

## SPECIAL ANALYSIS

# Labour market reforms in Germany and Sweden

**After a decade of high unemployment and weak growth, Germany introduced sweeping reforms of the labour market in 2003–2005. The Hartz reforms aimed to boost the supply of and demand for labour, improve matching between the unemployed and vacancies, and increase flexibility in the German labour market. The reforms are hotly debated in Germany but are believed to have contributed to the improvements in the German labour market since the mid-2000s. This special analysis first describes the various components of the Hartz reforms. It then looks at how the German labour market has performed since 2005 in comparison to the Swedish labour market, and how the Hartz reforms may have contributed. Finally, we examine how the past decade’s labour market reforms in Sweden differ from the Hartz reforms.**

### **HARTZ REFORMS INTRODUCED IN FOUR STAGES**

The Hartz reforms<sup>75</sup> are a cluster of policy measures intended to increase the labour supply, improve the efficiency of employment services and labour market policy measures, activate the unemployed and foster demand for labour through reduced regulation of the labour market. The reforms consisted of four packages (Hartz I–IV) implemented in 2003–2005 (see Table 19). A number of changes have been made since, but large parts of the Hartz reforms still apply.

### **THE HARTZ REFORMS CONTAINED MEASURES TO MAKE LABOUR MARKET POLICY MORE EFFICIENT**

To make labour market policy more efficient, the federal employment service was reorganised and active labour market policy programmes were shortened and re-focused on those expected to benefit the most. The effects of different labour market policy programmes also began to be evaluated systematically. The programme mix was revised to increase the focus on training initiatives, wage subsidies and start-up grants, while public employment programmes that had proved ineffective were phased out. For a period, special service agencies were trialled

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<sup>75</sup> The reforms take their name from Peter Hartz, chairman of the independent committee of experts that drew up the proposed reforms. A more detailed description of the reforms can be found in, for example, Ebbinghaus and Eichhorst (2006) and Jakobi and Kluge (2007).

with the role of hiring out and training the hard-to-place unemployed.<sup>76</sup> The active labour market policy programmes have since been revised continuously based partly on the results of evaluations.<sup>77</sup>

**Table 19 Summary of the Hartz reforms**

|                                                                                             |                                                                                                                                                                                                                                                                                                 |
|---------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>Hartz I</b><br/>Decided 1 Dec 2002<br/>Effective 1 Jan 2003</p>                       | <p>Deregulation of staffing agencies and short employment contracts, new service agencies for the unemployed, vouchers for complementary placement activities, vouchers for vocational training for the unemployed, stricter requirements for job-seekers, wage subsidies for older workers</p> |
| <p><b>Hartz II</b><br/>Decided 1 Dec 2002<br/>Effective 1 Jan 2003 and<br/>1 April 2003</p> | <p>New business start-up grant, deregulation of mini-jobs, new midi-jobs, extended exemptions from dismissal rules for firms with 5–10 employees</p>                                                                                                                                            |
| <p><b>Hartz III</b><br/>Decided 1 Dec 2003<br/>Effective 1 Jan 2004</p>                     | <p>Restructuring of federal employment service, recruitment contributions for older people and those with reduced capacity for work</p>                                                                                                                                                         |
| <p><b>Hartz IV</b><br/>Decided 1 Dec 2003<br/>Effective 1 Jan 2005</p>                      | <p>Reform of unemployment insurance (including reduced replacement rates, shorter duration of benefits), sanctions for the unemployed</p>                                                                                                                                                       |

Sources: Ebbinghaus and Eichhorst (2006) and Jakobi and Kluge (2007).

#### **UNEMPLOYMENT INSURANCE TIGHTENED TO INCREASE THE LABOUR SUPPLY**

To increase the supply of labour, unemployment insurance was made less generous through lower replacement rates, shorter benefit periods, stricter requirements for job-seeking and sanctions for those not accepting job offers.<sup>78</sup> The eligibility criteria for unemployment insurance benefits were tightened. For example, it was no longer possible to qualify for a fresh period of unemployment insurance benefits by taking part in an active labour market policy programme.

After the reforms, unemployment benefits were largely unchanged for the short-term unemployed<sup>79</sup> who qualified for unemployment insurance benefits. Those who had been out of

<sup>76</sup> These were withdrawn after a few years when evaluations showed that they did not lead to shorter periods of unemployment for those covered by the service.

<sup>77</sup> A detailed description of German labour market policy can be found in, for example, Caliendo and Hogenacker (2012).

<sup>78</sup> A detailed description of German unemployment insurance can be found in, for example, Caliendo and Hogenacker (2012).

<sup>79</sup> Up to 6–12 months of unemployment depending on previous duration of employment.

work for a longer period, on the other hand, faced a drastic reduction in benefits. This applied particularly to older people, who had a much shorter period of unemployment insurance benefits (see box in margin).

The big reduction in unemployment benefits in the Hartz reforms came after the period covered by unemployment insurance. Before the reforms, unemployment benefits after the unemployment insurance period were income-based and relatively high.<sup>80</sup> They were also paid without a time limit. The Hartz reforms merged the income-based benefit for the long-term unemployed with the social security benefit.<sup>81</sup> Today, there is only one benefit level for all long-term unemployed and for those not eligible for unemployment insurance benefits. For those who do not qualify for unemployment insurance benefits, the replacement rate is actually slightly higher than before. The reforms provided a greater incentive to take any available work, including casual and part-time work. To reduce high marginal effects, the long-term unemployed taking jobs on low pay got to keep parts of their unemployment benefit.<sup>82</sup> Wage subsidies were also introduced for older unemployed people accepting work on a lower wage than before they became unemployed. The reform of unemployment insurance is the element of the Hartz reforms that encountered the greatest criticism in Germany.

#### **HARTZ REFORMS ALSO AIMED TO BOOST DEMAND FOR LABOUR**

The Hartz reforms had a sharp focus on increasing the labour supply, but also aimed to stimulate demand for labour. This was done mainly by reducing the regulation of the labour market. It was made easier for firms to use short-term employment contracts and to hire in staff from agencies. Exemptions from the Employment Protection Act were extended to include all firms

#### **Unemployment insurance in Germany**

Unemployment insurance is compulsory in Germany. The replacement rate is 60 per cent of previous pay (67 per cent for those with children under 18) up to a monthly wage of EUR 6,200 in the western states and EUR 5,400 in the eastern states. Benefits are tax-free, and so the replacement rate after tax can be very high. Benefits are paid for a maximum of 6–12 months depending on duration of employment. Members are entitled to benefits for a maximum of six (12) months if they have worked for at least 12 (24) months. Unemployment insurance benefits for the short-term unemployed were not affected by the Hartz reforms.

Before the reforms, those aged 45–46 could receive benefits for up to 18 months, and the number of additional months of benefits increased with age, so that those aged 57 could receive benefits for up to 32 months, assuming that they had worked for at least 64 months over a seven-year period.

The Hartz reforms raised the age limit for a longer duration of benefits from 45 to 55 years, and the maximum benefit durations were shortened. For example, the maximum duration of benefits for those aged 57 was cut from 32 to 15 months. Benefit durations for the over-50s were extended again by a few months in 2008. Today, those aged 58 can receive unemployment insurance benefits for up to 24 months if they have worked at least 48 months over a five-year period.

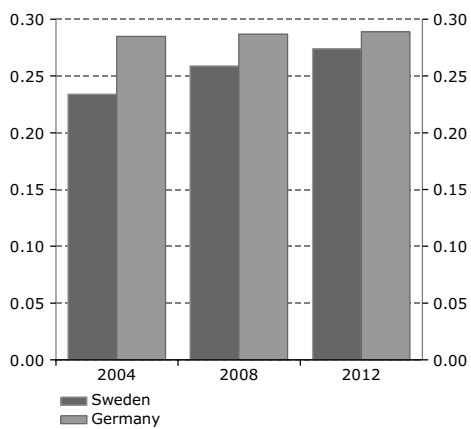
<sup>80</sup> The income-based benefit before the reform for the long-term unemployed (in other words after the period of unemployment insurance benefits) amounted to 53 per cent (57 per cent for those with children under 18). The benefit for the long-term unemployed was income-tested, however.

<sup>81</sup> The new benefit for the long-term unemployed and for those not eligible for unemployment insurance benefits (2016 levels) is EUR 404 per month for an adult living alone. An additional EUR 237–306 is payable per child depending on the child's age. Cohabiting adults are paid EUR 364 each per month. Costs for rent and heating are also covered. The benefit for the long-term unemployed is income-tested.

<sup>82</sup> According to statistics from the Federal Employment Agency, the number of people in receipt of unemployment benefits for the long-term unemployed who were in work climbed from 23 per cent in 2007 to 29 per cent in 2014. Monthly incomes of EUR 100–1,000 reduce the unemployment benefit by 80 per cent, and monthly incomes of EUR 1,000–1,200 reduce the benefit by 90 per cent.

**Diagram 135 Disposable income dispersion, post-tax**

Gini coefficient

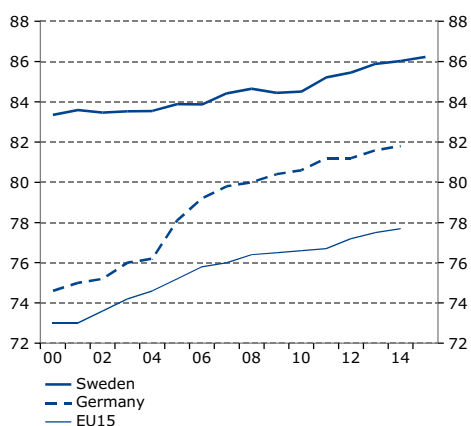


Note. The Gini coefficient takes values between 0 and 1, 0 representing total income equality and 1 total income inequality.

Source: OECD.

**Diagram 136 Labour force participation**

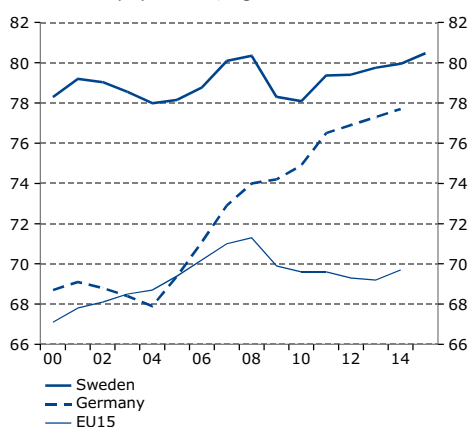
Per cent of population, age 20–64



Sources: Statistics Sweden and Eurostat.

**Diagram 137 Employment rate**

Per cent of population, age 20–64



Sources: Statistics Sweden and Eurostat.

with 5–10 employees, and the rules on dismissal were simplified. Employer contributions for the over-55s were reduced.

The reforms also meant reduced regulation of mini-jobs, a form of employment where monthly wages up to EUR 450 are exempt from most social security contributions.<sup>83</sup> It also became possible to have a mini-job alongside normal employment. To avoid high marginal effects, opportunities were also created for midi-jobs, where normal social security contributions and taxes were phased in for monthly wages of EUR 450–850. The deregulation of mini-jobs and midi-jobs effectively lowered the minimum wage, as the previous limit on how many hours could be worked was lifted.

Wage dispersion has increased in Germany since the reforms,<sup>84</sup> but the dispersion of disposable income has been more or less unchanged (see Diagram 135). Mini-jobs are more common in groups that have previously had relatively low participation rates, such as stay-at-home spouses and older people. Around 61 per cent of those with a mini-job in September 2015 were women, and 31 per cent were over the age of 55.<sup>85</sup> 12 per cent of those with a mini-job were born abroad, which roughly corresponds to the foreign-born share of the German population.

As a reaction to the increased wage dispersion in the lower part of the wage distribution, Germany has passed legislation introducing a national minimum wage in 2015–2016. This minimum wage of EUR 8.50 per hour is estimated to correspond to around half of the median wage and will affect around 15 per cent of all German employees and 23 per cent of those in the eastern states.<sup>86</sup> The minimum wage also applies to mini-jobs.

#### **SINCE THE HARTZ REFORMS, UNEMPLOYMENT HAS FALLEN SHARPLY AND THE EMPLOYMENT RATE HAS RISEN**

Labour force participation has increased in both Germany and Sweden since the mid-2000s (see Diagram 136). The participation rate is still higher in Sweden than in Germany, due mainly to higher participation among women in Sweden. The employment rate has risen further in Germany than in Sweden since

<sup>83</sup> Unemployed people taking a mini-job are still registered as unemployed and get to keep part of their unemployment benefit if the household's income is not too high.

<sup>84</sup> See Dustmann et al. (2014) for an analysis of wage dispersion in Germany since the 1990s.

<sup>85</sup> Minijob-Zentrale (2015).

<sup>86</sup> OECD (2014).

2005 but is still higher in Sweden (see Diagram 137). The number of hours worked per employee has fallen in Germany, because much of the increase in employment has consisted of part-time work.<sup>87</sup> In Sweden, hours worked per employee have trended neither up nor down (see Diagram 138). The number of hours worked per capita has moved similarly in the two countries (see Diagram 139).

The increased share of low-wage and part-time jobs in Germany has probably contributed to the relatively weak wage growth (see Diagram 140). Income dispersion has not, however, increased to any significant degree since 2004 (see Diagram 135). In Sweden, wage growth has been stronger, but income dispersion has increased somewhat (see Diagram 135).

Unemployment has fallen sharply since 2005 in Germany but been largely unchanged in Sweden (see Diagram 141). The difference in unemployment between the native and foreign-born populations was approximately the same in Sweden and Germany in 2005 (see Diagram 142). Since then, the gap has narrowed substantially in Germany but widened in Sweden. Part of this may be due to higher net immigration relative to the size of the population in Sweden than in Germany, and to differences in the composition of the foreign-born population (see Diagram 143). Sweden has received a greater proportion of refugees and family reunification migrants than Germany, where – at least until recently – immigration has been mainly from other EU countries. This is probably an important reason why Germany has also managed to bring down unemployment among the foreign-born population, whereas in Sweden it has only fallen in the native population. The difference between the two countries in terms of unemployment in the native population is substantially smaller (see Diagram 144).

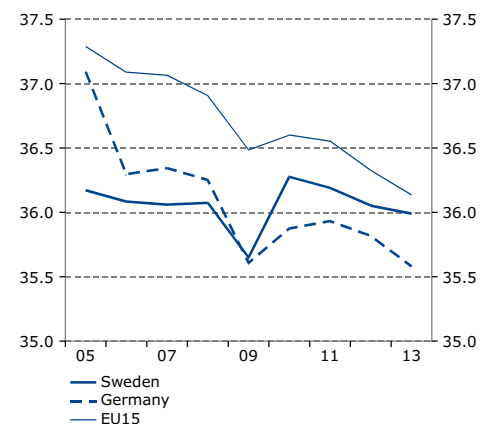
#### ARE THE IMPROVEMENTS IN GERMANY SINCE 2005 DUE TO THE REFORMS?

It is difficult to say how much of the German labour market's strong performance is down to the Hartz reforms. It is also difficult to identify reliably which elements of the Hartz reforms have had an impact, although this is an interesting question for decision-makers. The various parts of the reforms were designed to complement one another and were introduced at more or less

<sup>87</sup> In Germany, many women work part-time due to a shortage of childcare and short school days. Joint taxation and access to social security benefits through the husband's work are also reasons why many married women work part-time.

**Diagram 138 Hours worked per employed (at work), 15-74 years**

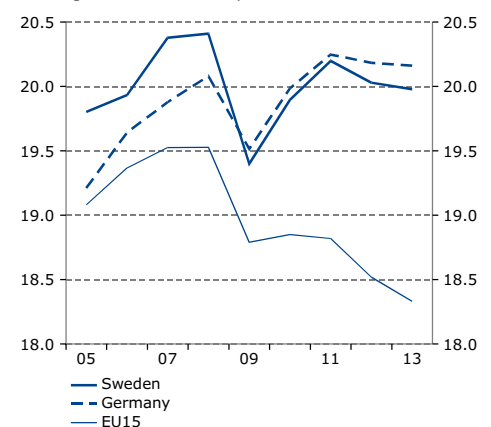
Average number of hours worked per week



Source: Eurostat.

**Diagram 139 Hours worked per person, 15-74 år**

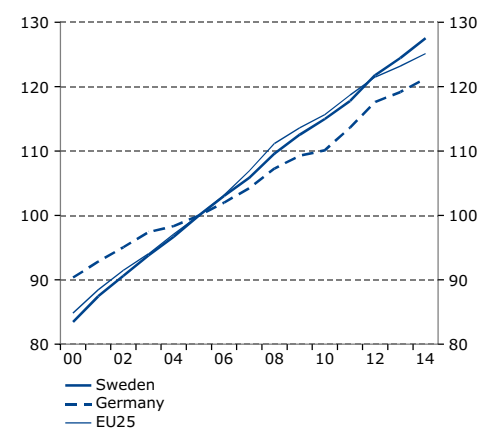
Average hours worked per week



Source: Eurostat.

**Diagram 140 Nominal wages, private sector**

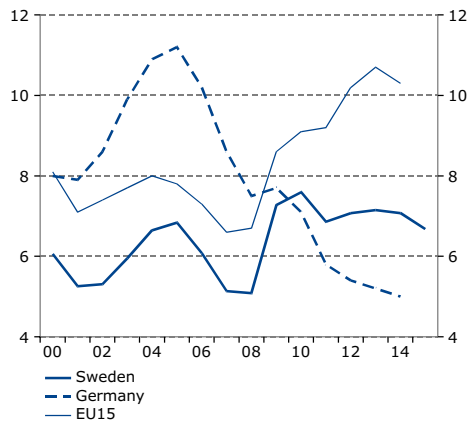
Index 2005=100



Source: Eurostat.

**Diagram 141 Unemployment**

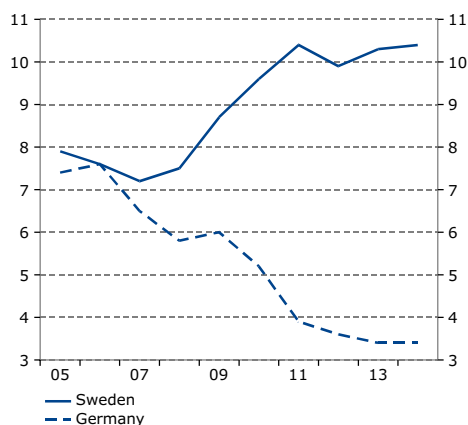
Per cent of labour force, age 20–64



Sources: Statistics Sweden and Eurostat.

**Diagram 142 Unemployment difference between foreign born and domestic born, 20–64 yrs**

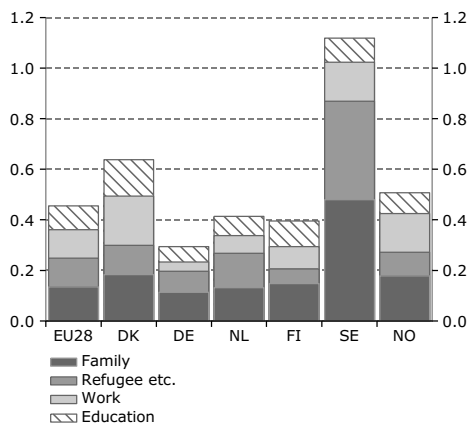
Percentage points



Source: Eurostat.

**Diagram 143 Residence permits awarded to persons born outside the EU, by cause, 2014**

Per cent of population



Source: Eurostat.

the same time, which makes it difficult to separate out the effects of different measures.

Empirical results from a number of studies suggest, however, that the Hartz reforms as a whole have led to significantly lower unemployment, shorter periods of unemployment and higher employment.<sup>88</sup> Flows from employment to unemployment decreased substantially following the reforms, especially among the older workers who were affected most by the tightening of unemployment insurance.<sup>89</sup> In addition, several studies have found that the reforms have had positive effects on matching efficiency.<sup>90</sup> Many parts of the Hartz reforms impacted on the reservation wage<sup>91</sup> and have probably also affected wage formation more generally. There is some evidence that the average wage has been affected negatively, that wage dispersion has increased, and that wages for those finding work after a period of unemployment have been lower as a result of the reforms.<sup>92</sup> It is also possible that the supply reforms, together with reduced regulation of the labour market, have lowered the level of undeclared work, although this is, by definition, difficult to measure.

The national minimum wage is still in the process of being phased in, and there are, as yet, no empirical studies of its effects. The introduction of the minimum wage is expected to lead to higher wages in the lower part of the wage distribution, reducing the risk of poverty and potentially stimulating the labour supply. At the same time, it will constrain demand for labour, and some researchers have argued that the introduction of the minimum wage will reduce job-finding rates among the inexperienced and the poorly educated and in some regions.<sup>93</sup>

Of course, developments in the German labour market have not been driven solely by the Hartz reforms. There are also studies<sup>94</sup> that posit other explanations for developments in the German labour market and wages since the mid-2000s, such as a long-term decline in unionisation and more decentralised wage formation, a relatively weak exchange rate, increased competi-

<sup>88</sup> See Krause and Uhling (2012), Krebs and Scheffel (2013), Launov and Waelde (2013), Dlugosz et al. (2014) and Stephan and Lecumbery (2015).

<sup>89</sup> See Dlugosz et al. (2014).

<sup>90</sup> See Fahr and Sunde (2009), Klinger and Rothe (2012) and Hertweck and Sigrist (2013).

<sup>91</sup> The reservation wage is the lowest wage that an individual is willing to work for.

<sup>92</sup> See Arent and Nagli (2013), Gianelli et al. (2013) and Engbom et al. (2015).

<sup>93</sup> See, for example, Boll et al. (2015).

<sup>94</sup> See, for example, Burda and Hunt (2011), Akyol et al. (2013) and Dustmann et al. (2014).

tion from Eastern Europe, and the use of short-term work during the financial crisis. Other reforms, such as that of pensions, have probably also contributed to the German labour market's strong performance. Demographic developments, with a dwindling working-age population, may also have contributed to lower unemployment.

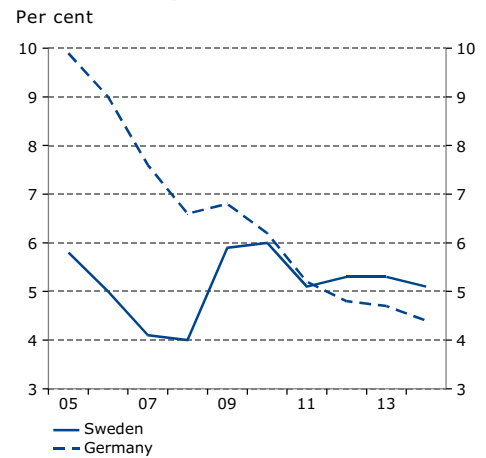
#### LABOUR SUPPLY REFORMS HAVE DOMINATED IN SWEDEN TOO

Sweden has introduced many reforms over the past decade that resemble the Hartz reforms in Germany.<sup>95</sup> Particular weight has been given to measures to stimulate the labour supply, although some measures have also affected demand for labour. Unemployment insurance has been tightened.<sup>96</sup> Together with the earned-income tax credit, this has increased the incentive to work. The reform of sickness insurance has led to an increased labour supply, but also more people registered as unemployed with the Swedish Public Employment Service.

Sweden's employers enjoy relatively high levels of flexibility through the use of short-term employment contracts and staffing agencies. Wage subsidies are also part of labour market policy (for example, the New Start and Entry Recruitment programmes) to boost demand for groups with a low job-finding rate. The RUT tax allowance for household services and reduced value-added tax on restaurant services are also intended to foster demand for labour with a weak attachment to the labour market. Reduced employer contributions for young and older workers have been introduced to support demand for these groups in the labour market.

The far-reaching reorganisation of the federal employment service in Germany is believed to have improved matching between the unemployed and vacancies. In Sweden, however, matching seems to have deteriorated.<sup>97</sup> A growing share of those registered as unemployed with the Public Employment Service are in groups with relatively low job-finding rates, such as recent immigrants, immigrants with limited education, and those who have been on long-term sick leave. This has affected how well

**Diagram 144 Unemployment, domestic born, 20–64 years**



Source: Eurostat.

<sup>95</sup> See, for example, NIER (2011), NIER (2013a) and NIER (2015) for descriptions of Swedish reforms since 2007 and the NIER's assessment of their long-term effects.

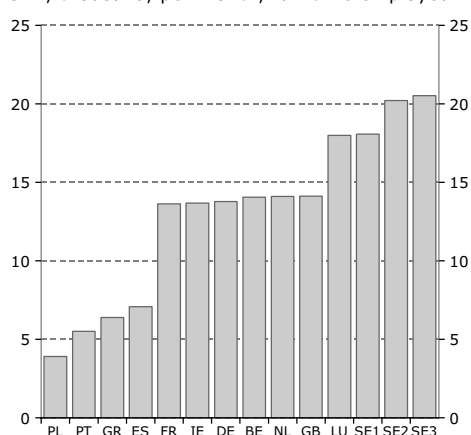
<sup>96</sup> For example, the eligibility criteria for unemployment benefits have been raised, the replacement rate has been scaled down for the long-term unemployed, renewal of eligibility via participation in active labour market policy programmes has been withdrawn, and more qualifying days have been introduced.

<sup>97</sup> See, for example, NIER (2014).



**Diagram 145 National minimum wages in European countries, and collective bargaining-based minimum wages in Sweden**

SEK, thousand, per month, full-time employed



Note. SE1: Local government employees, age 19+, no experience. SE2: Hotels and restaurants, age 20+, no experience. SE3: Retail, age 20+, no experience.

Sources: Eurostat and union web sites.

labour market policy has been implemented in Sweden. The Public Employment Service has been allocated more resources, but despite a change in its remit there has not been any major restructuring. It is also possible that the reform of unemployment insurance has had more of an impact in Germany because unemployment insurance is compulsory there. In Sweden, many of the unemployed are not members of any employment insurance scheme, and the proportion of those registered as unemployed with the Public Employment Service (and not on job creation schemes) who received benefits from unemployment insurance decreased from just over 70 per cent in the early 2000s to 41 per cent in 2013.<sup>98</sup>

Unlike in Germany, no reforms directly affecting minimum wages have been introduced in Sweden. Wage subsidies as part of labour market policy reduce wage costs for groups with a weak attachment to the labour market, but are time-limited and associated with administrative costs for employers. Wage subsidies in the form of active labour market policy programmes have probably not therefore had the same effects on demand for labour as generally lower wages. The earned-income tax credit and the tightening of unemployment benefits have probably had a restrictive effect on wages, but it is difficult to gauge the size of this effect.<sup>99</sup>

Collectively agreed minimum wages in Sweden are high by international standards at around SEK 20,000 per month, and the wage structure is compressed. In Germany, the new national minimum wage is equivalent to around SEK 14,000 per month for a full-time worker, and calculations suggest that this entails an increase for the very lowest paid. Minimum wages in the UK, Belgium, France and the Netherlands are around the same level as the new minimum wage in Germany. Of the European countries with a national minimum wage, only Luxembourg has one that is almost as high as collectively agreed minimum wages in Sweden (see Diagram 145). The high minimum wages in Sweden probably reduce employment among groups with low or uncertain productivity, such as non-Europeans and those with no more than basic education.<sup>100</sup>

<sup>98</sup> Swedish Public Employment Service (2014).

<sup>99</sup> The results in Benmarker et al. (2014) suggest that nominal wages were approximately 2-4 per cent lower in 2009 than they would have been without the reforms. The NIER believes, however, that the short-term effects are probably smaller than the study indicates, see NIER (2013b), pages 107ff. The Swedish Labour Policy Council (2016) believes that the pay deals struck since 2007 have not taken much account of the real net wage growth due to the earned-income tax credit.

<sup>100</sup> See NIER (2014) and Lundborg and Skedinger (2014).



## **HARTZ REFORMS CONSIDERED A SUCCESS, BUT MANY ARE STILL CRITICAL**

In some respects, the German labour market has outperformed the Swedish labour market over the past decade, despite the two countries introducing many similar reforms. One important reason why the reforms have had positive effects in Germany is probably the combination of extensive supply reforms with reforms that have greatly stimulated demand for the type of labour where supply has increased the most. Of course, developments in the labour market are not driven solely by reforms.

The labour force participation rate and the employment rate were lower in Germany at the beginning of the 2000s, providing more room for improvement. Demographic developments and immigration have also differed between Germany and Sweden, which probably also helps explain the differences in performance. The working-age population (20–64 years) has increased in Sweden over the past decade, but decreased slightly in Germany. The additions to the labour force in Sweden are to a great extent refugees and family reunification migrants, which is an important reason why unemployment in the foreign-born population is high in Sweden. The Swedish Labour Policy Council (2016) shows, however, that the relative employment rate among poorly qualified immigrants improved substantially in Germany from 1994 to 2012 but deteriorated in Sweden. A higher share of non-European refugees poorly equipped to meet the needs of the labour market will make unemployment a continuing major challenge for Sweden in the future. It is unlikely that the unemployment problems facing the poorly qualified can be resolved solely through training initiatives. There will probably be a need for a greater dispersion of labour costs to boost employment in groups with limited qualifications.

The German experience shows that increased wage dispersion probably increases employment but does not necessarily bring a marked rise in income dispersion. One reason for this is believed to be the relatively extensive social security system in Germany and especially the payments for those on low wages.

The Hartz reforms are considered to have been a success in terms of their macroeconomic effects in Germany, but many are still critical of them. German unemployment has fallen as a result of the reforms, but at the cost of increased insecurity in the event of unemployment. The duration of benefits in the unemployment insurance system for older people was therefore increased again in connection with the financial crisis. The German example demonstrates the importance of awareness of

conflicting objectives when implementing long-term sustainable reforms.

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