

The evolution of labour market- related expenditure

Labour market developments influence government expenditure in a number of ways. They affect spending on wage substitutes, means-tested social transfers and active labour market policy as well as the level of revenue from taxes and social security contributions. Alongside cyclical developments, the most significant influences over the past ten years have been the increase in long-term unemployment and, more recently, the reduction of active labour market policy measures, which were widely considered unsuccessful. Although the Hartz IV reform of the labour market entails higher spending by central government, the associated rise is much smaller for general government as a whole. The reform has made the transfer system both more transparent and more consistent. The adopted measures to restrict unemployment benefit and curb active labour market policy will ease pressure on government budgets in the future. Nevertheless, a clearer segregation of insurance benefits on the one hand and transfer payments on the other remains a key requirement. In addition, the optimisation and consistent implementation of existing policy instruments, coupled with further labour market flexibility, appear more promising than experimenting with new subsidised and minimum wage models. The contribution rate to the Federal Employment Agency should be set at a level that ensures that the system can also cope with economic downturns.

*Multiple links
between
government
and labour
market*

General government and the labour market are closely intertwined. Alongside the public sector's role as a major employer, government activities exert short, medium and long-term effects on macroeconomic developments and hence also on employment. However, the government also has a decisive impact on labour market regulation; moreover, the taxation and transfer system plays a key role in the incentives to recruit or accept a job offer. On the other hand – and this is the focus of this article – labour market developments also affect government budgets in several ways. Rising unemployment figures mean lower tax and social security revenue. Moreover, they entail higher spending, in particular, on wage substitutes or means-tested social transfers. Likewise, active labour market policy measures also have an impact on government budgets.

Overview of labour market-related burdens on government budgets between 1995 and 2005

*Determinants
of labour
market-related
burdens on
public finances*

In recent years, the development of labour market-related burdens on government budgets has been subject to both cyclical and structural influences. Thus on the one hand, the upswing around the start of the millennium led temporarily to a perceptible easing of the pressure on public finances. On the other hand, structural unemployment expanded noticeably between 1995 and 2005, which was reflected in a rise in long-term unemployment. This period was also marked by a mass of new legislation, particularly the

Hartz Acts (for a summary, see the annex on p 79).

On the expenditure side, labour market developments mainly have an impact on unemployment benefit (unemployment benefit I), unemployment assistance (unemployment benefit II since 2005) and active labour market policy measures. Social assistance and corresponding housing allowances for persons able to work and their dependants can also be included here (until the end of 2004), although they can be estimated only roughly. Total expenditure defined in this way rose from just under €81 billion in 1995 to €97 billion in 2005. As a share of GDP, it amounted to almost 4½% both at the beginning and end of the period under review, although it dipped considerably to below 4% in 2000 and 2001 (see the chart on page 61). A shift in the financing burdens towards the central government budget occurred over time, mainly in connection with the increase in long-term unemployment, the curbs on active labour market policy and the Hartz IV reform.

*Large
fluctuations in
labour market-
related
expenditure*

The fiscal burdens generated by unemployment also stem from lower tax and social security receipts. According to estimates made by the Institute for Employment Research (which are not fully comparable with the above definitions and calculations), these lost receipts amounted to around €40 billion in 2004; social security contributions accounted for roughly three-fifths and tax receipts for two-fifths of this total. Estimates for the revenue side invariably encounter greater methodological difficulties and should therefore be

*Fiscal burdens
on the revenue
side harder to
measure*

interpreted with caution (see box on page 62f). This article will focus on developments in expenditure.

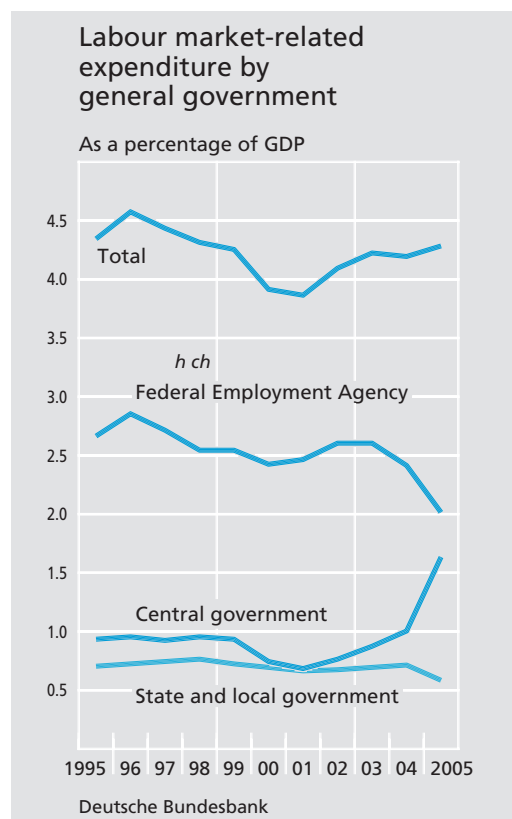
Federal Employment Agency: financial protection against temporary unemployment

*Social insurance
against
temporary
unemployment*

The Federal Employment Agency provides protection against the risk of a loss of income due to temporary unemployment, which is financed by contributions. As is typical of social security schemes, contributions are not differentiated according to an individual risk assessment. In addition, the Federal Employment Agency funds numerous labour market policy measures encompassing rehabilitation, training and job creation. It is also the public agency responsible for finding work for the unemployed.

*Federal
Employment
Agency's
income and
expenditure
structure*

The Agency's principal source of funds is earnings-related contributions from those employees liable to them (these accounted in the past for between 80% and 90% of total revenue). They are payable in equal measure by the employee and employer. Since 1993, the contribution rate has remained at 6.5%. Additional funds come notably from central government liquidity assistance during the year, which hitherto has been converted into a grant at year-end if the Agency's financial situation precludes repayment. In the past, fluctuating income and expenditure was regularly offset by the Federal grant as the Agency had no available reserves of note. Unemployment benefit I accounts for about half of all expenditure, while active labour market



policy represents between 30% and 40%. The Agency also incurred administration costs. Among its further expenditure, it paid insolvency benefits and payments related to phased retirement (see table on page 64).

The macroeconomic trend is of crucial importance for the Agency's finances. The favourable economic climate at the turn of the century spurred a temporary marked recovery on the labour market. Accordingly, the Agency's deficit bottomed out at just under €1 billion in 2000, after it had peaked at €7 billion in 1996, and again at just over €6 billion in 2003.

*Crucial
importance of
macroeconomic
development
for finances*

Unemployment benefit I

Unemployment benefit I is a temporary wage substitute paid to workers who lose their

The fiscal costs of unemployment according to calculations made by the Institute for Employment Research (IAB)

The fiscal costs of unemployment are reflected in the public sector budgets both on the expenditure side (in contribution-funded insurance payments and tax-funded transfer payments) and on the revenue side (in revenue losses from taxes and social contributions). This should be differentiated from the macroeconomic costs of unemployment, which cause a reduced economic output owing to unused potential production factors. The macroeconomic costs are defined much more broadly. However, it is difficult to accurately measure these costs because this especially requires having a clear idea of the potential output that can be achieved under full employment.

Only a part of the fiscal costs are also macroeconomic costs. While taxes and social contributions are paid from labour income and a reduction in their amount ensues from the reduced deployment of the production factor labour, transfers to unemployed persons are simply a redistribution of income, although they can have a stabilising effect during an economic downswing. However, these transfers do bring about macroeconomic costs to the extent that the transfers themselves and their funding cause further underemployment.

The Institute for Employment Research (IAB; *nst tut be ts a t und e u s chung*) regularly presents calculations regarding the overall fiscal costs caused by persons registered as unemployed.¹ The current calculations only go up to 2004 and therefore do not include the amalgamation of unemployment assistance and social assistance to form unemployment benefit II as of 1

January 2005. The amounts spent by the Federal Employment Agency on unemployment benefit, by central government on unemployment assistance and by local government on social assistance for persons registered as unemployed are taken into account as direct costs. This is supplemented by housing allowance payments. Revenue shortfalls from taxes and social contributions are factored into the equation as indirect costs, based on the remuneration received immediately prior to unemployment. The calculation does not include the fiscal costs of benefit recipients who are not counted as unemployed (cut-off for 58 year-olds, persons with reduced earning capacity and persons unfit for work owing to sickness).

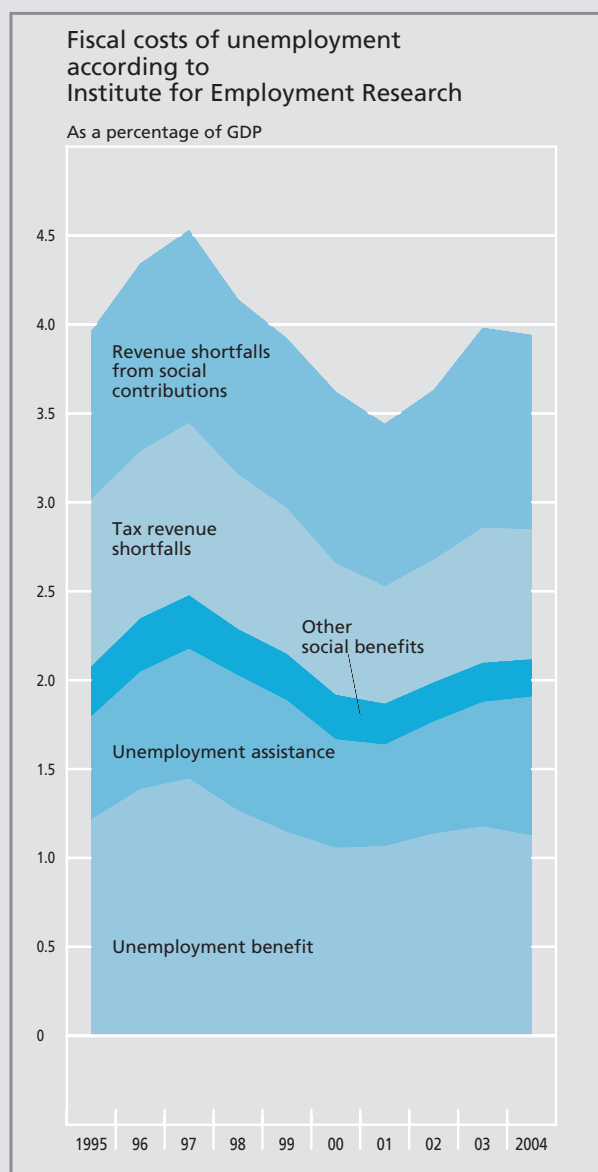
According to the calculations of the Institute for Employment Research, a person registered as unemployed in 2004 caused average expenses of €19,600 per year. Recipients of unemployment benefit accounted for the highest costs, namely about €23,000, whereas the amount for recipients of unemployment assistance was €18,900. By contrast, persons registered as unemployed who received neither unemployment benefit nor unemployment assistance caused significantly less costs (€14,700). The overall burden determined in this way amounted to just under €86 billion. About 54% of the cost was direct spending, while 46% was accounted for by revenue shortfalls – two-fifths attributable to taxes and three-fifths to social contributions.

Over time, the fiscal costs of unemployment are in line with the overall course of economic development. In 1997, they peaked at 4½% of GDP. After declining

¹ See Hans-Uwe Bach and Eugen Spitznagel, Was kostet uns die Arbeitslosigkeit?, in IAB Kurzbericht, No 10/2003.

to 3½% in 2001, they rose again to about 4% of GDP in 2003 and 2004. In this context, the importance of unemployment assistance, which is funded by central government, has particularly increased continuously. The revenue shortfalls from social contributions have also increased, whereas the tax revenue shortfalls have actually gone down slightly since 1997. While the course of development on the expenditure side is mainly characterised by cyclical fluctuations and a structural increase in long-term unemployment, tax and contribution rate changes are also a significant factor behind the revenue shortfalls. Rising contribution rates, such as for health insurance, have increased the revenue shortfalls. By contrast, the income tax cuts counteracted the effects of tax progression (fiscal drag) and ensured a certain stabilisation.

When interpreting the results, it should be borne in mind that some unemployed persons (in particular those above the age of 58, but also the hidden reserve labour force) are not taken into account in the calculations of the Institute for Employment Research. Furthermore, the calculation does not include the extensive expenditure on people who are not officially registered as unemployed because they are participating in employment promotion schemes or in training and qualification measures, or because as normal (part-time) employees, they receive top-up transfers owing to their low labour income. Because of this, the total cost is low. By contrast, the revenue shortfalls are set at quite a high level because it is to be expected that, on average, reemployment will only be possible at a lower labour income.



Trend in Federal Employment Agency finances

€ billion ¹

Item	1995	2000	2001	2002	2003	2004	2005
Revenue							
Contributions	43.1	46.4	47.3	47.4	47.3	47.2	47.0
Insolvency benefit levy	0.9	1.1	1.4	1.9	1.9	1.5	1.3
European Social Fund	0.1	0.5	0.8	0.6	0.3	0.3	0.3
Other revenue ²	2.0	1.7	1.1	1.0	1.1	1.3	4.1
Total	46.1	49.6	50.7	50.9	50.6	50.3	52.7
Expenditure							
Unemployment support	26.0	25.0	26.4	29.6	31.4	31.2	28.9
Unemployment benefit I	24.6	23.6	24.6	27.0	29.0	29.1	27.0
Short-time working benefit	0.5	0.3	0.4	0.6	0.7	0.7	0.6
Insolvency benefit	0.9	1.0	1.4	2.0	1.7	1.4	1.2
Active labour market policy measures	17.6	20.3	20.7	21.0	19.2	16.8	11.6
Vocational training ³	9.6	12.8	14.2	15.1	13.8	12.2	8.5
Job creation schemes	5.9	5.0	3.8	3.2	2.3	1.7	0.4
Occupational rehabilitation	2.1	2.5	2.6	2.8	3.0	2.9	2.6
Winter construction allowance ⁴	0.8	0.3	0.3	0.2	0.3	0.2	0.2
Benefits granted under the Partial Retirement Act	.	0.3	0.5	0.7	0.9	1.0	1.1
Compensatory payment	.	.	.	.	.	.	4.6
Other expenditure ⁵	5.2	4.6	4.7	5.0	5.1	5.3	6.7
Total	49.6	50.5	52.6	56.5	56.8	54.5	53.1
Surplus (+), deficit (-)	-3.5	-0.9	-1.9	-5.6	-6.2	-4.2	-0.4

Source: Federal Employment Agency. — ¹ D-Mark amounts converted to euro. — ² Figure for 2005 includes reimbursement of administrative costs from central government. — ³ Training initiatives including maintenance assistance or unemployment benefit for people in vocational training, Personnel Service Agencies and one-person business start-ups. — ⁴ Bad weather allowances,

winter allowances, productive winter construction allowances for employers, winter compensation payments. — ⁵ Administrative costs in particular, inflated in 2005 by the switch to unemployment benefit II; in 1995 there were still significant benefits being paid under the Early Retirement Act.

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Cyclical fluctuations in unemployment benefit I

jobs. As a result, associated spending is subject to relatively sharp cyclical fluctuations (see the chart on page 69), reaching almost €30½ billion in 1997. In conjunction with the subsequent more favourable macroeconomic trend, payments fell to €23½ billion by 2000, then rebounded to €29 billion in 2003 and 2004, mainly as a result of the economic slowdown. In 2005, payments declined once again, by €2 billion.

Number of recipients decoupled from the number of unemployed

It should be noted that spending on unemployment benefit I is not directly related to the number of registered unemployed. Instead, it depends on the number of insured people who have been laid off relatively recently and on the average benefit payment. The number of recipients (see the chart on page 65) has declined rapidly, particularly

since 2004. However, this has far more to do with the expiry of individuals' eligibility for unemployment benefit I as a result of ongoing unemployment than with any brightening on the labour market. Hence, the decoupling of unemployment benefit I spending from the total unemployment figure that has been seen of late primarily reflects growing long-term unemployment.

Since 1994, unemployment benefit I has been set at 60% of the recipient's previous standardised net earnings. If the recipient is the parent or guardian of at least one child, this rises to 67%. However, there was a sharp rise in individual entitlements following a ruling by the Federal Constitutional Court in 2000 which found that bonus payments had to be included in the earnings base from which

Unemployment benefit I rates

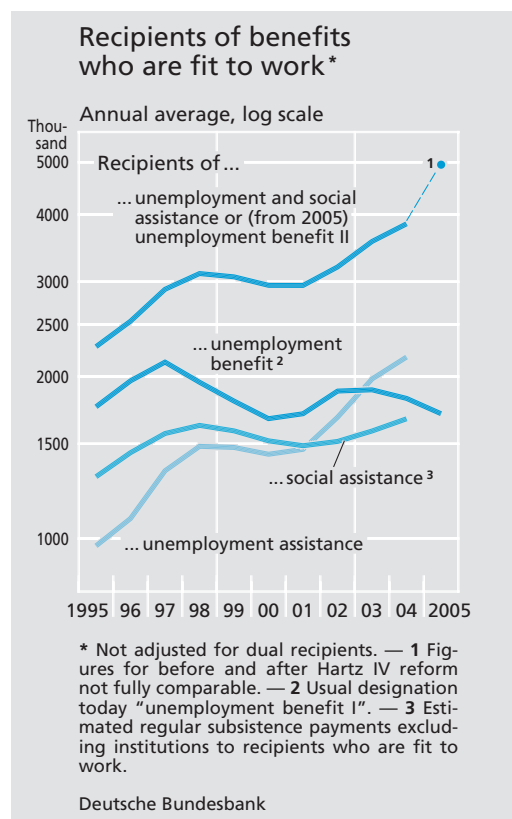
benefits are calculated.¹ The average monthly payment rose from €1,150 in 1995 to just over €1,300 in 2005 (including contributions to the statutory pension, health and long-term care insurance schemes). At 13%, the increase was somewhat greater than the rise in gross salaries and wages per employee. The maximum period of entitlement – which has since been reduced – was between 6 and 32 months depending on a person's age and the period they had been insured.

Active labour market policy and the effects of Hartz IV

Volatile expenditure on active labour market policy

Initially, 1997 saw a significant reduction in the Federal Employment Agency's spending on labour market policy. However, this was quickly followed by an exceptionally large increase in 1998, an election year. In the following three years, spending stabilised at a high level, although this concealed a marked shift away from job creation measures towards training initiatives. Since 2003, spending on active labour market policy measures has tapered off substantially and recently stood at its lowest level since 1990. Whereas the Agency also financed labour market policy measures for recipients of unemployment assistance until the introduction of the basic allowance for job seekers (Hartz IV), responsibility for such measures was transferred to central government in 2005. However, the decline in active labour market policy spending by almost €5½ billion in 2005 exceeded that due to the Hartz IV reform.

The structure of active labour market policy has been influenced by a raft of new legisla-



tion (see box on page 66 and the annex on page 79). The first two Acts Promoting Modern Labour Market Services (Hartz I and II) from 2002 deserve special mention. While they ushered in some new instruments, such as one-person business start-up grants to unemployed persons or the personnel service agencies (PSAs), other benefits – particularly training initiatives – were significantly curtailed. Whereas barely any funds were channelled into PSAs, a total of €1½ billion was spent on one-person business start-up grants in 2005. On balance, however, these instruments accounted for less than 13% of the Federal Employment Agency's total expenditure on labour market policy measures.

Relatively modest impact of new active labour market policy instruments

¹ This equated to permanent additional annual expenditure of around €2 billion, as no compensatory measures were taken.

Overview of active labour market policy instruments

Vocational training

Preparatory vocational training, off-the-job training institutions and vocational training aid.

Promotion of further professional training

Training measures to achieve occupational qualification level.

Aptitude testing and training measures

Measures to determine aptitude for specific occupations, provide additional qualifications, verify willingness and ability to work.

Job rotation

Assistance for replacement personnel during further training.

Promotion of the integration of people with disabilities (occupational rehabilitation)

Improving the chances of integrating persons with physical, mental or psychological disabilities into the workforce.

German language courses

Promoting workforce integration, especially for ethnic German immigrants and persons entitled to asylum.

Employment creation schemes

Temporary employment for unemployed persons who are difficult to place in order to maintain their employability (job creation measures and infrastructure measures to create work).

Job placement voucher

Engaging private employment agencies, the costs of which are borne by the Federal Employment Agency. Depending on the length of unemployment, the cost varies between €1,500 (less than six months) and €2,500 (more than nine months).

Support for career guidance and placement

Assumption of costs of applying for jobs as well as the expense of travelling to career guidance, placement, aptitude testing and interviews.

Measures directed towards employment in the primary labour market

- **Personnel service agencies:** subcontracted employment in conjunction with intensive training in between phases of subcontracted employment.
- **Reintegration grants:** financial compensation to employers for low productivity of job seekers.
- **Grants for start-ups hiring staff:** available to persons establishing businesses who hire unemployed persons.
- **Grants for hiring replacement staff:** available to employers who hire temporary replacements for staff on training courses.
- **Exemption from employer contributions:** employer contributions to Federal Employment Agency are waived if hiring an employee over the age of 55.
- **Combination wage for older workers:** support for persons aged 50 and over ending unemployment by taking

up a job that pays less than they earned before becoming unemployed.

- **Mobility assistance:** grants for travel, living and relocation expenses to take a job subject to social security contributions or begin dual training.
- **Bridging payments:** to secure livelihood and social security when setting up a new business as a self-employed entrepreneur if thus avoiding unemployment.
- **One-person business start-up grants (for unemployed persons):** monthly payment on a degressive scale over a maximum of three years.
- **Start-up grants:** replace bridging payments and business start-up grants from 1 August 2006. Former recipients of unemployment benefit receive assistance equivalent to their benefit entitlement plus €300 per month for social protection. Assistance is given for nine months with an option to extend only the €300 top-up for a further six months.

Discretionary assistance

Employment agencies can use up to 10% of integration funds to develop new labour market policy instruments (performance assessed on the basis of the integration record).

Grants for transfer measures

Paid when there is an imminent threat of job losses as a result of company restructuring provided the employer pays a significant contribution itself.

Promotion of year-round employment

Payment of seasonal short-time working benefits to avoid seasonal unemployment in weather-dependent industries.

Short-time working benefits

Stabilisation of employment contracts in enterprises experiencing temporary financial difficulties.

Phased retirement

Reimbursement of the increment to the pay and to the pension insurance contribution rate, if, after the employee has entered the work-free phase, a previously unemployed person or - in the case of companies with no more than 50 employees - a trainee is hired.

Additional assistance through the European Social Fund

To secure start-ups, occupational training and language courses for immigrants.

Special benefits as a part of basic allowance for job seekers

- **Start-up allowance:** additional assistance when starting a job subject to social security contributions or self-employment in order to overcome need for assistance.
- **Small employment opportunities (one-euro jobs):** community service employment serving the public interest and not posing a threat to existing employment contracts. Recipients of unemployment benefit II are reimbursed (€1 to €2 per hour) for the additional effort.

Compensatory payment levied if recipients of unemployment benefit are not found work

In parallel with the contraction of active labour market policy, a new stipulation was introduced in 2005 as part of the Hartz IV reform compelling the Federal Employment Agency to pay compensation to central government whenever benefit recipients switch from unemployment benefit I to unemployment benefit II.² This rule is intended to motivate the employment agencies to find jobs for benefit recipients before their entitlement lapses. The number of people transferring from unemployment benefit I to II was considerably overestimated in 2005. At €4½ billion, the actual compensatory payment fell almost one-third short of the estimated amount of just over €6½ billion.

Distribution of administrative costs affected by organisational reshuffle

2005 also brought changes in the allocation of administrative costs. The transference of responsibility for persons formerly receiving social assistance who are capable of working to newly created joint social entities comprising employment agencies and municipalities meant that the Federal Employment Agency incurred additional administration costs. However, these went hand in hand with an easing of the burden on municipal social welfare offices. Central government reimbursed the administrative costs attributable to recipients of unemployment benefit II. This resulted in an expansion of the Federal Employment Agency's balance sheet. However, the latter was eased by the fact that the administrative costs incurred for handling recipients of insurance-related payments (such as unemployment benefit I) were considerably lower. Overall, the Federal Employment Agency's administration costs rose from €5 billion to €6½ billion in 2005. The central

government grant towards administrative costs, which was paid for the first time, amounted to around €3 billion.

Central, state and local government: means-tested social benefits

Unlike social insurance, central, state and local government transfers to unemployed persons who do not, or no longer, claim unemployment benefit I and to low income earners do not constitute a wage substitute financed by contributions. Instead, they essentially constitute a tax-financed means-tested basic allowance. The financial burden on all sectors of government, particularly central government, has grown with the increase in long-term unemployment. Hence, tax-financed unemployment assistance based on a recipient's previous labour income was systematically inconsistent, an anomaly that was remedied with the amalgamation of unemployment assistance and social assistance for those able to work to form unemployment benefit II. However, a temporary income-linked supplement is still paid when transferring from unemployment benefit I. In 2005, the introduction of unemployment benefit II enlarged the base of recipients to include people who were previously ineligible or had never claimed. This change in the system caused a statistical break which complicates analysis of the trend over the past year.

Tax-financed means-tested social welfare benefits

² The compensatory amount is calculated as the number of recipients in the previous quarter transferring to unemployment benefit II within three months of the expiry of their entitlement to unemployment benefit I, multiplied by the average annual cost of an income-support household as defined in the Second Book of the Social Security Code (currently around €10,000).

Labour market-related expenditure by central government

 € billion ¹

Item	1995	2000	2001	2002	2003	2004	2005
Unemployment assistance	11.0	13.4	13.0	15.0	16.7	18.9	1.5
Unemployment assistance (narrow definition)	10.5	13.2	12.8	14.8	16.5	18.8	1.5
Wage substitutes	5.8	8.7	8.9	10.3	12.3	13.8	1.1
Social insurance	4.7	4.5	3.8	4.4	4.3	4.9	0.4
Other unemployment assistance ²	0.6	0.3	0.2	0.2	0.2	0.2	0.0
Basic allowance for job seekers ³	.	.	.	.	.	0.5	35.2
Unemployment benefit II	.	.	.	.	.	.	25.0
Wage substitutes ^{pe}	.	.	.	.	.	.	16.3
Social insurance ^{pe}	.	.	.	.	.	.	8.8
Contributions to accommodation costs	.	.	.	.	.	.	3.5
Integration measures	.	.	.	.	.	.	3.6
Refund of Federal Employment Agency administrative costs	.	.	.	.	.	0.5	3.1
Other basic allowance expenditure ⁴	.	.	.	.	.	.	0.0
Additional children's allowance	.	.	.	.	.	.	0.1
Other active labour market promotion measures ⁵	5.4	1.1	0.3	0.3	0.6	1.2	0.7
Housing allowance for persons fit to work ⁶	1.2	1.3	1.6	1.7	2.1	2.3	.
Grant to Federal Employment Agency	3.5	0.9	1.9	5.6	6.2	4.2	0.4
Total	21.2	16.7	16.9	22.7	25.7	27.1	37.9
<i>Memo item</i>							
Total, adjusted for compensatory payment	21.2	16.7	16.9	22.7	25.7	27.1	33.4

Source: Federal Ministry of Finance, own calculations. — ¹ D-Mark amounts converted to euro. — ² Integration assistance for *inter alia* ethnic German immigrants. — ³ In 2004, advance expenses pursuant to the Second Book of the Social Security Code. — ⁴ Expenses related to the Ombudsrat, communication and research. — ⁵ Integration

assistance and job creation schemes (transitional old-age benefits in the east German states, reintegration of the long-term unemployed and those who are difficult to place). — ⁶ Estimated assuming a constant expenditure share of 77% on people fit to work who require assistance.

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Trend between 1995 and 2004

Central government: sharp rise in spending on unemployment assistance

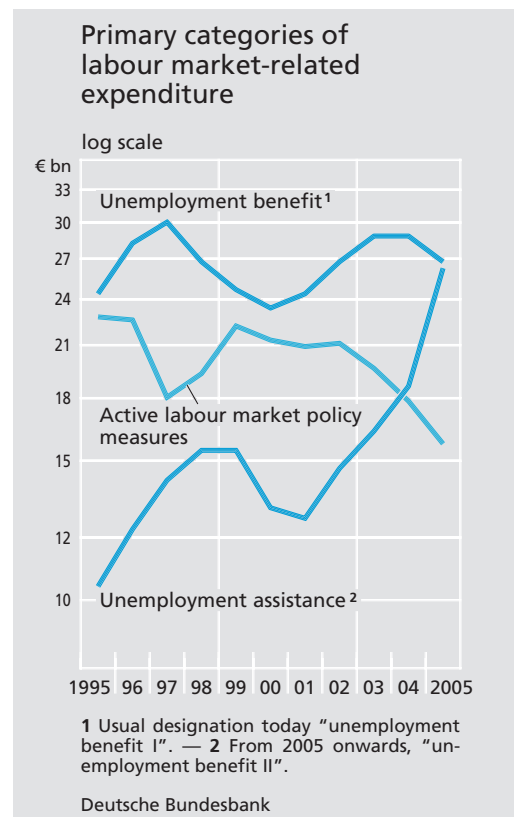
Prior to the introduction of the HartzIV reform in 2005, expenditure on unemployment assistance as narrowly defined accounted for the bulk of labour market-related spending financed directly from the central government budget (see the table above). Additional significant components of expenditure were the grant to the Federal Employment Agency and spending on housing allowances to unemployed persons who are fit to work (which is estimated here). As defined here, total labour market-related spending by central government rose from €21 billion to €27 billion between 1995 and 2004. Whereas spending on work promotion fell from €5½ billion to just over €1 billion, expenses relating to unemployment assistance nearly doubled to al-

most €19 billion. However, this trend was subject to considerable annual fluctuations (see the chart on page 69). It was constrained by the progressive tightening of the assessment base applied to social contributions transferred on behalf of recipients of unemployment assistance. Hence, the proportion of direct central government payments increased markedly compared with the social contributions paid for benefit recipients (from just over 55% to 74% of total transfers). However, easing the pressure on central government in this way led to a corresponding reduction in revenues for the statutory pension, health and long-term care insurance schemes. The increase in long-term unemployment was reflected in the statistics for recipients of unemployment assistance (see the chart on page 65). The number of recipi-

Labour market-related spending of state and local government

ents rose from an annual average of just under one million in 1995 to 1½ million in 1998; after stabilising for a time, it climbed to just over two million in 2004.

The labour market-related expenditure of state and local government lagged far behind that of central government and the Federal Employment Agency. This can be quantified only with difficulty, especially for earlier years.³ State government spent around €4 billion net a year on labour market policy, which equates to just over 1½% of its overall budget (the comparable figure for central government was around 10%).⁴ State government housing grants to unemployed persons able to work rose from €1 billion in 1995 to an estimated €1½ billion in 2004. On balance, labour market-related spending by state government has grown only relatively slightly since 1995. The corresponding figure for local government is likely to have been €10 billion in 2004. Spending on active labour market policy measures for recipients of social benefits able to work (promoting a return to work) has doubled to just over €1 billion since 1995. Over the same period, there was an 8% increase in additional (net) spending on the basic allowance paid to persons outside of institutions (social assistance narrowly defined). A rough estimate indicates that, in 2004, payments to social assistance recipients able to work and their dependants (under the amended Second Book of the Social Security Code) totalled just under €7 billion. These were augmented by the payments granted to such persons for assistance towards healthcare (estimated at just over €½



billion) and administrative costs (estimated at around €1 billion).

³ The following rough estimates are partly based on calculations made by the Conciliation Committee in June 2004 and the Federal Ministry of Economics and Labour in its 2004 audit report published in October 2005. These assume a constant 93% share of total expenditure on social and medical assistance benefits attributable to recipients able to work and their dependants, and a 77% share of housing allowances attributable to unemployed recipients. Owing to the rise in long-term unemployment, the expenditure calculated in this way might overstate the actual spending on unemployment in the past. The estimates of the Federal Ministry of Economics and Labour concerning the administrative costs attributable to social assistance recipients who are able to work are assumed to be virtually constant.

⁴ Federal Statistical Office, Rechnungsergebnisse des öffentlichen Gesamthaushalts, 2003, Fachserie 14, Reihe 3.1. These are the most recent results available. Spending between 1995 and 2003 was virtually constant. As well as labour market policy spending, this category of expenditure also includes other expenses (for instance, work safety provisions). As a result, it does not entirely match the classification of labour market-related spending generally used here.

Hartz IV reform and the trend over the past year

Hartz IV reform: regulations and ...

With the entry into force of the Fourth Act Promoting Modern Labour Market Services (Hartz IV) at the beginning of 2005 unemployment assistance, broadly defined, and social assistance for persons able to work were amalgamated into the basic allowance for job seekers known as unemployment benefit II. As with the former social assistance, standard unemployment benefit II is intended to cover only basic needs.⁵ Hence, it differs from the former unemployment assistance, which was initially linked to the recipient's previous estimated net earnings (most recently set at 53% for childless claimants and 57% for those with children). Alongside this standard benefit, the basic allowance includes a supplement, limited to two years, intended to cushion the transition from contribution-financed unemployment benefit I, contributions to the statutory pension, health and long-term care insurance schemes and the absorption of accommodation and heating costs. Moreover, benefits are envisaged for specific additional needs and integration measures.

... financing

The Hartz IV reform triggered considerable changes to expenditure responsibilities and financial relationships between the various levels of government. Central government took over financing of the basic allowance (standard unemployment benefit II plus a social allowance for dependants unable to work, payments for additional needs, social contributions and the temporary supplement for the transition from unemployment bene-

fit I) and the integration measures for recipients of unemployment benefit II, which had previously been provided by the Federal Employment Agency and by state and local government. Central government also refunds administrative costs and currently contributes 29.1% of the accommodation costs incurred by local government, with the aim of reducing the burden on municipalities by €2½ billion a year. This financing is in addition to funding one-off accommodation costs (eg for the first-time furnishing of a flat) and supplementary integration services (care, counselling). As already mentioned, central government receives a compensatory amount from the Federal Employment Agency.

With the Hartz IV reform in place, central government's total labour market-related expenditure increased sharply in 2005 by €11 billion to €38 billion. Adjusted for the revenue from the compensatory amount (€4½ billion) and for unemployment assistance for December 2004 (€1½ billion), the increase still amounted to just under €5 billion. This development was driven by the switch to the new basic allowance for job seekers and the growth in long-term unemployment. In 2005, expenditure on the basic allowance totalled over €35 billion, of which €25 billion was spent on unemployment benefit II, €3½ bil-

Steep rise in labour market-related spending by central government in 2005

⁵ Pursuant to section 9 of the Second Book of the Social Security Code, need is defined as any person lacking adequate means to secure a livelihood (for himself and any dependants) and join the labour force. The following criteria are taken into account when assessing need: net income in excess of €100 per month and personal assets above a specific threshold (a basic allowance equivalent to €150 for each year of a person's life, up to a maximum of €9,750, plus a retirement saving allowance equivalent to €250 for each year of a person's life, up to a maximum of €16,250 per adult plus a lump sum of €3,100 per child).

lion each on labour market reintegration benefits (especially the promotion of casual work in addition to benefits – “one-euro jobs”) and contributions to accommodation costs as well as €3 billion spent on refunding administration costs. As a result, expenditure was considerably higher than envisaged (+€7½ billion). The unexpected increase in expenditure primarily reflects the high number of unemployment benefitII recipients, which actually rose further from 4.5 million at the start of the year to 5.2 million by year-end.⁶ By contrast, the main saving compared with 2004 was the reduction in the grant to the Federal Employment Agency from €4 billion to just under €½ billion.

Overall rise in central, state and local government spending as a result of Hartz IV

On balance, the Hartz IV reform imposed a significant financial burden on central government. State government had agreed to pass savings on to local government although, given the available figures, the possibility cannot be ruled out that it, too, experienced some relief. Despite higher-than-anticipated accommodation costs, the burden on local government is likely to have eased perceptibly in the context of the new basic allowance owing to the abolition of the majority of social assistance subsistence benefits and active labour market policy measures (see box on p 72f for the financial repercussions of the Hartz IV reform). On balance, labour market spending by central, state and local government increased markedly in the past year. Nevertheless, the increase compared with the likely scenario had the old *status quo* been maintained was smaller than the margin by which central government missed its target (it had anticipated a decline in its

labour market-related expenditure), which has been at the centre of public debate.

Outlook for 2006 and 2007

The development of labour market-related government expenditure in 2006 is also likely to have been shaped not least by the economic recovery. In addition, the shortening of the entitlement period for unemployment benefitI and various savings in unemployment benefitII will make themselves felt in 2007. Overall, labour market-related expenditure is likely to exert less pressure on general government budgets this year and next than in 2005.

Federal Employment Agency

The Federal Employment Agency's expenditure will have fallen considerably by the end of 2007. A further decline is expected in spending on unemployment benefitI which, besides the favourable economic setting this year, can principally be attributed to the shortening of the maximum eligibility period that will gradually have an effect from February 2007. It was reduced as of 31 January 2006 to 12 months for the majority of recipients; an extended 18-month maximum entitlement period applies for unemployed persons aged 55 and over. However, this tightening may spark a temporary increase in the

Noticeable decline in labour market-related expenditure

⁶ The total number of people receiving unemployment benefits as defined by the Second Book of the Social Security Code (unemployment benefitII and the social allowance) rose from 6.1 million to 7.1 million, while the number of income-support households increased from 3.3 million to 3.9 million.

An estimate of the fiscal costs of the Hartz IV reform

A comprehensive evaluation of the effects of the Hartz IV reform on general government budgets requires a comparison between the actual labour market-related expenditure and the expenditure that would have resulted from a *status quo* scenario, ie the continued separate co-existence of unemployment assistance and social assistance. For this purpose, the actual trends in the labour market and in the need for assistance would have to be adjusted for the effects of the reform which cannot be clearly determined. Moreover, the limited data availability at state and local government level¹ complicates an accurate estimate of the impact on general government budgets. This article focuses on the purely fiscal effects of the reform, which encompass direct labour market-related expenditure but also additional welfare benefits affected by the reform, such as housing allowance, additional children's allowance and social assistance for persons able to work.

Different calculations

At the end of 2003, the Commission for the Reform of Local Government Finances foresaw that central and local government could save €3.3 billion annually by merging unemployment assistance and social assistance for persons who are able to work. While the audit report of the Federal Ministry of Economics and Labour, completed in the autumn of 2005, shows cost savings of €2.8 billion for local government in 2005, excluding the revenue received from central government, the Municipal Data Survey (*Kommunaldatenerhebung*), which was published at the same time by the Deutsche Landkreistag, arrives at an additional cost of €1.6 billion for local government, again excluding the contribution payments received from central government. One reason for these major differences is that the audit report is based on the – now repealed – legal criteria for reviewing the cost savings for local government. According to these criteria, those recipients of unemployment benefit II who previously received neither unemployment assistance nor social assistance but who would have been entitled to social assistance under the old legal *status quo* are counted as potential recipients of social assistance. Owing to the higher number of cases, the calculation therefore results in relatively big cost savings for local government. By contrast, the Municipal Data Survey only records the costs actually incurred for former recipients of social assistance who are able to work but does not take into account a possible rise in the number of recipients of social assistance that might have occurred without the Hartz IV reform in 2005. Moreover, the payment flows published in the government cash statistics indicate that the savings made by state government on housing allowance and integration measures may not have been passed on in full to local government as was agreed. According to the most recent figures of the Federal Ministry of Labour and Social Affairs, the costs to general government of €44½ billion after the labour market reform in 2005 were €1 billion higher than they would have been had the previous *status quo* continued.²

¹ For example, the payments in connection with Hartz IV for the city-states (Berlin, Bremen, Hamburg) are not listed separately in the relevant government finance statistics and can only be estimated. — ² See Deutscher Bundestag, Ausschuss für Arbeit und Soziales, Unterrichtung durch das Bundesministerium für Arbeit und Soziales, Ausschussdrucksache 16(11)197, 2 May 2006. See also B Kaltenborn and J Schiwarov, Hartz IV: Gefühlte Kostenexplosion, Wirtschaftsdienst 7/2006, pp 430-434. — ³ The difference vis-à-vis the comparative calculation of the Federal Ministry of Labour and Social Affairs can be explained, in particular, by the fact that this calculation assumes lower extrapolation rates for unemployment assistance and social assistance and that it takes into account the (estimated) expenditure for accommodation costs of recipients of other social benefits (eg basic allowance for elderly persons), which arise for local government after the cessation of the housing allowance for this group of persons. — ⁴ See also Deutsche Bundesbank, Impact of the amalgamation of social assistance

The table on page 73 shows the results of the calculations for the individual levels of government. While the draft budgets for 2005 envisaged cost savings of just over €1 billion compared with 2004, the actual expenditure of central government/the Federal Employment Agency, state government and local government in connection with the Hartz IV reform was €7 billion higher than the expenditure on unemployment assistance, social assistance for people able to work and housing allowance. The additional expenditure of central government (€9½ billion) contrasted with cost savings for the Federal Employment Agency, state government and local government (2½ billion). However, compared with the likely expenditure path given a continuation of the old *status quo*, the estimated additional expenditure owing to the reform would have been “barely” €4 billion, with the balance due to the poor labour market performance, which would also have caused a rise in costs under the old *status quo*.³ The draft budgets make provision for a further, albeit smaller rise in expenditure in 2006 before Hartz IV expenditure looks set to decrease for the first time in 2007 when the statutory changes agreed upon become fully effective. Taking all social security funds into account, the overall burden on general government is expected to be somewhat lower at first. The statutory pension insurance scheme and the long-term care insurance scheme, for example, achieved savings because the additional revenue from contributions for former social assistance recipients able to work and for new recipients who were not insured previously has so far been accompanied by marginal expenditure at most. In 2007, however, central government will effectively halve its pension contributions for recipients of unemployment benefit II.

Causes of the rise in expenditure

The unexpectedly high costs of the Hartz IV reform are primarily due to inaccurate assessments about the labour market trend and adjusted behaviour on the part of those entitled to payments, start-up problems and legal shortcomings.⁴ Already before the reform came into force, the unfavourable labour market trend led to a significant increase in the number of recipients of unemployment assistance and social assistance.⁵ Moreover, the level of need of the recipients of unemployment assistance and their number of household members were underestimated. For example, the poor labour market situation also caused the average household income – which is offset against benefits – to decrease. When preparing the budget for 2005, the Federal Government expected an annual average of only 2.5 million income-support households and 3.4 million beneficiaries able to work. However, by the end of 2004, there were already an estimated 4.4 million recipients of social assistance and/or unemployment assistance who were able to work (including their dependants able to work). According to estimates made by the Federal Employment Agency, 1.8 million recipients of social assistance

and unemployment assistance: initial findings, Monthly Report, November 2005, pp 40-41. — ⁵ The number of recipients of unemployment assistance increased by 10% in the period 2003-2004, while the number of recipients of social assistance of working age increased by 11% in the period 2002-2004. — ⁶ See Federal Employment Agency, Der Übergang von der Arbeitslosen- und Sozialhilfe zur Grundversicherung für Arbeitsuchende, special report, August 2005, and B Kaltenborn and J Schiwarov, Hartz IV: Deutlich mehr Fürsorgeempfänger/innen, Blickpunkt Arbeit und Wirtschaft 5/2006. — ⁷ Studies show that almost 50% of households in need did not draw on social assistance in the past. See J Wilde and A Kubis, Nichtanspruchnahme von Sozialhilfe – Eine empirische Analyse des Unerwarteten, Jahrbücher für Nationalökonomie und Statistik 225 (3), 2005, pp 347-373. — ⁸ Source: Federal Ministry of Finance, Federal Ministry of Labour and Social Affairs, Federal Statistical Office, Bundesbank calculations. Expenditure trend in 2005 based on old legal status quo (projection): extrapolation rates for housing allowance 6.5%,

able to work (plus 0.9 million dependants not able to work) – this is about 96% of all recipients of ongoing subsistence benefits outside of institutions – and 1.9 million recipients of unemployment assistance who are in need (plus 1.3 million dependants, just over half of whom are able to work) switched to the new basic allowance for job-seekers (6.1 million recipients in January 2005).⁶ The monthly total cost of €841 per income-support household on an annual average also exceeded the original budgeted figures (€819).

The further rise by 1 million in the number of recipients in the course of 2005 is not only due to the start-up problems in managing the flood of applications, but also to the increase in long-term unemployment stemming from the continued poor labour market situation and to a considerable degree also to the new legislation. Compared with the previous social assistance, the new Second Book of the Social Security Code led to an enlargement of the group of eligible recipients. For example, the defined income and asset ceilings for neediness were raised, the permitted margins to supplement benefits with earned income were improved and the housing benefit payments were structured more generously compared with the housing allowances granted previously. Many persons in need with a low level of income who had previously not applied for social assistance owing to insignificant entitlements, low limits for income and additional earnings, ignorance of statutory regulations concerning social assistance or the stigmatising effect of social assistance⁷ are now claiming unemployment benefit II. The latter is also indicated by the fact that the number of persons receiving Hartz IV benefits in addition to their earnings (“income boosters”) doubled in the time from the start of the reform to the autumn of 2005. This number is expected to continue to rise owing to the further improved options for top-up earnings as of October 2005.

In addition, there are legal shortcomings to which Parliament has now responded. For example, the onus of proof for couples claiming to live in a state of long-term cohabitation resembling marriage has now been shifted from the Federal Employment Agency to the applicants. The previous regulation allowed “cell divisions” in which couples who were living together separated *pro forma* (eg set up flat-sharing communities) in order to create autonomous income-support households and so avoid their partner's income being offset against unemployment benefit II. Moreover, the law made it easier for young people who had reached the legal age of maturity to move out of their parents' home and claim full social benefits and accommodation costs irrespective of their parents' financial circumstances. Such behavioural reactions are indicated by the significant rise in dependent one-person households from just under 1.9 million at the beginning of 2005 to 2.4 million in April 2006, with higher numbers of recipients particularly among young people. It was primarily this margin of discretion afforded by the statutory regu-

lations, and probably only to a small extent a rise in abuse of social benefits¹⁵ which, together with the general expansion of the benefit range, resulted in a substantial increase in the volume of benefits granted.

unemployment assistance 14.5%, social assistance 1.5% and assistance in cases of sickness 3% (in line with the development of previous years). The cost savings for state and local government resulting from the discontinuance of housing allowance and social assistance are determined by means of a comparison with the actual expenditure of the previous year or an extrapolation based on the old legal status quo, and not according to the – now repealed – statutory review criteria. — 9 Estimate based on the assumption of the Federal Ministry of Economics and Labour that about 77% of the expenditure in 2004 was attributable to persons in need with the capacity to work. — 10 Payments amounting to €1.5 billion made in 2005 for December 2004 were not taken into account. — 11 Target for 2006 and 2007 including the estimated savings from the adopted statutory changes. — 12 Including employment pacts for older persons (2006: €267 million, 2007: €232 million). — 13 Target for 2005 excluding the forwarded central government contribution towards accommodation costs according to calculations made by the

Expenditure of central, state and local government and of the Federal Employment Agency before and after the Hartz IV reform ⁸

€ billion

Item	Old legislation		New legislation			
	Actual	Proje- ction	Target	Actual	Target	Target
	2004	2005	2005	2005	2006	2007
Central government	21.2	24.2	21.2	30.7	34.4	28.7
Housing allowance (persons able to work) ⁹	2.3	2.5	.	.	.	.
Unemployment assistance in the narrower sense ¹⁰	18.8	21.5	.	.	.	.
Other unemployment assistance	0.1	0.2	0.0	0.0	.	.
Unemployment benefit II ¹¹	.	.	14.6	25.0	24.4	21.4
Contribution towards accommodation costs	.	.	3.2	3.5	3.6	2.0
Integration measures	.	.	6.5	3.6	6.5	6.5
Administrative costs	.	.	3.3	3.0	3.5	3.5
Other basic allowance ¹²	.	.	0.0	0.0	0.3	0.2
Additional children's allowance	.	.	0.2	0.1	0.1	0.1
Compensatory amount	.	.	-6.7	-4.6	-4.0	-5.1
Federal Employment Agency	5.2	5.2	6.7	4.6	4.0	5.1
Integration measures	4.2	4.2	.	.	.	.
Administrative costs	1.0	1.0	.	.	.	.
Compensatory amount	.	.	6.7	4.6	4.0	5.1
State government	1.9	2.0	2.2	1.9	1.9	1.9
Housing allowance (persons able to work) ⁹	1.7	1.8	.	.	.	.
Integration measures	0.2	0.2	.	.	.	.
Transfers to local government ¹³	.	.	2.2	1.9	1.9	1.9
Local government¹⁴	10.0	10.0	7.0	8.1	8.3	9.9
Social assistance (persons able to work)	6.9	7.0	.	.	.	.
Assistance in cases of sickness (persons able to work)	0.7	0.8	.	.	.	.
Administration	1.2	1.2	0.2	0.3	0.3	0.3
Integration measures	1.1	1.1	0.1	0.0	0.1	0.1
One-off benefits	.	.	0.2	0.2	0.2	0.2
Accommodation costs	.	.	11.0	12.1	12.4	12.4
Other social benefits	.	.	0.8	0.8	0.8	0.8
Transfers from state government	.	.	-2.2	-1.9	-1.9	-1.9
Central government's contribution towards accommodation costs	.	.	-3.2	-3.5	-3.6	-2.0
Total	38.3	41.5	37.1	45.3	48.6	45.6

lations, and probably only to a small extent a rise in abuse of social benefits¹⁵ which, together with the general expansion of the benefit range, resulted in a substantial increase in the volume of benefits granted.

parliamentary Conciliation Committee in June 2004, otherwise estimated on the assumption of a complete forwarding of the actual cost saving compared with 2004. — 14 Including local government level of the city-states (Berlin, Bremen, Hamburg). The expenditure for persons able to work on social assistance (excluding integration measures – support for work) and on assistance in cases of sickness is estimated based on the assumption of the Federal Ministry of Economics and Labour that 93% of expenditure is accounted for by this group of persons; the figures for administrative costs also correspond to the estimates made by the Federal Ministry of Economics and Labour. The 2005 target is derived from the Conciliation Committee's estimate from June 2004; the target figures for 2006 and 2007, which were not derived from the Federal budget, largely remained constant at the 2005 level. — 15 The Federal Employment Agency estimates that less than 3% of cases involve an abuse of social benefits.

number of claimants switching to unemployment benefit II. In addition, a significant reduction in spending on active labour market policy measures was recorded in the first half of 2006.

Favourable overall financial trend for the Federal Employment Agency in 2006 and 2007

On balance, the Federal Employment Agency will generate a surplus in 2006 that far exceeds the figure of just under €2 billion projected in the budget. Bringing forward the deadline for transferring social contributions, a changeover which has been in place since the start of 2006, will provide a one-off boost to the budgetary balance of just over €3 billion. Along with the central government grant, which will amount to €6½ billion in 2007 and be paid regularly from next year onwards, the 2006 surplus will also help to offset the loss of revenue, totalling around €15 billion, associated with the lowering of the contribution rate from 6.5% to 4.5%. Reserves are to be set up in future so as to cushion financial volatility, as in the other social security funds. This requires significant surpluses to be generated in buoyant economic phases, as the Agency's finances – both on the revenue and on the expenditure side of the balance sheet – react immediately to volatility on the labour market. If the reserves are insufficient, (interest-free) central government loans will be still available, although instead of being converted into grants as hitherto, they will now have to be repaid at a later stage.

Central government

The total resources earmarked for labour market policy expenditure in the central gov-

ernment budget for 2006 are about €1 billion above the 2005 outturn. Planned spending on the basic allowance amounts to just over €38 billion (€34 billion after adjustment for expenses covered by the compensatory amount), of which just under €24½ billion is allocated to unemployment benefit II. On balance, extra expenditure and savings could virtually cancel each other out during 2006 as a whole. Potential unforeseen additional expenditure on unemployment benefit II and accommodation costs is likely to be offset by a comparable fall in integration measures (budgeted amount: €6½ billion). As planned, the Federal Employment Agency will not require a grant from central government, and expenditure on other active labour market promotion measures is unlikely to exceed the 2005 figure.

Expenditure expected to increase only marginally in 2006 as a whole

The draft central government budget for 2007 projects a fall in overall spending on the basic allowance for job seekers to just over €33½ billion (€28½ billion after adjusting for the compensatory amount). However, the financial risks appear to be greater than in the current year. In view of the uncertainty surrounding some of the budgeted savings to be achieved through statutory changes,⁷ which are valued at just under €4 billion, the provision of €21½ billion for unemployment bene-

Draft 2007 budget: considerable cut in expenditure coupled with financial risks

⁷ The largest share (just under €2 billion) is attributable to the reduction from 2007 in contributions to the statutory pension insurance scheme for recipients of unemployment benefit II. However, this decline in central government spending is offset by a corresponding revenue shortfall for the statutory pension insurance scheme. Alongside certain legislative corrections to the range of benefits for those under 25, the remainder of the savings is principally to be achieved through imputed efficiency gains (€1.2 billion). These are set against spending increases of €0.2 billion caused by aligning contribution rates in eastern Germany with western levels.

fit II may have been set too low. Hence, €1 billion of cover for reintegration measures (another €6½ billion) has been earmarked to compensate for additional expenditure on unemployment benefit II. The budget estimate also assumes an increase in the compensatory amount due from the Federal Employment Agency (to just over €5 billion).⁸ Moreover, central government's contribution to local government expenditure on accommodation for recipients of unemployment benefit II is scheduled to be cut to €2 billion, though this must first be approved by the Bundesrat. The draft budget also proposes an increase in central government's labour market-related spending to just over €40 billion along with its new VAT-financed grant to the Federal Employment Agency.

Future challenges

Reducing structural unemployment

Reducing structural unemployment is a paramount economic policy requirement in Germany. This would substantially reinforce the necessary consolidation of public finances, particularly at central government level, by permanently easing the pressure on both the revenue and expenditure side of the general government budgets. A continuation of the current moderate wage trend, greater flexibility within both the labour market and the wage structure as well as further reforms to the tax and transfer system would make a significant contribution to achieving that goal.

By contrast, it will only be possible to reduce the average level of frictional and cyclical un-

employment very marginally. Cyclical developments are affecting revenues at all levels of government and are having a particular impact on Federal Employment Agency expenditure. The automatic stabilisers function smoothly if they balance out surpluses and deficits over the economic cycle while the Federal Employment Agency's contribution rate is kept stable. Given the high level of volatility, significant reserves must be built up in good times to obviate the need to borrow (as is the case in other social security schemes).⁹

Assuming the Federal Employment Agency's spending on administration and active labour market policy measures remains virtually unchanged at €10 billion then, at current benefit and employment levels, it would be possible to finance an average of around 1.5 million recipients of unemployment benefit I at a contribution rate of 4.5% (in 2005, this benefit was drawn by just over 1.7 million people). A fall (rise) in the average number of recipients by 100,000 would mean a reduction (increase) in the contribution rate by 0.2 per-

Cyclical fluctuations and Federal Employment Agency finances

⁸ One method of achieving this will be to expand the reference value for this payment in future to include people whose entitlement under unemployment benefit I falls short of the level of unemployment benefit II and who consequently receive supplementary unemployment benefit II (currently 160,000 to 180,000 people). To date, the compensatory amount has been due only after eligibility for unemployment benefit I had expired.

⁹ In future, it is envisaged that central government grants will only be provided in "emergencies". The aim is to prevent the Federal budget from having to bear the brunt of cyclical fluctuations. In view of the rationale behind the Federal government's budgetary rules restricting borrowing, central government loans to the Federal Employment Agency would, in future, have to be declared as something other than regular financial investment. This would prevent the constitutional threshold for new net borrowing from being systematically undermined if, as is currently standard practice, loan repayments are not concurrently booked as disinvestments.

centage point. If, for example, the number of people drawing unemployment benefit and the number of employees subject to social security contributions were to fluctuate within a margin of 500,000 people (between its cyclical high and low as in the period 1997-2000), this would require an annual surplus of around €4 billion at the cyclical peak. These surpluses would have to be accumulated over several years in order to bridge downswings of a similar duration. Given the favourable economic outlook at present, building up reserves now is essential to avoid a procyclical adjustment of the contribution rates in future. This also means that the habitual political temptation to boost spending or cut contribution rates when reserves are plentiful must be resisted.

Need to distinguish between insurance benefits and means-tested social benefits

The introduction of the basic allowance for job seekers has drawn a clearer distinction between insurance benefits on the one hand and the tax-financed means-tested basic allowance on the other. The latter has also been structured more systematically and more consistently. Carrying this logic further in future would necessitate reinforcing the Federal Employment Agency's insurance principle and, moreover, gearing unemployment benefit II more strongly to ensuring that tax resources are used sparingly and selectively and, at the same time, to increasing the incentive to take on regular employment.

Reform of unemployment benefit I

The statutory unemployment insurance scheme still entails a number of non-insurance-related benefits that should not be financed by wage-based contributions, including many active labour market policy

measures.¹⁰ The additional children's allowance paid as part of unemployment benefit I (which increases the payment rate from 60% to 67%) is a particularly striking example. Another questionable feature is the (albeit now shortened) extended eligibility period applicable to claimants aged over 55. Fundamentally, there is a danger that unemployment will become more entrenched the longer a person is eligible for unemployment benefit I. Therefore, a shorter eligibility period with lower contribution rates would make better sense.

The compensatory amount that the Federal Employment Agency has to pay to central government roughly counterbalances the fact that responsibility for funding active labour market policy measures for the long-term unemployed has passed from the Agency to central government. This being so, it may appear logical to link the payment to the number of people transferring from unemployment benefit I to II. Although this provides an incentive to find work for people before their entitlement to unemployment benefit I lapses, financing the payment through contributions appears fundamentally questionable in view of the insurance principle on which the Agency is based. Hence the compensatory amount is an extraneous liability imposed on the Federal Employment Agency, yet it corresponds to the income from 0.5 percentage point of the contribution rate. Conversely, the future central government grant to the Agency should likewise be reconsidered and coupled to the financing of clearly defined non-insurance-related benefits.

Need to reconsider the compensatory amount and the new central government grant

¹⁰ See German Council of Economic Experts, Jahresgutachten 2005/2006, pp 365ff (available only in German).

The debate about new labour market policy instruments

Unemployment and, in particular, long-term unemployment mainly affect individuals who can earn only relatively low income in the labour market owing to their low productivity. First, laws, wage agreements and *de facto* minimum wages set by legal precedence are partly responsible for the fact that there is insufficient demand for legitimate employment in the low-wage sector. Second, the social security system guarantees a (socio-cultural) minimum subsistence level which depresses the supply of labour if claims for benefits are not consistently reduced for persons who reject job opportunities.

The framework established by the Hartz IV legislation essentially makes it possible to considerably increase incentives to work. The key to this is that of those who are able to work, only those who are willing to accept a (full-time) job offer are entitled to the full amount of social benefits. If their household income then falls below the socio-cultural minimum subsistence level and their financial circumstances place them below the poverty line, the state grants a minimum income to avoid destitution. Thus, the system already provides state-subsidised pay. To increase the incentive to work beyond this, earned income is only partly offset against social benefits. If the grant to lowly paid employees were to be extended without reducing unemployment benefit II – ie a more comprehensive form of state-subsidised pay – this would inevitably entail a considerable fiscal burden and extensive “free-rider” effects. This would also contradict the basic principle of granting social benefits to prevent poverty.

If unemployment is to be reduced to a significant extent, the restrictions on the demand for labour also need to be eased to make the low-wage segment of the labour market more flexible. Both measures together would allow employment in the primary labour market to rise as market forces take effect. Targeted government intervention would then be largely restricted to preventing destitution if individuals fall below the poverty line and this aid is provided directly to those affected. The inherent danger of (industry-specific) minimum wages is that measures to increase the supply of labour will dry up as a result of the Hartz IV reform: if productivity is too low, the unemployed will not be integrated into the primary labour market.

Another possible approach might be for employers to grant *de facto* social benefits as part of broad-based wage cost subsidies. In this alternative, the government pays a grant to employers who then pay wages including the state subsidy. This would allow minimum wages to be set which enterprises could then adjust downwards to a level appropriate to the individual’s productivity with the subsidies making up the difference. Such a process would, however, have considerable disadvantages. Greater “free-rider” effects would be likely as subsidies would no longer be granted on a needs basis. It is extremely difficult to estimate the associated fiscal burdens, which would pose a major financial risk for the government. This would also entail government intervention in the market mechanism and the creation of a considerable degree of bureaucracy.

Basic allowance for job seekers requires further reform

The basic allowance for job seekers can also be claimed on the basis of need as an additional transfer on top of a low earned income. As such, it is effectively a wage subsidy. The government should refrain from introducing an additional comprehensive system of state-subsidised pay components or wage subsidies, which is associated with considerable financial risks, especially given the need to make the transfer system more transparent but also to more selectively target the beneficiaries of social benefits (see box on page 77). A better alternative would be to further refine the existing system – particularly its implementation.

A possible starting point could be to modify the current progressive thresholds enabling benefit recipients to obtain additional earned income, which are currently geared heavily to small top-up earnings, since they induce benefit recipients to take on only part-time work. A strategy of making acceptance of a full-time job offer compulsory, with a refusal entailing a sharp cut in the benefit entitlement, would help to ensure that potential claimants first exhaust all available possibilities of earning an income of their own before

claiming transfers from the state.¹¹ This would increase the attractiveness of full-time employment compared with unemployment (and the associated extra leisure time or income from illicit working). To reduce the unexpectedly large burdens on the central government budget, the existing level of benefits could also be adjusted. For example, it might be well worth reviewing the temporary increment paid during the transition from unemployment benefit I to II, which is incompatible with the insurance principle on which the Federal Employment Agency is based, or the level of personal assets that are not offset against the receipt of benefits, which is generously defined compared with the level that applied to the old social assistance. Lastly, the allocation of administrative responsibilities between the Federal Employment Agency and local government also needs to be more clearly defined.

¹¹ Another approach could be to cut the basic benefit rate across the board coupled with the compulsory provision of an employment opportunity. See German Council of Economic Experts, Arbeitslosengeld II reformieren: Ein zielgerichtetes Kombilohnmodell, Expertise im Auftrag des Bundesministeriums für Wirtschaft und Technologie, Wiesbaden, August 2006 (available only in German).