jump to the conclusion that the macro-economic success of the last decade is a result of the specific flexicurity model as just described. It is, however, essential to point out that the positive developments in the Danish labor market since the early 1990s are not attributable to the Danish flexicurity model alone. Without a successful balancing

of the macroeconomic policy and the trends in the international business cycle, the growth in employment and the falling unemployment would not have been possible. The coinciding of low inflation and a halving of registered unemployment rates is also the byproduct of a new agenda for collective bargaining and wage formation, which helped the labor market adjust to the shift from high unemployment to full employment while keeping wage increases at a moderate level and not departing from the international trend toward low inflation. This agenda developed gradually during the 1980s and was formalized by a joint declaration of the social partners in 1987, where they stated that they would take international competitiveness and the macro-economic balance of the Danish economy into account during wage-negotiations.

Table 6: An overview of the Danish system of “flexicurity”

	Basic traits of the Danish system of “flexicurity”	Specific developments in the 1990s
Political environment	Strong corporatist structures Implicit social contract concerning balance between security and flexibility	Broad political support for reforms of labor market policies Acceptance by social partners of need for wage restraint Decentralization of wage formation
Macroeconomic environment	Changing international economic conditions Active fiscal policy, but constrained by external balance	Strong internal demand Flavourable external balance Lower level of international inflation
Employment situation	High employment rate (around 75 Percent) Shifting levels of open unemployment Rising share of people receiving transfer income	Significant reduction in both open and gross unemployment Reduction in structural unemployment
Worker mobility (external numerical flexibility)	High by international standards	High by international standards
Employment protection	Weak	Weak
Unemployment benefits	Significant increase in compensation rate with reform in the late 1960s Cash benefits for non-insured unemployment	Slow decline in compensation rate, but still high by international standards Reduction in the maximum duration of unemployment benefits from 7 to 4 years
Active labor market policy	High expenditures on LMP in general Incremental policy adjustments since 1979	Decentralized Individualized Right and duty to early activation

Source: Madsen (2006a), table 1

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Drawing Lessons for Germany: Recommendations for Economic Policy Makers

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1. Essential Problems of the German Labor Market

Over the last several months, a significant improvement has taken place in the German labor market. On the one hand, this means a clear reduction of seasonally adjusted, registered unemployment. On the other hand, though, the number of employees subject to social insurance contributions rose after several years of decline (Figure 1).

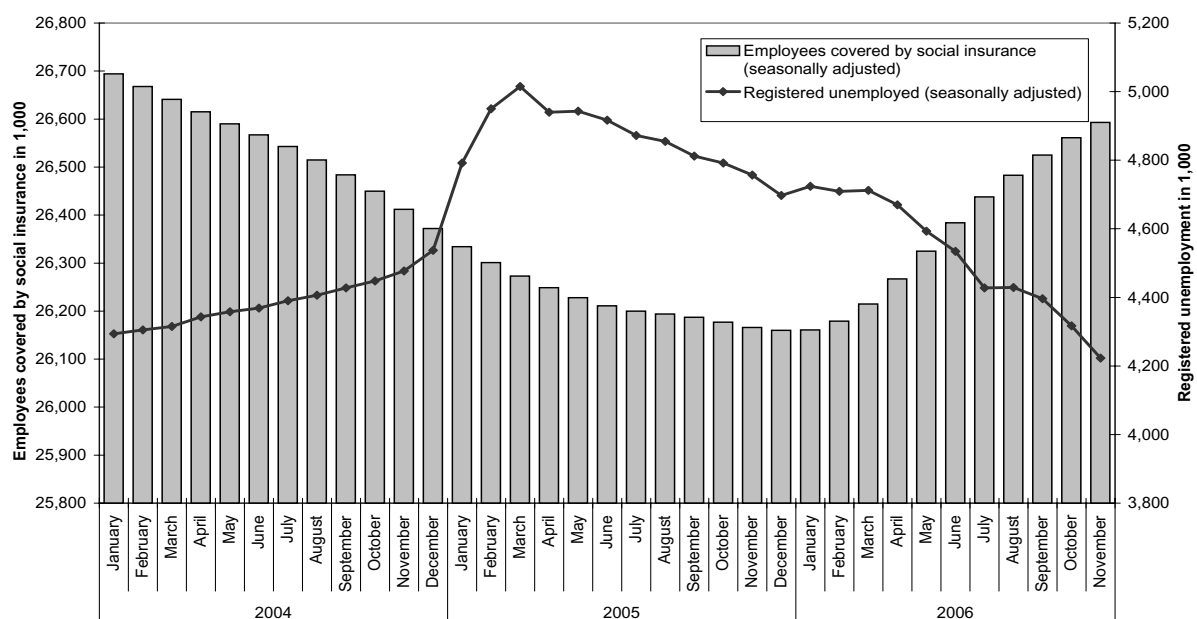
The recent improvement of the labor market situation should not, however, distract from existing structural problems. Table 1 illustrates the main labor market indicators.

First of all, the low average growth of GDP and employment in Germany during the last decade is noticeable. Employment has stagnated over recent years. The percentage of employed people in the working age population reveals a level similar to the average of the EU-15, but it lags behind compared to the figures from the individual countries. The gap in employment is most notable when compared to Switzerland with just under 12 percentage points and Denmark with a little more than 10 percentage points, even though both countries registered a slight decrease

in employment. Particular deficits still exist with regard to the employment of low-skilled workers. In this area, Germany has the lowest level of employment by far. The economic integration of women and young persons exhibits significant shortfalls as well. The employment rate of older people shows – coming from a low starting point – quite significant increases, but still does not reach the level of Switzerland or Denmark. At the same time, Germany still has one of the highest levels of unemployment and one of the highest shares of long-term unemployed. An unemployed individual counts as long-term unemployed after being jobless for more than a year.

Not only is the integration into the German labor market less pronounced than in the reference countries, but there also exists a distinctive segmentation of the labor market at the expense of certain groups of persons and between different forms of employment. With data from the German Socio-Economic Panel (SOEP), one can show that the ratio of full-time employees with an open-ended contract compared to all members of the labor force declines slowly, but steadily (Figure 2).

Figure 1: Seasonally adjusted unemployment and employment, 2004 and 2006



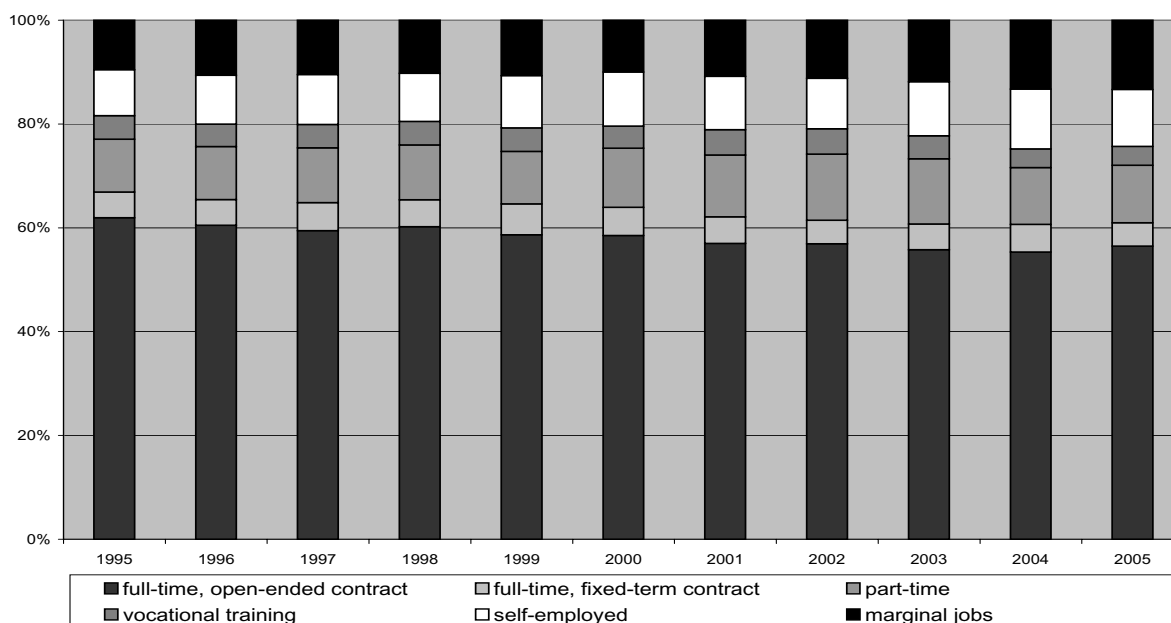
Source: Bundesagentur für Arbeit (BA)

Table 1: Employment and unemployment in 2005 and 2000

	Germany	Austria	Switzerland	Denmark	EU-15
Average real growth of GDP 2000-2006	1.30	1.80	1.70	2.00	1.90
Employment (2000 =100)	99.30	101.00	103.20	100.90	106.40
Employees in % of the employable population	65.4 (65.6)	68.6 (68.5)	77.2 (78.3)	75.9 (76.3)	65.2 (63.4)
- Women	59.6 (58.1)	62.0 (59.6)	70.4 (69.3)	71.9 (71.6)	57.4 (54.1)
- Men	71.3 (72.9)	75.4 (77.3)	83.9 (87.3)	79.8 (80.8)	72.9 (72.8)
- older people (55-64 years)	45.4 (37.6)	31.8 (28.8)	65.0 (63.3)	59.5 (55.7)	44.1 (37.8)
- youth (15-24 years)	42.6 (48.4)	53.1 (52.5)	59.9 (65.0)	62.0 (67.1)	39.7 (40.8)
- Low-skilled workers	48.6 (50.6)	52.2 (53.8)	66.1 (65.5)	62.0 (62.5)	57.5 (53.9)
Average year of exiting the work force	61.3 (60.6)	59.8 (59.2)	62.5 (63.9)	60.9 (61.6)	61.1 (60.3)
Standardized unemployment rate in %	9.5 (7.2)	5.2 (3.6)	4.5 (2.7)	4.8 (4.3)	7.9 (7.6)
Long-term unemployed as a share of total unemployment in %	54.0 (51.5)	25.3 (25.8)	38.8 (29.0)	25.9 (20.0)	44.3 (46.9)

Notes: Data for 2000 in brackets; GDP: Average of the yearly changes in 2000 until 2006; EU average restricted to the Euro zone; the top values for the employment of low-skill workers are from 2004; likewise for exiting the workforce in Germany; bottom values for exiting the workforce are from 2001.

Source: OECD Employment Outlook, OECD Economic Outlook.

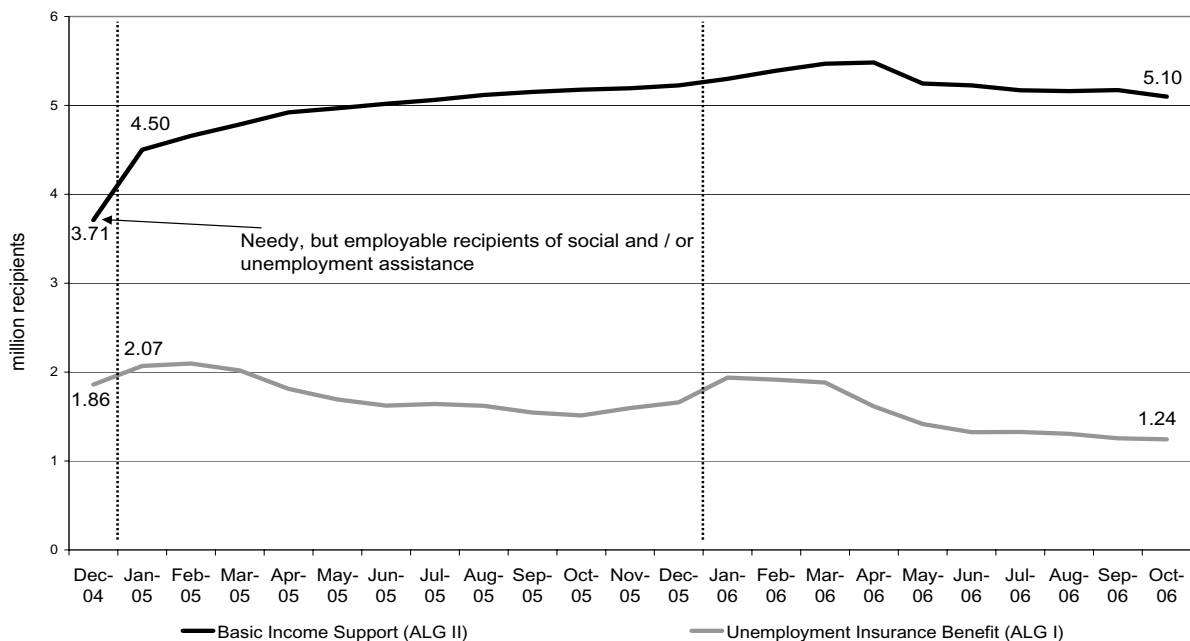
Figure 2: Structure of employment forms in Germany, 1995-2005

Source: SOEP, own calculations.

Employment forms that benefit from tax law, subsidies or less stringent labor law regulations become more important.

At the same time, there has been no success in reducing the dependency on subsidies among long-term unemployed. Figure 3 shows the opposite trend among the number of recipients of unemployment insurance benefits (ALG I) and basic income support (ALG II). While there is a perceptible reduction of the number of recipients among short-term unemployed – which can be explained by the modified procedures of the Federal Employment Agency and the improved economic situation – the recipients of basic income support (ALG II) benefit less from the recent economic boost. This holds true when considering the fact that slightly more than a million welfare recipients additionally work jobs that fail to secure their livelihoods, receiving additional benefits from basic income support (ALG II) (Federal Employment Agency 2007). But apparently there still exist massive problems with the labor market reintegration of long-term unemployed persons with low or devaluated job qualifications.

Figure 3: Unemployment insurance and unemployment assistance recipients



Source: Bundesagentur für Arbeit.

2. Main Findings of the Three Country Studies

The three reports from Switzerland, Austria and Denmark show a more favorable balance concerning labor market policies in multiple aspects. Without overestimating the coherence of the foreign “Success Models,” the following points are nevertheless remarkable:

1. All three of the comparison countries are successful regarding labor market policy, even though the generosity of their social benefit programs in the case of unemployment is similar to Germany’s. Indeed, Austrian unemployment insurance benefits have a relatively short duration and are somewhat smaller. In the case of longer unemployment, though, the benefits last for a longer duration and recipients can demand relatively high subsidy payments. In Switzerland, relatively high benefits from unemployment insurance can be obtained as well. The same holds true for Denmark, even though only low-income earners can expect a high wage replacement rate. Austria, and with some reservations Denmark, have also used income replacement benefits for the purpose of early retirement (early retirement in Denmark, disability pensions and old-age pensions in Austria). Comparatively large transfer payments generate incentive problems, though, if they are granted for extended periods and are not combined with a strict activation scheme.
2. For this reason, the three states follow a clear strategy of activating their benefit recipients. During recent years, receipt of wage replacement benefits was made more dependent on the participation of jobseekers, both in theory and in practice. Criteria for reasonability and availability were tightened; sanctions were imposed more often, even though a comparison of the relative “strictness” of activation strategies is still difficult. But in principle, receiving wage replacement benefits is dependent on the active participation of the benefit recipients. On the whole, available evidence points to the conclusion that a policy of consistent “support and demand” helps to make the switch from unemployment to employment. The evidence for this is also more clear-cut than for purely “supporting” measures of active labor market policy. Target groups for activation were expanded over time, especially including groups of long-term unemployed and welfare recipients. Incentives for early retirement in Denmark and Austria were reduced as well. This coincides with a reorganization of the responsible agencies and the change to goal-oriented governance (especially in Switzerland and Austria).
3. Unlike in Anglo-Saxon countries, all three of the examined countries’ in-work benefits – in contrast to temporary wage subsidies for employers – play only a marginal role. A remarkable exception is the “subsidized temporary employment” (Zwischenverdienst) in Switzerland, which is responsible for a partial increase of low earnings during periods of job search or unemployment.
4. The comparison countries benefit from different patterns of labor market flexibility, which, when evaluated together, result in a more flexible labor market than in Germany. This shows that an alternative mechanism of flexibility can lead to similar results in the labor market – assuming the overall flexibility is sufficient.
5. Regarding dismissal protection, all three countries have less strict laws than Germany. The regulation of the labor market is especially liberal in Denmark and Switzerland. In Austria, the recently introduced severance pay model makes a layoff by the employer easier as well.
6. Additionally, Austria has a distinct macroeconomic real wage flexibility within a coordinated negotiation system. At the same time, there exists a pronounced wage differentiation by age, sex or education. The

Swiss arrangement of decentralized, internal wage negotiations and the Danish system of “coordinated decentralization” are similarly adaptable to internal or external shocks. The almost universally binding collective wage agreements in Denmark and Austria result in virtual minimum wages, whereas in Switzerland part of the labor market is affected by generally-binding agreed minimum wages. On the whole, however, this does not constitute a noteworthy restriction of the flexibility of the respective labor markets.

7. Financing the welfare state leaves a much lower burden on employers in Denmark and Switzerland than in Germany and Austria, which use a social security system that is financed by contributions. The Danish welfare system is funded mostly by income and consumption taxes, which, apart from transfer payments, primarily provide services to the public. In Switzerland, company pension plans and private savings are the most important, for example financing health insurance via a “per-capita fee” (Kopfpauschale) or the supplemental payments for old-age provisions.

It is especially noteworthy that a somewhat generous unemployment insurance scheme does not create any negative incentives to work or foster unemployment if it is linked to a forceful activation scheme. In addition, the labor market on the whole has to be sufficiently receptive and flexible. That aspect of the labor market still needs adjustment in Germany.

Even though the three comparison countries are significantly smaller than Germany, one can use insights about the interactions of the different safety mechanisms and the funding of the welfare state for a labor market reform in Germany. This does not mean that a foreign welfare state model or “good practices” should simply be copied, but it should help formulate first principles of a functional em-

ployment policy and reform elements that are compatible with each other and promise an improvement in employment and growth. Nonetheless, Germany’s institutional requirements must always be kept in mind.

3. Major Policy Areas

The country analyses demonstrate how safety mechanisms against labor market risks (e.g. unemployment insurance, employment policies and labor market regulation) affect the functionality of the labor market and their effects on employment and unemployment structures. Further proof can be obtained from international studies (Bassanini/Duval 2006, OECD 2006).

The examples of Denmark, Switzerland and Austria, however, emphasize the importance of a sufficient adaptability of the labor market to structural and cyclical fluctuations. An appropriate combination of institutional frameworks can realize social security objectives without having an impact on the flexibility of the labor market. This allows for the prevention of long-lasting structural imbalances in the labor market. The main challenge is to turn welfare recipients into taxpayers and contributors to the welfare state.

3.1 Active labor market policy and transfer payments

With the implementation of the Hartz reforms, German active labor market policy underwent a fundamental shift, which is now on a similar level to the developments in other European countries (including the three presented). For a long time, active and passive labor market policies were mainly used to cushion problems in the labor market and to hide the true level of unemployment. Efficiency of labor market policies regarding reintegration into the workforce was not the primary objective, which led to a long period without a systematic evaluation of labor market policy.

The most recent reforms have changed the situation fundamentally. On the one hand, the instruments of labor market policy changed. This included a greater utilization of private service providers, mechanisms that mimic market behavior (for example training and placement vouchers) and an increase in

business startup grants. On the other hand, the Federal Employment Agency was restructured and a goal-oriented form of governance was implemented. Finally, the principle of activation was anchored in the policy for the first time (e.g. raising reasonability or availability criteria), following the example of other countries – even though the handling of sanctions or reasonability criteria has been rather reluctant up to now. “Hartz IV” started a relatively stronger activating strategy of unemployment benefits and welfare, which was linked to the replacement of earnings-dependent unemployment benefits with a flat rate and a means-tested unemployment assistance scheme (ALG II). This step was exceptionally remarkable in its scope (especially when compared to other countries), because it brought all employable welfare recipients equally into the activation scheme. A similar measure has now been implemented in Denmark. It came along with a change in administrative structures (work groups and “option communities”). Another first is that the effects of the reforms are systematically evaluated.

The final evaluation reports for the first three Hartz laws are already available. These laws contain the reforms dealing with policies for recipients of Unemployment Benefits I. A more robust evaluation of the efficiency of the different instruments is now possible (see Bundesministerium für Arbeit und Soziales 2006, Kaltenborn/Knerr/Schiwarov 2006, Schneider 2006, Eichhorst/Zimmermann 2007, Eichhorst/Schneider/Zimmermann 2006, Jacobi/Kluve 2006) One can observe that four of the economic policies have a positive effect: a) the placement voucher, b) publicly funded training schemes, c) business startup grants, d) hiring subsidies for employers. One has to consider significant windfall gains when evaluating the last twopolicies. Other instruments have had either no or a negative effect on employment opportunities. A large part of labor market policy has yet to be evaluated, though. The scientific

evaluation analysis of “Hartz IV” is still at the beginning.

There are many reasons to significantly reduce the amount of the currently 60 to 90 labor market instruments and to concentrate on the effective measures.

It makes sense to combine this with a reorganization of the agents in charge of labor market policy in SGB II and SGB III. Forceful, goal-oriented governance, similar to the system in place in Austria and Switzerland, should be combined with a shift of the decision-making authority regarding resources and policies to the regional or local level. At the same time, this must be linked with the responsibility for achieving targets and the resulting budgetary consequences. Such a system would make a legalization of details regarding instruments of labor market policy unnecessary, because the agents have a clear interest in using effective and efficient measures (Eichhorst/Zimmermann 2007, Eichhorst/Schneider/Zimmermann 2006).

In the SGB II (i.e. the supervision of long-term unemployed and other recipients of Unemployment Benefits II), such a decentralized structure already exists. In addition, the SGB II has fewer rules regarding economic policy instruments than the SGB III. There are, nevertheless, serious governance problems – not only in the work groups, but first and foremost at the intersection of Unemployment Benefits I and II.

In the current system, the Federal Employment Agency has few incentives to care about the early application of suitable policies to integrate the long-term unemployed. This can be solved by removing the supervision structures from these type of entitlements and creating decentralized units with decision-making and budgetary responsibilities, which have to compete in regard to their goals (benchmarking).

Apart from organizational problems, the consistent activation of Unemployment Benefit II recipients is lacking. Compared to the international standard, the transfer from unemployment and welfare benefits to Unemployment Benefits II has conserved a rather generous system of income security in the case of long-term unemployment or non-employment. But it has stressed the principle of activation in order to end the benefit period as soon as possible. It is especially difficult to provide proper incentives to larger families or low-skilled workers because transfer payments are equally high, if not higher than realistic earnings expectations on the regular job market. Moreover, there are significant incentives to use the existing possibilities to gain additional earnings to the transfer payments by working few hours and/or for low wages. In this sector, changes in the hourly wage or in hours worked have only marginal effects on disposable income. Therefore the indifference to wage reductions is high.

This problem can be solved by using the possibility given by SGB II to demand that recipients provide the equivalent of a full-time job in the form of a service as a condition for receiving transfer payments of the same value. This “workfare” (Bonin/Schneider 2006) approach deals with the benefits of leisure time and, due to the necessity to work a full-time job to gain transfer benefits, makes previously unattractive jobs in the low-wage sector viable. This principle should indeed be applied to all employable persons receiving welfare. “Workfare” utilizing public job opportunities, therefore, does not create a publicly-financed “third labor market” to which difficult-to-place unemployed get assigned permanently, but is based on the assumption that a large percentage of these individuals will find employment on the regular, non-subsidized labor market. Only a small proportion will remain dependent on permanent benefits – about 300,000 of the currently 2.6 million registered recipients of Unemployment Benefits II.

The workfare principle is an effective and attractive alternative to in-work benefits and minimum wages. In-work benefits are only effective when lowering the level of welfare benefits (as proposed by Sachverständigenrat 2006, Sinn et al. 2006). This has been demonstrated by IZA simulations and numerous other studies. If the welfare level is to be maintained at its current level, then an in-work benefit approach is expensive and ineffective. Without in-work benefits and similar components of the welfare scheme, the introduction of a minimum wage is unnecessary as well.

An activation strategy also incorporates the instrument of the Swiss *Zwischenverdienst* (Gerfin/Lechner/Steiger 2005), which provides a temporary income raise when performing low-wage jobs during periods of unemployment. Due to their contact with the labor market and potential employers, recipients of *Zwischenverdienst* have an easier time finding a new job than other unemployed persons. This marks the difference between the *Zwischenverdienst* and the wage replacement insurance of the elderly, which has a similar concept, but is scarcely utilized and does not

have significant effects (Ammermüller et al. 2006).

In this context, it is also appropriate to prolong the working life by reducing the number of early retirement models, shortening the benefit period for Unemployment Benefits I and raising the legal retirement age to 67 years. Those steps reduce the burden on social security systems and generate additional welfare contributions and tax payments through a higher employment rate. The labor market will adapt to these changes, which will lead to a “normalization” of the employment rate among the elderly, which has been intentionally lowered since the 1980s (Eichhorst 2006). It is important to continue the reforms consistently and to remove the remaining incentives for early retirement (e.g. the partial retirement scheme in its current form or the rule that makes it unnecessary for older unemployed persons to be available to the labor market).

3.2 Taxes and contributions

Regarding taxes and contributions, Germany has one of the highest tax burdens – both

Table 2: Net replacement rates during unemployment, 2004

		Germany	Austria	Switzerland	Denmark
Average income earner, single	1st month	61	55	70	61
	60th month	60	51	55	59
Average income earner, married, two children	1st month				
	- one income	77	71	81	73
	- dual income	91	82	87	77
	60th month				
Low income earner, single	1st month	62	55	80	84
	60th month	81	66	80	81
Low income earner, married, two children	1st month				
	- one income	82	76	82	89
	- dual income	93	86	88	94
	60th month				
Low income earner, married, two children	1st month	84	96	108	91
	- dual income	66	74	58	71

Note: Data of average income earners with earnings as high as the average within the manufacturing industry, low income earners with 67% of the average income.

Source: OECD.

when compared to other countries and within the European context. This applies to various income levels and household structures. As a result of the dominant position of social insurance in the German welfare state, a large part of the burden of taxes and contributions is still due to social security contributions, i.e. non-wage labor costs.

High taxes and contributions tend to impede the creation of employment, and for this reason add to the problems of the labor market, which in turn results in higher unemployment and a greater dependency on transfer payments. The negative effect on employment in the services sector and in the sector of low-skilled work is especially high.

At the same time, the share of tax revenues used to finance social security rose over the

last years – from 31.4 to 38.7 percent between 1991 and 2005. Prominent steps in this direction were the introduction of the environmental tax on gas, fuel and electricity (“Ökosteuern”), the subsidization of health insurance and the most recent VAT raise. But even the shift of the main focus of income replacement benefits and active labor market policy from SGB III to SGB II reinforces this development. However, a significant reduction of social security contributions could not be achieved. At least the burden of contributions could be reduced below 40 percent in 2007 for the first time since the 1990s. Still, the ratio between contributors and benefit recipients remains unfavorable. In addition to a continuation of the policy to raise the welfare level (combined with additional private or corporate provisions) and a greater funding via taxes, as well as structural re-

Table 3: Tax wedges for average- and low-income earners, income tax, contributions of employers and employees in% of labor costs, 2005

	Germany	Austria	Switzerland	Denmark
Average income earner, single				
Average burden of contribution	51.8	47.4	29.5	41.4
	(-4.1)	(-0.2)	(-1.6)	(-7.0)
1. income tax	17.3	10.9	9.6	30.2
2. Contribution to social security. employee	17.3	14.0	10.0	10.6
3. Contribution to social security. employer	17.3	22.6	10.0	0.5
Marginal burden	65.1	57.3	36.0	49.2
Low income earner, single				
Average burden of contribution	46.7	42.5	26.7	39.3
	(-4.1)	(-1.6)	(-2.2)	(-4.8)
Marginal burden	59.7	57.3	34.0	42.9
Low income earner, single parent, two children				
Average burden of contribution	33.8	24.6	13.1	13.8
	(+0.0)	(-2.0)	(-1.5)	(-10.9)
Marginal burden	57.9	57.3	29.0	42.9
Average income earner, married, two children				
Average burden of contribution	35.7	35.5	18.6	29.6
	(-4.5)	(+0.8)	(+0.5)	(-4.7)
Marginal burden	56.1	57.3	31.7	43.7
Average income earner, married, two children, second income of 33% percent				
Average burden of contribution	40.9	36.7	21.0	34.5
	(-4.6)	(+1.1)	(-0.5)	(-4.9)
Marginal burden	59.6	57.3	33.3	43.7

Note: Data of average income earners with earnings as high as the average within the manufacturing industry, low income earners with 67% of the average income.

Source: OECD.

forms to improve the efficiency of the health care system, a policy of integrating people into the labor market is pivotal.

3.3 Wage setting and collective bargaining

Transition to a flexible labor market has two dimensions in this context: On the one hand, flexibility regarding wages and work hours and, on the other hand, legal flexibility concerning the creation and termination of employment contracts.

Regarding wages and work hours, which are still mainly regulated through the collective bargaining parties on a sectoral level, flexibility in Germany has made clear improvements. This is true for various aspects:

1. During the last years, greater flexibility was realized in the collective bargaining system, especially because of the increased utilization and availability of the scope for organizing work via deviations from collective agreements by using exemption clauses and establishment-level wage agreements. This applies to wages as well as the organization of work hours. At the same time, the policy of transferring working hour agreements to the firm level led to a reversal of the previous trend toward shorter workweeks. Data from the IAB Establishment Panel show that for 2005, 13 percent of businesses with collective pay commitment could use exemption clauses. These companies provided employment for 29 percent of western Germany's and 21 percent of eastern Germany's employees. Approximately half of those companies did use the exemption clauses, particularly when facing operational difficulties and then mainly to affect work hours, rarely changing wages (Schnabel 2005, Kohaut/Schnabel 2007).
2. Flexibility of wages and working hours did not only increase in the economic sector affected by collective labor agreements.

The continuous decline of employment contracts subject to collective agreements also contributed to the increasing importance of firm-level agreements. In western Germany the share of employees with contracts bound to collective agreements dropped in the years 1995-2005 from 72 to 59 percent. In eastern Germany the share dropped in the years 1996-2005 from 56 to 42 percent. However, one can observe that employment contracts of almost half the employees in firms not bound by collective agreements are geared toward those agreements (Kohaut/Schnabel 2007).

3. The overall development of real wages in recent years was very moderate even without an explicit inter-sectoral coordination, which led to an improvement in international competitiveness and, therefore, to a stabilization of the employment situation – especially in the manufacturing industry. The situation also benefited from longer work hours without wage compensation.
4. In addition to the moderate overall wage development, one can observe an increase in wage dispersion, especially as the proportion of low-wage employment has increased in Germany. This phenomenon can primarily be observed in employment relationships outside of collective labor agreements, with jobs supplying only a second income (marginal jobs), or jobs providing an additional income to welfare (Unemployment Benefits II). Wages below €6.00 per hour – according to data from the SOEP – applied to only 3 percent of full-time employees, but to 21 percent of marginal workers (not including retirees, unemployed persons and students) as well as 23 percent of the economically-active unemployed in 2005 (Brenke/Eichhorst 2007).

With the exception of institutional regulations concerning additional income (such as earnings disregard clauses), these develop-

ments can be attributed to the actions of corporations, works councils and the collective bargaining parties – not to legislative action. From the point of view of employment policy, these developments should continue and should not be impeded by political interventions. The collective bargaining parties have displayed a large degree of flexibility. This means that a necessity for legal changes – for example with the determination of the *Günstigkeitsprinzip* (principle of the most favorable condition for the employee) or the enforcement of exemption clauses without being subject to agreement of the collective bargaining parties – is even lower than a few years ago.

This also applies to the question of wage dispersion. In recent months, political ambitions to expand the applicability of generally-binding collective minimum wage agreements through the law on the posting of workers, or with the establishment of a legally binding minimum wage, have become significantly more pronounced. Given the still high unemployment rate among low-skilled workers and the large share of long-term unemployed, the German labor market must provide labor market entry opportunities via low-wage jobs. Otherwise, long-term unemployment and transfer dependency will persist. This is why a legal minimum wage would make no sense economically. This is especially true if minimum wages were binding for the entire sector due to the “universality” principle of the law on the posting of workers. Pursuing a strategy of reintegrating workers with low or devaluated skills due to long unemployment is not compatible with the creation of additional entry barriers like minimum wages.

At the same time, the incentives to work part-time for very low hourly wages that currently exist in the welfare scheme and the preferential tax treatment of marginal jobs should be removed over the long term. This means the abolishment of marginal jobs, a limitation of the earnings disregard clauses and the force-

ful enforcement of the principle of accepting a full-time job in return for benefit receipt (“workfare”) among all employable recipients of Unemployment Benefits II. High minimum wages are incompatible with improved possibilities for the long-term unemployed to enter the labor market.

3.4 Regulation of the labor market

A look at the regulation of the labor market yields a contrasting picture. On the one hand, labor law still largely focuses on the stabilization of employment relationships and protection against dismissal. Internationally comparative OECD estimates demonstrate that the system of job protection in Germany is one of the more restrictive systems, which is mainly due to a complicated and time-consuming layoff procedure and the associated legal uncertainty (OECD 2004). However, contrary to a lot of other countries, there is no legally-guaranteed severance pay in the case of dismissal – apart from the exception introduced in the most recent reform, which gives the employee a choice between severance pay and an employment lawsuit. The introduction of this option should lead to increased bargaining for high severance pay in return for not filing a suit. In other respects, job protection has been only marginally modified in recent years, for example by repeated modifications of the minimum establishment size for layoff protection or the social fairness criteria (Jahn 2005). On the whole, job protection in Germany creates high transaction costs in the form of complex proceedings and legal uncertainty. This can influence the willingness to offer open-ended job contracts in favor of alternative forms of employment.

Fixed-term contracts and temporary employment displayed stronger flexibility tendencies, even though both models of employment are affected by re-regulation steps in opposite directions. For example, restrictions concerning short-term employment have been

eased over the long term, but the most recent reform of the part-time and temp work law has made it difficult to renew temporary contracts without justification. The Hartz reforms lifted several important limitations of part-time employment – but at the same time, the principle of equal treatment was introduced, which can only be circumvented via collective wage agreements. As a result, the temp work sector has been affected for the first time by collective wage agreements, which will possibly become mandatory in the near future. On the whole, the outcome is an above-average level of regulation on the flexible forms of employment.

National and international research demonstrates that changes in labor market regulation do not have a significant effect on the level of employment and unemployment (OECD 2006, Bassanini/Duval 2006). This also applies to small modifications to dismissal protection (Bauer/Bender/Bonin 2004).

But it is true that different levels of regulation with regard to dismissal protection, fixed-term and temporary employment, but also marginal jobs or self-employment influence the attractiveness of the different forms of employment. The more restrictive the regulations of an employment form and the easier the use of alternative forms, the larger the expansion of flexible employment forms. This correlation can also be demonstrated for Germany. At the same time, one can observe that the respective forms of employment have different entry barriers for certain la-

bor market groups, and transitions between different segments of the labor market can be problematic (cf. e.g. Fertig/Kluve 2006). This tends to negatively affect young employees or women who return into the labor market after a career interruption, but also individuals who enter the labor market after a period of long-term unemployment or non-participation.

A strongly regulated labor market comes along with longer employment durations at the core of the labor market, while periods of unemployment and short-term employment are concentrated at the margin. For stability of employment at the core, one has to pay with uncertainty and a greater risk of unemployment at the margin as well as a higher probability of long-term unemployment. For example, in the year 2000, the average duration of an employment contract was 8.3 years in Denmark compared to 10.5 years in Germany (Auer/Cazes 2002), but the percentage of long-term unemployed in Denmark was only 20 percent compared to more than 51 percent in Germany. A labor market that is flexible on the whole distributes the risk of unemployment more evenly. Facing a situation of an accelerated structural change, driven by technological developments and a proceeding worldwide integration, it is especially important to expand the flexibility of the labor market and to ease the reintegration into the labor force.

Compared to a situation with different levels of regulations and flexibility depending on the

Table 4: Regulation of the labor market, in 2003 and at the end of the 1990s

	Germany	Austria	Switzerland	Denmark
Dismissal protection	2,7 (2,7)	2,4 (2,9)	1,2 (1,2)	1,5 (1,5)
Fixed-term contracts	1,8 (1,8)	1,8 (1,8)	1,3 (1,3)	2,3 (2,3)
Temporary employment	1,8 (2,8)	1,3 (1,3)	1,0 (1,0)	0,5 (0,5)
Overall intensity of regulation	2,2 (2,5)	1,9 (2,2)	1,1 (1,1)	1,4 (1,4)

Note: Data for late 1990s in brackets. Source: OECD Employment Outlook 2004.

form of employment, a unified employment law is preferable. At the same time, however, the unified law should become more flexible to allow easier entry and switching between employment forms and positions.

One of the prerequisites is a systematic reform of the employment protection law to find an efficient solution which accounts for the job protection concerns of employees as well as the employers' interest in legal certainty.

A possible solution is replacing employment protection with an entitlement to severance pay dependent on job tenure and wage level. The Austrian model of a new pay-as-you-go scheme for severance pay (Abfertigung neu) serves as an example of how to reduce the occurrence of labor lawsuits. Also notable is the positive Austrian experience with "employment foundations" (Arbeitsstiftungen) in the case of mass layoffs, which support reintegration by helping dismissed workers with publicly-funded training or reeducation schemes, job placement or business startup grants. Positive long-term effects can be observed (Winter-Ebmer 2001), contrary to similarly-structured transfer payments in Germany, which at least during the short observation period did not show positive effects on labor market integration (IZA/DIW/infas 2006). A relaxation of dismissal protection should be considered if it is accompanied by the effective reintegration programs that are (partly) financed by the employer.

Such a systematic reform is preferable to replacing dismissal protection during the first two years of employment with expanded possibilities of a layoff without proper cause. This would not affect long-time employees at all.

4. Outlook

The international comparison demonstrates that by combining forceful activation schemes and higher labor market flexibility, structural improvements to the employment-unemployment ratio are possible. Germany achieved progress in these aspects as well, which should be continued consistently.

This means:

1. Employable persons receiving social benefits should not only formally but also in practice be tied to the principle of reciprocity (“workfare”), i.e. the duty to accept job offers or publicly funded work opportunities as well as to conduct extensive private search efforts. In principle, there should be no exceptions for persons of working age. The available means are sufficient to pursue this strategy.
 2. A consistent activation via “workfare” can only be successful without an ambitious in-work benefit scheme. Therefore, the existing incentives to work part-time (earnings disregard clauses) in the welfare legislation must be reduced. Without a reduction in the basic welfare level, an in-work benefit approach will be ineffective and expensive.
 3. Successful reintegration of the unemployed requires a flexible labor market that is receptive enough to offer a sufficient number of entrance and career opportunities. This implies a simplification of dismissal protection and the transition to a generalized regulation of all forms of employment in order to reduce incentives for atypical employment forms with poor career prospects. It also implies avoiding new entry barriers to like a legal minimum wage.
1. Education and advanced training: A highly-qualified labor force is of great importance for long-term growth and increased employment. The higher the qualifications and the more flexible they are to changing requirements, the lower the risk of long-term unemployment. In the near future, the primary focus should be to solve the problem of insufficient qualifications of labor market entrants and the massive shortcomings of on-the-job training. This would help prevent transfer dependency and reduce the strain on the social security systems. Likewise, the calls for in-work benefits and minimum wages would subside.
 2. In Germany, there still exists a conflict between family life and a professional career. By international standards, the decline of the labor market participation of mothers of small children compared to childless women is particularly significant. The consequence is a shortage of qualified workers and individual career opportunities. To prevent this, the childcare system must be tailored to actual needs while at the same time the tax and transfer system must strengthen the incentives for mothers to become secondary wage earners. This implies a reform of the preferential tax treatment of married couples and the abolishment of marginal jobs.
 3. Last but not least, a systematic immigration policy based on labor market needs still remains on the agenda. It could help overcome the existing and growing shortage of high-skilled workers.

In addition to the fields analyzed above, at least three further aspects are of great importance for the medium- and long-term development in Germany:

Overall, Germany has taken clear steps with the Hartz reforms toward a labor market that is more focused on integration and an activating labor market policy, combined with a limited improvement of the flexibility of the labor market. This path of action should be followed persistently. This requires a forceful implementation of the available activation

instruments (“workfare”) on the one hand, and a further improvement of labor market flexibility on the other.

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