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# ON FINANCING ACTIVE LABOUR MARKET POLICY

## 1. INTRODUCTION[1]

This paper aims at several questions that are important for the design and implementation of labour-market policies and their role in developed countries. These questions are all centred on financial issues. A basic question concerns the sources of financing: are they paid for by the general taxpayer, out of general tax revenue, or by specific contributions levied on employers and/or employees and does this interfere with their design and effectiveness? Another question concerns the gross and net costs of policies – as the "sticker price" of active labour-market policies usually does not reflect the complex financial flows that accompany these programmes. If creation of goods and services including human capital and multiplier effects lower the net-cost of active labour-market policies, what are the implications for financing? How can active labour-market policies be used as automatic stabilisers and again what are the consequences for financing?

This paper is intended to address these questions. Chapter two gives a definition of labour-market policies (LMPs) and provides some discussion of benefits and criticism of LMPs, especially active labour-market policies (ALMPs). Chapter three looks at financing of LMPs in Sweden, Denmark, France, Germany and the United States. A short historical summary as well as recent developments in financing ALMPs is presented. Some country experiences are evaluated in chapter four. The focus is on crowding out of ALMP by passive labour-market policy (PLMP) and how to prevent it. In the following chapter the net cost of ALMP and its implication on financing is discussed. Finally, in chapter six an added bonus of ALMP is investigated: the potential of ALMPs to contribute to macroeconomic stabilisation.

## 2. WHY LABOUR-MARKET POLICY?

### 2.1 Definitions

Labour-market policies are policies that provide either income replacement (passive labour-market policies) or labour-market integration programmes (active labour-market policies) mostly for the unemployed. Some measures apply also to underemployed or those looking for a better job.

[1] This paper was written for the ILO. Thanks to Peter Auer for his strong support and useful comments. I would also like to thank Janine Berg and Konstantin Wacker for their comments and help.



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The OECD considers the following measures to be part of ALMP:

- Public employment services and administration
- Labour-market training
- Youth measures
- Subsidised employment that includes public or non-profit job creation, subsidies to employment in the private sector and support for unemployed people to start an enterprise
- Measures for the disabled.

PLMP includes unemployment compensation (unemployment benefits and unemployment assistance) and early retirement for labour-market reasons. ALMPs often include a passive, income replacement component as well (e.g. unemployment benefits for unemployed who attend training programmes). Often, ALMPs are used to support specific target groups such as women, youth, or low-skilled unemployed. ALMPs contribute to matching labour demand with supply. They enhance supply through training measures, reduce demand by providing start-up support for enterprises, create demand by public job creation and enterprise creation or change the structure of demand by employment subsidies in the private sector (cf. Auer et al., 2004).

## 2.2 Activation over benefits

It is a widely shared view that it is better to finance activity than inactivity. There are strong reasons for active policies, especially when a broader view on unemployment is taken that goes beyond labour-market effects and takes economic and social market and non-market effects into account as well.

ALMPs are at least rhetorically widely preferred to mere PLMPs, especially in Europe, where they are promoted by the European Employment Strategy (EES). With longer spells of unemployment, activating policies become more important. During short spells of unemployment the use of public employment services and the individual search for work are economical strategies for matching and labour-market integration. If these are not successful other activating strategies become more important in combating the negative consequences of unemployment such as loss of skills, self-confidence and work motivation. In the European Union, the Luxembourg guidelines state that the unemployed should participate in active programmes after six months (youth – unemployed up to the age of 25) or 12 months (adults). Recent numbers (see table 1) show that the degree of implementation of these guidelines vary widely in the EU.

It is important to stress that unemployment is more than an income problem for those affected. “There is plenty of evidence that unemployment has many far-reaching effects other than loss of income, including psychological harm, loss of work motivation, skill and self-confidence, increase in ailments and morbidity (and even mortality rates), disruption of family relations and social life, hardening of social exclusion and accentuation of racial tensions and gender asymmetries” (Sen 1999, 21). Some observers see a connection between unemployment and terrorism. Massive unemployment, especially youth unemployment and associated hopelessness, may create a hotbed where terrorist organisations can



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recruit. Active labour-market policies can help to reduce or even offset many of these adverse effects or create positive effects. The loss of skills and work motivation can be tackled, psychological and health-related problems eased and social exclusion may be ended, depending on the kind of active labour-market policy applied. ALMPs have a social cohesion effect that can help to prevent mental and physical problems, have a positive impact on family relations and help to prevent crime.

**Table 1: New start**

The percentage of young/adult unemployed becoming unemployed in month x, still unemployed in month x + 6/12 and not having been offered a new start in the form of training, retraining, work experience, a job or other employability measure.

| Country and year | Young unemployed | Adult unemployed |
|---|---|---|
| Germany | 17.5 (2005) | 11.6 (2004) |
| Sweden (2005) | 4.5 | 10.9 |
| Belgium (2005) | 30.2 | 32.5 |
| Spain (2004) | 8.8 | 9.0 |
| Hungary (2004) | 31.3 | 24.5 |
| Malta (2004) | 60.8 | 91.9 |
| Netherlands (2005) | 16.0 | 13.0 |
| Austria | 2.1 (2004) | 2.5 (2003) |
| Portugal (2004) | 24.0 | 25.2 |
| Finland (2005) | 5.8 | 9.0 |
| United Kingdom (2004) | 0 | 0 |
| Lithuania (2004) | 16.5 | 18.5 |

Source: European Commission: Indicators for monitoring the employment guidelines, 2006 compendium.

In economic terms the distinction between direct labour-market effects and positive external effects and between market and non-market effects should be made. ALMPs have a direct impact on the labour market (employment, wages, quality of labour supply) but they produce a wide variety of positive external effects (better health, family relations, social cohesion etc.) that are difficult to quantify as well. On the other hand ALMP comes at a cost. Policy makers have to weigh the desired effects of ALMP against the cost of taxes and contributions.

LMPs may also produce undesired effects: they can discourage job search intensity and have an impact on wage setting by increasing workers' reservation wage. LMPs provide a wage floor which can be a disincentive to take up regular work (unemployment trap). Upward pressure on wages might result in unemployment. Potentially negative effects of LMP may be limited when LMP is implemented carefully, which includes job-search requirements for the unemployed and monitoring, a quality employment service and ALMP: "The adverse effects of generous unemployment benefits on unemployment appear to be mitigated by high public

spending on active labour-market programmes" (OECD 2006, 209). As will be shown later, the example of Denmark shows that generous unemployment benefits and extensive ALMP do not prevent Denmark from being the EU country with the highest employment rate and the lowest unemployment rate.[2]

An effect of ALMPs from a macroeconomic perspective is the stimulation and stabilisation of demand. LMPs can be useful as automatic stabilisers over the business cycle, a role usually attributed to PLMPs, but ALMPs are important in this respect as well (see chapter six). The value of goods and services produced within ALMP projects may increase the wealth of a society. ALMPs that focus on training do not produce goods and services but human capital. Training has positive effects on productivity and enables participants to cope with technological change better. ALMPs are instrumental in supporting structural change and facilitate the transfer of workers and employees from sectors with shrinking employment to sectors with rising employment. ALMPs have positive effects on tax income and social security revenue. Whether these effects are external or internalised depends on the mode of financing ALMPs. This is described in section 5.

There is no comprehensive overview quantifying the various external effects of LMPs. If externalities are insignificant, the evaluation of LMPs has to restrict itself to evaluation of the labour-market effects – mainly employment and wages. But if externalities are significant, and there is some evidence for considerable externalities, it is an important justification for LMPs and especially ALMPs. Further investigation of externalities might lead to insight into the design of efficient LMPs.

Schmid et al. point to advantages of financing active labour-market policy rather than passive policies. They argue that long-term payment of unemployment benefits or assistance to people who want to work is "economically irrational and socially undesirable". They add that those financing large numbers of unemployed persons "can hardly be expected to finance additional meaningful public tasks" (Schmid et al. 1990, 26, 27). This points to the heavy fiscal cost of unemployment (either contribution- or tax-financed unemployment benefits), which can be a serious burden. However, most ALMP measures have a higher sticker price or gross cost, their positive economic and social effects are not easy to pin down and often these are long-term as well. As a result, and as will be shown in section four, the unsuitable financing design often contributes to ALMPs being crowded out by PLMPs.

## 3. FINANCING LMP IN SELECTED COUNTRIES

The two main forms of financing labour-market policy are contribution-based funding and financing from tax revenue (general budget). Contributions are usually paid by both employers and employees. Sometimes only employers or employees contribute to financing LMP. Tax revenue used for LMPs may originate from any kind of tax. This section gives an overview of historical roots and contemporary design of financing ALMPs in some OECD countries.

[2] At the end of 2006 Denmark's unemployment rate dropped to 3.2% while the employment rate held at 75.9% in 2005, the latest year for which this figure is available.



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The countries chosen are Sweden, Denmark, Germany, France and the United States. All of these countries have a long tradition of labour-market policy.

Although institutions and policies of the individual countries differ, classifications are often made. In Esping-Andersen's welfare-state clustering as well as in a new OECD clustering (OECD 2006a) the countries investigated here are in the same group: Sweden and Denmark are characterised as social-democratic welfare states (Esping-Andersen) or countries that combine social security with flexibility (OECD). Generous welfare benefits and active labour-market policies amongst other policy measures have recently resulted in high employment rates, low income disparity and relatively low unemployment rates that come at the price of high budgetary cost.

The United States is an example of the liberal welfare model (Esping-Andersen) or a market-reliant country (OECD). Low unemployment benefits and hardly any active labour-market policies are characteristics of this highly flexible labour market. Strong economic growth rates have led to low unemployment in recent years. The budgetary cost of labour-market policy is low, but the United States has wide income disparities and little equality of opportunities.

Germany and France represent the conservative welfare state (Esping-Andersen) or belong to the group of other OECD countries (OECD). They have somewhat lower welfare benefits, less emphasis on active labour-market policies and strong employment protection. In recent years both countries have struggled with high unemployment rates. Highly disputed labour-market reforms have been at the centre of political debate: the "Hartz Reforms" in Germany, the "Contrat Première Embauche" in France.

The OECD's reassessment of its job strategy concludes that there have been two successful policy packages in developed countries in the recent past: the market-reliant countries and countries that combine flexibility with security and activate jobseekers by ALMP. Both achieved high employment rates – with Denmark and Sweden boasting even higher employment rates than the US – and unemployment rates below OECD average. The public cost of these policies is much higher and income disparities are much lower in the Nordic countries than in the US.

## 3.1 Historical background of LMPs

Unemployment insurance and ALMPs were introduced at different points in time and under different circumstances across countries. Protracted political conflicts preceded the introduction of unemployment insurance systems in the twentieth century in Europe and North America. Opposition was caused by the fact that benefits for unemployed establish minimum conditions of work on the labour market. Financing of unemployment insurance was shaped by history – historical political compromise and previous institutional traditions play an important role even in contemporary design of LMPs.

In Europe, social-security systems were established upon two governing principles: the Bismarck-type social security, named after the 19th century German chancellor Otto von Bismarck, and the Beveridge-type social security named after the British economist and social reformer William Beveridge, who published the Beveridge report in 1942. The



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Bismarck-type social-security systems are based on contributions that are usually linked to employment. Social security is divided into several branches (old age pension, health, and later unemployment) where all members pay income-related contributions. The Beveridge report proposed a tax-financed national insurance. In the event of unemployment, Beveridge systems pay a flat-rate unemployment compensation while in Bismarck systems benefits are linked to previous earnings and sometimes also to the duration of previous employment. LMP reforms in recent years show that the categories are becoming increasingly blurred; for example Germany has changed its unemployment assistance to a tax-financed flat rate. Today, no European country operates a pure form of either social-security system. Germany, Austria, Belgium and France resemble the Bismarckian system while Britain and the Scandinavian countries are closer to the Beveridge system (cf. Berie/Fink 2000). The United States resembles the Bismarck system. However, the proportion of private social expenditure is much higher than in Europe[3], for example there is no compulsory health-insurance coverage. Unemployment insurance in the United States is closer to the Bismarck system. Public social spending on LMP is much higher in Europe than it is in the United States.

But let us go back even further. In 1911, long before Beveridge wrote his report in 1942, Britain was the first country to introduce a public employment system, covering only 10% of the workforce and providing for a lump-sum minimal income. Contributions were borne by employers, employees and the central government. An even older form of unemployment insurance, named after the Belgian city that first introduced it, is the voluntary "Ghent" system, a trade union unemployment insurance that received public support and became widespread among municipalities in Europe. In Sweden, a state subsidy for local unemployment funds was introduced in 1922. Denmark, too, introduced the Ghent system. In Germany local funds were replaced by legislation on unemployment insurance in 1927 providing for participation of employers and employees and initially covering 40% of the workforce. Contributions were borne by employers and employees equally. In the United States unemployment insurance by trade union self-help organisations only covered a small proportion of the workforce at the start of the great depression of the 1930s. In 1935 a nationwide unemployment insurance system was introduced, which has retained its basic features until the present day. In France trade unions and the employer's association agreed on an initially voluntary unemployment insurance in 1958, which became compulsory only in 1967. Previously, there was a tax-financed welfare-type for the unemployed, introduced in 1915 (cf. Schmid et al. 1992).

ALMPs cover a wide range of activities, some difficult to distinguish clearly from other social or economic policy programmes. During the great depression in the 1930s, public work-schemes such as the "new deal" in the United States were established. Similar schemes were introduced in Europe but in Germany these were transformed by the fascist regime into compulsory work programmes. In Sweden ALMPs play an important role since the 1950s in the pursuit of a full-employment policy. Only in the 1970s did ALMPs become widespread among industrialised countries, gaining importance in the aftermath of the first oil price shock.

[3] In 1995 public social expenditure in the United States amounted to 15.8% of GDP while private social expenditure was 7.8% of GDP. In Europe private social expenditure in % of GDP was much lower: Denmark: 0.8%, Germany: 0.9%, Sweden: 2.1%. The highest rate within Europe was recorded by Britain with 4.2% (cf. Berie/Fink 2000).



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## 3.2 Labour-market policy spending in selected OECD countries

Financing of LMP in five countries is examined here in order to provide an overview of financing of LMP in economically advanced countries. LMP spending is part of social expenditure. Table 2 gives an overview on social and labour-market policy spending.

**Table 2: Public social-policy expenditure and labour-market policy expenditure in % of GDP in 2001**

| 2001 | Public social expenditure in % of GDP | Labour-market policy expenditure in % of GDP | Rate of LMP expenditure in % of public social expenditure |
|---|---|---|---|
| Denmark | 29.22 | 3.94 | 13.5 % |
| France | 28.45 | 2.92 | 10.3 % |
| Germany | 27.39 | 3.12 | 11.4 % |
| Sweden | 29.78 | 2.46 | 8.3 % |
| United States | 14.73 | 0.70 | 4.8% |

Source: OECD (2006).

Table 2 shows that European countries devote approximately twice as much to public social policy expenditure in terms of GDP as the United States do. The rate of LMP expenditure in % of public social-policy expenditure is influenced by several factors. High unemployment (France, Germany) increases this rate, as does high ALMP expenditure (Denmark) and generous unemployment benefits (Denmark, Sweden). The United States' public expenditure on social policy is comparatively low and LMP expenditure is only a small fraction of social spending as a result of low unemployment, low income-replacement rates and little expenditure on ALMP.

**Table 3: Where does the money for LMP come from**

| Country | Tax | Contribution |
|---|---|---|
| Sweden | ● | ● |
| Denmark | | ● |
| France | ● | ● |
| Germany | ○ | ● |
| United States | ● | ● |

● major source of funding ○ minor source of funding

In Sweden, LMP is basically financed by tax revenue and employer contributions, Denmark has changed its financing radically from taxes to contributions, France has separate labour-market institutions with separate financing, Germany relies heavily on contributions and the US has varying contribution systems. The European countries investigated devote a much

larger share of resources to active and passive LMP than the United States, as shown in tables 4 and 5. Denmark, France and Germany increased their spending on ALMP since the mid 1980s, while Sweden's expenditure in terms of GDP declined in recent years and the United States has constantly reduced its spending on ALMPs.

**Table 4: Expenditure for ALMP in % of GDP, 1985-2004**

| | Sweden | Denmark | France | Germany | United States |
|---|---|---|---|---|---|
| 1985 | 2.10 | n.a. | 0.66 | 0.60 | 0.26 |
| 1986 | 2.01 | 1.11 | 0.74 | 0.82 | 0.25 |
| 1987 | 1.88 | 1.08 | 0.80 | 0.92 | 0.24 |
| 1988 | 1.76 | 1.06 | 0.80 | 0.97 | 0.23 |
| 1989 | 1.54 | 1.13 | 0.73 | 0.93 | 0.22 |
| 1990 | 1.68 | 1.09 | 0.81 | 0.93 | 0.23 |
| 1991 | 2.46 | 1.27 | 0.92 | 1.29 | 0.22 |
| 1992 | 3.07 | 1.43 | 1.04 | 1.65 | 0.21 |
| 1993 | 2.97 | 1.74 | 1.25 | 1.57 | 0.21 |
| 1994 | 2.99 | 1.74 | 1.27 | 1.33 | 0.20 |
| 1995 | 2.36 | 1.88 | 1.29 | 1.32 | 0.19 |
| 1996 | 2.25 | 1.78 | 1.34 | 1.42 | 0.17 |
| 1997 | 1.96 | 1.66 | 1.35 | 1.23 | 0.17 |
| 1998 | 1.91 | 1.68 | 1.31 | 1.27 | 0.17 |
| 1999 | 1.77 | 1.79 | 1.38 | 1.31 | 0.15 |
| 2000 | 1.37 | 1.58 | 1.31 | 1.23 | 0.15 |
| 2001 | 1.39 | 1.65 | 1.29 | 1.18 | 0.15 |
| 2002 | 1.62 | 2.00 | 1.25 | 1.28 | 0.18 |
| 2003 | 1.27 | 1.88 | 1.07 | 1.25 | 0.17 |
| 2004 | 1.24 | 1.83 | 0.97 | 1.14 | 0.16 |

Source: OECD, Eurostat.

Table 3 shows that ALMP expenditure varies widely between countries, and shows major changes over time in some countries. In general ALMP expenditure is much higher in Europe than in the United States. Within Europe, the Scandinavian countries spend more than the Rhineland states. In the last ten years there seems to have been some convergence towards ALMP spending between 1% and 2% of GDP within the European countries examined here. This may be influenced by a European employment strategy that calls for activation. Sweden cut back on ALMP spending after the deep economic crisis at the beginning of the 1990s, whereas Denmark continues spending on ALMP despite falling unemployment. Investment in ALMP, especially investment in training for those in employment as well as the unemployed, is used as an instrument for the Danish workers and enterprises to meet the challenges of globalisation (Denmark's National Reform Programme, 2005). France increased ALMP

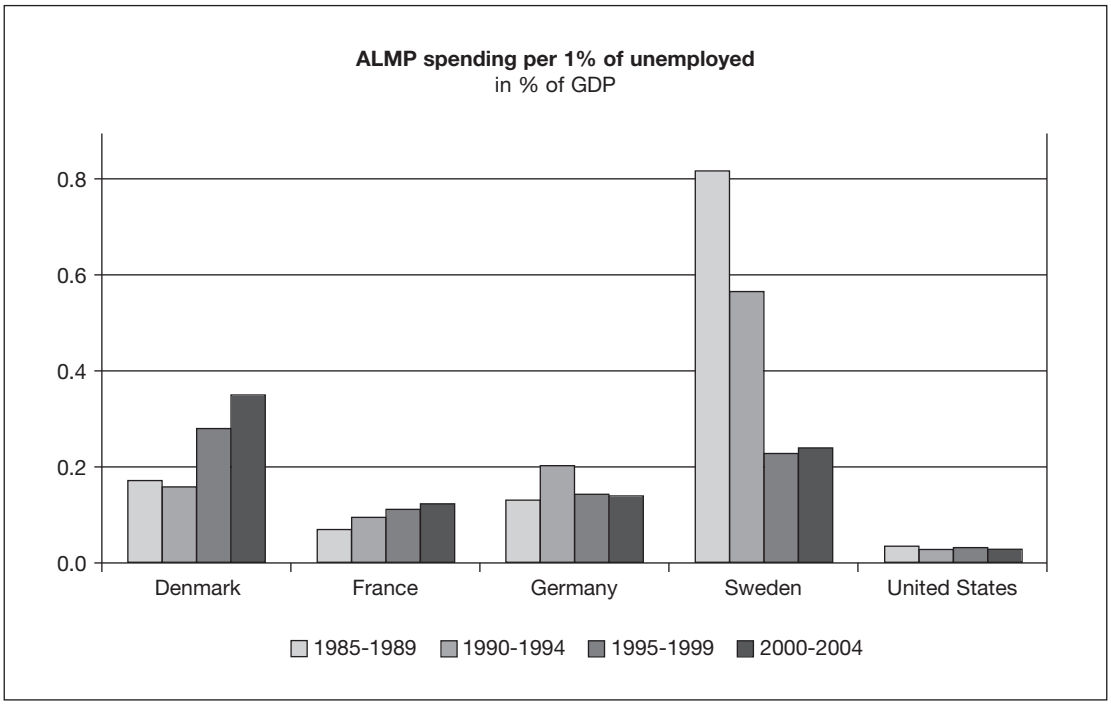


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spending in the 1990s but has cut back on it recently. In Germany ALMP budgets seem to be relatively stable after a temporary push for ALMP expenditure following German reunification. Early indications point to lower ALMP expenditure as a result of the Hartz reforms. In the United States ALMP has never played a major role over the past 20 years and today does so to an even lesser extent.

More information can be obtained if ALMP spending is related to the unemployment rate in individual countries. Figure 1 shows ALMP spending per 1% of unemployed. This figure makes it possible to compare the relevance of ALMP between countries. It also permits a comparison of ALMP expenditure development over time.

**Figure 1: Active labour-market policy spending per 1% of unemployed, 5 year averages 1985-2004**




Source: OECD, Eurostat.

The figure for Sweden at the end of the 1980s and beginning of the 1990s is eye catching. These mark the final years of successful Swedish full-employment policy when unemployment was below 2% in some years and generous ALMP spending was used to bring the unemployed into training or employment. A sharp rise in unemployment between 1990 (1.8%) and 1994 (9.8%) caused by a deep economic crisis was first countered by an increase in ALMP spending. The higher ALMP spending could not be sustained, however, owing to emerging inefficiency and the enormous cost. Sweden is still a country that places emphasis on ALMP but no longer occupies the exceptional position in Europe that it once did. Denmark on the contrary has attracted a lot of attention in recent years thanks to its successful "flexicurity" approach in LMP. Danish "flexicurity" is often described as a "golden triangle": The sides of the triangle consist of "1. Relatively loose legislation for employment protection; 2. Generous social safety net for the unemployed; 3. High (intensity) spending (per unemployed) on ALMPs." (European Commission, 2006/2, p.78). The labour-market reform of

1994 even increased the ALMP spending in absolute terms as well as per 1% of the unemployed. The German figure reflects the temporary attempt to combat growing unemployment after reunification by expanding ALMP at the beginning of the 1990s. In France ALMP expenditure gained importance until the turn of the century and has fallen back somewhat since then, while in the United States ALMP is quantitatively insignificant.

**Table 5: Expenditure for PLMPs in % of GDP, 1985-2004**

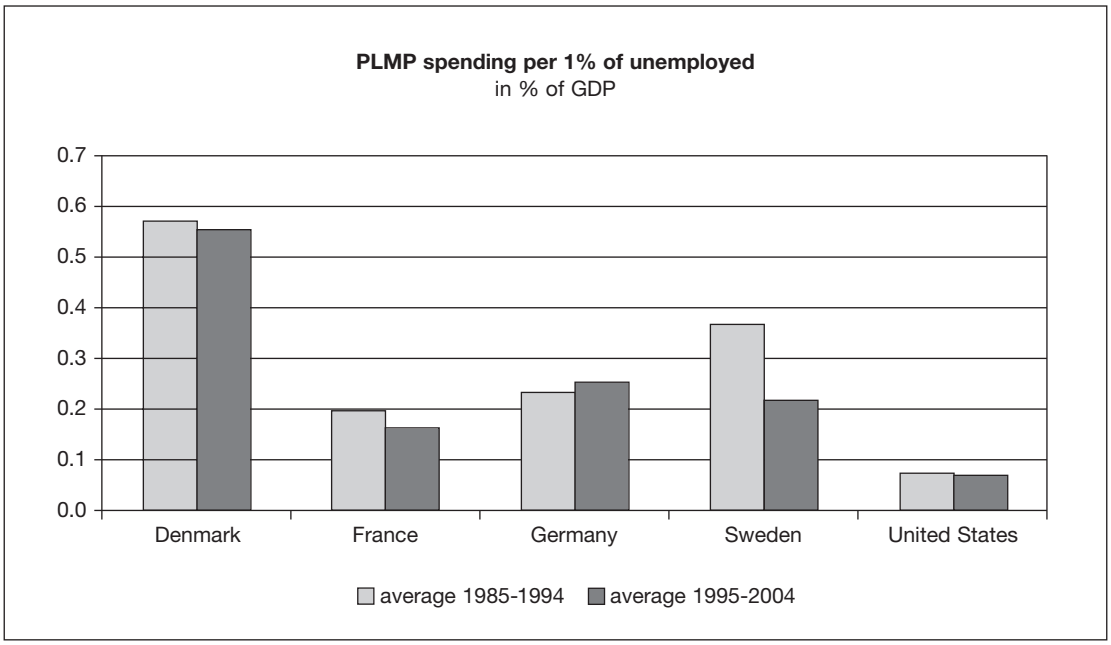
| | Sweden | Denmark | France | Germany | United States |
|---|---|---|---|---|---|
| 1985 | 0.87 | | 2.37 | 1.28 | 0.54 |
| 1986 | 0.88 | 3.8 | 2.26 | 1.2 | 0.5 |
| 1987 | 0.8 | 3.8 | 2.18 | 1.23 | 0.45 |
| 1988 | 0.68 | 4.06 | 2.04 | 1.24 | 0.39 |
| 1989 | 0.63 | 4.36 | 1.86 | 1.1 | 0.42 |
| 1990 | 0.88 | 4.26 | 1.84 | 0.99 | 0.47 |
| 1991 | 1.65 | 4.57 | 1.91 | 1.75 | 0.65 |
| 1992 | 2.71 | 4.81 | 1.98 | 1.91 | 0.59 |
| 1993 | 2.76 | 5.33 | 2.07 | 2.52 | 0.43 |
| 1994 | 2.53 | 4.93 | 1.93 | 2.47 | 0.34 |
| 1995 | 2.26 | 4.42 | 1.77 | 2.33 | 0.33 |
| 1996 | 2.27 | 4.15 | 1.79 | 2.49 | 0.26 |
| 1997 | 2.03 | 3.83 | 1.84 | 2.53 | 0.25 |
| 1998 | 1.86 | 3.41 | 1.8 | 2.28 | 0.25 |
| 1999 | 1.62 | 3.15 | 1.75 | 2.12 | 0.23 |
| 2000 | 1.37 | 3.04 | 1.64 | 1.9 | 0.3 |
| 2001 | 1.07 | 2.29 | 1.63 | 1.94 | 0.55 |
| 2002 | 1.04 | 2.31 | 1.58 | 2.14 | 0.49 |
| 2003 | 1.21 | 2.65 | 1.74 | 2.28 | 0.51 |
| 2004 | 1.32 | 2.66 | 1.72 | 2.31 | 0.37 |

Source: OECD, Eurostat.

Expenditure on PLMPs has developed roughly in line with the unemployment rate of each country. Differences between countries are explained by different unemployment rates and different income replacement rates for the unemployed. Figure 2 shows that, except for Sweden, unemployment benefits per 1% of the unemployed have hardly changed over time in the countries observed. The markedly lower Swedish benefit expenditure per 1% of the unemployed may be explained by the cut in the replacement rate that took effect in 1996.

Expenditure for LMPs differs between countries, as does its financing. Now we will take a closer look at the individual countries' LMP-financing systems.

**Figure 2: Passive labour-market policy spending per 1% of unemployed, 10-year averages 1985-2004**




Source: OECD, Eurostat.

## 3.3 Sweden

In Sweden ALMPs and PLMPs are integrated into the national budget. ALMPs are predominantly financed by taxation. PLMPs are financed from a state grant funded by tax revenues, employer contributions and to a much smaller extent by employees, who pay contributions to trade-union unemployment funds. The integration in the national budget has the advantage that an increase in participation in ALMP programmes directly reduces the number of beneficiaries from unemployment insurance and expenditure. Given a political priority for (more expensive) ALMPs, the additional expenditure is partly offset by lower PLMP expenditure.

Employers pay labour-market contributions as part of the compulsory social insurance contributions. This money is transferred to the labour-market authority and allocated to 40 certified unemployment insurance funds, which are administered by as many sectoral trade unions.

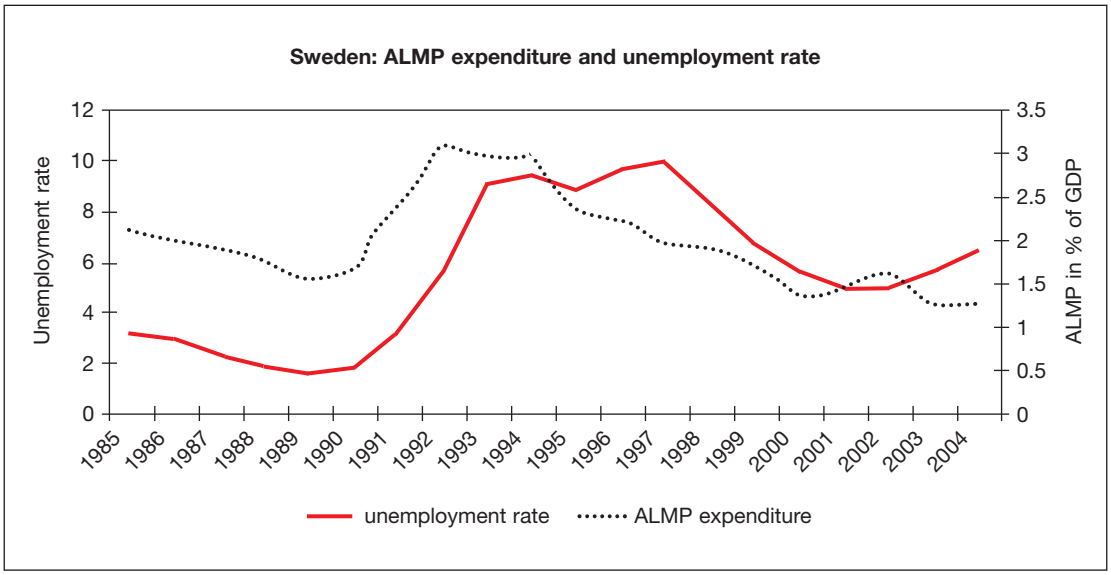
The employee contribution – voluntary and closely linked to trade union membership – is paid directly to the unemployment funds. The majority of employees are members of an unemployment insurance fund (in 1993: 87%). Those who are not covered by a fund and meet certain requirements qualify for cash assistance, which is much smaller than employment insurance benefits. The trade unions determine the member's contribution rate according to the risk of unemployment in the sector. The monthly contribution fees vary widely, but cover only a small proportion of unemployment benefits. 96% of the unemployment insurance funds' expenditure is covered by the state. The above-mentioned employers' contribution is intended to cover 65% of the state contribution to the unemployment funds, but due to the recession and rising unemployment in the mid-90s, in 1994 it covered only 26% of the total expenditure on unemployment benefits and cash assistance benefits. This caused considerable fiscal strain

and increased public debt, which led to the introduction of a new employee contribution in 1994. But when Social Democrats returned to power the employee contribution was removed and replaced by an increase in employers' contributions. A reverse move in health insurance contributions helped keep the overall payroll tax unchanged. The level of compensation was lowered and stricter control of job-searching activity enforced in order to keep the public deficit in check.

ALMPs are funded mainly (around 89%) by general tax revenue. In order to react quickly to developments on the labour market, the financial resources for ALMPs are not only provided by the annual budget bill but also complementary and supplementary budgets.

Employment counselling and placement, job-creation measures and sheltered employment for the disabled are entirely financed by general taxation. Funds for other ALMPs (temporary lay-off compensation, training programmes and work experience schemes) are partly re-financed from labour-market contributions by employers (cf. Anxo/Johannesson 1995).

**Figure 3: Expenditure on ALMPs in % of GDP and the unemployment rate in Sweden**




Source: OECD

Figure 3 clearly shows the counter-cyclical use of ALMP, which weakened in the 1990s and not longer holds since 2002. Periods of slow economic activity and rising unemployment were countered by a rise in ALMP expenditure. Schmid et al. as well as Anxo/Johannesson show the counter-cyclical use of ALMP for the 1970s and early 80s. But in the 1990s this anti-cyclical policy weakened. In 1993 and 1994 the deep recession led to a severe rise in unemployment but no further rise in ALMP expenditure, which already exceeded 3% of GDP in 1992. A new rise in unemployment in 1996 and 1997 was accompanied by a fall in ALMP expenditure to 2%. Anxo/Johannesson explain this in two ways: first, ALMP had reached its limits of administration and efficiency. Second, a shift in economic policy took place in the early 1990s when the main objective of Swedish economic policy shifted from full employment to price stabilisation. Crowding out of ALMPs only took place when total LMP expendi-

ture approached 6% of GDP. The Swedish tradition of a heavy emphasis on counter-cyclical ALMP was no longer observable after 2002, when unemployment increased but ALMP spending fell to its lowest level in at least 20 years.

LMP activity rates, that is the proportion of ALMP expenditure in total LMP expenditure, were above 70% in the late 1980s. They decreased to around 50% in the latter half of the 1990s, which is still very high and shows that activation is still given priority over benefits (see table 6).

**Table 6: Activity rates – expenditure for ALMPs in % of total LMP expenditure, 5-year average**

| | Sweden | Denmark | France | Germany | United States |
|---|---|---|---|---|---|
| 1985-1989 | 70.7 | 21.5 | 25.9 | 41.0 | 34.4 |
| 1990-1994 | 56.9 | 23.1 | 35.0 | 42.1 | 30.8 |
| 1995-1999 | 50.6 | 31.9 | 42.7 | 35.8 | 39.3 |
| 2000-2004 | 53.4 | 40.9 | 41.4 | 36.6 | 27.4 |

Source: OECD, own calculation.

## 3.4 Denmark

Denmark's unemployment insurance system is voluntary and covers around 90% of employees and self-employed (cf. OECD 2004a). Danish LMPs are often characterised as being very generous, with high unemployment benefits and extensive ALMP measures. The unemployment benefit is 90% of previous wage up to a relatively low ceiling of €447 a week before tax. Unemployment benefits are therefore a flat rate for many unemployed. Employees and the self-employed voluntarily pay a small membership contribution to unemployment insurance funds. However, all employees and the self-employed must pay 8% of their gross income towards the labour-market fund that finances ALMP and PLMP. Deficits are covered by the general budget.

Financing of LMP changed with the 1994 tax reform. Until then most passive and all active LMPs were funded by general tax revenue. The contributions of wage earners and employers to the various unemployment insurance institutions amounted to less than 30% of the cost. The long-term unemployed were entitled temporary subsidised employment either in public services or the private sector, after which they were able to receive unemployment benefits again. ALMP therefore had a supporting role for unemployment insurance. Rising structural unemployment and trouble with the design of ALMPs led to the labour-market reform of 1994, including its financing.

In June 1993 a tax reform and a labour-market reform were adopted simultaneously by the Danish parliament. The tax reform lowered the personal income tax gradually from 1994 until 1998. The substantially lower income taxation was accompanied by the adoption of so-called green taxes (higher vehicle, petrol and electricity taxes, charges on water and waste). A labour-market contribution was introduced in order to finance labour-market policy. Beginning in 1994, employees and the self-employed had to pay a new tax of 5% of their gross

earnings, rising to 8% from 1998 onwards, while employers have contributed 0.6% of the wage bill since 1998. However, the employers' contribution was repealed in 2000. The contribution originally financed three labour-market funds: an unemployment benefit fund, an activation fund and a sickness benefit fund (see below). This burdening of the bulk of financing LMPs on the employees still left them with higher net income due to lower income taxes.

The overall lifting of the tax burden resulted in a strong push for private consumption and economic growth. Private household consumption grew by an impressive 6.3% in 1994 and continued growing in the following years. This helped fuel strong economic growth (5.5% in 1994), which lasted until the end of the decade and contributed to falling unemployment. The unemployment rate fell continuously, from 9.6% in 1993 to 4.9% in 1998. In 2006, at 3.8%, the unemployment rate was the lowest in the European Union.

Initially the reforms put a strain on public finances. The budget deficit remained high, at 3.3% of GDP in 1994, but strong growth and falling unemployment and unemployment expenditure helped to reduce the budget deficit each year. From 1998 onwards Denmark has achieved an annual budget surplus.

Despite the introduction of labour-market contributions, Denmark still has the smallest non-wage labour costs within Europe and smaller non-wage labour cost than the United States, Canada and Japan.

**Table 7: Non wage labour cost in selected OECD countries in 2005**

| 2005 | non wage labour cost in % of wages |
|---|---|
| France | 93.1 |
| Germany | 76.6 |
| Sweden | 70.5 |
| United States | 44.8 |
| Denmark | 33.6 |

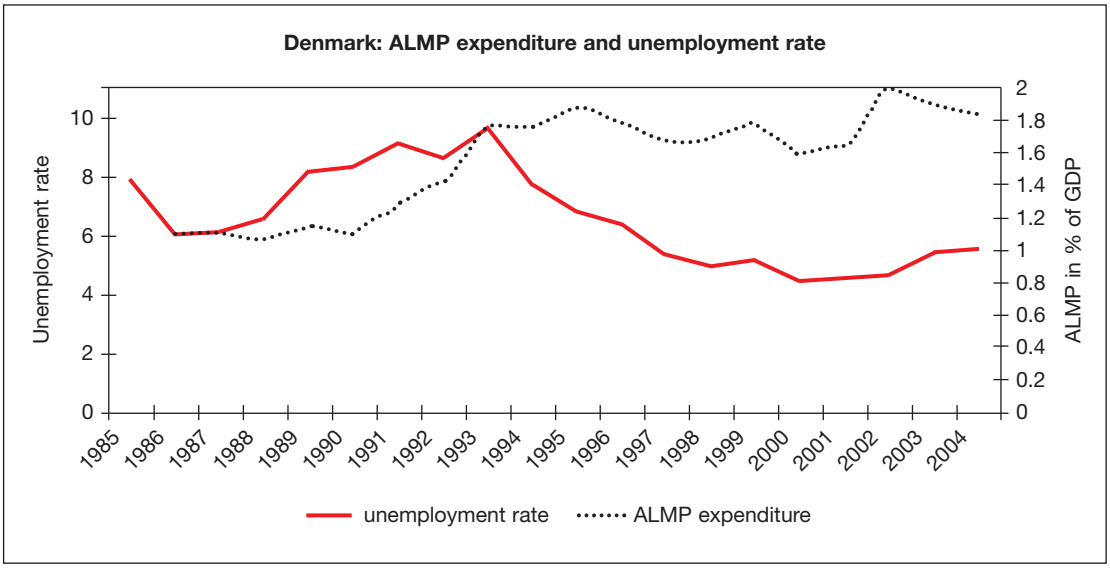
Source: Guger 2006.

Traditionally, Denmark enhances its international competitiveness by having small non-wage labour costs but high indirect taxes (e.g. a value added tax of 25%). This keeps the price of exports down (low non-wage labour costs, no value-added tax) while increasing the price of imports (high value-added tax on imports). The labour-market reform of 1994 increased the non-wage labour cost but since other social expenditure is tax financed (sickness, family allowances, social pension) the non wage labour cost remained low as shown by table 6. German policy makers are also intending to lower non-wage labour costs by increasing value-added tax and reducing labour-market contributions as of 2007.

Three separate funds were established in order to prevent crowding out of ALMPs by PLMPs. The first fund paid unemployment benefits, early retirement benefits and other benefits. The second fund financed ALMPs, vocational training and company leave for education. The third fund covered sickness allowances, maternity benefits, parental leave and a sabbatical programme, which has since been abolished. Contrary to the initial design, with individual

contribution rates for each fund, means were transferable between funds (cf. Toft 2000; Wagner/Obst 2000). Since 1999 these three funds have been replaced by an overall labour-market fund. While this makes crowding out of ALMP possible, it has not happened. Denmark has continued to invest in ALMP. A change in government from Social Democrats to Liberal-Conservatives did not alter ALMP spending but shifted the focus somewhat from labour-market training towards employment subsidies.

**Figure 4: Expenditure for ALMPs in % of GDP and unemployment rate in Denmark**




Source: OECD, Eurostat

Figure 4 shows there was no crowding out of ALMP following the 1994 LMP reforms. ALMP expenditure has remained at a very high level despite a fall in unemployment. ALMP became more flexible, with the unemployed being entitled to an activation plan and participation in an ALMP programme. Company leave and job-rotation were introduced in order to increase flexibility. A special focus was placed on vocational training for adults, which provides a range of short- and medium-term programmes (cf. Toft 2000).

No distinctive counter-cyclical policy can be observed: while ALMP expenditure grew roughly alongside unemployment up until the reforms, it has since remained at a high level with slight counter-cyclical patterns. This high level of ALMP spending has increased LMP activity rates. But due to generous unemployment benefits the LMP activity rate is still lower than that of other European countries (see table 6).

## 3.5 France

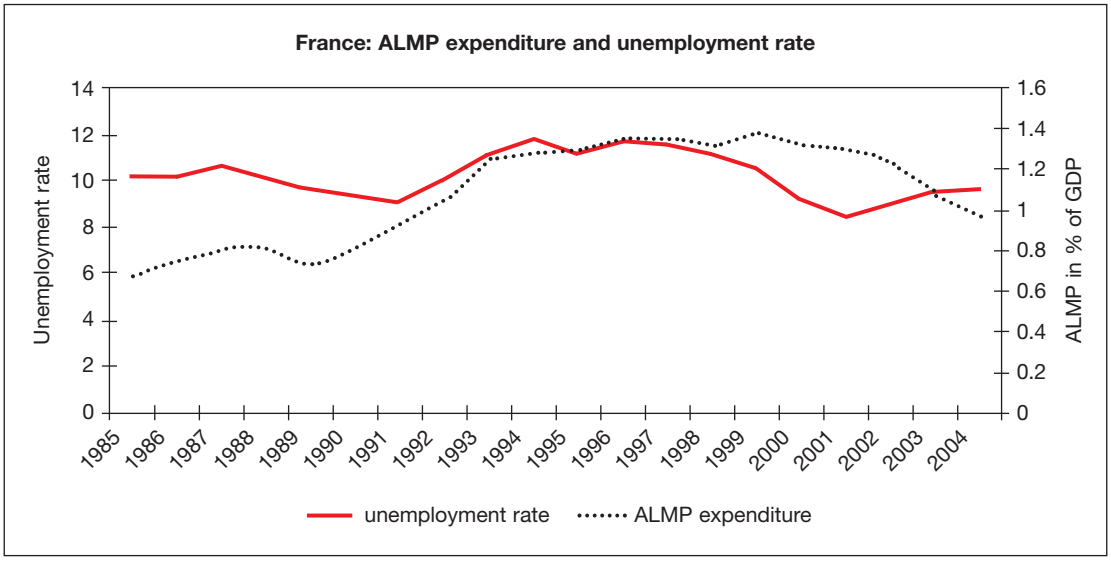
The separate labour-market institutions in France are funded separately. The unemployment insurance is based upon a collective agreement between the employers' association and the trade unions. The unemployment benefits are financed by contributions. Employers contribute a larger share than employees but the wage earners' share rose to 37.5% in 1995. The contributions are 2.4% of wages for employees and 4% of wages for employers up to a

ceiling of €10,000 a month (cf. MISSOC 2004, comparative tables part 2). There is in addition a special levy on layoff of older employees and those on short-term contracts. The contribution rates are adjusted annually, dependent on the level of unemployment. This feature makes financing pro-cyclical and deprives France of an automatic stabiliser (see chapter six for a discussion of automatic stabilisers). In addition tax income is used to cover a deficit. There are two forms of unemployment assistance: allocation d'assistance for long term unemployed with sufficient years of employment and RMI (revenu minimum d'insertion) for all other. Both are funded by the general budget.

ALMPs are organised by the unemployment insurance, government institutions (ANPE – Agence Nationale Pour l'Emploi) and the local governments. ALMP is funded by general tax revenue and to a very small part by contributions.[4] The main focus of policies in France is on reducing the labour costs for employers by lowering their social security contribution for low and medium wages. In the 1990s a range of measures to reduce employers' social-security contributions was introduced. The various schemes were reduced to a single contribution relief measure in 2005. The one condition for entitlement is the wage level. Approximately nine million employees (about 40%) are covered in the eligible companies. Other incentives for low-income workers to return to work include an earned-income tax credit, from which more than eight million households benefit. Financial resources for vocational training have declined in recent years, amounting to less than 12% of LMP expenditure in 2005 (cf. European Commission 2004). The LMP expenditure statistics from the OECD, however, do not include social-security subsidies and earned-income tax credit.

As mentioned before government is not the only financier for ALMPs – in 1994 the contribution-financed unemployment insurance institution started funding activation policies. Contributions earmarked for unemployment benefits were rededicated for ALMPs in order to achieve the goal of strengthening activation over passive policies. The proportion of ALMPs funded by contributions is very small.

**Figure 5: Expenditure for ALMPs in % of GDP and unemployment rate in France**




Source: OECD.

[4] Information by Carole Tuchszirer, Institut de Recherches Economiques et Sociales, Paris.

Until 1999, France showed a tendency towards increasing ALMP expenditure (figure 3). In 1999 the expenditure was nearly double in terms of GDP compared to the mid 1980s. As unemployment rose, ALMP expenditure grew too. But even in some years of falling unemployment ALMP expenditure grew, leading to rising activity rates (see table 5). The growing emphasis on ALMP ended at the beginning of this century. Despite rising unemployment between 2001 and 2004, ALMP expenditure fell by 25% in terms of GDP.

## 3.6 Germany

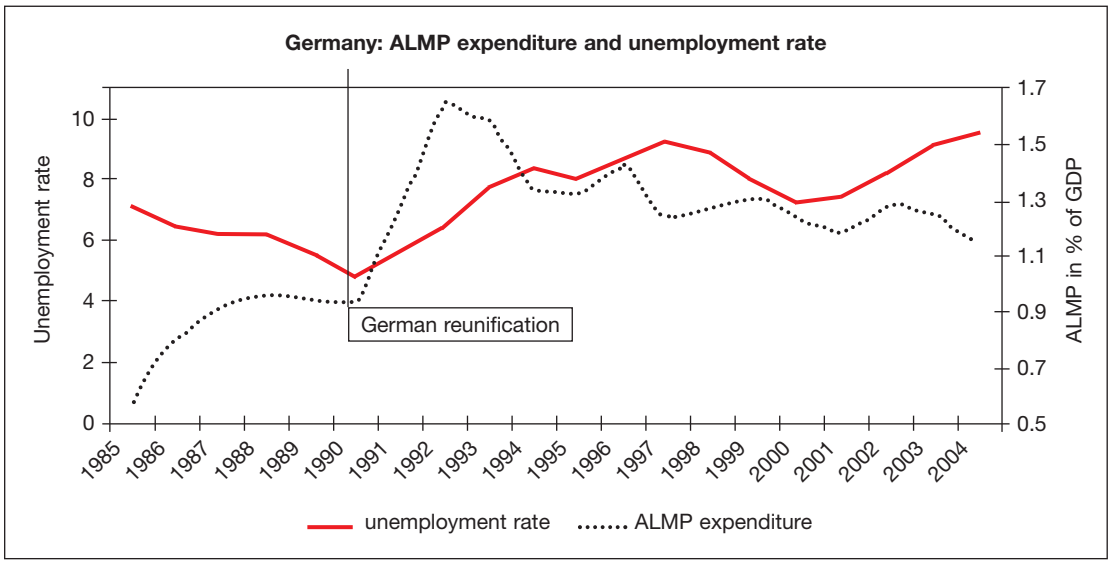
In Germany ALMPs and PLMPs are mainly financed by employers' and employees' contributions, which are managed by the tripartite Federal Employment Agency. Until the end of 2006 the contribution rate was a payroll tax of 6.5% shared equally by employers and employees with an upper monthly gross income limit of more than €5,000. Since 2007 the unemployment insurance contribution has been reduced to 4.2% of gross income. At the same time, value-added tax has been raised by 3 percentage points. It is planned to finance the cut in contribution income by lower expenditure and by using part of the higher value-added tax for LMP. Tax financing is planned to cover 15% of ALMP and unemployment benefit expenditure in 2007 (cf. Bundesagentur für Arbeit 2007). Unemployment assistance continues to be financed by tax income.

Unemployment benefits and ALMP expenditure are borne by the mainly contribution-funded Federal Employment Agency. When a deficit cannot be covered by available reserves it is covered by a non-repayable subsidy from the federal budget. In 2003, after a prolonged economic slump and rising unemployment, the federal budget subsidy amounted to €6.2bn, or 11% of the total budget of the Federal Employment Agency. This was considerably more than in previous years and added to political pressure to reduce expenditure on unemployment.[5] In 2005, the first year after extensive labour-market reforms that included its financing, the federal budget subsidy fell to €0.4bn. In 2006 the reforms and German economic recovery resulted in a huge financial surplus of €11.2bn for the Federal Employment Agency (cf. Bundesagentur für Arbeit 2006). The cut in contribution rates will run down the surplus in 2007.

Let us take a look back to the 1990s. The reunification of Germany in October 1990 constituted an important breach in German economic history. At the beginning of the 1990s a third of jobs in the former East Germany were lost as a result of the economic transformation. The government tried to stem the massive job losses by establishing training programmes, economic part-time work and job-creation schemes known as Arbeitsbeschaffungsmaßnahmen (ABM). ABM are publicly sponsored temporary jobs in public and non-profit institutions. These measures raised LMP spending at the beginning of the 1990s but did not succeed in bringing unemployment down. From 1990 until 1993, LMP expenditure more than doubled, from less than 2% of GDP to more than 4%. ALMP expenditure per 1% of unemployed and ALMP expenditure in relation to GDP peaked in 1992. During the following years continuing growth in unemployment and PLMP expenditure met with falling ALMP expenditure. The economic boom of the late 1990s delivered only a short-lived fall in the unemployment figures.

[5] In 2000 the subsidy from the general budget amounted to ?0.9bn, and has risen continuously until introduction of the Hartz reforms.

**Figure 6: Expenditure for ALMPs in % of GDP and unemployment rate in Ger-**




Source: OECD.

Unemployment rates of nearly 10% led to the "Hartz reforms" from 2003 until 2005, accompanied by political controversy. The Federal Employment Agency was reformed, for example by merging the employment-service office with the social-welfare office, and ALMP and PLMP were substantially restructured. ALMP changes include support for self employment and business start ups (Ich-AG), temporary employment companies that try to get the unemployed into temporary employment (Personal Service Agenturen), reduced training for the unemployed, "one-Euro-jobs" for the long-term unemployed who receive unemployment assistance and can earn one or two Euros an hour for working in the public or non-profit sector. Beginning in 2005, unemployment assistance for the long-term unemployed and social welfare were consolidated to establish means-tested unemployment assistance (Hartz IV). The latter met widespread public resentment. Unemployment assistance has been and continues to be funded by the general budget. However, for each long-term unemployed person who switches from unemployment benefits to unemployment assistance the Federal Employment Agency has to pay a fixed sum, the "Aussteuerungsbetrag". In 2005 this amounted to €4.5bn and covered 20% of unemployment assistance. In 2006 it fell to €3.3bn. The Federal Employment Agency is effectively fined by the "Aussteuerungsbetrag" for failure to prevent long-term unemployment. However, it has turned out that this fine does not yield desired behaviour. There is a segmentation of unemployed: unemployed people who are prepared to work are placed on the labour market, unemployed with little motivation are activated, and those who need qualification receive training. Unemployed people with little chance of labour-market integration only receive benefits until they become long-term unemployed and the "Aussteuerungsbetrag" is to be paid.[6] This selection reinforces social exclusion, and those who need ALMP most do not receive it until they have become long-term unemployed.

Early results indicate that the Hartz reforms have resulted in lower investment in ALMP as shown by a fall in ALMP expenditure in 2004. According to the 2005 labour-market report by

[6] Information from Josef Wallner, head of labour market department, Arbeiterkammer Wien, following a study trip to the Federal Employment Agency, Berlin.

the Federal Employment Agency, ALMP expenditure continued to fall in 2005, especially expenditure for training programmes. ALMP expenditure as recorded by the Federal Employment Agency – which may be different to OECD and Eurostat definitions – fell by more than 27% in 2005 and by another 18% in 2006.

LMP activity rates show little variation over five-year periods. But there is substantial variation within individual years, when ALMPs are crowded out. From 1992 to 1994 – a period of rising unemployment – the activity rate dropped from 46.3% to 35%. The lowest activity rate consequently coincides with the highest unemployment rate in 1997. Crowding-out of ALMP in Germany is discussed in some detail in chapter 4.1.

## 3.7 USA

In the United States, ALMPs and PLMPs are usually conceived separately from each other and they are institutionally separated as well. Unemployment insurance is located at state level whereas ALMPs are the responsibility of the federal government. Federal law obliges the states to establish an unemployment insurance system that is to be financed through employers' contributions by a payroll tax. The contribution rate, the level and duration of unemployment benefits differs markedly between states (cf. Schmid et al. 1992). In three states there is a small employee contribution. The unemployed can receive benefits for a maximum of six months in most states with a possible extension of 13 weeks – in some states 20 weeks – when unemployment rates are high.

An interesting feature in the United States is experience rating, a tax on layoffs to finance unemployment benefits. Experience rating links the employers' contribution rate to the layoff history of the company. It requires employers who pursue a hire-and-fire policy to contribute more to financing unemployment benefits than employers who prefer long-term employment contracts. Experience rating is intended to provide an incentive for the stabilisation of employment. Its aim is to prevent temporary layoffs in a labour market that is very flexible with no job protection and a low minimum wage. In 2002 employer contributions only partially covered the cost of unemployment insurance. The remainder is financed by general taxation. The employers' contribution coverage rate varies widely across states, ranging from 72% in New Hampshire to 14% in Georgia (cf. OECD 2004; Cahuc/Malherbet 2004).

In periods of high unemployment there is a federal programme for those who have exhausted their claims, financed by a small federal payroll-tax and individual state unemployment funds. In 2004 of a total of 8.15m unemployed (household survey data), 3.27m received unemployment benefits, a coverage rate of a modest 40%. Though this number is not comparable to much higher European coverage rates (different data source of out of work recipients, most European countries have unemployment assistance for long-term unemployed, unemployed in the United States who run out of unemployment benefits but receive a different type of benefit are not counted) it nevertheless shows that welfare for the unemployed is much more generous in Europe.

In many European countries there are more recipients of out-of-work income maintenance and support than there are unemployed (see table 7). This might be due to the fact that job searchers who participate in activation programmes are not counted as being unemployed

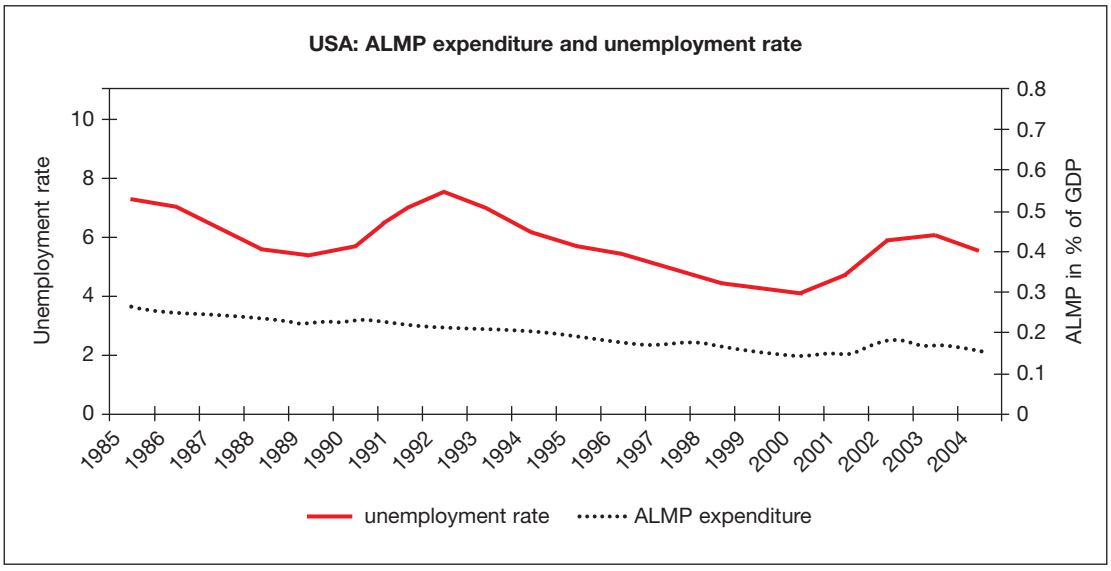
**Table 8: Rate of unemployed receiving out-of work income maintenance in 2004**

| 2004 | number of unemployed | out-of work-income recipients | Unemployment benefit coverage rate |
|---|---|---|---|
| Denmark | 159,600 | 195,860 | 123% |
| France | 2,639,900 | 2,602,161 | 99% |
| Germany | 3,931,000 | 4,348,496 | 111% |
| Sweden | 295,500 | 332,734 | 113% |
| United States | 8,149,300 | 3,273,919 | 40% |

Source: Eurostat, US Department of Labor, Bureau of Labor statistics, Employment and training administration[7]

(e.g. participants in labour-market training) according to the ILO and Eurostat definitions of unemployment. As a result European countries that place a strong emphasis on ALMP have "coverage rates" of more than 100%. At the same time ALMP programmes can lead to an underestimation of unemployment.

**Figure 7: Expenditure for ALMPs in % of GDP and unemployment rate in the United States**




Source: OECD[8]

ALMP programmes are on a very small scale (see table 3) and have been declining over recent decades.[9] They are financed from federal budget funds but implemented and shaped by individual states and regions. One of the most famous ALMP schemes is Job Corps, a vocational training programme that serves disadvantaged youth and has been in existence since the 1960s. Employment services are financed through the federal unemployment insurance tax.

[7] The number of out-of-work recipients in the United States results from calculating the average weekly number of initial unemployment benefit claims plus the number of continued claims in 2004.
[8] The fiscal year starts on October 1 of the previous year.
[9] There are some training programmes in individual states and a federal programme retraining workers who have lost their jobs due to the North American Free Trade Agreement (NAFTA). These may not be included in the OECD numbers.

Expenditure for ALMPs in the United States is too small to have a stabilising effect on the economy and employment. It does not seem to respond to economic downturns. Since 1985, it has not been possible to observe either a pro- or an anti-cyclical pattern. Consequently, LMP activity rates were highest in the economic boom of the late 1990s but dropped considerably in the ensuing downturn (see table 5). As in all countries investigated, PLMPs, however, have a clear anti-cyclical pattern. PLMP in the United States is therefore an automatic stabiliser.

## 4. CROWDING OUT AND LEGAL ENTITLEMENT TO ALMP

The previous chapter described the financing of LMPs in different OECD countries. Table 9 sums up the results on main sources of financing. This section will focus on the advantages and disadvantages of contribution versus tax financed LMPs. A special focus is on the chances of crowding out of ALMPs by PLMPs and financing of ALMPs over the business cycle. If financing is not designed carefully there is a chance there will not be sufficient funding for ALMPs when they are most important – in recession, when unemployment is rising. While unemployment benefits are a legal entitlement in many countries when criteria are met, participation in ALMP programmes is usually up to the discretion of public employment services, except for some countries such as Denmark, where activation participation is an entitlement but compulsory as well.

**Table 9: Main sources of financing LMPs in Sweden, Denmark, France, Germany and the USA[10]**

| | | General taxation | Employers contribution | Employees contribution |
|---|---|---|---|---|
| Sweden | ALMPs | 89% | 11% | |
| | Unemployment benefits | 34% | 62% | 4% |
| Denmark | ALMPs | | | 100% |
| | Unemployment benefits | | | 100% |
| France | ALMPs | close to 100% | | |
| | Unemployment benefits | | 63% | 37% |
| Germany | ALMPs | | 50% | 50% |
| until 2006 | Unemployment benefits | | 50% | 50% |
| Germany | ALMPs | 15% | 42.5% | 42.5% |
| 2007 | Unemployment benefits | 15% | 42.5% | 42.5% |
| USA | ALMPs | 100% | | |
| | Unemployment benefits | 28-82% | 18-72% | |

[10] In many countries with contribution-financed unemployment benefits, deficits are covered by the – tax financed – general budget (see individual country chapters).



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In recession, contributions as well as general tax revenue stall or even decline. The expenditure on unemployment benefits however rises rapidly and ALMP programmes become more important as the number of long-term unemployed grows. ALMPs are important at this point of the business cycle in order to keep work motivation and provide qualifications that are helpful when an economic upswing increases labour demand. Recession is the crucial phase of a business cycle for evaluating the funding of ALMPs. Both contribution and tax-financed ALMPs face funding difficulties when they are most needed.

As has been shown, financing of ALMPs and PLMPs differs between the countries investigated. The source of financing ALMP is mixed but all countries fund unemployment benefits at least to a large extent by contributions from employers, employees or both. The rationale seems to be that those who benefit from the unemployment insurance have to contribute towards its financing. But does the mode of funding LMP have an influence on the quantity of ALMP in individual countries over the business cycle?

Wagner/Obst (2000) conclude that political preferences are more important in determining the design of LMPs than the mode of financing is. Denmark shows that a change in financing did not change the priority of ALMPs over PLMPs. On the contrary, LMP activity rates increased significantly. It has to be added, however, that the Danish financing system has not yet faced the stress test of significantly rising unemployment. In addition, generous Danish unemployment benefits, which are up to 90% of previous wages, possibly require compulsory activation programmes in order to provide non-financial incentives for unemployed to take up employment.

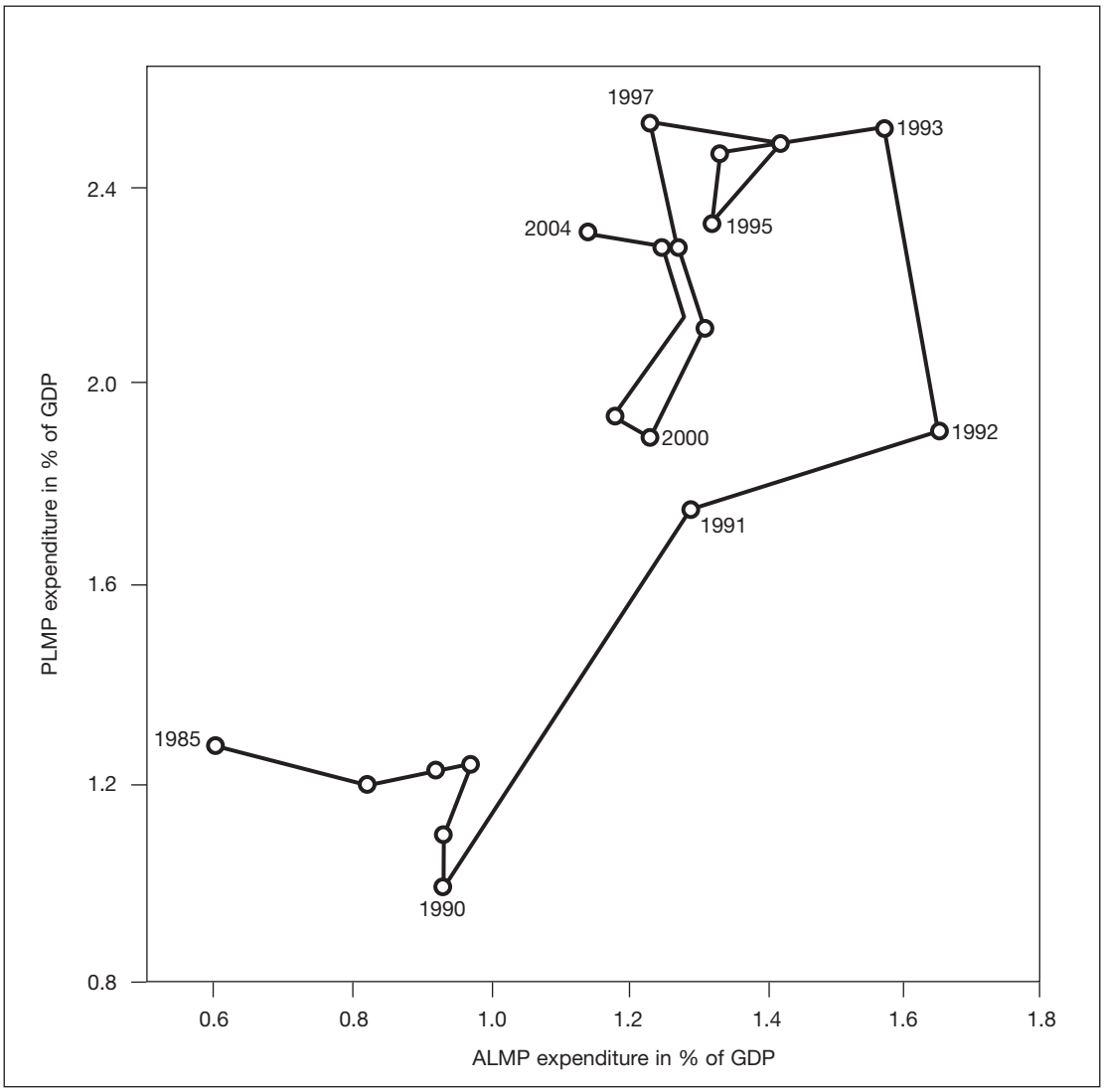
## 4.1 Crowding out of ALMPs in Germany

The financing of LMPs in Germany causes crowding out of ALMPs, as can be shown by spending patterns. At the beginning of an economic downturn ALMP expenditure rises. But with a continuing rise in unemployment ALMP expenditure falls and a strong pro-cyclical pattern of ALMP expenditure emerges, which continues at least until the early stages of falling unemployment. Schmid et al. (1992) have earlier described this pattern for the period from the early 1970s until the late 1980s.

In the period covered here, we find declining unemployment rates from 1985 until 1990 but rising ALMP expenditure until 1988. Unemployment rose significantly until 1994 – PLMP expenditure until 1993 – but ALMP expenditure in terms of GDP peaked in 1992 and slipped back afterwards (see figure 8). This was due to the economic and labour-market shock caused by German reunification: ALMP programmes like the publicly sponsored temporary jobs – “ABM” – which were intended to bring temporary labour-market relief have not been sustained for the prolonged period of economic trough Germany experienced after reunification. In 1993 and 1994, ALMP was crowded out by PLMP.

In 1996, when unemployment rose again, there was initially a small increase in ALMP expenditure, which was reversed the following year when the unemployment rate continued to soar. But when unemployment fell until 2000, ALMP expenditure rose slightly until 1999. Rising unemployment after 2000 met with approximately stable or slightly declining ALMP

**Figure 8: Crowding out of ALMP by PLMP in Germany**




Source: OECD.

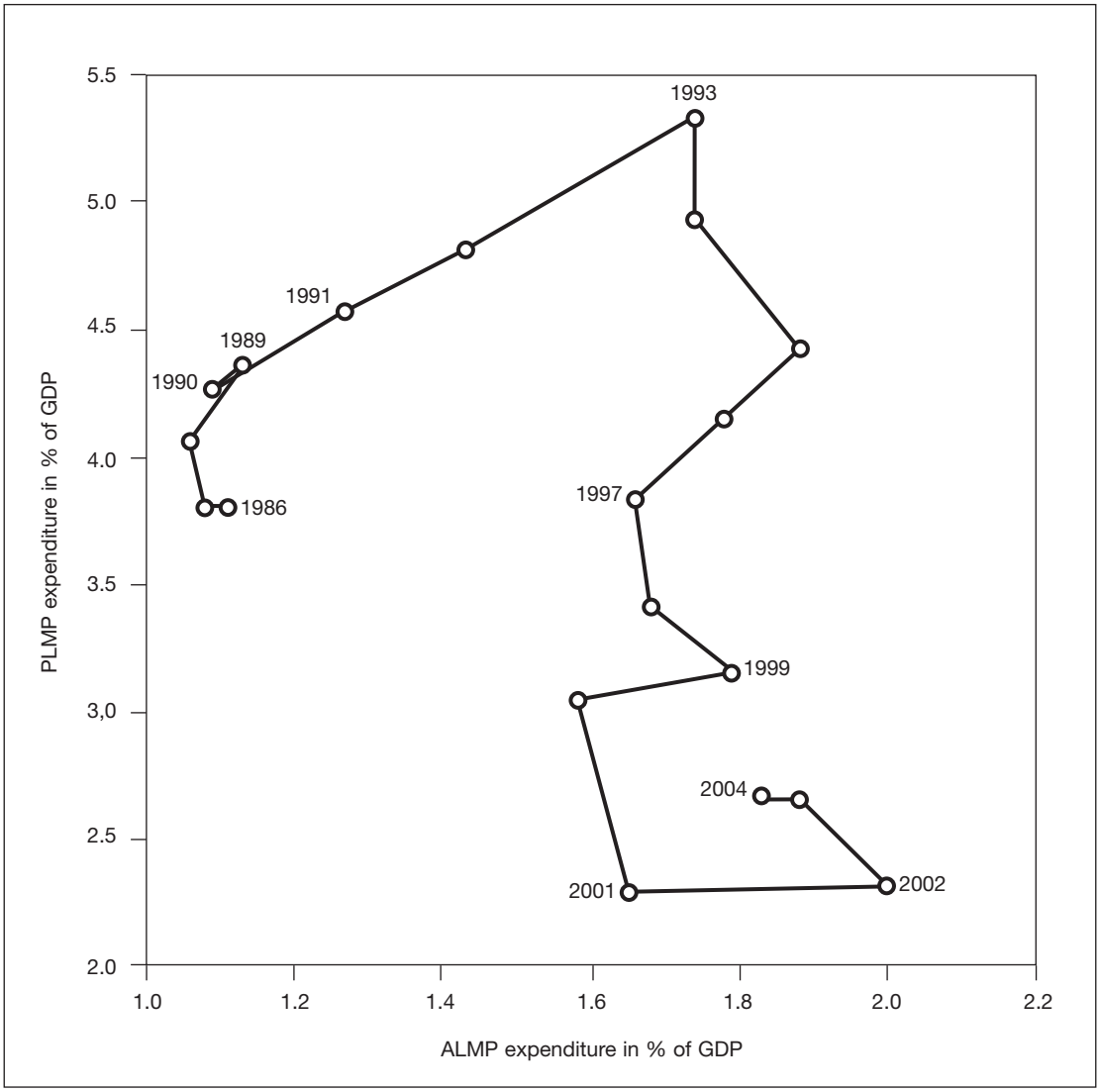
expenditure until the Hartz reforms were introduced. Preliminary data (see Chapter 3.6) indicate falling ALMP expenditure since then.

Schmid et al. (1992) earlier explained this disturbing pattern as being "to a large extent" a result of the financing system: "When unemployment increases at the beginning of an economic downturn, the Federal Employment Institute has usually accumulated reserve funds at its disposal sufficient to finance both the increased need for wage-replacement benefits and increased expenditure for active labour-market policy. However, when a sharp economic downturn occurs, the reserves of the FEI are quickly exhausted. The federal government must cover the ensuing deficit and initiates restrictive measures to eliminate it, which primarily affect active labour market policy programmes because they can be most easily reduced" (Schmid/Reissert/Bruche 1992, 218). Inefficiencies may result when funding and participation in activation programmes is governed by budget constraints rather than labour-market considerations. To recapitulate, contribution-financed ALMP in Germany causes crowding-out of ALMPs by PLMPs and contributes to the pro-cyclical pattern of ALMPs in Germany.

## 4.2 ALMP entitlement as a safeguard

Even without analysing the German experience, Wagner/Obst (2000) conclude that it seems to be easier to pursue ALMPs in an anti-cyclical way when financing is tax-funded. Crowding out of ALMPs is more likely when funds for all LMPs come from contributions. The history of German LMP shows that in prolonged economic downturns cutting ALMP programmes is more likely than raising contribution rates. Contribution-financed ALMP in Denmark, however, have not experienced significant crowding out. In the early 1990s, ALMP expenditure rose and fell with PLMP expenditure (see figure 9). A significant fall in PLMP expenditure and unemployment after Danish labour-market reforms did not result in declining ALMP expenditure until 2002. ALMP expenditure per unemployed person rose. In 2003 and 2004, rising PLMP expenditure met with declining ALMP expenditure. However, it might be a correction of the steep increase in ALMP spending in 2002 rather than crowding out. In Denmark, some legal entitlement to ALMPs plus linking benefits to participation in an ALMP programme combined with the political tradition seems to be a safeguard against crowding out of ALMP.

**Figure 9: Crowding out of ALMP by PLMP in Denmark**




Source: OECD, Eurostat.

When the general budget is the financial source for ALMP, it competes against all other government expenditure. The fiscal squeeze of a growing budget deficit can lead to crowding out of ALMP by PLMP. This risk increases when ALMP is tax-funded and PLMP is entirely contribution financed: when consolidation efforts in the general budget curtail ALMP, the increasing expenditure on PLMP has to be tackled in a different budget.

To recapitulate, the danger of crowding out is high when both ALMPs and PLMPs are contribution-financed, because a prolonged rise in unemployment can only be countered by an increase in contributions, lower unemployment benefits or cuts in ALMP programmes. In many countries, the last of these is politically the easiest to accomplish.

In recession, both tax- and contribution-financed ALMPs face the danger of crowding out. When unemployment – and especially the number of long-term unemployed – rises, revenue from either source becomes scarce. This danger can be avoided when the long-term unemployed have a legal entitlement to participate in ALMP programmes. A broad variety of ALMP programmes should provide unemployed and the public employment service with individually and economically suitable options. An entitlement to a specific ALMP programme seems to be inflexible given the inhomogeneous nature of the unemployed, changing labour-market conditions over the business cycle and structural change. Some sort of individual mutual agreement between the unemployed and the public employment service might therefore be more efficient. The different programme options come at different costs, and care is needed to ensure cost-efficiency. The design of an entitlement to ALMP needs to prevent more expensive but efficient programmes from being scrapped in recession and expansive but less efficient programmes being used in an economic upswing.

A legal entitlement to ALMP expenditure could reinforce a European employment strategy that calls for the participation of long-term unemployed in activation programmes. Very prudent implementation of activation policies is necessary however. There needs to be careful balancing between entitlement and compulsory activation. Activation that resembles forced labour would discredit ALMP.

## 5. GROSS AND NET COST OF ALMP

It has been shown that many European countries invest quite substantial resources – between 1% and 2% of GDP a year – in ALMP. However, this is the gross cost. This chapter will analyse ALMP in Germany using surveys by Spitznagel/Bach (2000; 2003) and show that net cost can be substantially lower.

Spitznagel/Bach investigate the economic impact of some ALMP programmes in Germany using cost-benefit analysis. Unemployment leads to a loss in value added expressed in foregone GDP. The authors estimate that the loss in production volume caused by unemployment in Germany has amounted to more than 10% of GDP in each year since 1993. The loss in output developed along similar lines to the unemployment rate, reaching more than 14% in 1997. For 2002, they estimate an 11% loss in production

volume. This is based upon a potential productivity estimate of the unemployed that is 15% to 20%[11] below the average of the working population, remaining frictional and structural unemployment of 1.5% and the sufficient existence of real capital. The more narrowly defined fiscal cost of unemployment arises from expenditure for the unemployed (unemployment benefits, unemployment assistance, etc.), forgone tax (wage tax, value added tax) and social security contributions. Spitznagel/Bach estimate the total fiscal cost of unemployment as being more than 4% of GDP in the late 1990s and somewhat less for the following years (2002: 3,5%).

Analysing the benefits of ALMPs is difficult. Net employment effects, deadweight and distortion by financing have to be considered. Net employment effects may be small if labour demand is exogenously determined and ALMPs only lead to the rotation of employed and unemployed.[12] This consideration of Spitznagel/Bach needs to be analysed more closely: while small net employment effects might be a serious concern in subsidised employment in the private sector the effect is not of much relevance in carefully designed public or non-profit job creation and measures that support unemployed to start their own enterprise. Furthermore, LMPs create income security and additional aggregate demand that in turn creates stronger demand for labour. In developed as well as developing countries, demand side ALMPs, for example building infrastructure (for example roads, railways or irrigation) enables enterprises to produce and offer goods and services and might lead to sustainable additional non-subsidised employment.

Deadweight occurs when LMPs bear the burden that employers and employees would otherwise carry themselves. Examples may be found in training that the unemployed would have taken on their own initiative, investment in in-firm training or subsidised work (private and public) that would have been carried out anyway. For Germany, the authors conclude that regulations provide a good safeguard against windfall gains.

From a macroeconomic perspective, funding LMP might lead to distortion. Financing LMP by contributions or taxes lowers disposable income and can result in crowding out of private demand for consumption and investment. This depends on the contributors' and beneficiaries' propensity to consume. Given that the contributors' propensity to consume is lower than that of beneficiaries, aggregate demand will increase. Usually, benefit recipients' propensity to consume is substantially higher than that of employees and employers. In a tax-financed system the same will be true if those paying taxes have a lower propensity to consume than beneficiaries.[13]

According to Spitznagel/Bach's evaluation design of opportunity cost, unemployment decreases as participation in ALMP programmes increases. These direct effects activate indirect effects stemming from multipliers.[14] Multiplier effects come from higher income and demand for production inputs. They calculate estimates of the net cost of two different kinds

[11] Potential productivity in former East Germany is estimated to be 15% that in former West Germany 20% below average. This equals the earned income prior to unemployment.
[12] Rotation of employed and unemployed has individual and economic consequences on its own, because long-term unemployment and its associated loss of employability are limited.
[13] Crowding out might also happen on the capital market, where a large uptake of state loans drives out private investment, raises the interest rate or reduces the scope for fiscal policy in the future.
[14] Spitznagel/Bach use an input-output model for estimating the multiplier effects.

of ALMP programme, training measures (FbW) and job-creation schemes (ABM). These programmes were quantitatively important and corresponded to half of total ALMP expenditure in Germany. The gross expenditure on these programmes was borne by the contribution-funded Federal Institute of Employment. The participants in training and subsidised employment were mainly long-term unemployed. They typically receive tax-financed unemployment assistance, not contribution-financed unemployment benefits. These ALMP programmes therefore relieved the federal budget but charged the contributors (employees and employers).

The Hartz reforms led to substantially lower expenditure for the ALMP programmes discussed here – FbW and ABM. Contribution-financed expenditure on FbW in 2005 was halved and expenditure on ABM was only 20% of its 2004 value. Financing for both programmes was reduced again in 2006. However, tax-financed ALMP programmes were introduced. ALMP expenditure for long-term unemployed who receive unemployment assistance is now financed by tax revenue. This improves the German LMP financing structure by giving more favourable incentives to the institutions in charge of LMP. Total expenditure (contribution and tax funded) for ALMP however, has declined (cf. Bundesagentur für Arbeit 2006).

In training measures, 60-66% of expenditure was covered by lower expenditure elsewhere (mainly federal budget, but municipalities and states as well) and additional income (social insurance, tax income through additional consumption). Indirect effects such as employment creation for trainers and teachers, teaching material etc. are not included. Hence a 60-66% cost-coverage rate might be regarded as a lower limit. The net burden of financing training measures was borne by the Federal Employment Agency, but the federal budget and to a small extent the social insurance institutions, local and regional budgets profit from these ALMP programmes.

The second ALMP programme investigated was “ABM”, where wage subsidies are paid for unemployed who are difficult to place. The direct effects are estimated to cover 64-66% of the cost of these ALMP measures. Including the indirect or multiplier effects, 88-95% of the cost is covered. The coverage rate of direct effects is the lower boundary, whereas the coverage rate including indirect effects marks the upper boundary[15] of the estimation. Again, the federal budget is the main beneficiary, followed by the social-insurance institutions, municipalities and federal states. The Federal Institute of Employment and the agencies that employ the formerly unemployed bear the gross cost.[16]

Spitznagel/Bach show that the economic net cost is considerably lower than the gross expenditure for ALMP programmes. These cost-benefit considerations, however, do not take account of some benefits that are difficult to quantify, such as smoother redeployment of workers from declining sectors of the economy to growing sectors of the economy (which is an important goal of ALMPs in many economies facing continuing structural change due to globalisation), increase in human capital (training measures), additional goods and services produced, better social cohesion and other externalities.

[15] The estimate for indirect effects marks the upper boundary of cost coverage because favorable assumptions are made in the input-output model.
[16] These agencies have to bear part of the wage and material costs.

**Table 10: Cost coverage rate of two ALMP measures in Germany, 1994-1999:**

| Total fiscal cost coverage rate in % | | | | | | |
|---|---|---|---|---|---|---|
| | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** |
| FbW (training measure) | 65 | 66 | 65 | 65 | 61 | 60 |
| Lower boundary ABM | 64 | 65 | 65 | 66 | 65 | 66 |
| Upper boundary ABM | 90 | 91 | 93 | 95 | 88 | 89 |

Source: Spitznagel/Bach 2000.

A principle of public economics states that all agents and institutions should contribute according to the benefit they gain. Spitznagel/Bach show that public funds draw substantial gains from ALMP. Tax income from ALMP justifies at least partial tax financing of ALMP. The tax-financed allowance for ALMP should be substantial. In countries with contribution-financed health and pension provisions (Bismarck type) the cooperation between health insurance, pension insurance and unemployment insurance should include financing of ALMP. Health insurance and pension insurance should contribute to ALMP financing.

Ideally, their financing should focus on ALMP programmes that protect employees from employment-related illness and invalidity. Most highly developed economies face an aging labour force and are trying to increase employment rates of older workers.[17] ALMP programmes that prevent employees from becoming unemployed or unable to work due to (employment-related) health reasons and ALMP programmes that reintegrate unemployed people with health problems might gain in importance. Participation in their financing by health and pension insurance might pay off as a result of lower invalidity rates.

## 5.1 Investment in ALMP and public revenue

If the investment in ALMP pays off to some extent by gaining higher tax and social security contributions, there should be an observable connection between ALMP expenditure and forgone tax income.

Spitznagel/Bach divide the fiscal cost of unemployment into expenditure for the unemployed (unemployment benefits and assistance, social insurance for the unemployed, social welfare and housing subsidies) and loss of public revenue. This loss of public revenue arises from lower income-tax revenue, lower value-added tax revenue and lower social security contributions.

On average, unemployment benefit and assistance payments, social-security expenditure for the unemployed and other social expenditure amount to 54% of the cost. Forgone tax and social-security contribution income amounts to 46% of total fiscal cost according to the Spitznagel/Bach figures.

[17] The Lisbon strategy of the European Union calls for an increase in the employment rate of workers over 55 years from 40% (2004) to at least 50% in 2010.

Ceteris paribus, a rise in ALMP expenditure (A) should result in lower loss of public revenue (R) and vice versa. But with unemployment (U) varying there are four expected outcomes:

$U \Uparrow, A \Uparrow \Rightarrow R$ rising (slowly)

$U \Uparrow, A \Downarrow \Rightarrow R$ rising (fast)

$U \Downarrow, A \Uparrow \Rightarrow R$ fall (fast)

$U \Downarrow, A \Downarrow \Rightarrow R$ fall (slowly)

**Table 11: ALMP expenditure, forgone tax and social insurance contributions and the number of unemployed in Germany, 1993-2002**

| Year | ALMP expenditure in Mio. € | Number of unemployed | Forgone receipts in Mio. € |
|---|---|---|---|
| 1993 | 26,040 | 3,419,141 | 27,700 |
| 1994 | 22,997 | 3,698,057 | 34,500 |
| 1995 | 23,816 | 3,611,921 | 33,900 |
| 1996 | 26,002 | 3,965,064 | 36,600 |
| 1997 | 22,956 | 4,384,456 | 38,500 |
| 1998 | 24,487 | 4,279,288 | 35,700 |
| 1999 | 25,979 | 4,099,209 | 35,200 |
| 2000 | 24,996 | 3,888,652 | 34,200 |
| 2001 | 24,559 | 3,851,636 | 31,800 |
| 2002 | 24,962 | 4,060,317 | 33,400 |

Sources: OECD, Spitznagel/Bach 2000; 2003; Bundesagentur für Arbeit 2006

**Table 12: Year-to-year change in unemployment, ALMP expenditure and forgone tax and social insurance contribution receipts**

| Year | change of U in % | change of A in % | change of R in % |
|---|---|---|---|
| 1994 | 8.2 | -11.7 | 24.4 |
| 1995 | -2.3 | 3.6 | -1.6 |
| 1996 | 9.8 | 9.2 | 7.8 |
| 1997 | 10.6 | -11.7 | 5.3 |
| 1998 | -2.4 | 6.7 | -7.3 |
| 1999 | -4.2 | 6.1 | -1.4 |
| 2000 | -5.1 | -3.8 | -2.8 |
| 2001 | -1.0 | -1.7 | -7.0 |
| 2002 | 5.4 | 1.6 | 5.0 |

Source: own calculations

The postulated relationship between change in unemployment, ALMP expenditure and loss of public revenue holds for all of the years. In some years the relation does not seem to be very strong. Overall, it seems that investment in ALMP has a positive effect on public revenue.

### 5.2 Consequences for financing

The empirical results for Germany show that the net cost of two ALMP programmes evaluated is less than half of gross expenditure and possibly only a fraction of it. Estimates for multiplier effects of ALMP are crude but multiplier effects have the potential to induce fiscal income that reduce the net cost of ALMP. This supports the case for ALMP. ALMP provide positive labour-market and external effects at a small net cost. What are the consequences for financing?

Spitznagel/Bach's results provide a strong case for at least partial funding of ALMP programmes from the general budget because ALMP provide additional tax income[18] (income taxes and consumption taxes). The Hartz reforms at least partially reflect that.

The former German financing design of LMP – where ALMP was entirely contribution-financed and long-term unemployed receive allowances from the federal budget – contributed towards the crowding out of ALMP. When the long-term unemployed participated in ALMP programmes the gross burden was on the contribution-financed Federal Employment Agency but the government budget was lightened. Additional tax income from ALMP was neither earmarked nor traceable and therefore not recognised as a fiscal benefit from ALMP. However, the Federal Employment Agency's deficits had to be financed from the federal budget. This imposed pressure to cut ALMP in recession. Whether financing reform will change the ALMP spending patterns in Germany over the business cycle remains to be seen.

Those funding ALMP in contribution-financed systems are not those receiving the financial benefits (the difference between gross and net cost of ALMP) – contributors are indirectly subsidising the general budget. Funding ALMP mainly from contributions gives false incentives to contributors – who are usually at least partially in control of their contributions. This may result in smaller ALMP expenditure than economically desirable. In addition to partial tax financing of ALMP, in Bismarck type social security systems there should be co-financing of ALMP from the health and pension insurance.

## 6. ALMP AND ECONOMIC STABILISATION

Previous sections have shown that the need for ALMP varies over the business cycle and that ALMPs have fiscal repercussions. In this section the discussion looks at the potential of ALMP to stabilise economic activity and smooth out the business cycle. This is an added

[18] This additional tax income comes with some time lag, as is common with multiplier effects. Production of goods and services enhances GDP immediately; human capital production has future effects.



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bonus of ALMP that is often neglected. Carefully designed ALMP can be an important tool of counter-cyclical fiscal policy. Ideally, it should have the properties of an automatic stabiliser.

PLMPs are often portrayed as automatic stabilisers of the business cycle. PLMPs provide the unemployed with income and therefore support demand for private consumption. In an economic upswing an unemployment insurance system has large revenue but low expenditure because the level of unemployment is low. During a recession the insurance will suffer from lower revenue and much higher expenditure, because the level of unemployment will be high. In an economic rebound the unemployment insurance saps aggregate demand but provides a stimulus to aggregate demand in recession by providing income to the unemployed. The stronger the boom and the more severe unemployment in recession, the greater will be the effect of the stabiliser, hence it is automatic. PLMPs will automatically stabilise the economy when two requirements are met. Firstly it has to be a pay-as-you-go system. Secondly, a surplus in the upswing must not be touched while extra spending in the recession must not be accompanied by cuts in spending elsewhere to cover a deficit. Neither the level of contribution rates or tax rates nor that of benefits should be adjusted for funding reasons.

## 6.1 Swedish stabilisation policy

ALMPs can also be used for economic stabilisation. They can prevent unemployment during troughs in the business cycle and hence stabilise the level of employment directly. In Sweden, ALMP (defined in a broader sense including Keynesian-style relief work) has traditionally been a very important fiscal policy tool and contributed significantly to stabilisation of employment and economic activity. In Sweden ALMP was not used as an automatic stabiliser, but the rapid responsiveness of the budgetary process enabled it to act counter-cyclically. Keynesian relief work programmes provided for stabilisation of employment and public investment was increased in economic troughs in order to counter rising unemployment.

If ALMP does not have the properties of an automatic stabiliser, design of financing and budgetary responsiveness is vital in order to be a useful tool of fiscal policy. Anxo/Johannesson (1995) conclude that the high efficiency of ALMP in Sweden is related to its financing. They point to the general budget funding of ALMP and the rapid responsiveness facilitated by the budget process as being important features of Swedish economic policy. Parliamentary decision on regular funds is taken for the coming fiscal year, but complementary and supplementary budgets can be provided several times during the year facilitating a rapid reaction to labour-market developments. The timely responsiveness of labour-market budgets is thus a lesson to be learned from Sweden. In order to achieve high efficiency of ALMP, the budgetary process has to be rather flexible, especially when ALMP is used for stabilisation purposes.

Ohlson (1995) has observed that demand-oriented programmes have played the main role in making ALMPs act counter-cyclically in Sweden. Job-creation programmes stabilised employment during the troughs in the business cycle in the 70s and 80s. Olson's analysis of the impact of ALMPs on the level of unemployment and wage inflation shows that job-creation programmes have led to significantly lower unemployment in the short term without having an impact on wage inflation in the long term.

## 6.2 ALMP – a potential automatic stabiliser

Sweden achieved its counter-cyclical patterns of ALMP by funding that responds rapidly to labour-market developments. Discretionary ALMP requires such responsiveness in funding. This is not easily achievable in many countries. In order to avoid lags in ALMP that induce inefficiency, ALMP ideally should work as an automatic stabiliser.

Quiggin (2001) draws on human and social capital theory for his suggestion for automatic counter-cyclical ALMP. Education and work experience result in human capital accumulation, but prolonged periods of unemployment lead to skill atrophy or depreciation of human capital stock. Research in the United States shows that human capital is the single most important component of wealth in developed economies (Sturn/Wohlfahrt 1999). In addition, the unemployed, especially the long-term unemployed, suffer from loss of informal contacts and social networks that are vital in finding new employment (social-capital theory).

Quiggin (2001) argues that the relative importance of human and social capital varies over the business cycle. This should be reflected in the design of labour-market policies. The proportion of resources allocated to different ALMP programmes should vary over the course of the economic cycle. More important with respect to financing is his suggestion that ALMP expenditure should adjust automatically in response to the business cycle, making ALMP an automatic stabiliser. Quiggin proposes either an entitlement for the long-term unemployed to participate in an ALMP programme or a fiscal-policy board. Such a board, similar to a central bank, has the right to make temporary adjustments in income-tax rates and decides on expenditure on ALMP.

In addition to stabilising the economy, well-designed counter-cyclical ALMPs might help to add to higher growth rates over the business cycle by enhancing the skills and potential productivity of the unemployed (human-capital theory). The pain of structural reform is eased and vocational training for adults may be a tool in dealing with an aging labour force – a problem that many developed countries will face in coming years.

In addition to a legal entitlement for ALMP programme participation and the need for variation of ALMP over the business cycle (cf. Quiggin 2001), there needs to be individual tailoring of ALMP and a fixed ALMP budget per participant. ALMP design that works as an automatic stabiliser should have three properties:

1. legal entitlement to ALMP participation for a specified target group (e.g. long-term unemployed)
2. broad range of ALMP programmes reflecting the labour-market situation (business cycle) and individual fitting (needs and wishes of unemployed)
3. defined financial ALMP resources on average per participant

A legal entitlement to ALMP participation that is handled flexibly prevents crowding out (chapter 4). Those entitled might include youth or women and the unemployed in danger of becoming long-term unemployed. The definition of the target group should not be altered over the business cycle. Each unemployed person should receive an individually suitable ALMP programme that takes the labour-market situation into account. There should be comprehensive choice of ALMP programmes. Care has to be taken that the ALMP is flexible.



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In addition there should be a fixed average budget per participant: some unemployed people need less expensive activation programmes than others. Total expenditure is limited by the defined sum per participant and the number of participants. This ensures constant ALMP expenditure per participant over the business cycle.

When these three properties are achieved ALMP is an automatic stabiliser. ALMP designed this way should cover the majority of a country's ALMP. Other discretionary ALMP programmes should be used in a way that does not interfere with ALMP's use as an automatic stabiliser.

Using ALMP for stabilisation of the economy and employment over the business cycle requires a political preference for a full-employment policy and substantial financial resources in an economic downturn. ALMP funding should at least be partially tax based (chapter 5). If ALMP evens out the business cycle, the rationale for at least partial tax financing is reinforced: recession is connoted by the destruction of goods and productive capacities and consequently lower tax income. ALMP that prevents loss in tax revenue and fosters employment is therefore a fiscal policy tool that should be funded accordingly.

Using ALMP as an automatic macroeconomic stabiliser can fend off important criticism of discretionary counter-fiscal policy. The level of application is neither too weak nor too strong and its timing coincides with labour-market developments.[19] Using both PLMPs and ALMPs as automatic stabilisers contributes to a smoother business cycle and ALMP especially can contribute to achieving full employment.

## 7. CONCLUSIONS

It is widely agreed that it is better to finance activity than inactivity, but the design of LMP financing in some countries gives policy makers unfavourable incentives. The need for and the availability of financial resources for ALMP diverge over the business cycle. Resources for ALMP are scarcest in recession, when they are most urgently needed, and a policy design of obligatory PLMP expenditure and discretionary ALMP expenditure easily results in the crowding out of ALMP by PLMP. Crowding out can be prevented by participation in ALMP programmes for the long-term unemployed as proposed by the European employment strategy. However, ALMP programme participation should be a legal entitlement for those in danger of becoming long-term unemployed.

ALMP programmes induce additional tax revenue and social-security contributions. This justifies at least substantial tax co-financing of ALMP. In Bismarck-type social-security, health insurance and pension insurance should contribute to ALMP financing as well. ALMP can even be designed to serve as an automatic stabiliser, a characteristic usually only attributed to PLMP. When used as a tool of fiscal policy to stabilise economic activity and employment, this provides for a supplementary argument for tax funding of ALMP.

[19] It has to be added though, that (un)employment usually lags behind economic growth.



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## ABBREVIATIONS

ABM – Arbeitsbeschaffungsmaßnahmen (Germany)
ALMP – Active Labour-Market Policy
ANPE – Agence Nationale Pour l'Emploi (France)
EES – European Employment Strategy
FbW – Förderung beruflicher Weiterbildung
GDP – Gross Domestic Product
ILO – International Labour Organisation
LMP – Labour-Market Policy
NAFTA – North American Free Trade Agreement

OECD – Organization for Economic Co-operation and Development
PLMP – Passive Labour-Market Policy
RMI – Revenu Minimum d'Insertion (France)

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