



HARTZ IV – WELFARE TO WORK IN GERMANY

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The need to reform the labour market in Germany is urgent. With the enactment of the “Hartz laws” (named after the chairman of the reform commission) the federal government has introduced fundamental reforms in some areas of the labour market. The government is thereby aiming at an increase in employment and, particularly, at a reduction of long-term unemployment. The labour market reforms are meant to “activate” recipients of social benefits. The guiding principle is the well-known “right-and-duty” principle.

The labour market reforms include the establishment of temporary work agencies for the previously unemployed (“Personnel Service Agencies”), the introduction of a subsidy for setting up a one-person company (“Me Inc.”), new regulations for low-paid employ-

ment (“mini” and “midi jobs”) as well as the restructuring of the *Bundesagentur für Arbeit* (Federal Labour Office) to become a service-oriented institution. Restructuring involves reorganising the placement of job seekers by increasing the use of private employment services and by intensifying counselling (“Hartz I-III”). In addition, two major benefit programmes, unemployment insurance and social assistance, are being reformed. This is being done by combining unemployment assistance and social assistance to form a new “unemployment benefit II”, by increasing earnings disregards for welfare recipients, by imposing sanctions for those who refuse an acceptable job offer, etc. (“Hartz IV”), as well as by shortening the period in which the (contributory) “unemployment benefit I” can be received (Table 1).

The old system of unemployment insurance and social assistance

Until the end of 2004 there was a three-pronged system in Germany which provided protection against the risk of becoming unemployed and other income risks. In this system, unemployment benefits were part of a compulsory form of insurance financed by contributions. The benefits for the unemployed with at least one dependent child amounted to 67 percent

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Table 1

“Hartz laws”

Law	Passed	Measures	Effective as of
First law for modern services on the labour market (“Hartz I”)	December 2002	Setting up Personnel Service Agencies	1 January 2003
Second law for modern services on the labour market (“Hartz II”)	December 2002	Introduction of one-person companies (“Me Inc.”); Reform of low-paid jobs (“mini” and “midi jobs”)	1 January 2003 and 1 April 2003
Third law for modern services on the labour market (“Hartz III”)	December 2003	Restructuring of the Federal Labour Office	1 January 2004
Fourth law for modern services on the labour market (“Hartz IV”)	December 2003	Unemployment assistance and social assistance combined to form unemployment benefit II; new definition of acceptable jobs, sanctions; increased earnings disregards; community service	1 January 2005
Law to reform the labour market	September 2003	Duration of unemployment benefit I shortened	1 February 2006

Source: www.bundesregierung.de.

of the earlier net income and to 60 percent for those without children. Unemployment benefits were paid without any means test. The maximum duration of benefits was between 6 and 32 months, depending on age and the period covered by contributions. After this period, means-tested unemployment assistance was paid for an unlimited period of time. Unemployment assistance was financed via taxes. The benefit amounted to 57 or 53 percent for recipients with and without children, respectively. Social assistance provided the basic welfare net. Again, benefits were means-tested and paid for an unlimited period of time. Social assistance benefits were only paid if the individual seeking help was unable to help himself and no other welfare benefits were available.¹ As the comparison shows, unemployment assistance had an intermediary position between unemployment benefits and social assistance. As with unemployment benefits the amount of unemployment assistance depended on the last net earnings. However, because of the unlimited entitlement together with a means test, it was a second form of basic welfare benefit, as is underlined by the fact that it was financed by taxes instead of contributions.

This system of unemployment insurance and social assistance has contributed in an important way to the high unemployment in Germany, especially among poorly qualified workers. There is fairly clear micro evidence that a longer benefit entitlement leads to longer unemployment duration (Nickell et al. 2005). As was shown above, the duration of unemployment benefits was long and payment of unemployment assistance was even unlimited. Furthermore, the level of benefits has a negative effect on the transition from unemployment to employment because high benefits are connected with high reservation wages. Since companies are not willing to pay high wages to take on workers with low performance, unemployment becomes permanent. At the end of 2004, the effective net replacement rate for recipients of unemployment assistance (including additional benefits for the recipient and, if necessary, other household members) was approximately 80 percent for a single and about 90 percent for a single parent (Breyer et

al. 2004, 32). Social assistance (including housing assistance) amounted to 65 percent of average net earnings for a family with one gainfully employed parent and two children in Western Germany (Sinn et al. 2003, 14). Compared with net earnings derived from low-wage employment the net replacement rates were even higher.

In the end, the incentive to take on a job depends on the additional net income it would provide. Recipients of unemployment assistance who did not work longer than 15 hours a week could earn up to an additional EUR 165 per month. Net income above that was completely set off against unemployment assistance. With social assistance benefits, earned income up to 25 percent of the normal rate of benefits (EUR 74 monthly) was not set off against social assistance. Thereafter the rate by which transfers were reduced amounted to 85 percent. That means that the income available to social welfare recipients increased by a mere 15 percent of the additional earned income. A net earned income over EUR 568 led to a transfer reduction rate of 100 percent (Sachverständigenrat 2005; Box 16). For the recipients of unemployment and social assistance the high rates of transfer reduction show that the incentive to earn additional income was minimal.

The growth in the number of unemployed is shown in Figure 1. During the 1960s, average annual unemployment was less than 200,000 persons. Thereafter unemployment increased from one economic downturn to the next. In 2004 an average of 4.4 million people were unemployed, many of them for the long term. Part of this problem was caused by German unification. But a considerable percentage of unemployment, specifically of persons with minimal qual-

Figure 1



¹ In 2003 2.02 million people received unemployment benefits, 2.03 million unemployment assistance, and 2.81 million social assistance.

ifications, can be attributed to the effects of the German welfare system. Figure 1 shows that of the persons registered as unemployed in 2004, approximately 34.3 percent have not completed vocational training, this figure being the mean between the Western German level of 41.1 percent and the Eastern German level of 20.6 percent. The proportion of employable individuals without vocational training is 17 percent in Western and 8 percent in Eastern Germany. Thus, the specific rate of unemployment for persons without vocational training is 21.7 percent in Western Germany and 51.2 percent in Eastern Germany (Reinberg and Hummel 2005).

An overview of “Hartz IV”

The core area of the labour market reforms of the Social Democrat–Green Party coalition government includes the measures put into effect by “Hartz IV” (and the complementary shortening of the period in which contributory unemployment benefits can be received). As mentioned above, these measures aim at activating recipients of unemployment benefits and are based on the “right-and-duty” principle.

Starting from February 2006, the period in which unemployment benefits can be received will be shortened for the unemployed up to 55 years of age to 12 months and for those over 55 to at most 18 months. With this law Germany is approaching the regulations that exist in most of the OECD countries. Shortening the period during which unemployment benefits can be received is in line with research findings for Germany according to which long-term unemployment will be reduced by this measure (Steiner 2003).

Starting from January 2005, unemployment assistance and social assistance were combined for people able to work to form unemployment benefit II. The new benefit is means-tested, the benefit level being similar to that of the old social assistance benefit. Individuals who are unable to work will continue to receive social assistance. For recipients of unemployment benefit II there are no limits as to what jobs are acceptable. If a recipient rejects a job, he will have to face sanctions in the form of a reduction of unemployment benefits for a limited time. At the same time, earnings disregards have been increased in order to make it more attractive to take on work.

If it is not possible to integrate benefit recipients in the regular labour market, community jobs will be

offered to them, as could be done in the past on the basis of the federal social assistance law (“help to work”). These jobs may include, for example, activities to improve the social infrastructure at the municipal level. Recipients of unemployment benefit II will receive compensation for their extra expenses in connection with this work (Koch and Walwei 2004).

Unemployment benefit II: the new safety net for job seekers

Since January 2005, those in need of help who are able to work and cannot claim unemployment benefit I receive, as explained above, unemployment benefit II. Apart from housing and heating assistance, responsibility for unemployment benefit II lies with the Federal Labour Office. It is financed by the federal government. Within the scope of an experimental clause, some municipalities are allowed to take over the responsibility for all the tasks connected with operating the basic safety net for job seekers. Granting social assistance to those unfit for work continues to be the responsibility of the municipalities (Löschau 2005).

Individuals are considered able to work if they are capable of working for three hours a day under the usual conditions of the labour market and will not be hindered to do so in the foreseeable future because of illness or handicap. The individual working ability is evaluated purely from a medical standpoint. It is decided by the institution responsible for the safety net, i.e., usually the local employment office.

An individual is needy if he/she is unable to earn a living for him/herself and for the other family members living together in one household. The individual in question is required to take on an acceptable job and use his own income and assets as well as that of his/her partner. There are, however, allowances; certain assets are not taken into account at all (Bundesministerium für Wirtschaft und Arbeit 2004).

The monthly standard payment for unemployment benefit II amounts to EUR 345 in the first 6 months of 2005 for singles or single parents in Western Germany (including Berlin) and EUR 331 in Eastern Germany. For children the standard payments are lower. Furthermore – if certain preconditions are fulfilled – there is an additional supplement limited to two years for those who move from unemployment benefit I to unemployment benefit II. Needy, non-

Table 2

Unemployment benefit II: Lump sum standard payment (SP)

	Single or single parent	Other household members		
		Children up to 14 years of age each	Children between 15 and 18 years of age each	Adults (19 years of age and above) each
	100% SP	60% SP	80% SP	90% SP
Western Germany including Berlin	345 €	207 €	276 €	311 €
Eastern Germany	331 €	199 €	265 €	298 €
	<u>Additionally per household:</u>			
	<ul style="list-style-type: none"> ▪ Transfer for lodging and heating ▪ (If the preconditions are fulfilled), a limited additional payment of up to EUR 160 for gainfully employed individuals and for their partners and up to EUR 60 for each child ▪ Contributions to compulsory social insurance (health, nursing care and old age) 			

Source: Bundesministerium für Wirtschaft und Arbeit (2004).

employable individuals who live in a household with an employable recipient of unemployment benefit II are entitled to receive a new social benefit (Sozialgeld). In addition to these lump sum transfers the actual costs for lodging and heating are provided, if deemed appropriate, as well as compulsory social insurance contributions and payments for special needs (Table 2).

Unemployment benefit II is very similar to the former social assistance benefit. The standard payment in Western Germany (EUR 345) is higher than the social assistance benefit (EUR 295 since July 2004); nevertheless social assistance benefits included more additional payments than unemployment benefit II. In comparison to former unemployment assistance (on average EUR 550 in 2003 in Western Germany) unemployment benefit II is less generous.² This should result in pressure on the jobless to take on work. Furthermore, there will be an increased tendency to take on work because the stricter means test leads to a reduction in the percentage of unemployed who receive benefits.

Sanctions

Transfer payments will not only be less generous because of their (assumed) reduction but also because of the tightening of the eligibility criteria. Of

particular importance is the new definition of employment that a recipient of unemployment benefit II must accept. According to “Hartz IV” every kind of work is basically acceptable. A job cannot be turned down because it does not correspond to an individual’s profession or education or because the conditions are less favourable than in the last job held.³ Compensation below the collectively bargained wage rate or local wages does not make the job less acceptable. The offer may not, however, be a violation of the law (for example, a universally binding collective agreement) or *contra bonos mores*. According to current judicial decisions such a violation would occur, for example, if payment was 30 percent below local wages.

Those who reject acceptable work (but also training, community service or placement services) shall receive 30 percent less of the standard transfer payment for three months (approximately EUR 100 less). For the same period, the limited supplementary payment will also be withdrawn. If work is rejected a second time the transfer payments are reduced once more by EUR 100. If there are repeated violations of any obligations, unemployment benefit II is eliminated entirely. If individuals under 25 years of age reject work, they receive no transfer payments at all for three months. The costs for lodging and heating during this period are paid directly to the landlord (Bundesagentur für Arbeit 2004).

The question arises whether the sanctions implemented by “Hartz IV” will encourage recipients of

² It should be taken into account, however, that the recipients of unemployment benefit II also receive payments for their actual costs for lodging whereas the recipients of unemployment assistance could only qualify for supplementary social welfare assistance and housing assistance if they fulfilled special conditions. As there is no statistical information on this point, the impact of this additional transfer cannot be estimated at the present time. It is thus impossible to state with certainty whether transfer payments have become less generous after the introduction of “Hartz IV” or not.

³ Taking on work is, however, not acceptable when, for example, children up to the age of three must be taken care of or other family members require nursing care.

unemployment benefit II to take on work. This will of course depend on the actual implementation of the sanctions. The Federal Labour Office in Germany has had experience with the imposition of sanctions. Its agencies suspended benefits temporarily also in the past if benefit recipients rejected acceptable work. Similarly, the municipalities have imposed sanctions on social assistance recipients who in some way did not fulfil their obligations within the scope of the “help to work” programme (municipal employment promotion). Valid data on the implementation of sanctions are not available, however. The Federal Labour Office (Bundesagentur für Arbeit 2003) has figures on the number of sanctions imposed,⁴ but not on the number of acceptable jobs that were not accepted. The same is true of the sanctions imposed by the municipalities.⁵ According to experts sanctions have been imposed in relatively few cases when recipients had not accepted work (Gerhardt 2004). And only 41 percent of all sanctions that were imposed were actually executed (Wilke 2003). With the introduction of “Hartz IV” it is questionable whether the imposition of sanctions will become stricter. On the one hand, the burden of proof for rejecting acceptable work now lies in the hands of the unemployed. On the other hand, “clever” individuals will always be able to escape sanctions. Moreover, the employees of the placement services and the municipalities are often reluctant to impose sanctions.

The effectiveness of “Hartz IV” sanctions not only depends on how they are implemented but also on how the unemployed react to them. For Germany there are no studies on this issue. The microeconomic studies by Abbring et al. (2000), van den Berg et al. (2003) and Lalive et al. (2002) for the Netherlands and Switzerland indicate that sanctions are an effective instrument to increase the integration of the unemployed in the labour market. The meta-evaluation of Ashworth et al. (2004) shows for the US the resounding success of sanctions as a measure to reduce unemploy-

⁴ Of 4.87 million cases of unemployment benefits and unemployment assistance granted in 2003, some 185,000 periods of exclusion from benefits were imposed because employment offers were rejected or integration measures were not completed (Bundesagentur für Arbeit 2003, 79 and 93).
⁵ In 2002 101 cities reduced welfare assistance in 11,800 cases (with 92,794 individuals in community service programmes) (Fuchs and Troost 2003, 34).

ment. Further studies show that the positive effects are not only a product of the sanctions themselves (ex-post effects) but are brought about in anticipation of possible sanctions (ex-ante effects).

Increased earnings disregards

The previous system of unemployment insurance and social assistance benefits offered little incentive to work. “Hartz IV” has improved this situation. With unemployment benefit II, the reduction of transfer payments depends on gross earned income. Beyond an allowance of around EUR 50 there is a transfer reduction rate of 85 percent of the net earned income up to a gross income of EUR 400. For gross earned income between EUR 400 and EUR 900 there is a transfer reduction rate of only 70 percent for the corresponding net earned income. For income between EUR 900 and 1500 the transfer reduction rate rises again to 85 percent. For gross earned income over EUR 1500 unemployment benefit II is reduced at a rate of one for one.

The incentive effects are further clarified in Figure 2. The figure shows the new gross-net income curve in comparison to the old social assistance system and in comparison to a welfare-to-work policy suggested by the Ifo Institute (Sinn et al. 2003). All the curves take into account total taxes, social insurance contributions and income from public transfers (social assistance, housing allowance, child benefit). For the tax regulations and the social insurance contributions the status quo at the beginning of 2005 for Western Germany was assumed. The figure is based on the case of a family with two children. The relevant graph indicates that a recipient of unemployment benefit II

Figure 2

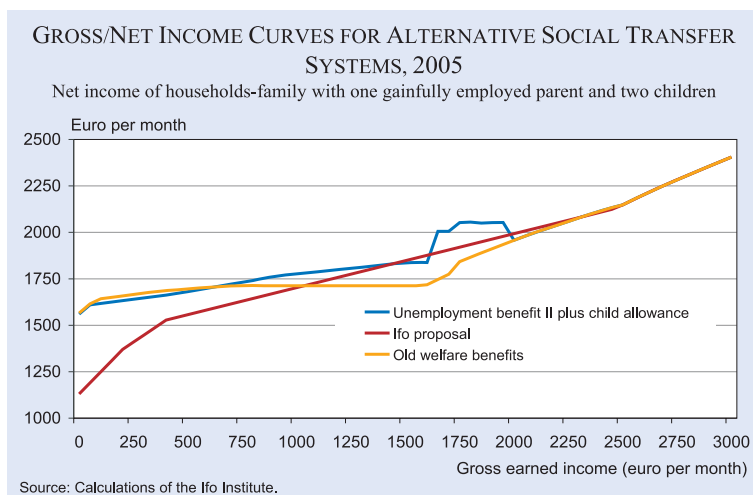


Table 3

Marginal tax burden of gross income in percent, 2005^{a)}

Gross income in EUR	Unemployment benefit II	Old social assistance	Ifo proposal
Married couple with two children			
50 – 400 ^{b)}	85	79	3
400 – 900	80	95	71
900 – 1500	88	100	71
Single			
50 – 400 ^{b)}	85	79	4
400 – 900	80	95	71
900 – 1500	69	... ^{c)}	68

^{a)} Status quo 2005 assumed for tax regulations and social insurance contributions. - ^{b)} Allowance for unemployment benefit II of EUR 50. - ^{c)} No claim to social benefits.

Source: Calculations of the Ifo Institute.

with a gross earned income of up to EUR 400 has to return 85 Cent of every Euro earned. Between EUR 400 and EUR 900 he has to go without 80 Cent as a result of transfer reductions if he earns one Euro more.⁶ Between EUR 900 and EUR 1500 the transfer reduction is on average 88 percent for every extra Euro of gross income earned.⁷ Except for the income range above EUR 900 the transfer reduction rate of singles is the same as that of families (Table 3). In comparison to the old social assistance system for recipients of unemployment benefit II the financial incentive to work has been slightly improved. The transfer reduction rate for the unemployed taking on work is, however, still very high. In contrast, the Ifo proposal (see below) offers increased earnings disregards, especially in the lowest earnings brackets (Sinn 2004, 234–43).

Community service

Even though achieving gainful employment has priority, short-term jobs are offered to recipients of unemployment benefit II by municipalities and charitable associations. This work should be in the public interest and it should not displace regular employ-

ment. Offering this work to the unemployed who are difficult to place is meant to promote their entry into the regular labour market. Furthermore, it offers an opportunity to check whether those unemployed are actually available for the labour market. According to the Federal Ministry for Economy and Labour, up to 600,000 jobs are to be created for this purpose. In 2004, there were approximately 210,000 municipal jobs (Sachverständigenrat 2005, Ziffer 252).

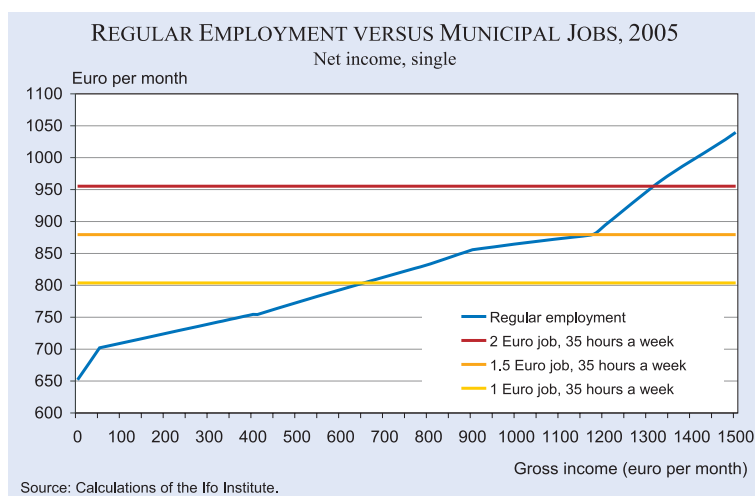
For community service jobs the recipients of unemployment benefit II receive 1 to 2 Euros per hour in addition to their unemployment benefits as compensation for additional costs. In contrast to income from regular employment this additional payment is not set off against unemployment benefit II. This means that the effective hourly wages can be higher for a municipal job than for regular employment. If compensation of 1 Euro per hour and a working week of 35 hours is assumed, a single employed in the regular labour market would have to earn a gross income of EUR 652 per month (= EUR 4.30 per hour) to have the same net income of someone employed in community service. With compensation of EUR 1.50 he would have to earn EUR 1,173 per month (= EUR 7.73 per hour) to reach the same net income. With compensation of EUR 2.00 per hour, it would be EUR 1,313 (= EUR 8.66 per hour; Figure 3). This comparison shows that the incentive to take on a regular job for recipients of unemployment benefit II who are employed in community service is relatively low (Buscher 2004). The Social Insurance Code, however, clearly prescribes that taking on regular employment has priority over staying in a temporary municipal job. If regular employment deemed acceptable is rejected by the unemployed individual, the sanctions described above apply.

In addition to the danger that community service might become a permanent segment in the labour market, there is also concern that regular employment will be displaced by community service. Despite the rules for community service, municipal work that up until now has been carried out by private companies could now be undertaken by municipal employment agencies at a lower price. The displacement effect would, however, be compensated by the fact that the money saved could be used to award contracts to private companies for other work. Furthermore, private companies could profit in that community service would bar entry into the shadow economy, and in this way the demand for moonlighting would be deflected into the regular market.

⁶ The difference between the transfer reduction rate as specified in the "Hartz IV" law (70 percent between EUR 400 and EUR 900) and the reduction rate in Table 3 (80 percent) is due to the fact that in the first case the reduction rate relates to net earned income and in the second case to gross earned income. In the EUR 400 bracket the two transfer reduction rates are the same because net and gross income is the same in this case (regulations for "mini jobs"). See the detailed account in Boss and Elendner (2005).

⁷ The odd shape of the curve between EUR 1,600 and EUR 2,050 gross earned income is the result of a special "child supplement" to unemployment benefit II.

Figure 3



Summary

With “Hartz IV”, Germany started thoroughly reforming an important part of the labour market, thereby contributing to an activation of recipients of welfare benefits. Especially the long-term unemployed and recipients of social assistance have been targeted in an effort to reintegrate them into the labour market. The guiding principle behind this reform is the “right-and-duty” principle. The most important elements of the reform are the reduction of the duration of unemployment benefit I, the combination of unemployment assistance and social assistance to form a new unemployment benefit II, the reduction of transfer payments compared to the old unemployment assistance scheme, stricter sanctions if acceptable work is rejected, the increase of earnings disregards for recipients of unemployment benefit II, and the expansion of jobs in community service. These measures primarily aim at reducing the reservation wage of the unemployed and thus at increasing the demand for labour.

The “Hartz IV” reforms make important steps in the right direction. They will make it easier for unemployed welfare recipients to find regular employment. It is still too early, however, to estimate the extent of the effect on employment (and their fiscal effects). This will be left to the evaluations that will accompany “Hartz IV” (Kaltenborn et al. 2004). However, some deficiencies connected with “Hartz IV” are already under discussion. The earnings disregards for recipients of unemployment benefit II have not been increased sufficiently.⁸ Moreover the incentives for

⁸ According to an agreement between government and the opposition of April 2005 earnings disregards will be further increased starting from autumn 2005.

the employed in low-wage jobs to work more and/or to attempt to earn higher wages are not adequate. Both issues are connected with the fact that the government was not willing to reduce the minimum level of unemployment benefit II. Furthermore, compensation of 1 to 2 Euros for community work has resulted in a weak incentive to enter regular employment. And finally sanctions lead to bureaucratic decision-making processes and legal checks that could be avoided with sufficient financial incentives.

The Ifo Institute’s suggestion for an “activating social assistance” scheme is mainly based on financial incentives. It calls for a notable reduction of unemployment benefit II for those able but not willing to work and a lower transfer reduction rate in the lowest income bracket (Table 3). At the same time, the employed in low-wage jobs would be offered favourable conditions for earning additional income. For each additionally earned euro of gross income at least 30 Cents could be kept as additional net income. Those who do not immediately find employment in the private sector have the right to a community job with compensation corresponding to the standard rate of unemployment benefit II. The municipalities would have the right to assign these workers to private companies through private temporary work agencies (Sinn et al. 2003, Sinn 2004, chapter 4). The Ifo proposal makes it possible for recipients of welfare benefits to accept lower wages, which would lead in turn to an increased demand for labour on the part of the employers. However, a larger wage dispersion at the bottom end of the wage distribution would require the co-operation of both the employers and the unions.

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