

**Targeted wage cost reduction in the Netherlands:
A comment from Austria
by
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1. Introduction

For economic and social policies to be effective, account needs to be taken of the particular institutional arrangements in which they are to operate. There are many examples of policy measures which work well in one country but fail in other countries with a different institutional environment (*Freeman, 1998*). Thus what is a 'good' ALMP cannot be safely evaluated *in vacuo*.

It is also evident from experience that success of a particular active labour market initiative may depend on associated or complementary measures. Thus, the current Dutch wage cost reduction scheme to reduce the persistently high unemployment rate of low-skilled workers, is associated with a consensus approach to labour market reform involving

- wage moderation in sectoral agreements (assisted by tax relief);
- the need to narrow the gap between the legal minimum wage and the minimum wages in agreements;
- re-opening of existing agreements to allow re-negotiation of lower wages for low-skilled workers;
- appropriate adjustment to the social security provisions in order to provide greater incentive for the unemployed to seek employment;
- provision of employment opportunities in the public and health care sectors;
- a more integrated job placement system (*OECD, 1998*).

These features are pertinent in any evaluation of the merits of the Dutch scheme. Moreover, Dutch experience has also shown that historically entrenched labour market and social security arrangements are more easily modified, without confrontation and threat to social cohesion, when they are negotiated by the social partners on a consensus basis.

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2. The merits of the Dutch targeted wage cost reduction scheme.

The scheme under consideration at this meeting is that which currently provides:

- A permanent discount (WVA-SPAK) on the wage tax amounting to 10 percent of the wage cost of employing a low-skilled unemployed person at wage rates up to 115 percent of the legal minimum wage (LMW).
- A discount (t-SPAK) for two years amounting to 50 percent of the SPAK discount for those earning more than 115 percent of the LMW. These first two facilities cover nearly 20 percent of the workforce (Graafland and van Opstal)
- A further discount (VLW) for four years, of 13 percent of the wage cost of employing a person who has been (continuously?) unemployed for more than one year.
- Promotion under the WVA-VO training scheme of working and learning.

It will be evident that what distinguishes SPAK from more common wage subsidy schemes is the indefinite term of the subsidy. It is interesting to note that John P Martin of the OECD has advised that employment subsidies should be 'of short duration, targeted and closely monitored' (John P Martin, 1998).

Reflection on the Dutch scheme raises three points for discussion.

1. Consideration is currently also being given to providing employment incentives on the side of supply because a large number of people 'are no longer searching for a job'. (D Hagoort, E Vogels, P Stein and B Dunnewijk) This arises from concern as to whether there is sufficient inducement for the low skilled to be employed on the LMW rather than to subsist on the dole, i.e. the issue of the reservation wage and the unemployment trap. To meet this problem, the Netherlands Government is planning to introduce, as from 2001, an *earned income tax credit* (EITC) scheme as a supplement to SPAK in order to encourage those unskilled workers who are disinclined to seek employment on present wages, to do so. It is proposed that a given sum of tax credit will be paid to all employees earning the LMW, and for the amount of credit to decline progressively, reaching zero at 170 percent of the LMW.

In so far as there is a significant unemployment trap, this is an eminently sensible move to ensure not only that jobs are available for the low skilled workers but also to ensure that they are induced by a financial reward rather than by stricter employment tests, to work and to gain work experience which will sustain them in long term employment. The cost of the scheme would be offset in part by additional income tax revenue from increased employment and by the saving on unemployment benefits, but the social advantage of people being employed rather than being on the dole, should not be ignored. A point worth emphasising, is the need to ensure that the effective marginal tax

rate is adjusted to avoid the disincentive effect of a sharply rising marginal tax rate for those entering employment.

2. However, the proposed introduction of an EITC scheme as a supplement to SPAK raises the question whether there is merit in applying the EITC scheme fully as the primary basis for promoting employment of low skilled rather than as addition to SPAK. The excellent paper by Graafland and van Postal refer to the difficulties arising from employer abuse of the scheme; the difficulties of targeting only those who are employed following a period on unemployment benefit as against providing a general subsidy for the low skilled; the efficiency loss from deadweight and displacement effects² in the general subsidy scheme; the tax wedge problem on employers, and other difficulties. There is, of course, rarely a foolproof labour market initiative, and it becomes a matter of balancing costs and benefits, monitoring the operation of the scheme and making changes, if necessary in the light of experience.

However, it is arguable some of the difficulties of the reduced wage cost scheme under SPAK may be avoided if the incidence of subsidies fell entirely on the employee. In addition, if the LMW is a serious discouragement to employment on the demand side because of the productivity trap, as appears to be the case, it would be necessary to lower the LMW in order to stimulate employment of low skilled workers. Since those on the LMW cover only about 3 percent of the workforce (OECD, 1996), it may also be necessary to encourage the re-opening of existing agreements in order to lower the minimum wages in these agreements. The extent to which the LMG (and other minimum wages) should be lowered would depend on demand elasticity estimates. This is likely to be rather low. Thus, in order to make a significant dent in the rate of low skilled unemployment, a greater lowering of minimum wages and a correspondingly higher EITC to employees would be necessary³.

Further, in order to provide unemployed workers with adequate incentive to work rather than to live on the dole in an unemployment trap, it would be necessary to ensure that the disposable income from work of low skilled workers is significantly greater than the existing unemployment benefits. Also, the progressivity of income tax rates in the relevant income range, would have to be adjusted to avoid the work disincentive of high effective marginal income tax rates.

Leaving aside political and consensus considerations, whether such a scheme should apply only to the long term unemployed or generally to low skilled workers, is a matter of judgment based on cost and efficiency considerations as well as on distortions of employer behaviour of the kind noted by Graafland and van Opstal.

² The combined effect for a number of countries, including the Netherlands, has been estimated at 90 percent. See John P Martin, *op.cit.*

³ It will be appreciated that this proposal is different from the one which was rejected by the Social Economic Council (SER) a few years ago. That proposal involved a reduction in the LMW without compensating income tax credit.

The administration of the scheme should be reasonably simple and low in cost because it involves a simple tax adjustment in weekly pay packets.

3. Although it has not been raised as an issue in the Netherlands, it is conceivable that in some countries, long term unemployment of low skilled workers varies to an important extent regionally. In such circumstances, especially where labour mobility is a problem, both the SPAK and the EITC type schemes could be applied on a differential regional basis.

4. As to the MIMIC-results: the model offers valuable insights into the impact of ALMP. Its deficiency is, of course, the lack of empirical content – therefore the results have to be complemented by empirical research.

3. Transferability of the Dutch scheme to Austria

On the matter of the transferability of the Dutch scheme to peer countries, apart from the issue of institutional differences, the following questions relating to low skilled workers arise for consideration by peer countries:

1. Is there a high long term unemployment rate of low skilled workers?

Austria has one of the lowest unemployment rates in the EU, irrespective of the method of measurement, i.e. EU-household survey or administrative data (social security data and registered unemployment) – it had a span of 4.4 percent (EU-LFS) to 6.5 percent (admin. data) in 1998. It is thus somewhat lower than the Dutch rate. Long-term unemployment is less of a problem in Austria than in other EU-countries. During 1998 38,000 or 16 percent of all registered unemployed were unemployed for more than 1 year, 30 percent were unemployed for more than 6 months. According to the labour force survey the share of long-term unemployed (more than 1 year) amounted to 27 percent, i.e. half the figure for the Netherlands.

If one looks at the skill structure of unemployed (*OECDb*, 1998) the unemployment rate of the low skilled workers (educational attainment below upper secondary education) is higher than for the medium and high skill segment (university level education). It amounted to 6 percent, for men and women alike in Austria in 1996, and was thus somewhat lower than for Netherlands (men: 6 percent, women: 9 percent).

A closer look at the duration of unemployment by educational attainment in Austria shows that it is not the unskilled workers who have the longest duration of unemployment. Rather, persons with general upper secondary education have had the longest duration of unemployment in the last

couple of years (137 days in 1998)⁴, followed by persons with no more than lower secondary education (129 days 1998), and upper secondary (medium skill) vocational schools (125 days).

Long-term unemployment is a multifaceted phenomenon and cannot be reduced to a problem simply of low-skilled workers. Older workers exhibit the highest share of long-term unemployment – more than 40 percent of the over 50 year olds are long-term unemployed in Austria.

The share of long-term unemployment is somewhat higher for women (27 percent of all unemployed women in 1998) than for men (21 percent). This is due to the fact that certain industries and professions, which employ an above average share of women, experienced a severe increase in competitive pressure in the last couple of years – partly as a result of integration into the EU, partly due to the opening up of Eastern Europe, and partly from technological change. Technological change is responsible for the high share of long-term unemployment amongst clerical workers (63 percent of all unemployed clerical workers); transfer of production of consumer goods production to CEEC helps explain the high share of long-term unemployment of textile, leather and clothing workers (close to 70 percent of all unemployed in these occupations).

2. Does long-term unemployment vary regionally?

Another aspect has to be taken into account: long-term unemployment is not distributed evenly over the regions. The highest share of long-term unemployment is in Vienna (close to 40 percent of all unemployed), followed by Lower Austria and Styria – where the closure of old industrial sites and the limited potential for geographical and occupational mobility (of older workers and women with family responsibilities) account for the high share. These problems can hardly be alleviated by a regional reduction in wage-taxes for the unskilled. Rather, they would be more effectively dealt with by an integrated set of industrial, re-skilling and social policies (horizontal issue). This is the objective of regional employment pacts, which are currently devised as an element of the employment policy of the National Action Plan.

The majority of the long-term unemployed have a physical disability. Of all the 129,000 registered unemployed men in 1998, 31,000 or 24 percent were hard to place – 67 percent of whom because of such disability. The share of the hard-to-place was even higher in the case of women: 49,000 or 45 percent of all unemployed women. Family duties were the main reason (63 percent of the hard to place women) for not accepting job offers anywhere and anytime (limitations of working hours and distance from home).

⁴ They constitute, however, only 2.4 percent of all unemployed, whereas persons with no more than lower secondary education constitute 42 percent of all unemployed. They are often seasonal workers (tourism, construction, agriculture), where frequent layoffs are part of the normal working life.

3. In relation to the productivity of low skilled workers, is the legal minimum wage a significant factor in their unemployment?

Before one can answer this question one has to look at the system of minimum wages in Austria. Austria has no statutory minimum wage but a system of minimum wages negotiated in collective agreements (awards). The minimum wage differs by education, occupation and work experience, by age, region and industry. As a result Austria has a wide spread of contractual minimum wages and over-award payments are common. In order to facilitate international comparisons, Austria calculates a notional minimum wage which it sets at 60 percent of the average gross wage. The introduction of a statutory minimum gross wage of 12,000 AS has been demanded by the unions and interest groups (two years ago by a women's right movement) again and again.

In 1997 the gross median monthly wages amounted to AS 20,400 (EURO 1,500), for men: AS 23,600 (EURO 1,700), for women: AS 15,700 (EURO 1,100). 60 percent of the median wage amounts to AS 12,000 (EURO 900). According to the wage-tax data, some 20 percent of Austrian wage- and salary earners (excluding apprentices) earn no more than this 'minimum wage'. If one takes into account that about 10 percent belong to this group because of part-time work (their hourly wage rate is higher than the 'minimum') we are left with a share of minimum wage earners of some 10 percent of all employed, i.e. some 330,000 persons. This is a large share by international standards. The Dutch figure is 3 percent. In this number, casual workers (*geringfügig Beschäftigte*) are included, i.e. persons who work for not more than AS 3,600 per month (EURO 300). Since this type of employment is becoming more prominent, firms have to pay social security contributions for them (since 1998) even though the individual has no full social security coverage (only accident insurance). As it turns out, the majority of the casual workers are not persons who depend mainly on earned income to sustain life, they are to a large extent pensioners, students and partners of breadwinners.

The relatively large number of casual workers (some 150,000 in 1997) and the high share of self-employed and family helpers in total employment (14.4 percent in 1997) contribute to the above average activity rate of Austria compared to the Netherlands and the EU (73 percent vs 69 percent). As demand for casual labour increases, substitution of full- and part-time workers for casual workers may set in (there is a rising number of persons with multiple casual jobs). This implies that we may have to expect a growing number of families, who have to subsist on part-time and casual labour. In this case we may need to top the income up by supplements to avoid poverty (earned income tax credit).

It has been argued in the past that one of the reasons for the low unemployment rate in Austria is the above average micro- and macro-economic wage flexibility (*Blaas & Guger, 1985*); the large spread of wages by skill, region and industry are a crucial element of the industrial relations system and the collective bargaining process in Austria. As a result, low productivity labour finds employment at low wages. There is another side to this coin, however, i.e. low wages preserve low

productivity work processes, outdated technology as well as traditional consumer goods production. Austria's foreign worker policy played an important role in keeping wages down by increasing the supply of un- and semi-skilled workers as well as tradesmen in consumer goods production; it facilitated the survival of low productivity jobs and industries.

4. Is the non-wage cost of low skilled workers in the form of social security and other payroll taxes unduly high?

The issue here is whether non-wage costs (in conjunction with a high minimum wage) are so high as to warrant relief in order to stimulate employment. Nominal hourly wages in Austria are amongst the highest in the world (OECD, 1997). Non-wage costs as a proportion of total wage costs are significantly above the OECD-average. In 1994 direct wage costs amounted to 50.5 percent of total hourly wage costs of an average production worker (manufacturing industry). This is somewhat less than in the Netherlands (55.6 percent) at the same time, and similar to Italy (49.8 percent), Belgium (51.6 percent) and France (51.9 percent). The high proportion of non-wage costs in total wage costs is the result of a peculiar Austrian wage system, in which two additional monthly salaries (the 13th and 14th) are treated as non-wage labour costs – a means of reducing the tax load for employers and employees alike. If one adds the 13th and 14th wage/salary to the yearly direct wage income, non-wage labour costs are reduced to the OECD-average. Social security contributions are the major part of non-wage labour costs- they amount to 45 percent of gross wages and salaries.

The wedge between the take-home wage (net income) and the production wage (wage cost) is one of the highest in the industrialised world and has been increasing since the mid 60s (OECD 1997). The employer contribution for blue collar workers amounts to 25 percent of the gross wage, for salaried employees 22 percent; in addition the employer has to pay 4.5 percent of the wage bill into a family allowance fund. The employee pays about 17 percent of the gross wage/salary into the social security fund.

The total tax wedge amounts thus to 46.5 percent, which is similar to the Dutch case. The rising tax load on labour has been transferred to a significant extent (up to 70 percent) to the product market in the form of higher prices. Through this mechanism employment growth has been negatively affected. As a result Austria is considering to transfer some of the tax load away from labour towards other resources, e.g. energy.

The tax/benefit position of low-income earners (67 percent of the average earnings of a production worker) in 1997:

Gross yearly earnings:	AS 199,700 (EURO 14,500)
Take-home Pay:	AS 154,900 (EURO 11,300)
Wage costs:	AS 263,200 (EURO 19,100)

The average income tax amounts to 4.3 percent, the average employee's social security contribution to 18.1 percent – total payments less cash transfers amount to 22.4 percent for the employee. The total tax wedge including employer's social security contributions amounts to 41.1 percent in the low wage/income segment (OECD, 1998c). It is thus somewhat smaller than in the case of the average (45.6 percent) and above average (167 percent of the average) income earner (50.5 percent).

All that said, wage costs and the non-wage component are high on average but the spread is fairly wide such that the productivity trap can be minimized. There is, however, an incentive problem to take up work at low wages since the marginal tax is high, i.e. Austria has an unemployment trap due to high replacement rates in relation to the minimum wage. For certain groups of the unemployed there is no financial advantage in changing from unemployment benefit to paid work. Supply side measures like the introduction of EITC should be envisaged in Austria as well, in order to make work pay (for the individual).

5. What has been the experience with ALMP including employment subsidies?

Austria spends a comparatively small amount of money on active labour market policy measures (0.4 percent of GDP versus the OECD average of 0.9 percent and the EU average of 1.2 percent in 1996). The major thrust of ALMP is on education and training measures (35 percent of expenditure on ALMP in 1996) in order to secure the longterm employability of workers. In the course of the 80s Austria developed a fairly differentiated gamut of ALMP, some were in the field of employment/wage subsidies. Wage subsidies have always been targeted, e.g. to youth or longterm unemployed adults, or to socio-economically handicapped persons. These ALMP have always been used sparingly, in order not to affect the functional mechanisms of the labour markets, in particular the wage structure and the incentive systems linked to it (never more than 8,000 persons a year, 5 percent of ALMP-expenditure in 1996).

Currently Austria offers wage subsidies to handicapped and longterm unemployed, when they are employed in non-profit institutions or private enterprises. The subsidy is limited to a certain period of time (up to 36 months for handicapped persons, for other longterm unemployed in particular older workers the subsidy is granted for up to 12 months). The subsidy is seen as an instrument to help the target group get into a job. It is not envisaged as a continual subsidy to counter the low productivity of the target workers. The experience of this instrument as to longterm integration of the target group into the labour market is encouraging, but not overwhelming. Deadweight loss and substitution effects are large.

In 1997 a new instrument was introduced – as a result of the attempt to transfer passive measures into active measures expressed in the National Action Plan. If a firm employs a longterm unemployed, it receives the longterm unemployment benefit plus the social security contribution, i.e. the total cost of a longterm unemployed to the Labour Market Service. In turn, it has to offer a

fulltime job at the going wage rate (but at least the contractual minimum wage). This measure was taken on very quickly (5,000 workers in the first year) and is currently under review as to its capacity for net job creation. It is also seen as a temporary subsidy for target workers only.

6. Are unemployment benefits a significant discouragement to work?

Not only is the level of unemployment benefits in relation to the minimum wage fairly high, which discourages to take up a low-wage job, but in addition the regulation that the unemployment benefit is calculated on the basis and in relation to the last income, acts as a deterrent to take up a low wage job. A person, who has lost a well paying job and accepts a job which does not pay more than the benefit, receives, in the event of the loss of this job, 40 percent of the gross wage as unemployment benefit. While livelihood was still assured at the low wage, this may not be the case when receiving unemployment benefits after an employment spell at a low wage. Accepting a low-wage job after the loss of a wellpaying job, may set a downward spiral of benefits in motion. This is a major discouragement for taking on a low wage job.

7. Are effective marginal income tax rates a significant discouragement to work?

In addition to the type of unemployment trap mentioned one has to point out that there is hardly a way back into the labour market after having dropped out of the labour market altogether, i.e. if one is on social aid (Sozialhilfe). Social aid is only granted after asset and income tests. It has to be repaid if one earns a market income. This is in effect a 100 percent marginal tax and contributes to social exclusion.

4. Concluding observations

I believe that the type of targeted wage cost reduction in the Netherlands is not an appropriate instrument to solve the Austrian labour market problems. Austria has a much higher activity rate and lower unemployment rate than Netherlands and a fairly small proportion of longterm unemployed. The labour market problems of the longterm unemployed arise only to some extent from low skills, the skill deficiency is often only a component of several problems. ALMP measures targeted at their specific needs and employment/wage subsidies to ensure longterm integration into the labour market ought to be the priority. Our differentiated minimum wage system and the inbuilt flexibility to respond to low productivity of regions, industries and occupations and even enterprises, fosters the employment of low productivity workers as well as the survival of industries which are under severe international competitive pressure. The downside of this microeconomic wage flexibility is the preservation of low wage jobs and industries.

One aspect of the Dutch labour market policy mix ought to find consideration in Austria, however, i.e. an earned income tax credit (EITC) scheme to supplement income for workers who have to

sustain their livelihood from casual and parttime labour with low hourly wages. For such workers, there is a case for EITC related to household income. In the context of alleviating the unemployment trap, some form of income supplement to the individual should also be considered. The former would be a welfare/equity measure rather than a means of generating employment but the latter could increase employment.

The SPAK scheme could be transferred to Austria, however, if it were targeted to older workers only (over 50). Austria does not only have a very low degree of integration of older workers into the workforce, but unemployment of older workers is significantly above average and longterm unemployment constitutes almost half of the unemployed. Minimum contractual wages are high because seniority plays a major role in wage agreements. As a result we have the problem of a productivity trap, which could be alleviated by demand side measures like a permanent discount on the wage tax for older workers. Such a measure could help secure the employment of older workers and maybe even increase their activity rates.

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