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WELFARE TO WORK IN GERMANY

A Proposal on How to Promote Employment and Growth

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Preface

This study has been prepared at the Ifo Institute for Economic Research in the Department of Social Policy and Labour Markets. It was completed in May 2002 and has, since then, influenced the public debate in Germany on labour market reform. The study investigates the reasons for high-level unemployment in Germany, specifically among the low-skilled. As welfare benefits appear to play a major role in explaining the long-term upward trend in unemployment, a proposal is developed on how to redesign current welfare programmes in order to activate individuals who are able to work but, under the existing framework, cannot find a job. The strategy suggested combines a reduction in benefit entitlements for those who refuse to take up work, a tax credit for those who enter the low-wage segment of the labour market, and the provision of community service jobs that are mainly needed as a temporary substitute for regular employment. The proposal is supported by surveying the international experience and making extensive quantifications with respect to the impact on wages, labour demand, employment and public budgets.

Keywords: labour market policy; social protection; unemployment; unemployment benefits, welfare benefits; low-wage sector, wage subsidies.

JEL codes H 53; I 38; J 21, J 31, J 68.

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Summary

One of the major obstacles to the employment of low-skilled people in Germany is the current system of welfare benefits, particularly the social assistance scheme that defines a minimum level for benefit entitlements irrespective of whether one is working or not. Social assistance establishes a minimum level in the wage structure and produces unemployment. In a competitive environment, no private enterprise would hire anyone whose value added is less than the wage paid and no welfare beneficiary would take on a position where the wages were not sufficiently above the level of social assistance. Beneficiaries whose productivity is not above, or only somewhat above, the level of social welfare cannot be placed. As a result, the labour market for individuals with low qualifications has dried up and an important factor of production lies idle.

The Ifo Institute has worked out a detailed proposal to reform the system of welfare benefits and made estimates regarding the consequences for employment, distribution of income and fiscal costs. The Ifo proposal aims at making the German labour market functional again without lowering the standard of social protection already achieved or imposing additional burdens on the federal budget. These goals can be reached through a fundamental reform of the social assistance scheme, with a change from the present system of wage replacement to one of wage supplements. This would abolish the current minimum wage, allow for more differentiation of wages and encourage profit-minded enterprises to create more jobs.

If the proposal were implemented, 2.3 million additional jobs could be created in the low-wage sector over the medium term, implying an increase in aggregate employment of ca. 6%. The increase in employment implies an increase in the domestic product and in the level of aggregate demand. The gain in the gross domestic product can be estimated at ca. 1.9% or €38.4 billion, coming as a surge in growth that could permanently raise the domestic product over the levels achieved otherwise. The conventional wisdom that growth creates employment would be turned upside down. Higher employment itself will create growth.

The Ifo Institute recommends the following three steps to reform:

- First, claims on social assistance (including housing assistance granted as a lump sum in these cases) will be noticeably reduced for employable individuals who do not work in the regular labour market. The new minimum level guaranteed through

public welfare benefits will be so low that it is only attractive to those having income elsewhere.

- Second, in order to support employment in the regular labour market, subsidies are granted for low wages. The wage tax credit created for this purpose is to be determined so that even with part-time employment low-wage earners will have a household income at the current level of social assistance through the combination of wages earned and subsidies granted. In the case of full-time employment, income will exceed this level by far.
- Third, the state will offer jobs to employable individuals who cannot find work in the regular labour market. Wages for these jobs are to be calculated so that the household income of the recipients is exactly at the level of current social assistance.

Each of the three steps depends on the others to function and cannot be carried out alone. Only through a combination of all three elements is it possible to achieve the fundamental goals of the welfare state and find a way to consolidate the national budget.

In order to eliminate the effective minimum wage that prevents workers with low qualifications from being employed, the state cannot provide low-wage earners in the private sector with lower transfers than employable individuals who do not work. If this condition is to be met with the current level of social assistance and the group of beneficiaries is increased to include many wage earners through a reduced transfer withdrawal rate (negative income tax), then additional costs will arise amounting to approximately €80 billion year for year. In view of the rocketing social expenditures and the general budget restrictions, this is no alternative.

Within a realistic fiscal policy, the necessary incentive effects can only be brought about through reductions in social assistance for employable individuals who do not work. These reductions will free the resources necessary to promote employment through wage subsidies and increase the incentives to take up regular employment at the same time.

The problem with this kind of reform is that through the reduction of social assistance, individuals who cannot find work very quickly would be forced under the subsistence level, thus provoking a conflict with the goals of the welfare state as laid down in the

German constitution. The third step of the Ifo proposal is a solution to this problem. If municipalities are compelled to offer everyone the possibility to work for wages at the current level of social assistance, then social hardship can be effectively avoided. Without the third step, the first cannot be implemented, and without the first, the second cannot be paid for.

The third step weakens but does not eliminate the incentive to work in the private sector. On the one hand, the attractiveness of both social assistance and the shadow economy financed through will be strongly reduced; on the other, the compensation for public employment of this kind is only about half of the income that low-skilled individuals could earn in the regular labour market. The switch from community work into private employment will lead to a major increase in income despite the wage decrease to be expected from the reform.

The municipalities should assign the task of employing recipients of social assistance to independent non-profit or private companies and give them the incentives to prepare these individuals as efficiently as possible for employment in the regular labour market. Further, the help of staff-leasing agencies might be used to bring some of the individuals in employment who cannot be placed directly into regular jobs. (Formally these individuals would be employed by the municipalities but are commissioned by them to provide services in the private sector.) Temporary employment agencies have had great success in Germany and other countries in helping to integrate less-qualified individuals into the regular labour market.

In addition to the three core elements of the reform, the Ifo proposal requires the abolition of current unemployment assistance and current programmes of active labour market policy. Beneficiaries of the former and participants of the latter are to be transferred into the new social assistance scheme. Child-related benefits should no longer be reduced with increased income but fixed to be essentially constant for all income classes.

On balance the fiscal effects of the reform will be positive. If all 2.3 million unemployed people with low qualifications can be integrated into the regular labour market, as is the goal of the Ifo proposal, then this would lead to fiscal savings of €6.2 billion per year. Additional expenditure of €19.2 billion for the wage tax credit are set off by additional social security contributions of €9.1 billion and savings on benefits and measures of current labour market policy of €16.3 billion. Even if only 1.8 million unemployed individuals (i.e., 80% of the target group) find a regular job, the balanced

fiscal effect is a surplus of €2.8 billion. If only 60% of all potential workers find work, then there will be some minor fiscal costs.

The implementation of this reform proposal would generally improve the efficiency of the labour market. There would be few losers and many winners. If measured by the income of a typical individual with low qualifications receiving social assistance now, the degree to which social policy can accomplish its goals will clearly increase. At the same time, taxes imposed on those who are currently working will go down. Up to the present, the percentage of individuals in the active labour force has continuously decreased as the number of non-employed individuals has increased because of the rising income transfers that those who worked had to provide for those who didn't. This is the point of departure for the Ifo proposal that will strengthen the welfare state without expanding its budget.

Introduction:**Securing a minimum level of income in the welfare state**

During the last thirty years Germany has exhibited an ominous and continuous tendency of growing unemployment not only during economic recessions but also in periods of growth. Every economic boom was seen by politicians as an indication of a turnaround due to a temporary increase in the numbers of employed in the labour market, but in the following periods of stagnation, the number of unemployed tended to climb even higher than before. For the current year an average of approximately 4.5 million people registered as unemployed can be expected. Numerous individuals who are employable and interested in working are not even included in this figure since they were pensioned off early, took advantage of a part-time work arrangement for older employees, have given up looking for work or, as welfare recipients, are not registered as being unemployed.

This problem is particularly serious for workers without formal qualifications who are often regarded as impossible to place or have been pushed into the shadow economy. With a proportion of almost 40% of all unemployed, they are particularly hard-hit. Moreover, people without sufficient vocational skills have a risk much higher than average of remaining unemployed for a long period of time.

The Ifo Institute is presenting a proposal for the reform of the German welfare system that will specifically facilitate the entry or re-entry of low-skilled individuals into the German labour market and bring about an upturn in economic activity. Not all problems can be solved here, but this is one way of overcoming the ongoing employment crisis and it could have a major impact on economic growth.

More than 2 million new jobs can be created in the low-wage sector through the implementation of our reform proposal. It promises a 2% increase in economic growth, less government spending and is consistent with the goals of social policy – helping people to help themselves – by enabling former welfare recipients to raise their income substantially through work. These goals may seem to conflict with each other, but this is not the case. They can in fact be achieved together because, in providing a general minimum level of income, the present system of social assistance is inefficient and not in line with the real goals of social policy.

The major problem of social policy arises from the fact that it causes a good part of the unemployment that it seeks to alleviate. In Germany, social and unemployment assist-

ance¹ is now designed as wage replacement schemes, granting benefits when someone loses his or her job. Benefits are reduced or cut off completely when the recipient starts a new job. As a result, there is little incentive to seek new employment. The more serious ramification is that high levels of assistance define high reservation wages demanded by those in unemployment, effectively rendering many potential jobs unprofitable and causing the low-wage sector to dry out. Welfare recipients are condemned to inactivity and it is virtually impossible for them to free themselves with their own resources. This is completely contrary to the philosophy of the social market economy. It impedes economic development and destroys the social welfare state from within.

The primary task of the welfare state should not be to alleviate the effects of job loss, as the present system of social assistance essentially tries to do. Instead, it should take up the cause of individuals who through insufficient qualifications and low productivity are not able to earn the income to support themselves that they could achieve through regular employment. Individual claims should not depend on unemployment status but on income potential and a willingness to earn income. Help should go to those who want to help themselves through their own efforts in accord with their abilities.

To reform the German system of social assistance, wage supplements already so successful in many other countries should supplant wage replacement. A reform of this nature will eliminate the implicit minimum wage based on high reservation wages drawn from the social assistance system to date. It will lead to a wage reduction in the lowest level jobs and encourage businesses to open up additional jobs and develop the low-wage sector that has been blocked until now. Wage supplements will help all individuals with low income potential to earn their own living responsibly and make a productive contribution to economic development as a whole.

Ifo's proposal for a new orientation in the system of social assistance is part of a comprehensive concept to reform the German system of welfare benefits and labour market policies in general. We see this as a contribution to the public debate on economic policy that offers workable solutions for more employment and growth in Germany.

¹ Throughout, we use the term "social assistance" when referring to benefits derived from the German *Sozialhilfe* scheme. The term "welfare benefits" will be used to denote a broader class of benefit entitlements meant to secure some minimum level of income, like social assistance (*Sozialhilfe*), unemployment assistance (*Arbeitslosenhilfe*, a non-contributory benefit for the long-term unemployed), or means-tested housing benefits (*Wohngeld*, which is paid on a nearly automatic basis to beneficiaries of the two other programmes).

Chapter 1

Incentives of the German social assistance system

The present system of welfare benefits which guarantees a minimum level of income, particularly the social assistance scheme, is a major obstacle to the employment of less-qualified workers, who are over-represented by far in the group of benefit recipients. The way in which these benefits are arranged clearly reduces the employment opportunities in the regular labour market for those in the workforce without completed vocational training. In other words, the social system itself pushes many of these people over the edge. They don't work at all or, if they do, then in the shadow economy. The demand for workers who, due to a lack of qualifications, can only fill positions in the low-wage sector can hardly be met because of the incentives offered by the present tax-transfer system. But a correction of these false incentives is possible through a restructuring of the social system. This doesn't mean that the multi-faceted problems of the German labour market can be completely solved, but a major reduction in the number of the less-qualified unemployed individuals will certainly contribute to overcoming mass unemployment and the economic dynamics missing in Germany.

The arguments supporting this proposition will be presented step by step in the following sections. First, we will analyse the existing situation to determine the number of employable individuals with minimum qualifications who are not working in Germany at this time. Next, the link between welfare benefits, wage structures and unemployment will be developed, building on an international survey of the approaches taken by other countries to solve a related set of problems. Finally, we will present the Ifo Institute's concrete proposal for reform.

1.1 Increase in the number of social assistance recipients

German social assistance in the narrowest sense refers to the granting of so-called "assistance with the ongoing costs of living" to individuals living in private households and not in institutions. The statistical survey of both the number and structure of recipients who fall into this category shows numerous discontinuities over time. Nevertheless certain basic trends can be recognised from the available data (Figure 1.1). During the 1960s the total number of recipients fluctuated at around 500,000 persons (end-of-year figure for West Germany) and increased from 1970 onwards parallel to the increase in

registered unemployment (Haustein 2001, pp. 372–3).² In 1982 the number passed the one million threshold and in 1991/92 exceeded two million due in part to the inclusion of the new states of eastern Germany in the statistics. There was a further break in 1994 with the introduction of the *Asylbewerberleistungsgesetz* (“law concerning benefits for people seeking asylum”) on the basis of which 450,000 individuals were excluded from receiving social assistance payments. At the same time the official social assistance statistics were being restructured in order to better analyse the effects of social assistance grants.

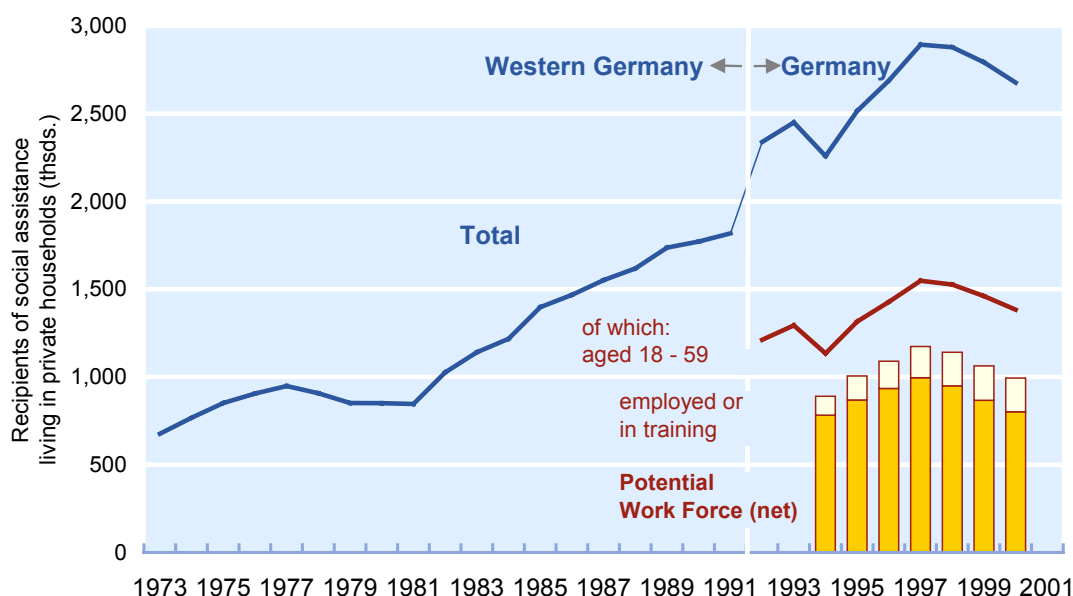
Currently the number of recipients of social assistance (narrowly defined) is approximately 2.7 million.³ Only a portion of this group is available for employment. Many people cannot be included as potential members of the work force on account of age, illness, invalidity or, for example, child care. From data collected since 1994, the Federal Office of Statistics has developed a simple system to determine the number of potentially employable recipients of social assistance (cf. Haustein 2001, pp. 378–9) The total labour force potential of those receiving social assistance is made up by all beneficiaries between the ages of 18 and 59 who remain after removing individuals who cannot be employed due to illness, disability, other reasons for inability to work, or having to stay at home for child care or care of other relatives. A small percentage of this total effectively works and receives only some additional assistance. Another small group is receiving training or continuing education and is unable to work as a result. The remaining group of recipients makes up the so-called net labour force potential indicated in Figure 1.1, applying the same criteria as far as possible. At present (2000) around 802,000 individuals are in this group.

This number is the most visible expression of the problems, which the German system of welfare benefits produces in terms of destroying job opportunities for less-qualified people. It is probably only the tip of the iceberg. First, there is a relatively large group of employable individuals who would be willing to give up their current unemployable status and choose the path of low-paid employment if there were additional financial incentives. Second, the number does not take into consideration the fact that social assistance pushes up the total wage scale in the low-wage sector and also creates unemployment among individuals who do not qualify.

² See, in addition, the following section, specifically Figure 1.2. Of course, causality cannot be inferred from parallels in time one way or another. It should be noted, though, that at the present time just under 40% of all employable recipients of social assistance are registered as unemployed.

³ *Statistisches Bundesamt* (Federal Office of Statistics), *Fachserie 13, Reihe 2*, 2000, Tab. A.1.1.

Fig. 1.1 Social Assistance Recipients and Potential Work Force



Source: *Statistisches Bundesamt* (Federal Office of Statistics, end-of-year information).

Most of those welfare recipients classified as employable have only minimal qualifications. Approximately half of all working-age recipients have not completed vocational training (Haustein 2001, p. 378) If the number of recipients is included for whom there is no information concerning vocational training, this group increases to 65% of all welfare recipients aged 18 to 59 holding no formal qualifications. Furthermore, it can be assumed that almost all employable recipients are only available for jobs demanding few qualifications because of their long phases of unemployment and the accompanying loss of former qualifications. Certainly, even recipients with completed apprenticeships or higher vocational training are not easy to place in positions requiring specific qualifications. They usually have to start at the bottom and work their way up into more qualified positions. Thus, they may be able to exchange their positions in the low-wage sector for ones with higher skill demands only over longer periods of time.

The current outlook for finding work in the German labour market is not at all good for any welfare recipients at working age regardless of their specific attributes, partially because of their place in the waiting line behind recipients of unemployment benefits or assistance and, in addition, because some are no longer registered as unemployed.⁴

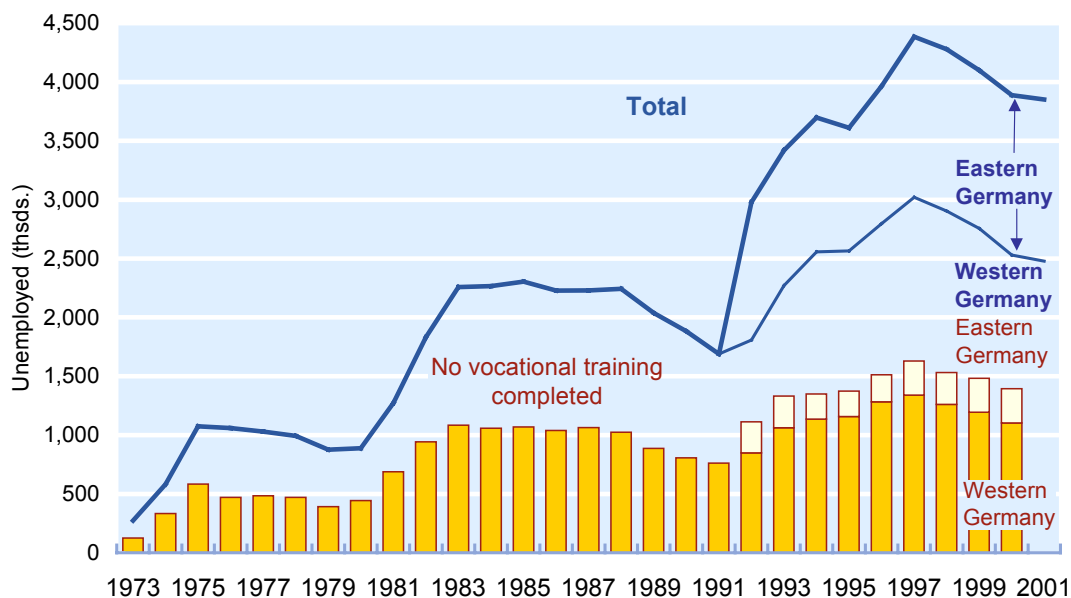
⁴ From the net labour force potential of welfare recipients previously mentioned, 607,500 (75.5%) are registered as unemployed; of those only 219,000 (27.3%) receive unemployment benefits based on the *Arbeitsförderungsgesetz*, specifically unemployment assistance.

1.2 The growth in unemployment

The growth of the number of unemployed and the unemployment rate in Germany is very well known. During the 1960s the average annual unemployment was under 200,000. Thereafter unemployment increased from one economic downturn to another at almost always the same tempo. Booms held off the increase temporarily and raised hopes for a turnaround that never came. Today the trend towards increased unemployment has not diminished. The present recession has raised unemployment even more. For 2002 an average of 4 million unemployed was expected (Figure 1.2).

Part of this problem has been caused by eastern Germany where employment has decreased year for year. A self-sustaining upswing has not set in after the jump-start intended from the “*Fördergebietsgesetz*” (a law providing aid and support for the new Federal states) failed. The proposals presented here for the mobilisation of the labour market are therefore of great importance for the recovery of eastern Germany.

Fig. 1.2 Unemployment and unemployed individuals with low skills



Sources: *Bundesanstalt für Arbeit* (Federal Labour Office); 2001: pending figures; 2002: Ifo prognosis.

The data on unemployment include some recipients of social assistance. As mentioned above, a considerable percentage of the remaining unemployment, specifically of persons with minimum qualifications, can also be attributed to the effects of the German social assistance system. Figure 1.2 shows that of the persons currently registered as

unemployed, approximately 37.8% have not completed vocational training,⁵ this figure being the mean between the western German level of 46.3% and the eastern German of 22.4%. The low level in eastern Germany is still a result of educational policy in the German Democratic Republic: the proportion of employable individuals without vocational training is 7% in eastern and 15% in western Germany. Thus, the specific rate of unemployment for persons without completed vocational training is 23.3% in western Germany and 53.3% in eastern Germany.⁶ In the end what really matters is the creation of new employment opportunities for individuals with minimum qualifications or for just under 40% of all those registered as unemployed.

The target group for a new low-wage sector is not only given by the unemployed with minimum qualifications, but also all long-term unemployed individuals with completed apprenticeships or higher vocational training (Kaltenborn 2001, p. 12). In the long run, however, people in these groups have access to better opportunities with higher qualifications if they succeed in regaining employment.

By their type of benefit entitlement, those officially recorded as unemployed are subdivided into individuals receiving unemployment benefits (2000: 1,694,500) and unemployment assistance (1,456,500) as well as individuals, who for various reasons do not qualify for benefits from “passive” labour-market policies (510,500).⁷ How these minimum qualifications are distributed in these sub-groups is not known.

In addition to official unemployment there are also several types of hidden unemployment. For instance, there are individuals targeted by specific measures of active labour market policies promoting employment outside the regular labour market, the ABM and SAM employees, who in 2000 totalled 316,000 on average, of which 246,000 lived in eastern Germany. In order to give a complete picture of the unemployment prevailing in Germany, the Council of Economic Advisors (*Sachverständigenrat*/Council of Economic Advisors 2001, Tab. 21 and 15*) has for years regarded this group as an integral

⁵ *Bundesanstalt für Arbeit* (Federal Labour Office), *Amtliche Nachrichten (Sondernummer): Strukturanalyse 2000*, Tab. I/1, II/1 and III/1.

⁶ *Bundesanstalt für Arbeit* (Federal Labour Office), *Amtliche Nachrichten (Sondernummer): Arbeitsmarkt 2000*, Chap. III. This information is based on the 1998 calculations for the specific unemployment rates among various problem groups and not on current labour market statistics. Since these figures have to be reconstructed from different databases, they can only be calculated at irregular intervals.

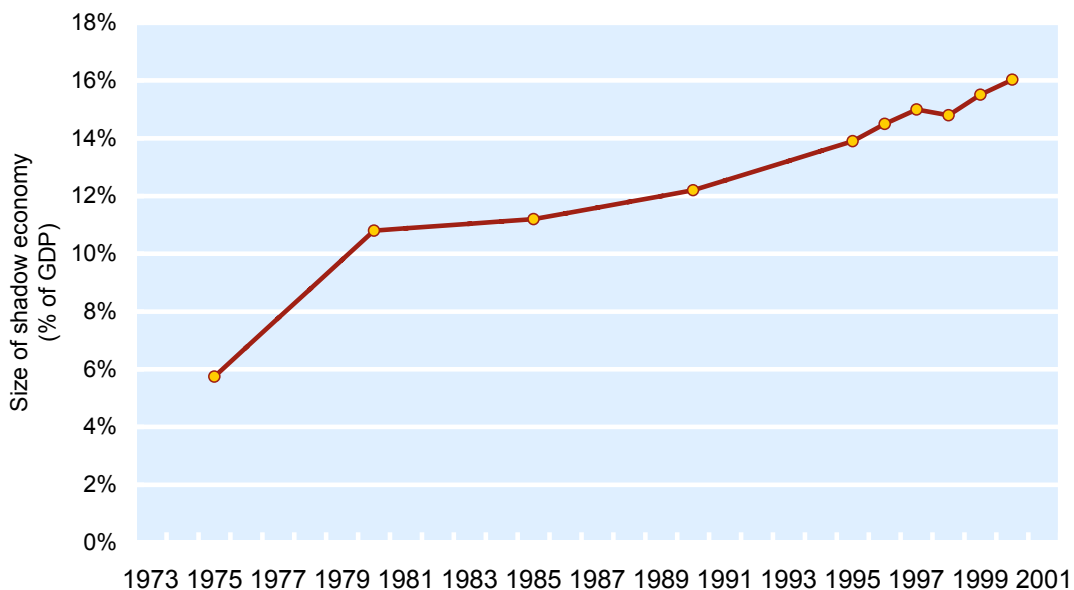
⁷ The low number (23,000) of individuals receiving “integration assistance” based on the “*Arbeitsförderungs-gesetz*” can be disregarded. Recipients of unemployment assistance can receive additional supplementary social assistance. The overlaps of the target groups of various instruments providing welfare benefits will be examined further in the following.

part of concealed, as opposed to officially registered, unemployment. As the ABM and SAM programmes largely fail to place participants in the regular labour market, participants with minimum qualifications should be included in the immediate target group for reforms in the German welfare benefit system.

1.3 Employment in the shadow economy

There are various factors that force many forms of employment into the shadow economy. A major factor is the false incentives of the welfare benefit system (Schneider and Enste 2000). Another factor is the burden on value added by taxes and social security contributions from which unemployment insurance and general welfare benefits are financed.

Fig. 1.3 The size of the shadow economy



Source: Mummert and Schneider (2002).

The very nature of the shadow economy renders it difficult to make a direct statistical appraisal of its scope and structures. Various approaches have been used to try and gauge the size of the informal sector of the German economy.⁸ Figure 1.3 shows the

⁸ Besides trying to derive information directly from micro-data, there are indirect methods using estimates of various gaps in official economic statistics, for example, the discrepancy between the output side and expenditure side of the gross domestic product, between the developments in labour force participation rates and effective employment, or between the time trends for the use of physical inputs

developments that have taken place based on the so-called “cash demand approach” (Mummert and Schneider 2002). The results indicate that illegal activities have increased greatly in the last thirty years. Whereas in the 1960s they amounted to 2–3% of the official national product (Schneider 2000) and had reached 6% by the beginning of the 1970s, they are now about 16% and worth approximately €350 billion.

It is even more difficult to estimate the number of individuals working in the shadow economy on the basis of its size. Schneider and Enste (2000) have made some rough estimates, concluding that from 1974 to 1982 2–3 million people were employed in the shadow economy (8–12% of the population between 20 and 59 years), but by 1997–98 there were 5 million (22%). Of course, this does not imply that individuals work only in the informal sector. Also, no statements can be made about the qualifications of “full-time” illegal workers or about the numbers of welfare recipients who work illegally part- or full-time. Nevertheless, these estimates shed some light on areas of economic activity that owe their existence to the public tax and transfer system. Not only the estimates referred to here but also anecdotal evidence lead to the suspicion that illegal work is rampant among individuals registered as unemployed or receiving welfare benefits, whether they are classified as being able to work or not.

1.4 The labour force potential of individuals with low qualifications

In the literature exploring the motives and opportunities for expanding the low-wage sector in the German labour market, there is broad consensus that the labour force potential for this sector is somehow given by individuals registered as unemployed, ABM and SAM jobholders and recipients of social assistance as the most important observable components. It will also include some people from outside the current labour force, like those seeking work who are not registered as unemployed for various reasons (recipients of social assistance among others), individuals discouraged about finding work due to the present labour market situation and individuals who through their inclusion in early retirement schemes or similar programmes are no longer considered to be part of the labour force.⁹

(e.g., use of electricity) or the means needed for monetary transactions (cash demand) and official economic activity. For an overview, see again Schneider and Enste (2000).

⁹ For an attempt at quantifying these forms of non-employment, see Thon and Bach (1998). Currently, the “hidden reserves” of official unemployment are an estimated 1.2 million (Bach et al. 2001).

Concentrating on statistically identifiable quantities, an upper limit of the labour force potential available for an expanded low-wage sector is thus composed of

- individuals registered as unemployed
- participants in programmes of active labour market policies
- non-employed social assistance recipients aged between 18 and 64.

This figure stands at about 5.1 million after being corrected for double counts.¹⁰ Depending on what further aspects are taken into account – “hard” obstacles to participating in the labour market, existence of higher formal qualifications, etc. – earlier estimates of the labour force potential for an extended low-wage sector placed the relevant figure at between 4.3 and 2.2 million people.¹¹

A proper identification should not rule out any of the previously mentioned groups. Yet, the main concern should lie with employable individuals with minimum qualifications, including a realistic selection of welfare recipients effectively available for the labour market. Here, the classification made by the Federal Office of Statistics, based on self-evaluations of benefit recipients, is only of limited value. In the end, how much of the calculated potential can be moved into the regular labour market will depend on the new policies adopted and the resulting reduction of labour costs.

1.5 Why welfare causes unemployment

One of the most important causes of the high unemployment among low-skilled individuals in Germany is social assistance. It is conceived as a wage-replacement scheme, securing some minimum level of income for needy people and protecting against risks such as loss of work and the resulting poverty. It is not only a response to unemployment but also contributes to its creation.

¹⁰ Alternatively, Riphahn, Thalmaier and Zimmermann (1999) identify the upper limit as the sum of individuals registered as unemployed, participants of active labour market policy programmes and some more individuals outside the current labour force expected to be interested in finding a job. Thus, they obtain a total of 6.8 million.

¹¹ Riphahn, Thalmaier and Zimmermann (1999, p. 36: 4.3 million), Raffelhüschen (2001, p. 16: 2.3 million), or Kaltenborn (2001, p. 15: 2.2 million). The higher estimate from Riphahn et al. is due to a fairly arbitrary assessment of how close the various components of broadly defined unemployment are to entering the labour market regardless of their qualifications. The lower estimates exclude recipients of unemployment assistance with low qualifications (Raffelhüschen) or recipients of social assistance who should be classified employable (Kaltenborn).

Social assistance produces a minimum wage level that prevents the wage distribution from spreading downward in line with the market. As all earned income reduces social assistance benefits on nearly a one-to-one basis, these benefits define a binding reservation wage for potential entrants to the low-wage sector of the labour market. Hardly anyone would be prepared to take up a job that did not offer a noticeably higher income than the welfare benefits she or he would be entitled to receive without working. As a result, maintaining a necessary distance to welfare benefits is an ongoing consideration in collective wage bargaining. Since wages lower than benefit entitlements would hardly be acceptable, social assistance effectively fixes the lower end of the wage structure in collective bargaining.

This creates a problem for the labour market since the number of jobs available depends primarily on the wage level. Companies can offer productive and less productive jobs. Productivity depends on the type of labour input, the personal qualifications of the jobholder and particularly the capital investment per employee. Employers will offer jobs that generate more value added than they cost to create and maintain. The lower the wage rate, the lower the value added which has to be generated and therefore the greater the number of positions the employer can offer without incurring losses. This is why a reduction in wages would lead to an increase in the number of jobs offered. How strong the effect would be is an empirical question. Roughly speaking, empirical research indicates that a decrease of 1% in the wage rate would raise the number of jobs by 1% over the medium-term. The effect would be even greater the longer the economy has to adjust.¹²

This is the problem. Since no one eligible for benefits would be prepared to accept wages below the social assistance level and no employer would be willing to hire someone who doesn't produce more value added than she or he costs to be employed, then jobs that only generate value added lower than the social assistance level cannot arise. In fact, jobs are not even offered unless the wages paid for working on a full-time basis are not sufficiently higher than the social assistance benefits of eligible recipients. People affected by this problem are in effect denied a right to work.

In the light of these considerations, it is not surprising that the unemployment of individuals without vocational training has risen since 1980 more noticeably than unemployment in general. According to the most recent available data, the unemployment rate among unskilled people has now reached 24% (*Sachverständigenrat/Council of Economic Advisors* 1999, Box 5). Building on the market mechanism, the wage spread

¹² We will return to this subject with an extensive survey of the literature in Section 3.7.

over different skill categories would have had to increase with an increase of unemployment for those with lower skills, as was the case in other EU and OECD countries. Yet, in Germany the wage structure has changed very little (Franz 1999). If anything, it has been compressed rather than spread out. Social assistance benefits and wages for unskilled workers have developed parallel to each other since the 1960s (Boss 2001, p. 61) and the increase in social assistance entitlements is probably the driving force behind these trends.

Tab. 1.1 Employment in the lowest pay scale groups (1999)

Sector of industry	Pay scale groups	% of sectoral employment
Metal industry (Region I, West) ⁱ⁾	No.s 1 + 2 out of 8	0.7 %
Metal industry (Region II, West) ⁱ⁾	No. 2 out of 10 ^a	2.9 %
Metal industry (electronic devices, cars, machinery, foundries; Lower Saxony) ⁱⁱ⁾	No.s 1 + 2 out of 10	~ 3.0 %
Chemical industry (West; 1998) ⁱ⁾	No. 1 out of 13	2.0 %
Private Insurance (East and West) ⁱ⁾	No.s 1 + 2 out of 8	2.8 %
Retail trade (full-time employees, West, 2000) ⁱⁱⁱ⁾	No. 5 ("no formal qualification") out of 4 ^b	6.0 %
Retail trade (full-time employees, East, 2000) ⁱⁱⁱ⁾	No. 5 ("no formal qualification") out of 4 ^b	2.0 %
a) Group No. 1 effectively not used. b) Group No. 1 not defined.		

Sources: i) Council of Economic Advisors (*Sachverständigenrat*, 2000, Tab. 29).

ii) IG Metall, Bezirk Hannover (Metal worker union/Hanover region 1999, p. 5).

iii) Verdi (Service sector union, 2000, pp. 13 and 49).

The fact that social assistance sets a binding minimum wage level for the wage structure may also offer an explanation as to why the lowest pay scale groups, with wages only slightly higher than welfare benefits, are hardly ever used. This is what the few available studies on the wage structure reveal (Table 1.1). The pay scale group designated for unskilled jobs is used least frequently in the metal industry, the chemical industry, the private insurance industry and retailing. This can be attributed to the fact that it is not profitable for firms to offer jobs at these wages, due to the low productivity of the workers qualifying for these levels of compensation. At the same time, the wages offered are so close to social assistance benefits that it is not attractive for workers to offer their services. In any case, social assistance defines the minimum wage level which, depending on how hard the work is, has to be exceeded by an adequate margin. Avail-

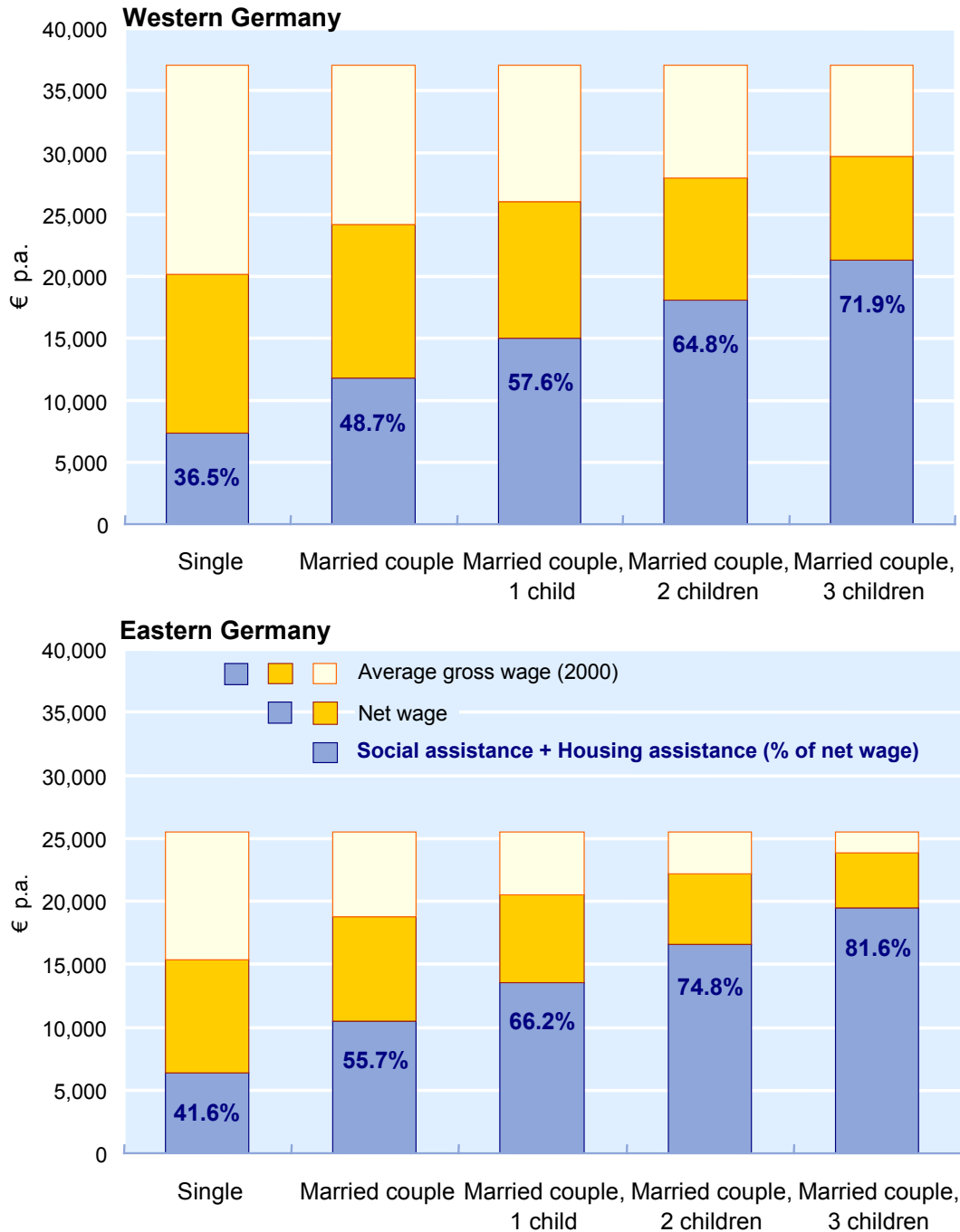
able data indicate that the income for unskilled workers in manufacturing still exceeds the average level of social assistance to a sufficient amount. In contrast, in certain service industries the net earnings of unskilled people hardly exceed social assistance benefits or are even below (Engels 2001; Boss 2001), making such jobs not particularly attractive for individuals with minimum qualifications.

The impact of social assistance on the wage structure might not be such a problem if benefits were low in comparison to average wages. However, this is not the case. Figure 1.4 shows the gap between wages and social assistance for average earners in various household types in eastern and western Germany, rather than for the lowest groups in the pay scale. This wage difference indicates how far social assistance benefits are below the disposable income of those earning average wages. In families with one earner and two children, social assistance plus housing benefits reach approximately 65% of the average net wage. Correcting for the effect of tax progression and assuming that firms pay wages in line with an individual's productivity – a basic tenet of the economic theory of the labour market – it follows that there is no way to find an acceptable job for a western German household head eligible for benefits whose productivity is less than 50% of the average.¹³ In eastern Germany where, for a one-earner family with two children, social assistance is up to 75% of the average net wage, even more people are condemned to inactivity. There, the threshold for an individual's productivity is 65% of the average, such that those who are less productive can never find work if they are not willing to be worse off than they would be on social assistance. For households with more than two children these thresholds are raised even higher.

When compared to married couples with two children, the gap between wages and welfare benefits for married couples with one child, married couples with no children and singles is larger. Still, social assistance puts up very high hurdles to limit their employment. Only people who are capable of performance close enough to the average or above it can enter the labour market. Anyone less able is denied the possibility of legally contributing to the national product.

¹³ The gap between social assistance benefits and net wages earned is then zero. Since any incentive to apply for work depends on a positive wage difference, then the threshold is even higher for individual productivities to be marketable under the present conditions.

Fig. 1.4 The scope for a wage spread in West and East Germany by type of household (Employees in the producing sector, commerce, banking and insurance)



Source: Ifo calculations (for the year 2000).

The long-term decline in employment of people with low skills is not limited to Germany but can be observed in most other European countries (OECD 1996; Nickell and Bell 1996). In the literature, this is basically attributed to a decline in the demand for

unskilled workers due to technological progress and/or a change in the international division of labour in the age of “globalisation”. On the other hand, there are obviously different strategies of coping with these trends. While in the US the decline in demand for the unskilled was compensated through a stronger differentiation of wages, in Germany and most other countries of the European Union it was associated with a sharp decline in the employment of unskilled workers due to the fairly rigid wage structures (OECD 1996; for Germany, see Steiner and Mohr 2000). In turn, the rigid wage structures in European countries can mostly be attributed to high minimum wages that are collectively negotiated or legally defined or to a high level of welfare benefits.

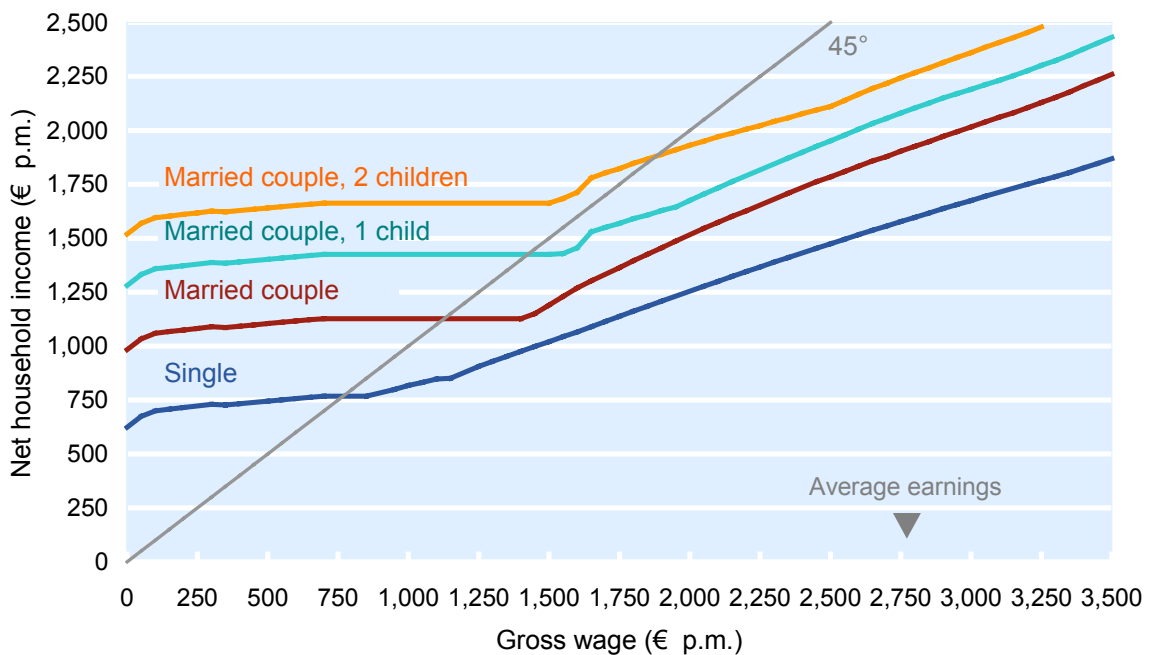
Empirical evidence on the link between benefit levels and the wage spread can be drawn from international comparisons made by the European Economic Advisory Group at CESifo (2002). The report shows a clear relationship between the relative level of social assistance and wage dispersion. The smaller the gap between social assistance and the median wage, the less was the spread of market wages observed. Based on realistic assumptions regarding the elasticity of substitution between unskilled and skilled labour, these observations could explain a great deal of the relative decline in employment for individuals with minimum qualifications.

Figure 1.4 relates to the case of full-time employment, illustrating the relation between net wages earned by individuals with average qualifications and the social assistance claim that is guaranteed for people without employment. Even more of a problem is the impact of social assistance on reservation wages demanded in the case of part-time work. Even with high hourly wage rates, individuals affected will have problems to earn enough to compensate for the reduction in social assistance benefits they would be faced with. Work incentives are virtually absent for jobs with short working hours. Stated the other way round, the lower the amount of time an individual is planning to work, the higher the hourly reservation wage.

Figure 1.5 highlights the overall problem through a set of curves showing the correlation between gross earnings and net income for individuals living in different types of households. The calculations encompass social assistance benefits, children’s allowance (*Kindergeld*), income taxes and social insurance contributions levied on wages. Starting from zero gross wages, there is a small basic exemption for wage earners; once wages exceed this exemption, additional earnings lead to an almost complete cutback in social assistance. With gross wages higher than as little as €70, social assistance is reduced by 85%. With gross wages above approximately €700, the reduction rate becomes 100%. In other words, the marginal tax burden is then 100%. The state cuts by 1 Euro the sup-

port of anyone earning 1 Euro more than this. As a consequence, household net income remains virtually unchanged as long as gross wages fall in the range from €70 to up to €1,500. The curves displayed in Figure 1.5 are nearly horizontal lines up to about the 45-degree line. The realm of social assistance is only left and the marginal tax burden is reduced to under 100% when gross earnings exceed a certain threshold that is strongly dependent on the type of household.

Fig. 1.5 The German tax–transfer system for wage earners



Included are wage earnings, social assistance, housing assistance (*Wohngeld*), child benefits (*Kindergeld*), income taxes (plus the "solidarity surcharge", *Solidaritätszuschlag*), church taxes (*Kirchensteuer*), and social insurance contributions (employees' share). Calculations refer to Western Germany (laws as of 2002).

Source: Ifo calculations.

Today the lowest effective wage rate in many industries in western Germany is about €8.70 per hour. This would imply earning a monthly income of approximately €650 when working on a half-time basis, which, in the examples given, is obviously not enough to leave the horizontal area of the curves and earn a higher net income than when not working. Even when the amount is doubled to €1,300 with full-time work, there is still not a substantial increase in income for married couples that would compensate them for working. In all cases, full-time employment of all adult family members would be necessary in order for them to move away from the horizontal range of household incomes, i.e. to escape from the social assistance trap.

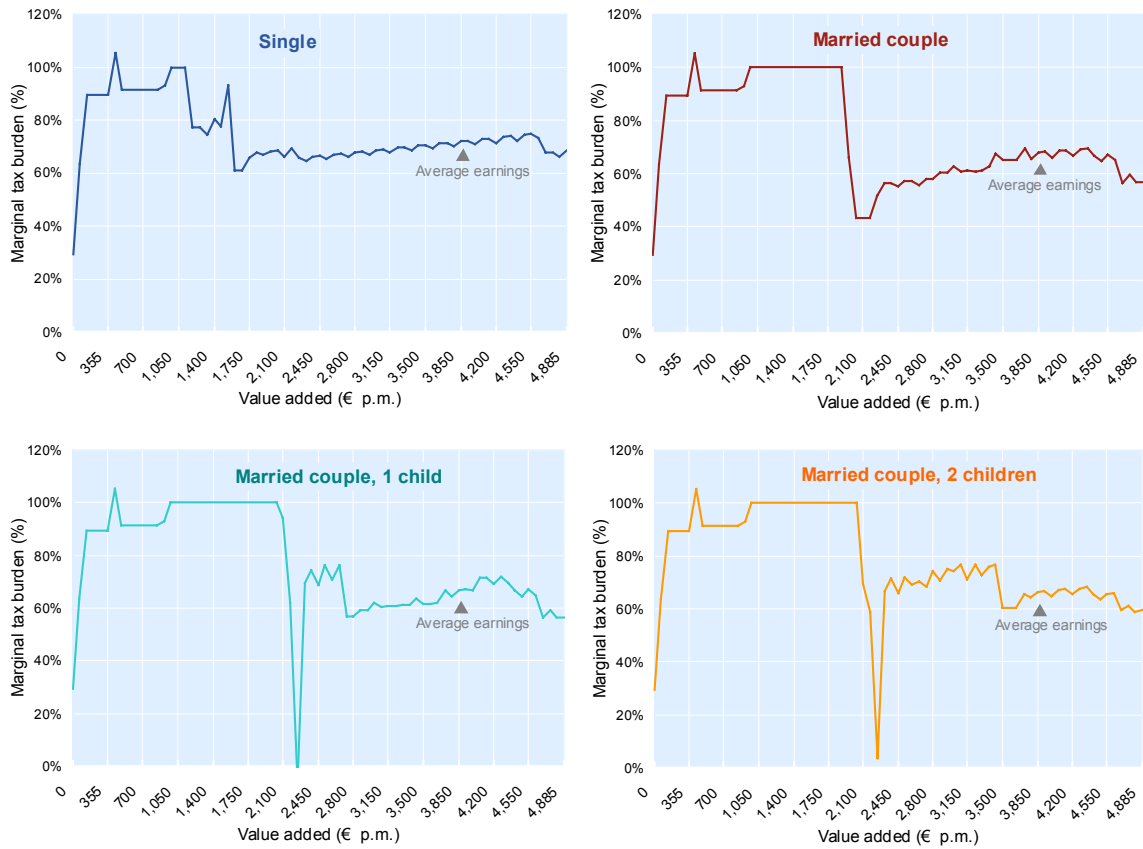
The consequence is that entering into regular employment is made extremely difficult. Employed persons who have the chance to start work for a limited number of hours per week or for a low wage would be so massively penalised through withdrawal of support that they would be foolish to even try. Even the opportunity of acquiring higher qualifications will remain unattractive as long as the initial level of income to be earned is located inside the horizontal area.

Figure 1.5 illustrates the false incentives of social assistance. To assess this in more detail, one needs to look at the marginal tax burden imposed on the value added, not on the “gross wage” earned, through working. In the end, it is of minor significance whether the marginal burden comes about through high rates of transfer reduction, high tax rates falling on employees, or high taxes falling on their employers. What effectively matters is the sum total of all these effects. Figure 1.6 shows the results of extensive calculations based on the Ifo Tax Model. The model encompasses virtually all wage-related transfers and taxes that drive a wedge between value added and net wages in Germany, including the employers’ share of social insurance contributions as well as value added taxes paid by employers or their customers. These fiscal charges have exactly the same effect for labour supply and demand as the visible taxes levied from wage earnings. They contribute to barring access to the regular labour market for people with low skills and are no less responsible for forcing them into inactivity or illicit work to the same extent as the deductions from wage income itemised on the income-tax card.

Calculating the total tax burden for gross value added of labour produces the curves of the marginal tax burden shown in Figure 1.6. These curves indicate how much is taken away from one Euro of value added by higher work effort through effective increases in taxes and other fiscal charges as well as through a reduction of transfers. For all types of households considered, the marginal tax burden exceeds 80% in the low-wage bracket and sometimes even goes up to 100%. The amount of value added where the marginal tax burden is 100% increases with the size of the household and is very large even for married couples without children. These conditions are both problematic and absurd (Sinn 2002, p. 22).

It should not come as a surprise that the German labour market cannot function well under these conditions. The real surprise is that conditions so intolerable for a market economy could have survived so long without economic policy trying to come up with serious reforms.

Fig. 1.6 Marginal tax burden in % of the value added of labour



Included are the increases in social assistance benefits due to (additional) children (including average housing costs, see Engels 2001), housing assistance (*Wohngeld*), child benefits (*Kindergeld*, but not the special child-rearing benefit for children under 2 years, *Erziehungsgeld*) as well as the effect of the child tax allowance (*Kinderfreibetrag*) and the household allowance (*Haushaltsfreibetrag*, granted up until 2005 to single parents of children born before 2002) on income tax liabilities (incl. the "solidarity surcharge", *Solidaritätszuschlag*) and the church tax (*Kirchensteuer*). Calculations refer to Western Germany (laws as of 2002).

Source: Ifo calculations.

Chapter 2

Approaches to reform

In recent years various proposals have been discussed in German economic and political circles concerning the implementation of wage subsidies as a way to create jobs in the low-wage sector (for an overview, see Buslei and Steiner 1999, 2000). Part of these proposals is based on wage subsidies in so-called “combi-wage” models that directly subsidise employees with low earnings. As of 1 March 2002, the so-called “Mainz Model” that had been tested in several state employment offices in *Rheinland-Pfalz* and *Brandenburg*, was extended throughout the country in modified form.

Before we presenting the Ifo reform proposal, we will briefly explain and critically evaluate the Mainz Model (in its modified form) and other German experiments. In addition, we will outline the experiences that the US, the UK and France have had with wage supplements aiming at increasing employment in the low-wage sector of the regular labour market.

2.1 The Mainz Model and other German experiments

The Mainz Model favoured by the Federal Government for stimulating employment of people without formal qualifications foresees a degressive wage-dependent subsidisation schedule of employees’ social security contributions in the low-wage sector provided that earnings are in keeping with local or union standards. Single or married people with a monthly income between €325 and €897 for singles or €1,707 for couples are entitled to subsidies. Single parents are to be treated as married couples in terms of support levels and amount of subsidies. The subsidy matches employees’ contributions to social security with wages of €325 and decreases within support limits. For each child there is an additional wage-dependent child allowance of maximum €75. Employees who currently earn below the lower social security contribution limit will also be entitled if they take a job subject to social security contributions as long as they are within the income limits mentioned and weekly work time is at least 15 hours. It is also possible to receive assistance within these limits in the transition from one position requiring social security contributions to another when this involves a change of employers. The maximum length of time is 36 months and the model will run only until 2006.

A serious problem of the Mainz Model is that with increased earnings the net income of an individual household would sink over a relatively large income range due to transfer withdrawals and reductions of the children's allowances. This might be tolerable for groups of secondary earners who are not entitled to receive social assistance. Along with the social assistance system, which has been fairly much left out of public discussion, the absurdity of the whole system with its excessive marginal tax burden described above stands out even more.

Figure 2.1 highlights the situation for two specific types of household.¹⁴ Here we see that the Mainz Model leads to an upward bulge in the net income curve. For those who have reached the lower limit for assistance there is certainly an incentive to increase gross income through employment with low time requirements, but in the area of reduction the opposite is the case. Their net income can be raised not through an increase but a decrease in gross income. The reason for this perverse result lies in the fact that employees' contributions to social security are fully taken into account when social assistance is calculated. Assistance based on the Mainz Model does not result in a change in other benefit entitlements. The reduction of this assistance, which goes together with an increasing income, thus causes a decrease in net income.¹⁵

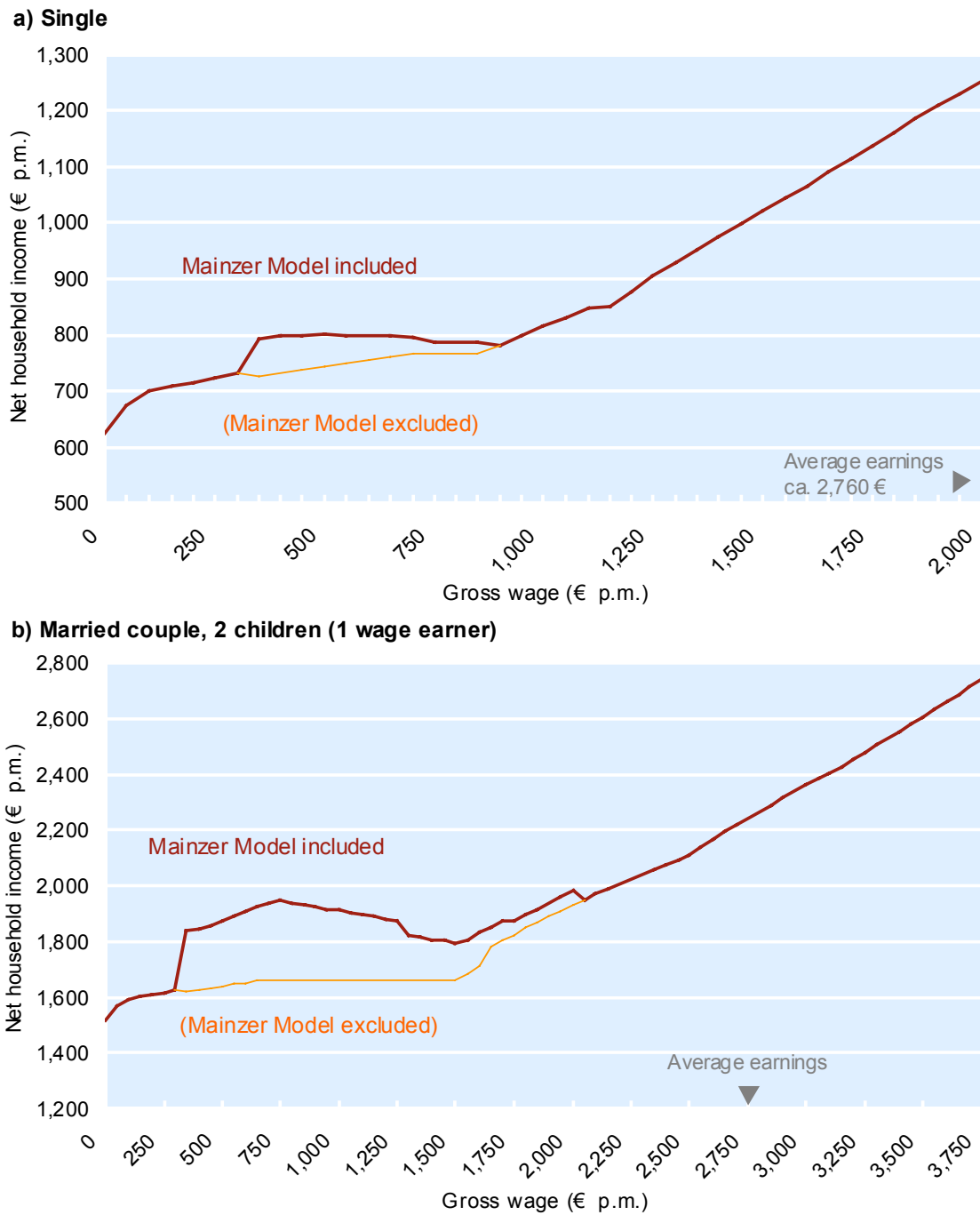
Figure 2.2 again shows the accompanying marginal tax burden in regard to value added through work. While the marginal tax burden on the aid threshold is negative, it rises in the phase out range to far more than 100% at times. For a married couple with two children the marginal tax burden in the value added of app. €750 to €1,500 per month goes up to 110% and even higher at certain points. Anyone who generates one Euro in additional value added through his or her work faces a net wage cut of 10 cents or more.¹⁶

¹⁴ In comparing, for example, two single wage earners with the same social assistance entitlement, one who earns €500 per month and the other €850, it turns out that the wage earner with the lower gross income draws €15 more in net income (Fig. 2. a 1). When looking at a couple with two children the effect is even more drastic: If a working income of €750 per month is earned, then the net (family) income, assuming average social assistance benefits, is app. €1,945, whereas a family with a gross income of €1,500 per month receives only about €1,800, or €150 less. A family with two children will then have a net wage of more than €1,945 at their disposal when a gross wage of more than €1,900 is earned (Figure 2. b 1).

¹⁵ In the guidelines for the implementation of the special programme it is clearly stated that the subsidies granted will not be deducted from social assistance (see Art. 1 (1), *Bundesanzeiger* from 28 February 2002). In the previous pilot projects this was not certain and some welfare agencies ended up actually nullifying the aid effect through such deductions.

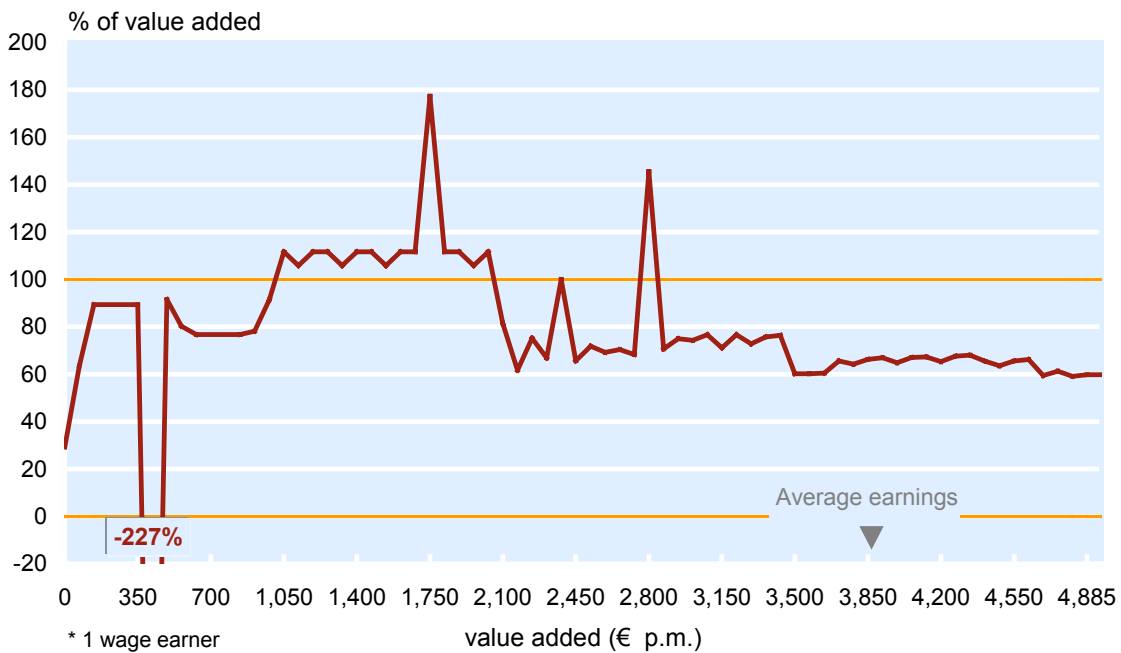
¹⁶ In the version used during the experimental phase the marginal tax burden even reached 124% in many areas (see Sinn 2002).

Fig. 2.1 The German tax–transfer system (with the Mainz Model)



Source: Ifo calculations (on methodology: see Fig. 1.5).

Fig. 2.2 Marginal tax burden (with the Mainz Model): Married couple + two children



Source: Ifo calculations (on methodology: see Fig. 1.6).

Starting in 1999, with a somewhat modified form in terms of subsidies, duration of assistance and the target group, the Federal Government tested the Mainz Model in several districts of the public employment agencies in the states of *Rheinland-Pfalz* and *Brandenburg*. Originally the model was oriented toward long-time unemployed and individuals without formal qualifications. This target group approach was suspended in 2001 and does not apply to the special programme implemented nation-wide with slightly modified regulations from March 2002. This was because participation in the model projects fell well below the expectations of its advocates. Up until August 2001 only about 500 applications had been filed. Only part of the those seeking subsidies had been unemployed earlier, over a third was receiving social assistance before entrance in the programme and every tenth participant had been in low-paid employment.¹⁷

Based on the experiences with these model projects, the German federal government expects to achieve a moderate increase in the low-wage employment sector of 20,000 to 30,000 persons with the expansion of the Mainz Model at an estimated fiscal expense of ca. €40 million. These figures are within earlier estimates on employment effects from comparable recommendations for the introduction of “combi-wage” models in Germany (Buslei and Steiner 2000). Nevertheless, it can be expected that the fiscal cost of the

¹⁷ See *Sozialpolitische Umschau*, No. 31/2001, p. 338.

Mainz Model will definitely be higher than the federal government has indicated. Their estimates apparently make the implicit assumption that wage subsidies can be restricted to employees who were not previously required to make social security contributions. This means, however, that a given gross employment income within aid limits is connected to individually varying net income, depending on whether or not the employee was employed before the introduction of the Mainz Model.

Even individuals who were previously employed with low income could improve their financial situation if they started work with another employer for the same gross wage. If such adaptation processes are to be avoided, then all low wage earners have to receive the same subsidy independent of their previous work status. This would demand a substantially higher subsidy volume. The exemption for individuals previously in low-wage employment, for whom a subsidisation of social security contributions is planned, is also cost-intensive. Finally, there could possibly be substantial fiscal costs due to the fact that, as described above, the tax revenue may decline as transfer recipients reduce their working hours.

On the whole the extension of the Mainz Model throughout Germany cannot be expected to provide any real solution for employment problems in the low-wage sector. Specifically, it will hardly help individuals without formal qualifications escape the poverty trap created by the incentive structures of social assistance. In fact, it makes the problematic incentive effects for the labour market even worse. This model is simply a patchwork that is not geared to the social security system and does not solve the problems in the labour market for low wage earners.

Other wage subsidy models have been recently tried out in Germany, and further alternatives, which will be examined below, have been created to aid recipients of unemployment assistance and social assistance

The model of the so-called *Saar Gemeinschafts Initiative* (SGI) was being tried out at the same time as the Mainz Model in three regional offices of the public employment agencies in *Saarland* and in the regional office in Chemnitz, *Sachsen*. The goal of this model was to reduce the relatively high employment costs for unskilled work with compulsory social security contributions through a degressive subsidisation scheme of employers' social security contributions. Businesses were eligible that employed individuals without formal qualifications or unemployed for a gross hourly wage of less than DM 18 with compulsory social security contributions. Moreover, the employee's share of social security contributions was subsidised, but individuals did not receive the sub-

sidy, which was instead paid into a regional training fund to be used for qualification programmes for those receiving subsidies.

The participation in this experiment in *Saarland* was absolutely minimal up until now, and it was hardly even used in *Sachsen*. One reason could have been that in eastern Germany sufficient other projects have been offered as a part of active labour market policy and these are substantially better endowed. For example, the wage costs for active labour market programmes (ABM and SAM) are either partially or completely taken over by public employment agencies. Even in western Germany there are more attractive forms of wages subsidies offered to private businesses for so-called problem groups in the labour market (older workers, people with health limitations, teenagers) than those of the SGI Model.

Because of low participation in the SGI Model, new aid guidelines were put into effect in 2001 that advised doubling the maximum aid length to 36 months and using a different target group orientation. The restriction allowing aid grants only to individuals without formal qualifications and the long-time unemployed was also revised: All low wage earners with an hourly wage of under DM 18 can receive aid (Forschungsverbund CAST, 2001). Up until October 2001 a total of 128 participants had taken part in the SGI Model, of which 4 were in eastern Germany. In view of these figures the question about the effects on employment of the SGI Model in its previous form is superfluous.

In addition to the Mainz and SGI Models there are still more model projects limited to certain regions that represent different versions of combi-wage models or direct wage subsidies paid to employees (overview in Kaltenborn 2001). The target group of these initiatives is primarily recipients of social assistance and specific problem groups in the labour market. In this instance the existing legal possibilities based on the Federal Welfare Law (Art. 18 (5) BSHG) since 1996 are used to aid social assistance recipients in starting to work. Originally the law foresaw a wage earner subsidy which was limited to 6 months, was reduced with every aid month and when full employment was achieved, and was not to exceed the regular rates in the first month. Since 1998 the subsidy can be extended to 12 months when there is employment with compulsory social security contributions or self-employment; a monthly reduction is no longer mandatory. Up until the end of 2000 the municipalities were able to implement deviating regulations through an “experimentation clause”.

There are model projects being conducted in several states at the local level based on this approach. The so-called “entry pay” being tested in several municipalities in *Ba-*

den-Württemberg and the combi-wage models practised in *Hessen* and *Nordrhein-Westfalen* (see Kaltenborn 2001) are among the possibilities that are being tested. What all these model projects have in common is that they seek to increase the willingness of welfare recipients and long-time unemployed in starting regular employment through temporary direct income subsidies. The costs of combi-wage models are to be kept down by limiting it strictly to this target group and setting a time limit. As was stated above in the criticism of the Mainz Model, the time needed for behavioural adaptation is not taken into consideration. Concerning the time limit for the subsidy, it is predicated on the premise that individual productivity or the attachment to gainful employment increases through participation in these programmes so lastingly that after the discontinuation of the subsidy, work is preferable to staying on assistance.

The model projects conducted within the framework of the experimentation clause need to be evaluated in terms of their employment effect. Since this is supposed to take place under the auspices of a statistical ex-post evaluation study and most of these projects are still in progress, there are no meaningful results at this time. Earlier ex-ante evaluations of comparable combined wage models from Buslei and Steiner (1999) indicate that the expected employment effect of slightly increased extra earning possibilities or of a reduced transfer withdrawal in welfare and unemployment assistance remains extremely low as long as the present level of performance is maintained in these transfers.

2.2 Welfare to Work in the US

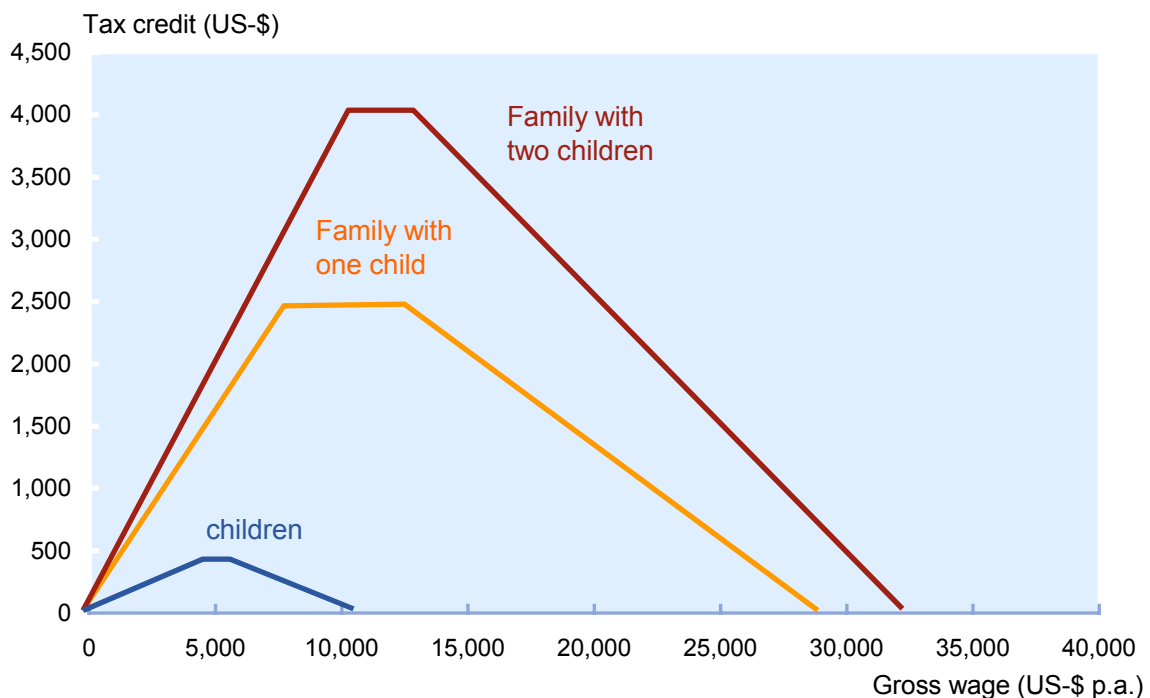
The German experiments and approaches to reform do not fundamentally challenge the German social system, which essentially offers wage compensation for the non-employed. The most advanced reform is the Mainz Model, which seeks to change the orientation of social assistance by raising the incentives to start work. In contrast, other countries have reformed their social welfare systems fundamentally and adopted a concept of active social policies that subsidise work and not inactivity.

This political concept is followed in the US most consistently. Whoever does not work has to accept very low social benefits (food stamps etc.) and, on the other hand, whoever works is rewarded. Those working in the low-wage sector of the regular labour market receive a federal tax credit, which raises their net income. In granting the Earned Income Tax Credit (EITC), incentives to find work are created. Employable people who fail to find jobs in the regular labour market are offered community work. They receive regular welfare benefits (Temporary Assistance for Needy Families, TANF) only if they

accept this work. As opposed to German social assistance, TANF is granted in return for work.

The EITC is directed at households with low income. In principle, groups receiving aid are required to pay federal income tax. If the tax credit is higher than the tax to be paid, then the difference is paid out to the claimant. Otherwise it is credited against the tax due. Only wage earners, specifically individuals with children, are entitled to receive benefits. The amount of the tax credit is dependent on gross wages earned (including a specifically defined income for self-employed). There are three different phases: First, the tax credit increases linearly with rising gross income (phase I), then it remains constant (phase II), and then it decreases when a certain income level is reached (phase III). The amount of the tax credit and the income limit is decided according to the type of individual household. Families with two or more children, families with one child and individuals without children are handled differently, with the first group receiving the highest benefits (see Figure 2.3).

Fig. 2.3 The EITC in the USA for different types of households (2001)



Source: US Census Bureau.

The exact parameters of the EITC for 2001 are shown in Table 2.1. According to this a family with two or more children with an income between 0 and \$10,020 would receive

a tax credit of \$0.40 for each additionally earned Dollar.¹⁸ The credit reaches a maximum of \$4,008 with a gross income of \$10,020 and is maintained at this amount up to a gross income of \$13,090. Every Dollar earned above \$13,090 reduces the tax credit by \$ 0.21 (exactly \$ 0.2106). As a consequence, the tax credit is reduced to zero with a gross income of \$32,121. In this phase-out sector the marginal income tax burden is higher than the marginal rate for regular income taxes. The total marginal tax burden is about 50% in the phase-out range of earned income.

Approximately 20 million employees took advantage of the EITC in 1999. The total expenditure was some 30 billion Dollars, about 0.3% of the US gross domestic product.

In 1996 EITC grants were supplemented by a fundamental reform of the public welfare system based on the principle of reciprocity. Thereafter welfare recipients were required to work in return for transfer benefits. Moreover, there was a time limit placed on social welfare grants. In return the government had to provide communal jobs when needed and pay for welfare.

Tab. 2.1 Parameters of the „*Earned Income Tax Credit*“ in the US (2001)

Type of household	Earnings Bracket I (Phase-in)		Earnings Bracket II	Earnings Bracket III (Phase-out)	
	Transfer rate (%)	Earnings thresholds ^{a)} (US-\$)	Maximum Transfer ^{a)} (US-\$)	Reduction rate (%)	Earnings thresholds ^{a)} (US-\$)
Families with one child	34.0	0– 7,140	2,428	15.98	13,090–28,281
Families with two or more children	40.0	0–10,020	4,008	21.06	13,090–32,121
Individuals with no children	7.6	0– 4,760	364	7.65	5,950–10,710

a) Annual amounts of earnings and transfers involved in the EITC, respectively.

Source: U.S. Census Bureau.

The public authorities offer positions in community services to individuals who cannot find work in the regular labour market. In Wisconsin, for example, a state that has taken the lead in social policy, it is possible to work 30 hours a week and attend training courses for another 10 hours. The job experience and skills necessary for a regular job can be acquired through participation in community service. What counts here is punc-

¹⁸ 1 US Dollar = 1.12 Euro (yearly average in 2001). Income limits are indexed to prices year for year.

tuality, reliability, social behaviour and the ability to work continuously. Participants received \$673 per month in 2000 without being able to claim the EITC. In comparison the market income achieved by this group in Wisconsin was \$1,236 (1998) and it is further increased through EITC. Individuals not able to participate in community service are offered the option of therapy or rehabilitation (Ochel 2002b).

The American welfare-to-work policy has shown considerable success in getting people to work. Job participation has increased with the reform, and many of the unemployed have found work. Although individuals previously employed work fewer hours a week, the employment volume on the whole has increased with job promotion in the low-wage sector through EITC. Starting work in the regular labour market has been promoted through the introduction of an obligation for welfare recipients to work. The number of recipients declined significantly; 70% of all former benefit recipients in Wisconsin found a regular job. On average they improved their net income even though quite a few continued to be dependent on additional benefits. 30% of the former recipients did not find work. They are the losers of the American welfare reform (Ochel 2002c).

2.3 Tax credits for low-wage earners in the United Kingdom and France

As in the US there has been a long tradition in the UK of assisting low-wage earners. In 1971 the Family Income Supplement was introduced. It was replaced in 1988 by the Family Credit, which itself was replaced at the end of 1999 by the Working Families Tax Credit (WFTC).¹⁹

The WFTC is also a wage supplement with the goal of raising the net income of low-wage earners and thereby creating an incentive to accept low-paid work. Families with at least one child can take advantage of the WFTC when one adult works at least 16 hours a week. Families with capital assets of £8,000 or more are excluded.²⁰ Out of a total of ca. 27 million employed, 1.1 million people fulfilled the requirements for WFTC in 2000.

The amount of the WFTC is determined by the make-up of the family (see Table 2.2). The regular rate per week in 2001 was £59 for adults and £26 to £26.75 for children according to age. The transfer is raised £11.45 per week for family members working

¹⁹ A New Deal programme, with intensive employment programmes and temporary jobs offered by the state, supports the WFTC.

²⁰ 1 Pound = 1.61 Euro (yearly average in 2001).

employed, which is the result of the higher marginal income tax burden in the phase-out range. As a result, among WFTC recipients the percentage of part-time jobholders who work 16 or more hours a week is commensurately high (Ochel 2002a).

Tab. 2.3 Unemployment benefits v. wages in a low-wage job in the UK (2001)^a

	Single parents, 1 child		COUPLES, 1 CHILD	
	Part-time employment	Full-time employment	Part-time employment	Full-time employment
with WFTC	110 %	70 %	143 %	92 %
without WFTC	58 %	46 %	76 %	60 %

a) Net household income without working as a percentage of net household income when working. Net household income includes gross wages, Income support, Child benefit, minus income taxes and employees' National insurance contributions, and, where appropriate, the WFTC.
Assumptions: Low-wage pay = 3.70 £ per week; 4.3 weeks per month; child care subsidies not included.

Source: Brewer (2000).

Following the US and the UK, France also introduced in 2001 a work premium for low-wage earners (*Prime pour l'emploi*) which is at present limited to three years.²¹ The premium is granted as a tax credit, which raises the net income of low-wage earners – i.e., individuals whose earnings are in the range of 0.3 times to 1.4 times the legal net minimum wage (*Salaires minimum interprofessionnel de croissance*, SMIC).²² The amount of the tax credit is equivalent to the rates for taxable income: 2.2% (2001), 4.4% (2002), 6.6% (2003). It is successively reduced when wages exceed the SMIC.²³ The tax credit is reimbursed yearly in September based on the income tax statement for the previous year. The amount is either deducted from the taxes to be paid or a refund is made. In September 2001, 8.1 million low-wage earners with taxable income received an average tax credit of €150.²⁴ This amount will double in 2002 and triple in 2003.

The French work premium increases the incentive of the unemployed to take a low-paid job. Couples in particular benefit from it. Nonetheless, since the legal minimum wage

²¹ Finland also introduced an earned income tax credit that is administered at the municipal level (Ochel 2000).

²² The SMIC amounted in 2001 with full-time employment to gross €6.72 per hour (€1,136 per month) and net €5.38 per hour (€909 per month). See <http://www.tripalium.com/chiffres/smic/chiffre2/htm>.

²³ For more information on the numerous special rules concerning the length of weekly work hours, the number of dependants, the composition of married couples' income, see <http://www.impotrevenue.com/fp-PrimeEmploi.htm>.

²⁴ See <http://www.impotrevenue.com/fp-PrimeEmploi.htm>.

cannot be undercut, there are limits to the reduction of gross wages resulting from the introduction of the work premium and with it, the expansion in the demand for wage earners with low qualifications.

Chapter 3

The Ifo proposal: From welfare to work

3.1 Three steps to reform the welfare system

The pursuit of social policy has come to mean giving the poor money that has been taken from the rich. This is in principle all right since the uncertainties of life and career risks are reduced in a way that the private insurance industry couldn't possibly manage. The problem is that redistribution of resources changes the behaviour of givers and takers and, in doing so, reduces the size of the cake to be divided up. For this reason, redistribution must be limited and it should be organised so that the willingness of citizens to work is affected as little as possible.

If the low-wage sector of the labour market is to be made functional again, then there are virtually no alternatives to a fundamental reform of the German welfare system, adopting elements of the American model. The level of federal welfare benefits granted in the US may not seem sufficient from a German or European point of view, but the incentive mechanisms used there can be copied. The most important point is that unemployed workers with low skills should receive wage supplements instead of a compensation for wages foregone when dropping out of employment. Unlike the current social assistance scheme, wage supplements help create jobs and support those who do not earn enough through their work efforts in achieving a better income position than is possible in the present system.

The Ifo Institute proposes a new social assistance system in which the effects on labour supply and demand in the low-wage sector would be fundamentally changed without creating huge fiscal burdens. Indeed, if the reform is allowed to develop fully, it can lead to financial relief for the public budget.

The core elements of the Ifo proposal comprise three steps.

- Step 1 calls for a notable reduction in social assistance entitlements (including housing assistance) for employable individuals who do not work in the regular labour market for whatever reasons. The new minimum level should be so low that to remain there can only be attractive for individuals who are working in the shadow economy or are insured elsewhere.

- In step 2, employment in the regular labour market is supported by a new wage tax credit. This wage supplement is calculated so that with full-time work at a typical wage rate for low-skilled individuals, the sum of wages earned and state support would lead to a household income that is higher than social assistance at present.²⁵
- Step 3 calls on the state to offer jobs to employable individuals who seek but cannot find work in the regular labour market. Compensation for these jobs is to be set precisely at the level of current social assistance entitlements. Under these conditions, no one has to live with an income lower than the socio-cultural subsistence level after the reform has come into effect if only she or he is prepared to take part in publicly organised employment.

Details of the individual reform steps will be explained below. Here, we will concentrate on how these elements are expected to fit together. The wage tax credit modelled on international reforms is a new element. Its design implies that there are three wage brackets with different forms of assistance. Very low wages are to be subsidised through a special credit integrated into the tax system so that none of the fiscal charges paid by wage earners are incurred. Instead, the income of an individual household increases by more than a Euro for every Euro of wages earned.²⁶ In the next bracket, the tax credit remains a constant amount. Over the third bracket, the tax credit is phased out gradually so that the recipients of middle and higher wages come to be net contributors to the state through taxes and social security contributions

As a rule, the tax credit should be given out as promptly as possible. It is important that individuals making decisions about jobs notice the effect of the reform immediately. Thus, it would make sense to pay out the credit on a provisional basis together with monthly wage payments, based on a corresponding entry in the wage tax card. The final amount can then be re-assessed when filing income taxes on an annual basis. For married couples being taxed at the household-level, a splitting method might be set up to reduce the necessity of correcting actual entitlements to wage subsidies later on.

By reducing benefits for employable individuals who do not work, the proposal removes the negative effects of the present social assistance scheme on the labour market. The old type of social assistance constitutes a minimum wage level as benefits are re-

²⁵ In any case, even with low wages it would be higher than transfers to the non-employed.

²⁶ However, value added in this range is still subject to the employers' share of social insurance contributions and value-added taxes. Both fiscal charges taken together indicate that the net burden on value added from employment remains positive despite the wage tax credit. For an illustration, see Figures 3.3 to 3.7 (panels c).

duced almost one to one for anyone earning income themselves. As a result, individuals entitled to receive benefits whose productivity (measured in value added) is below the social assistance level cannot possibly be employed under the present conditions.²⁷

Together, the first two steps of the Ifo proposal would abolish the fixed wage floor and allow for a noticeable reduction of wages paid for low-skill jobs. Those affected would be willing to accept low-wage jobs since they could get more state support by working than they would if they did not work at all. In collective bargaining, unions would have to do their part to make the wage tax credit accessible for their clientele through the definition of new low-wage groups at the bottom end of the wage scale. Private businesses and households could create new jobs, as they would try to benefit from a broad array of services provided at low pay. In this way the low-wage sector can develop, driven by market forces that have been made inoperative by the state until now.

The creation of a low-wage sector in the labour market would lead to a supply-side induced growth spurt for the economy through the activation of an idle factor and its integration into the production process. Growth comes about through more employment and not *vice versa*. Fears that there will be no demand for the additional supply of labour, goods and services are ungrounded. Additional production naturally creates additional demand. The value of additional supply and extra earned income of all parties involved can be turned into an increase in demand down to the last cent.

In principle, the first two steps of the Ifo reform proposal are enough to bring about the desired effects for employment.²⁸ The individuals covered would be brought back into working life and get the chance to benefit from further training on the job. Employment in the shadow economy would lose its basis. Yet, as with any structural reform, patience will be required until the transformation of the social assistance system shows its full effect. During the adjustment period, the number of jobs created through the new measures will hardly be sufficient to provide all previous welfare recipients with work and

²⁷ With entitlements for a four-member family in western Germany (eastern Germany) at 65% (75%) of average net wages, equivalent to 50% (65%) of average gross wages, it is easy to conclude that unemployment among welfare recipients is caused for the most part by social assistance itself (see Section 1.5).

²⁸ As mentioned above, this also depends on the reaction of collective bargaining parties. Apart from institutional reasons (currently, conflicts between insiders and outsiders of the labour market are probably resolved in a very one-sided fashion through the mechanisms of collective wage bargaining), the willingness of firms to pay efficiency wages, or personal characteristics of those who have been long-time unemployed (in particular, serious disqualification affecting even their ability to cope with normal work on a regular basis) could make it difficult for all employable individuals to be absorbed by the regular labour market.

sustenance in the regular labour market. To get this problem under control, the state has virtually no other option than to offer jobs itself. During the transition, more jobs organised by the public sector will be needed than later, but the state will have to remain in the business of providing jobs to some extent even in the long run. As will be explained later on, one option is private staff leasing agencies that can offer individuals an indirect way into private-sector employment.

A policy relying on the first two steps only and accepting a massive decrease in household income for individuals who do not find employment in the regular labour market would certainly have strong incentive effects and cause the private low-wage sector to develop rapidly. At the same time, it would bring about unjustifiable hardship for the individuals affected. In Germany, such a policy is openly ruled out due to the legal responsibility of the state for guaranteeing the social subsistence level for everyone. To deny benefits at this level to someone who has seriously tried to find work would conflict with the constitutional rights of citizens, which the Constitutional Court would certainly tend to support.

Under these conditions going without the third step would mean in effect going without the first and the second one: it would not be possible to substantially reduce benefits for non-employed individuals if those affected are not given secure means with state-run jobs to earn the wages necessary for their own support. Only when public jobs are offered is it possible to ensure that everyone has the chance to earn income equalling the amount of current social assistance benefits. In turn, a considerable reduction in benefits for non-employment has been shown to be the precondition for establishing the necessary incentives for entrance into working life.

Leaving untouched the present benefit level for employable individuals who don't work and introducing additional wage subsidies is not an alternative. The well-known proposals for a negative income tax go in this direction. Proposals which stick to the current benefit level (and imply a similar transfer reduction rate as the Ifo proposal) would generate (gross) fiscal costs of about €80 billion according to DIW (1994) and Gern (1996).²⁹ Neither the DIW nor Gern give any information about the number of individuals expected to be entitled to receive these benefits or possible reductions in expenditure that are due to additional wage earners. The DIW merely calculates a partial relief of €16 billion from savings in the current social assistance scheme. Gern merely asserts:

²⁹ See variation 3 of the DIW proposal with 75% transfer reduction rate, or version 3A of the Gern proposal with a 70% reduction rate (DIW 1994, Gern 1996, as well as the *Experten-Kommission Alternative Steuer-Transfer-Systeme* 1996).

“Throughout all variations, the fiscal costs of introducing a ‘*Bürgergeld*’ (negative income tax) – particularly if fixed at the present level of social assistance – are so high that a debt-neutral financing through reduction of expenditures elsewhere doesn’t seem to be possible” (1996, p. 425). A negative income tax would always generate extra costs through the creation of new subsidies that are on top of the existing entitlements instead of replacing them.

This cannot be the way for Germany to go since the marginal tax burden on labour is already intolerably high. At present, the average German employee is faced with a tax burden of about 65% on whatever value added he may create through increased work-time or improvement of qualifications (see Figure 1.6). When compared on an international level, this is the highest burden observed across all industrial countries.³⁰ Thus, there is no alternative to financing wage tax credits through a reduction in social assistance for individuals who decide not to take up work under the new legal framework. The way towards more employment in the low-wage sector and to the utilisation of the full labour force potential can only be made possible through a reform like the one proposed by the Ifo Institute, combining the following elements: reduction of welfare benefits for employable individuals who refuse to work; subsidisation of low-wage employment in the regular labour market; and state-guaranteed jobs for individuals who cannot find regular employment.

For the reform to become effective, it is important to define exactly the individuals to be included and determine the criteria for employability of welfare recipients. The latter problem is not really a new one. In fact, it is already being resolved in practice even if unclear boundaries and many uncertainties remain. We will return to this issue when defining the target group for the Ifo proposal and quantifying its fiscal effects. First, we discuss further considerations regarding the reform elements already mentioned, adding some new ones as well.

3.2 Parallel reforms of labour market policy

The aim of the Ifo proposal is to get unemployed individuals back into the labour force. The central feature of this reform is that social assistance no longer replaces wages but offers a wage supplement. To ensure that this reform is successful, other elements of labour market policy have to be examined to see how they can contribute to increased employment and changed when necessary. Among these are unemployment benefits

³⁰ Leibfritz et al. (2000).

and unemployment assistance as the main instruments of passive labour market policy as well as all activities subsumed under active labour market policy, like counselling and placement, training, and public employment schemes (the main types being *Arbeitsbeschaffungsmaßnahmen*, ABM, and *Strukturanpassungsmaßnahmen*, SAM).

Unemployment benefits are considered insurance benefits that are granted during the early period of unemployment. The purpose is to maintain income and allow unemployed individuals time to look for a new job. The way unemployment benefits are designed is rarely challenged in the current discussion.³¹ However, the system of unemployment assistance has come under heavy attack. Unemployment assistance is granted when insurance benefits have expired, and the duration is basically unlimited. As with unemployment insurance, the amount of benefits is determined based on the last net income, but unemployment assistance is subject to a means test and, unlike unemployment benefits, is financed from the general government budget.

Unemployment assistance clearly contributes to the development of long-term unemployment. The primary reason for this is the unlimited duration of benefits, a feature avoided in most other EU countries (see the relevant surveys in the DICE database under <http://www.cesifo.de>). Comparative international studies have shown that unemployment increases with the length of time public transfers are granted (Nickell and Layard 1999; Nickell et al. 2002). This finding is related to the fact that unemployment assistance, like social assistance, sets a lower limit for the wage structure and prevents the creation of new jobs.

There has also been criticism regarding the hybrid nature of unemployment assistance, which, as a wage-related welfare benefit with means testing, has large overlaps with social assistance. Unemployment assistance is calculated based on long-past market wages. As a rule, anyone who has been long-term unemployed could manage to reach this level of wages only after a longer period of time needed for reintegration in the labour market. Nevertheless, wage expectations are still tied to earlier earnings. In this way unemployment assistance fixes high reservation wages of the formally well-qualified unemployed and reinforces their continued unemployment. For the less-qualified unemployed, unemployment assistance can fall below the subsistence level so that supplementary social assistance can be claimed at the same time. Two systems are then responsible for one person. Benefit recipients have to contend with two sets of

³¹ Reductions in the duration of unemployment benefits are often recommended (*Sachverständigenrat/Council of Economic Advisors* 2001, No. 424), or a cutback in benefits is recommended the longer they are drawn (Franz 2002). Nonetheless, reforms of unemployment insurance are outside our focus.

rules and administrations while the public administration is faced with a vast amount of duplicate work (Berthold et al. 2000).

The separate responsibilities of labour offices (for unemployment assistance) and municipalities (for social assistance) create another serious problem in combating long-term unemployment. The labour administration, funded by social security contributions and the federal government, concentrates on promoting employment of recipients of unemployment assistance while the municipalities target their activities at the recipients of social assistance. The separation of functions encourages shuffling transfer recipients back and forth from one system to the other. Fiscal concerns with respect to individual budgets come to play a much greater role than is advisable in terms of sound employment and social policies (Feist and Schöb 1998; Hanesch and Balzter 2000).

All these considerations indicate the need to combine the unemployment assistance and social assistance schemes. More precisely, Ifo proposes integrating unemployment assistance in the reformed system of social assistance that has been recommended before. The new social assistance scheme should be administered by the municipalities. Promoting employment is more efficient when done on a local level rather than being centrally run by the federal administration (Huber and Lichtblau 2002).

Among the instruments of active labour market policy, intensive counselling and improved placement of the unemployed will have a much larger role in the future than they did in the past. Recent legislation, e.g. the so-called Job-AQTIV law, has already provided important impulses in this direction. In addition, it will be impossible to do without efforts to promote continuing job-training in the future, even though existing evaluation studies for Germany indicate fairly low levels of effectiveness of the existing programmes (Hagen and Steiner 2000; Schmidt et al. 2001). Current measures need to be adjusted so as to improve the chances of participants in the labour market and reduce mismatches as much as possible.

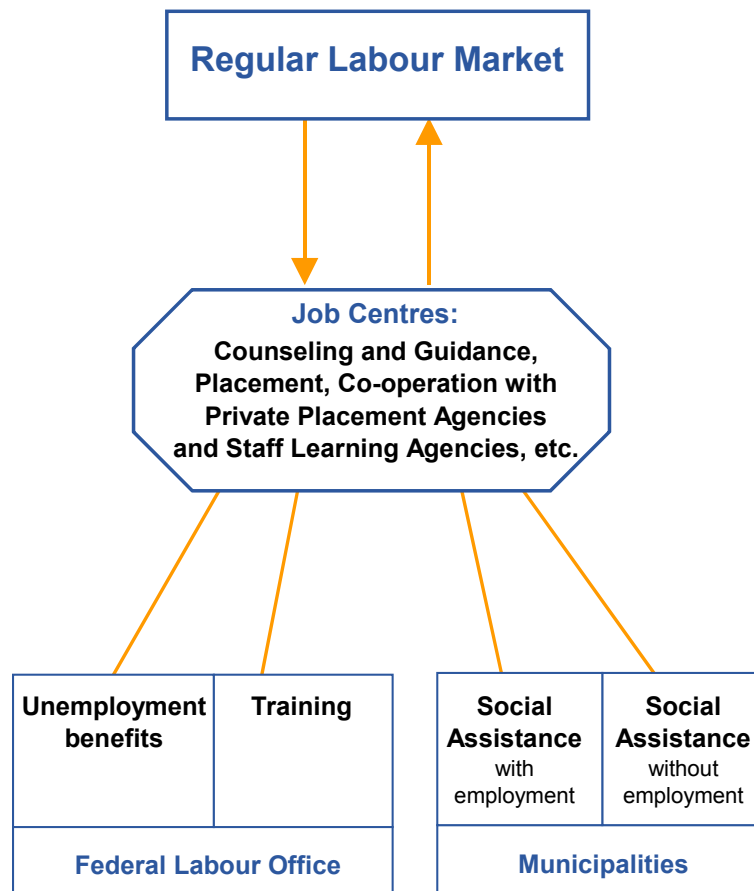
Public employment programmes (ABM and SAM) should not be continued. These measures do not fit to a welfare system centred on work in the regular labour market since they hardly improved chances for moving into regular employment in the past (Bergemann and Schultz 2000; Eichler and Lechner 2001). With the reforms suggested here, many of the typical participants in ABM and SAM programmes will find attractive jobs in the regular labour market. Those who remain unemployed will receive social assistance and have jobs provided by the municipalities with a clear incentive to get a regular job at the earliest opportunity. The activities of those in employment provided

through the municipalities could be similar to many current ABM-type jobs, but could also take place indirectly in the private sector with municipalities farming out the recipients of social assistance in their care to staff leasing agencies.

With the implementation of the reforms outlined here, the system of labour market policy would be made much simpler. The Federal Labour Office would still be responsible for granting unemployment benefits and training activities. The municipalities would be responsible for paying out social assistance and organising public work programmes. The labour administration and the municipalities could jointly establish job centres at the community level with the task of looking after the unemployed individually, getting them into work in the regular labour market as quickly as possible and handling benefit claims for both the Federal Labour Office and the municipalities (Figure 3.1). This solution is similar to the “one-stop” models, providing all services for the unemployed from one source that were introduced in various other countries during fundamental reforms of labour market policies and social security systems. In this way job centres are able to co-operate with private job placement firms and bring in private staff leasing agencies to place individuals who do not have direct access to job opportunities in the private sector.

Through the abolition of unemployment assistance, ABM and SAM, on one hand, and the introduction of some kind of “reciprocity” for welfare recipients, on the other, reductions and increases in fiscal costs will arise at different levels of government and administration. Generally speaking, removing tax-financed unemployment assistance will relieve the federal government. Abolishing ABM and SAM measures directly relieves the Federal Labour Office and municipalities and burdens the federal government. The integration of unemployment assistance into social assistance and the introduction of community work to be accepted in return for receiving benefits ultimately burden the municipalities. It is not possible here to go into the net effects for the public budgets involved, nor to spell out how those facing higher fiscal costs can be compensated by others who are essentially relieved. In any case, the ideas of Huber and Lichtblau (2002) about combining unemployment assistance and social assistance are particularly useful in this regard.

Fig. 3.1 Future system of labour market policy



Source: Ifo Institute.

3.3 Why wage subsidies? Distribution and incentive effects

For many observers, particularly economists, the proposal to offer government subsidies for low-wage income may sound strange. Certainly, some distrust is always justified toward massive subsidy programmes that are supposed to influence the behaviour of businesses or private households. In this case, however, arguments in favour of wage subsidies prevail, particularly when they are compared to the status quo, which in effect amounts to a subsidisation just as massive of low-skilled workers for not working.

One of the most important rationales for granting a wage tax credit as proposed by the Ifo Institute is that this is the only way to rapidly lower the wage level in the low-wage sector in order to raise the demand for individuals with low qualifications. Targeted subsidies for the previously unemployed, for instance, (see Jerger and Spermann 1997; Spermann 1998) can have similar effects over the long-term at best and only after com-

plicated adjustment processes. Furthermore, proposals for targeted subsidies are based on the problematic assumption that the most important bottleneck for higher employment is the missing incentive to work or a performance handicap of low-skilled individuals, which could be corrected through a limited period of training on the job.

The Ifo Institute does not agree with this evaluation. Basically, individuals are willing to work but would be behaving irrationally if they were to start jobs that paid less than their social assistance claims. Because of this, jobs with minimum qualifications are lacking because they are simply too expensive. As soon as wages paid for these jobs decline, additional jobs will be created since it will then be profitable for employers to do so. Also, one should keep in mind that there are many people whose capabilities will always remain below average than the deviation from average net income allowed for by social assistance. As a consequence, these individuals can only be integrated into regular employment through permanent reductions of wages.

To the extent that people already working can be substituted by former transfer recipients, reducing wages for the latter will not be enough. This would force businesses to replace some of the incumbent jobholders with new arrivals who are willing to work for lower wages because of the wage tax credit. Former jobholders would then become transfer recipients who are eligible for targeted subsidies. To avoid this effect, there is no way around a wage reduction for all the low-skilled individuals and the necessity of granting a wage tax credit to everyone active in the low-wage sector.

These considerations reflect that granting a wage tax credit should not only be seen as an incentive device but also as an instrument of distributional policy. Even the US Earned Income Tax Credit essentially serves to combat the phenomenon of the working poor. Full-time jobholders with low wages are subsidised in order to raise their household income above the poverty threshold. Given that, it is pointless to worry about “inefficiencies” involved in the wage tax credit due to the fact that it would be paid not only to individuals who previously have not worked, but to all households on low-wage income (Riphahn, Thalmaier and Zimmermann 1999, pp. 43–44; Kaltenborn 2001, p. 47). If wage subsidies were only intended to create incentives for work, then there would indeed be a problem. But if Ifo’s reform proposal has the effect of reducing wages for people with low qualifications, then a lasting subsidisation of wages is needed that includes all individuals affected, including wage earners already working. What some might see as an inefficiency that should be avoided is a fundamental condition for the success of the Ifo proposal.

There are additional reasons for subsidising the income of low-wage earners that have been overlooked in the debate over wage subsidies in the low-wage sector. It should be clear, however, that the Ifo proposal implies a relatively preferential treatment of wage tax credit recipients, while it is a subsidisation of utilising relatively unproductive labour on absolute terms.

The proposal of the Ifo Institute follows the US practice in not just imposing zero taxes on those who take up work. While the current social assistance scheme is characterised by a 100% marginal tax burden on work due to transfer withdrawal over a wide range of incomes, the wage tax credit leads to an effective subsidisation of low wages, thus creating a negative marginal tax burden.³² Whoever decides to work does not have to pay wage earners' contributions to social security or other wage-related taxes but instead will receive a 20% subsidy up to a certain amount of income which adds to the new level of social assistance for those non-employed.

It is true that only the marginal tax burden imposed on income is negative, not the burden on the full value added. As already mentioned, the latter is important from an economic perspective since it includes the sum of all fiscal effects on labour supply. Beginning with the first Euro of wages, the value added through work is subject to employers' contributions to social security and also the value-added tax paid by the employer. In total this means that the marginal tax burden on the value added is 14.3% for very low earnings despite subsidisation of wage income. That is much lower than the marginal tax burden of almost exactly two thirds of value added which the average wage earner in Germany has to face (see Figures 1.6 and 3.3 to 3.7).

Even the relative subsidisation of low-skilled labour can be criticised for the large incentives to employ low-wage earners, implying an unequal treatment of various types of wage earners.³³ Still, this type of policy can be supported for various reasons of economic importance that arise from the positive external effects of employing low-wage earners:

- Anyone starting to work in the low-wage sector will probably manage to advance into higher positions in the wage hierarchy later on, then paying taxes and higher

³² Keen (1997) emphasises that this is the distinctive feature of the US EITC model when compared to other models for guaranteeing the subsistence level.

³³ See for example Breyer (2002) who refers to the distorted incentives created through any type of subsidisation. This is the typical perspective of an economist, being as simplistic as it is deceptive. It is appropriate only in the ideal world of the "first-best" or with a tax system that completely eliminates all kinds of market failure in terms of a "second-best" solutions from the very beginning.

social security contributions. This leads to a fiscal externality with positive effects for other beneficiaries of the government budget or other taxpayers, which justifies the subsidisation of job entry and the increase in employment through fiscal incentives.

- Any job offered requires a certain amount of instruction and training through the employer. While employees have an unconditional right to terminate, it is not possible for the firm offering this training to protect itself against wage earners who leave when training is completed in order to offer elsewhere what they've learned. This leads to an under-investment on the part of businesses in their efforts to hire and train new entrants that can be countered through a wage subsidy.³⁴
- Anyone actively looking for a job because of a wage subsidy lowers the search costs that other market partners are faced with. As a result, the existence of positive search externalities for potential market participants can be taken as an important argument for these subsidies.
- Assuming that taxpayers who finance the wage subsidies have a paternalistic motive to influence the behaviour of welfare recipients, then this is an externality embodied in their utility function which has to be respected even in a liberal approach to economic policy.³⁵
- The family situation of individuals affected will stabilise through employment. In particular, adolescent children will be exposed to a more advantageous environment. The false orientation that children receive through their parents' being unemployed or working in the shadow economy will be avoided. Subsidising labour force participation is an important ingredient in the education of the next generation.
- Having a regular job distracts from other activities causing problems that might serve as a substitute, like resorting to criminal practices. Certainly, the Neo-Nazi movement among young people in eastern Germany is to a great extent a result of the lack of career and other perspectives due to unemployment. In turn, the latter is a major result of the incentives created by the system of social policy. This is another indication of the necessity to provide the proper incentives to take up work as proposed in the Ifo model.³⁶

Taken together, all of these factors might even be enough to support a subsidisation of low-wage jobs on absolute terms. At least, they should justify the subsidisation relative to other groups of jobholders that is characteristic of the Ifo proposal.

³⁴ See also Beckmann and Werding (2002).

³⁵ See Hochman and Rogers (1969).

³⁶ Further justifications for wage subsidies in the context of wage-setting and bargaining models can be found in Layard et al. (1991, p. 490 ff.).

3.4 Community service for welfare recipients

The reform of the social welfare system proposed by the Ifo Institute would lead to a lasting increase in employment in the low-wage sector. Nevertheless, it cannot be ruled out that a group of the long-term unemployed may not at first find regular jobs until the market reacts to these measures. For these individuals it will be necessary to insure the minimum requirements for the social subsistence level stipulated in social assistance law. According to the Ifo proposal, they would continue to receive assistance at the present amount; however, this assistance would only then be granted when the welfare recipient agrees in return to work in a community project.

From an economist's perspective public provision of jobs is not without problems, since it creates a new sector of government employment that didn't previously exist. One should not overlook the fact that government jobs are a serious alternative to the government-financed inactivity found in Germany today and are the lesser evil for a variety of reasons:

- With the community service requirement, receiving social assistance payments will no longer seem attractive and this will also increase the incentive to look for work in the private sector.
- For the same costs to the state and no matter how insignificant the productivity of the individuals involved might be, useful jobs can be performed that otherwise wouldn't be.
- Community jobs help activate welfare recipients and ease the transition for them into the regular labour market.

The obligation to work is anchored in Art. 18 of the current *Bundessozialhilfegesetz* (BSHG, Federal Social Assistance Law). In accordance with Art 25 BSHG, social assistance can be reduced under the legal subsistence level if there is refusal to start a reasonable job. In a legal sense, social assistance does not give cause to remain inactive. These laws are often not even applied in practice. The legal practice now in effect ignores Art. 18 BSHG. Specifically the regulation in Art. 18 (3) that states that it is reasonable to expect an assistance recipient to take up employment is open to interpretation by the courts. In addition, the burden of proof is exceedingly difficult for the social assistance offices, which often give up trying. The fact is that social assistance is currently drawn, depending on the definition, by anywhere between 800,000 and 1 million employable individuals who don't work at all or at least not in the regular labour market. It shows how little practical meaning the legal obligation to work really has

The Ifo model is freed from such difficulties due to the fact that the old amount of social assistance will take on the character of wages for community work. If for whatever reasons assistance recipients fit to work fail to appear for work, they will receive only the reduced rate (amount) provided for the non-employed. In this way the question of burden of proof becomes superfluous and instead shifts over to the question of who is fit to work.

As will be explained more in depth, the Ifo proposal is based on the so-called “Leipzig Model”. In this model the regular rate and one-time benefits are cut off for non-working individuals who are fit to work and only benefits for children and housing assistance are maintained.³⁷ This severity is necessary because otherwise the desired incentive effects would not be achieved. At the same time it is reasonable since public employment is being offered. Literally everyone would have the opportunity to earn an income through his or her own job performance at the present social assistance level. Whoever turns down the public employment offer can be assumed to have enough income from other sources, legal and illegal. Public employment leads to a self-selection of the really needy and, as a result, to a targeting of social assistance that is substantially more precise than the best administrative procedures would be capable of realising.

As explained at the beginning of this chapter, there are irrefutable reasons for the introduction of a community employment obligation for welfare recipients that is derived from the given legal and fiscal limitations in Germany. On the one hand, individuals who cannot find work in the regular labour market cannot be denied an income at the level of present social assistance. On the other hand, in view of the fact that the tax burden on regular employment is already too high, the state cannot possibly raise its expenditures for social purposes further. Both aspects demand the solution that the Ifo Institute proposes, since without a community work obligation, the payments to non-employed individuals will not go down. Without such a reduction, the necessary incentive effects on the labour market would be prohibitively high for the state.

An obligation for welfare recipients to take up community work can be justified on the following grounds:

³⁷ The extent of the reduction of entitlements for recipients of social assistance proposed by Ifo should remain in legal limits. Even now regular subsistence payments are to be reduced at least 25% of the regular rate when there is a refusal to work. Additional reductions over and above are subject to the discretion of the public assistance authorities (Bäcker et al. 2000, p. 381). Several municipalities, including the city of Leipzig, have cut off public assistance completely when work was refused.

- Personal limitations that reduce the ability to work can hardly be claimed as a reason for refusing to accept a community job. Community employment organisations can adapt the job demands to the abilities of workers in a way not possible in the regular labour market and assign welfare recipients activities that are suited to them. This then makes possible a narrower interpretation of general disability. Even individuals with a limited ability to work can and should be employed.
- The obligation of welfare recipients to work serves not only to support a reduction of social assistance entitlements for the unemployed, but also has the goal of activating recipients and equipping them to take on regular employment. It works against the downgrading and demotivation of long-term unemployed connected with the old forms of unemployment and social assistance. The skills necessary for a regular job can be acquired or reacquired through community employment, among them being punctuality, reliability, social behaviour and the ability to work over an extended period. Job-related skills can be acquired through on-the-job training.
- Through the introduction of obligatory work, welfare recipients would be prevented from taking on unregistered employment, since whoever works eight hours a day for the state would not be able to take on a substantial amount of work in the shadow economy. Social assistance would also lose a good part of its attractiveness through community work, which in addition to wage tax credits would lower the reservation wage for regular employment and help to create more jobs.
- In the end, granting social assistance would gain more acceptance in the society if recipients were expected to work and contribute to the well being of the community.

Community employment differs fundamentally from the present job-creating measures in its clear intent in providing a transition into regular employment as quickly as possible. For the time being, jobs to be offered would be similar to those found in existing programmes like ABM: landscape conservation, gardening, crafts, social services, working in kitchens and laundries, environmental protection and recycling. These jobs should improve the chances of participants in the regular labour market, are of public interest and create assets. No one should have any illusions concerning the productivity and willingness to work of the individuals in question, but on the other hand we should not forget that welfare recipients do nothing in the present system and create no assets whatsoever. Low performance for the society is better than none at all.

The implementation of community work, here the employment welfare recipients, does not mean that public administrations or charities should become employers. Municipalities should delegate these activities to independent, private or non-profit organisations. With their personnel and professionalism, they are more in the position to organ-

ise employment measures and connect them with a qualification and social support. As is the case in Wisconsin, the municipalities could, through advertised bidding, put these organisations in charge of the employment of the welfare recipients for a certain time limit. A fixed budget would be placed at their disposal fixed to the recipients' specific length of stay in the project. If the organisations stay below their budget, then a part of the difference could be kept as profit. In this way there is a financial incentive to get the participants into the regular labour market as quickly and permanently as possible. The role of the municipalities is to set up a budget and the bidding procedure and control and evaluate the project.

In any case, municipalities should have the freedom to choose the best way to organise community work. This could be done through community or private staff leasing agencies that provide the private sector with the services of individuals who have few or no skills for a negotiable price in line with their low productivity. Instead of being paid private wages and given a wage tax credit, they are paid a community wage at the present social assistance level for working full-time. The employment relationship is with the municipality, which maintains the right to assign the individuals in its charge to the staff leasing agencies. This is an attractive possibility to extend the range of available positions and increase the chance for community workers of finding a productive and instructive occupation.³⁸ Bringing in private staff leasing agencies is a logical step to take since they have had years of experience in providing employment for workers with various qualifications and have the necessary profit incentive to find the best possible positions for the individuals entrusted to them. Indirect integration in the regular labour market offers the best possible conditions for a transition into regular employment because there are always new prospects either with the employment agency itself or with businesses that are its customers. The Netherlands provides an example of how it can be done. Part of the "job miracle" came about because 7% of all employees found work with temporary employment agencies. These agencies can offer municipalities a realistic and practical way to fulfil the task of finding employment closely connected to the regular labour market.

The reason often used as to why the state should not provide jobs is the fear that this would affect private enterprise negatively. Would not private gardeners suffer if welfare recipients worked for public gardeners? While this might seem to be the case, illusions based on partial analysis should be avoided. In the Ifo model the state would not spend more money altogether on the social assistance and low-wage sector than it does under the present system. Whatever money it would have used in commissions to private gar-

³⁸ See also Hölder (2002).

deners can be applied elsewhere, for instance in the services of private firms. A displacement of private enterprises only takes place in the sense that the state shifts its demand into another area, but there would not be a net shift in public demand for private services. This is an important point often overlooked in the public discussion.

With some skill it should be possible to set up the jobs paid from social assistance so that private tradesmen do not suffer hardships. On the one hand, it is possible that community employment organisations would compete with private businesses, but on the other hand, the new social assistance policy should eliminate the need for unregistered work and redirect the demand for trade services in the black market back into the regular market. There is no reason that the staff leasing agencies could not offer the services of welfare recipients in their employ to private businesses. A large percentage of individuals who had previously worked illegally could then be entrusted to firms in the regular labour market and previously illegal work be done under normal conditions. Discussion about a displacement effect that disadvantages private firms would no longer be valid.

3.5 Benefits for families with children

The lack of incentives from this social system for the labour market is increased by the way in which children are integrated into this system. In the low-wage sector, all existing entitlements to social benefits derived from having children decrease if earned income increases: the greater the number of children, then the larger the entitlement from the government and the wider the income range where more work does not lead to an increase in net income. Reduction of government benefits for families with children has the same effect as reduction of social assistance benefits for adults who work. It penalises regular employment and raises the entitlement wages that have to be exceeded for regular employment to be worthwhile.

The major cause for this is the social assistance paid for children, including the housing assistance entitlement that rises with the number of children; for single parents there is an additional aid.³⁹ For single parents with one child living in western Germany, these benefits (when compared to individual household income for childless singles) add up to €405 per month, for married couples with one child (compared to childless married couples) to €255 and for married couples with two children (compared to married cou-

³⁹ The children's allowance is calculated in full with social assistance excluding the tax-free amount of €10.25 for one child and €20.50 for two or more children.

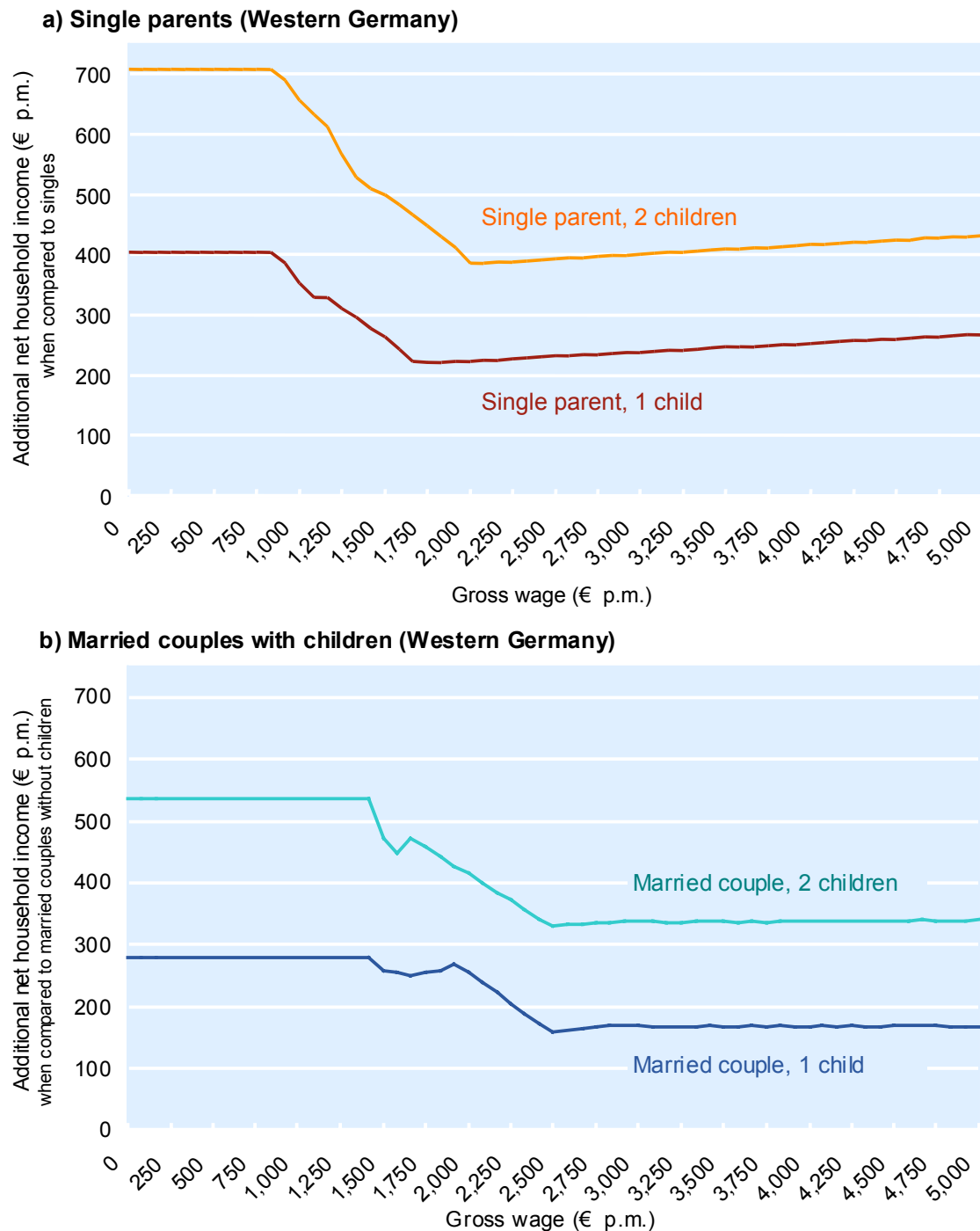
ples with one child) to €280. With increased self-earned income, these amounts essentially shrink back to the children's allowance of €154 for each of the first three children or €179 per additional child.

Figure 3.2 shows how child-related benefits change in connection to income. What has to be considered here is the fact that with high income, the children's allowance is gradually overlaid by the children's tax allowance. Child subsidisation generally is at its highest level with low income and falls drastically with an increase in income for a wide range of incomes. In families with two children, the range is between €1,500 and €2,500. Thereafter it stays almost constant and climbs only gradually with higher income.

In eastern Germany there are very similar results in terms of structure, although the differential amounts turn out to be less in the lowest income sector due to the lower social assistance rate as well as for the income threshold due to lower housing assistance entitlement.

Granting a specific social assistance entitlement for children is a well-thought-out measure in terms of social policy. The reduction of government benefits with rising income is a problem in that it leads to high reservation wages in the regular labour market, causing jobs to be eliminated or not even created in the first place. The disadvantage of social assistance is aggravated in the following way: the larger the number of children, the larger the amount of money that the state makes available for non-employment and the more remote the chance that a profitable job with a higher income can be found in the private sector. The fact that parents act more responsibly than childless individuals and are inclined to go to work on account of their children does not contradict this and is no reason not to take the problem seriously.

Fig. 3.2 Effect of child-related benefits in the German tax-transfer system



Included is the value added associated with wage earnings (= gross wages plus the social insurance contributions paid by employers and the value added tax) as well as the marginal tax burden involved in the reduction of social assistance and housing assistance (*Wohngeld*), in the income tax (plus the “solidarity surcharge”, *Solidaritätszuschlag*), the church tax (*Kirchensteuer*), employees’ and employers’ share of social insurance contributions and in the value added tax. Calculations refer to Western Germany (laws as of 2002).

Source: Ifo calculations.

Large families in particular receive false signals concerning work from social assistance. This is perhaps one of the greatest deficits of social assistance at this time. Children accustomed to joblessness and illegal work as a normal part of life are pushed in the wrong direction with this upbringing and may follow the same pattern as adults. Skills and habits in dealing with social service offices help establish an alternative way of life outside of the regular labour market, as does knowledge of the way the black market works. There is a danger that an underclass will be created and consolidated over generations that serves as a breeding-ground for the erosion in society.⁴⁰

To avoid this, it is desirable to include children in the overall tax-transfer system and see that the financial effects for those on social assistance vary as little as possible from self-earned employment income, ideally remaining constant through all income classes.⁴¹ This basic consideration is part of the Ifo proposal for reforming the system of welfare benefits.

If child-related elements of the tax transfer system should be as independent of income as possible, then another major factor to consider is their level. Maximum social assistance benefits for children at the lowest income level cannot be taken as the norm and applied to families in all income classes. If this were done, the fiscal burdens would be so high that they outweighed the fiscal effects of all other reform elements by far.

Recently, both politicians and researchers have proposed various reforms aiming at increased child-related benefits for families.⁴² In most cases, the burdens on the federal

⁴⁰ This is a major argument in the US literature about the relevance of wage subsidies for low-wage earners (see Phelps 1997 or Solow 1998).

⁴¹ For various reasons it is worthwhile to consider a differentiation in effects according to age and number of children. – According to decisions taken by the *Bundesverfassungsgericht* (Federal Court of Justice) on 10 November 1998 (BVerfGE 99, p. 246) and 29 May 1990 (BVerfGE 82, 60) benefits for children that are completely income-independent require that their level is above the tax reduction due to the children's tax allowance at the highest tax rate on the income tax scale.

⁴² The *Wissenschaftlicher Beirat für Familienfragen* (Scientific Advisory Council for Family Affairs; 2001, p. 251–252) has recommended introducing a standard children's allowance as an element of the fundamental reconstruction of family policy measures that would have the external effect of equalising family benefits. The exact amount of required payments is open as is the question or the extent to which they could be integrated into a "negative income tax" system for children which was considered at the same time (p. 250–251). While the programmes of the present federal government concerning family taxation are driven by rulings of the *Bundesverfassungsgericht* (Federal Court of Justice; BVerfGE 99, p. 216), the consistent development of an income-independent child's allowance was a focal point of government policy (*Bundesministerium für Finanzen*/Federal Ministry of Finances 2001). The Social Democrats (SPD-Parteivorstand 2002) announced in their election programme that they would continue this course and raise the children's allowance in the medium-term to €200. The

budget have proven to be a major limitation. The proposal of the Ifo Institute does not rule out an increase in the level of child-related benefits as long as they largely constant (or non-decreasing) over all income brackets. In any case, these changes should be considered an issue separated from reforms that concentrate on the problem of increased employment for low-skilled individuals.

In the outline of the parameters of the Ifo proposal provided in the following section as well as in our estimates regarding the fiscal effects, we assume that uniform child-related benefits are granted that remain at the children's allowance level to date and that the effects of the children's tax allowance (increasing with higher gross income) continue as they were previously. How the funds necessary to increase children's benefits could be mobilised and what effects this would have on the employment of parents in the lower-income sector is beyond the range of these considerations.

For the time being it should be noted that assigning net household income to individual household members, or ear-marking benefits directed to children as child-related benefits, has little to do with reality. In the end total available income for a household is spent independently of where it comes from and irrespectively of the political intentions that motivate transfers and tax reductions. Thus, limiting child-related benefits to the present level of the children's allowance is nothing less than a reduction of reservation wages for individuals with children. At the same time, work incentives for the same group of people can be strengthened through the wage tax credit that raises household income substantially even with a low-paid job.

If jobs in the regular labour market cannot be found immediately or at all, benefits at the current social assistance level should again be guaranteed only with the stipulation that the individuals in question must be willing to begin community employment.⁴³ An accompanying measure of the reform would have to be an increase in the number of child-care facilities, a factor as important to the effective employment of many parents as the financial aspect.

CDU/CSU group in the *Bundestag* (2001) has developed a concept of integrating the children's allowance and child-rearing benefits in an age-differentiated "family allowance" between €300 and €600 for all children under 18 years.

⁴³ To determine exactly the reduced social assistance level in family households, this guarantee can require that the calculated hourly wage in the second labour market be differentiated according to marital status or number of children.

3.6 The structure of the wage tax credit

In the conception of welfare systems that ensure a minimum level of income, there are at least three goals to follow. It is necessary

- to provide an acceptable level of income for individuals with a low earnings potential,
- to offer enough incentives to work
- and to strain the government budget or whoever finances these benefits as little as possible.

It will not be easy to attain these goals but it is possible. The present social assistance system concentrates on the first and last of them, but inevitably fails to reduce employment incentives of social assistance recipients through high transfer withdrawal rates. To increase these incentives without giving up the present minimum protection level, one could omit the transfer withdrawal when individuals start work and subsidise all wage earners with minimum qualifications in the same way as non-employed social assistance recipients are now – a generous example of a negative income tax, which was initially rejected. Income distribution would become more equal because wage income would add up to a government income subsidy level as high as social assistance now for individuals with minimum qualifications. The price of such a solution, however, would be immense in terms of additional fiscal costs. It would cause an additional burden on the Federal budget of at least €80 billion. Considering the current budget constraints, this is no way to go. The third goal is being flagrantly disregarded.

Even with policies like these, in order to balance the federal budget, the transfer withdrawal from rising income has to take place somewhere. The marginal tax burden of middle and high-income earners would increase. The negative incentives to work of a high transfer withdrawal rate would only be foisted off on higher income earners. It can be feared that the labour supply of individuals with higher productivity would fall.

For these reasons there is no way around lowering the minimum level of income for employable individuals without earnings and creating a system that increases the possibilities of earning an income. The core of the Ifo proposal, a switch of welfare benefits from wage compensation to wage supplements, does this. A wage supplement that raises a low income up to a social target level not only creates employment by reducing reservation wages; as opposed to a negative income tax it has the advantage of lowering the claim rate and clearly shows lower transfer withdrawal effects in the reduction area

as a result. In addition, the government can reduce welfare expenses, as will be shown. The number of subsidised individuals will increase, but the fiscal effect would be more than compensated by a per capita reduction in welfare benefits. At the same time, the degree of goal accomplishment in social policy would be maintained or even improved by comparison to the present system with an income at least as high as social assistance. In most cases, even more can be earned through a combination of individual earnings and government assistance. This way it is possible to overcome the apparent conflicts between the goals first mentioned.

The effects of the Ifo proposal on gross wages, labour demand, work incentives for welfare recipients and fiscal costs are ultimately shown by the overall development of net household income in the low wage (or value added) sector. In calculating these effects, numerous elements of the German tax and transfer system have to be taken into account. These are, as mentioned, not only personal income tax and jobholders' social security contributions, but also employers' contributions and value added tax.⁴⁴ The reduced minimum level of welfare benefits and the parameters of the wage tax credit have to be fixed in such a way that the profiles illustrated in Figure 1.5 are modified adequately.

An isolated treatment of individual instruments, even the form of the new wage subsidies as such, is secondary. This has not been considered in many reform proposals. They are often only partially analytical and don't take into account what kinds of interactions there are with the rest of the fiscal system and how the course of the effective marginal income tax burden is altered. With this in mind our study offers a complete overview concerning the marginal tax burden of labour value added derived from the combination of virtually all relevant fiscal effects.

The structure of benefits involved in the Ifo proposal is shaped by the following factors:

- Following the Leipzig Model,⁴⁵ the social assistance entitlements will be drastically reduced for employable benefit recipients who are unemployed in the regular labour market and refuse community employment. The standard rate and one-time benefits included in the regular social assistance payments will lapse completely.

⁴⁴ The value-added tax incurred on the jobholder's self-earned value added is as relevant a reason to work in the shadow economy as the employer-employee social security contributions or the personal income tax.

⁴⁵ See Feist and Schöb (1998) as well as Schöb (2002).

- From the previous minimum subsistence entitlements to social assistance, only the entitlement to the housing allowance (dependant on the amount) will continue to be granted. As an example, the minimum welfare benefit for a single person living in western Germany will no longer be €624 (social assistance and average housing allowance including heating costs) but instead €293 (housing allowance for individuals without personal income).
- Social assistance entitlements of additional non-employable adults in a household will remain essentially untouched by such benefit reductions. This applies without restriction to the standard rate entitlements granted to them but not completely to one-time benefits (since these benefits cannot be individually calculated).
- Adults considered to be non-employable are those who are sick, disabled or handicapped or have to stay at home to care for relatives, specifically children. Non-employability resulting from home care can as a rule only be claimed by one adult in a household with several adults. Childcare as a reason for non-employability applies as a rule if at least one child is younger than 4 years, at least two children are younger than 7 years, or at least three children are younger than 12 years.
- In the future, standard amounts for children living in a household at the level of the children's allowance to date (generally €154 and €179 for three or more children) will be paid out regardless of the (work) income of the parents.⁴⁶ The increased needs of families in terms of housing costs will be implicitly taken into consideration by adjusting the minimum welfare benefits to the housing allowance to date.
- The new model of welfare benefits is conceived in such a way that the net household income in the low-wage sector is determined only by the reduced minimum level of welfare benefits and the effects of low wage income subsidisation. The marginal effects of all other transfer benefits, transfer reductions and fiscal charges will be integrated into the new system and overlapped as much as possible.⁴⁷
- Individuals who can find no employment in the regular labour market and can claim social assistance according to existing law are entitled to community employment with payment at the present social assistance level.

⁴⁶ Higher amounts are possible but will not be considered here. See Section 3.5.

⁴⁷ For example, the following illustrations are set up so that from the first Euro of wage income, social security contributions accrue as if the status of side-line employment had been abolished. At the same time the wage subsidy is planned to cover the wage earner's portion of social security contributions in the lowest income sector and over and above that provides direct subsidies of the gross wage. The wage tax credit remains constant with higher and additionally rising income and then is reduced again with a constant transfer withdrawal rate. Beyond the earned income where the wage tax liability (incl. solidarity surcharge and church tax) comes in effect according to existing law, the additional burdens will be compensated by a slowed reduction of the new tax credit in order to keep the total marginal tax burden constant at the predetermined level.

For single individuals who are employable and earn income through employment in the regular labour market, the wage tax credit is designed so that the net household income (calculated with the total gross employment income earned in a household) shows the following characteristics:

- Gross earned income up to €200 is not to be burdened by fiscal charges or transfer reductions but is subsidised instead at the rate of 20%. The wage tax credit will completely compensate for the cuts in social assistance and individuals involved will receive €0.20 from the government for every Euro of self-earned income that increases their net income by €1.20. Wage earners' social security contributions will also be reimbursed (annuity, health/ nursing and unemployment insurance). Employer's contributions to social security will not be reimbursed. Including value-added tax, a marginal tax burden of the value added totalling ca. 14.3% net will be incurred at the beginning when all components are calculated.
- The wage tax credit will remain constant at an income between €200 and €400, but full social security coverage will then be compulsory. The government will absorb about 20 cents of each additional Euro of gross earned income and requires from each additional Euro of value added ca. 43 cents (total of all employer/employee social security contributions and value added tax.).
- The tax credit will be reduced at a rate of 50% for all income above €400. With compulsory social security coverage, there will be a total marginal tax burden on gross income of ca. 70%. If employers' social security contributions and value-added tax are included, then the marginal tax burden of the value added in this phase can be estimated at just under 80%.

If two or more individuals living in a household can be expected to earn their income in the regular labour market, then, based on the current scale for social assistance, the wage tax credit will be laid out so that the income limit is increased by 80% of the level for single people. Essentially the same rules as above will apply to compulsory social security coverage and marginal tax burden. The income limits only shift between the various areas:

- Earned income up to €360 per month will effectively be subsidised at a rate of 20%, but through a combination of value added tax and employers' contributions to social security, there will be a 14.3% marginal tax burden of value added.
- The tax credit will remain constant for earned income from €360 to €720. The marginal tax burden of gross income including jobholders' social security contributions

will be ca. 20% and the total marginal tax burden of value added including all components 43%

- There will be a marginal tax burden on gross income totalling ca. 70% and on value added of 80% for earned income over €720. Above a certain income threshold that varies for every household, the net household income will pass over into status quo income.

When these concepts are applied to several specifically chosen household types using western German examples, a clear pattern emerges (Figures 3.3 to 3.7):

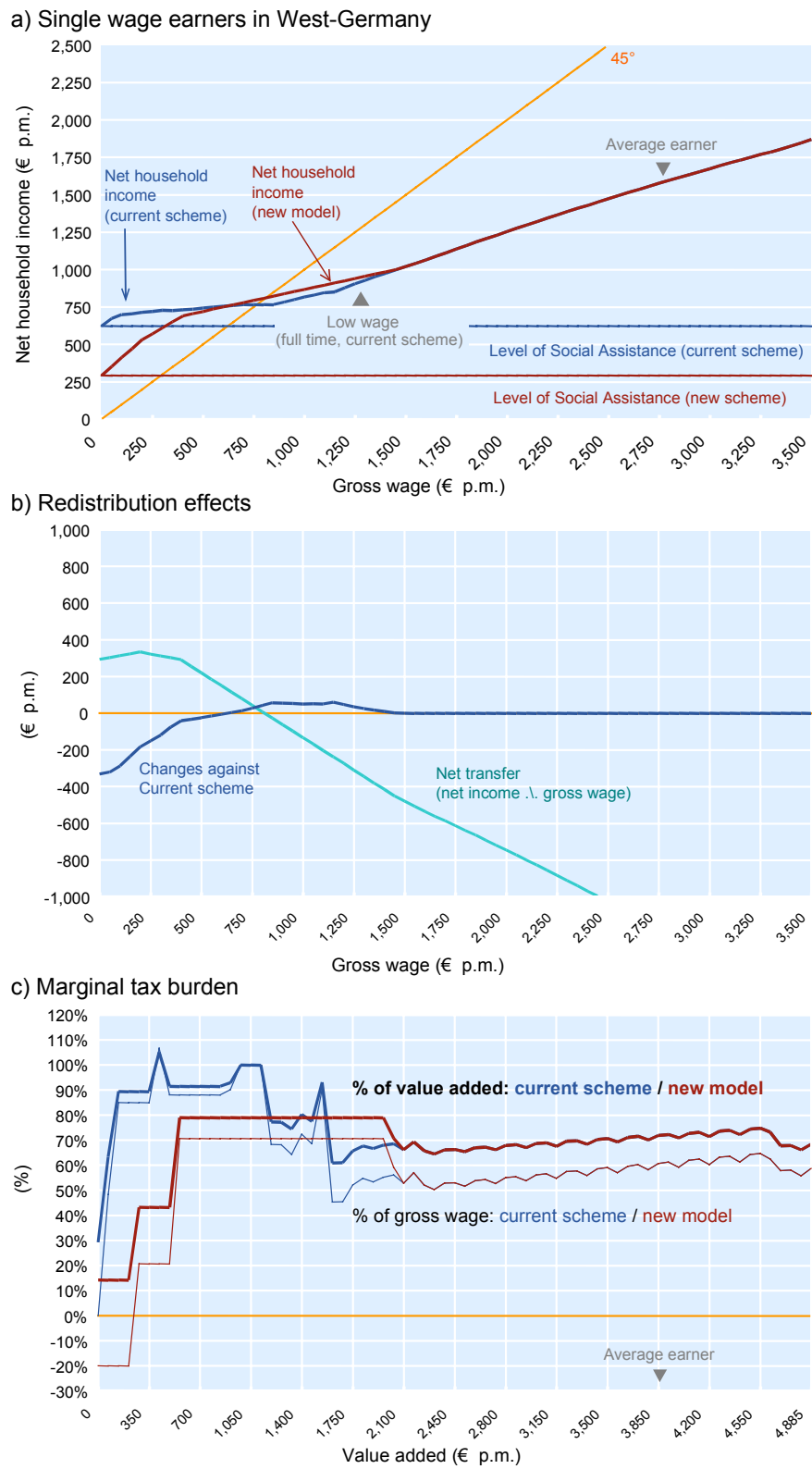
- a) for the curve of net household income dependent on current gross earned income,
- b) for the distributional effects of net transfers, and
- c) for the total marginal tax burden of value added and of gross wage income.

For the sake of comparison, the effects of the law to date (or the deviations from them) will be included in all graphics. Data on the previous and new minimum level of welfare benefits (old and new level of social assistance), on the previous net household income for full-time employment with the typical hourly wage for wage earners with minimum qualifications (old minimum wage for full-time employment)⁴⁸ and on net household income of an average earner⁴⁹ will provide some means of orientation. The gross earnings in the low wage sector and for the average wage earner will be doubled in households with two earners.

⁴⁸ An hourly wage of €8.70 is estimated for employment in the low wage sector. This is the bottom level of the effective wage rate for simple services to date. The total number of man-hours worked is based on a projected 150 hours a month that result in monthly gross earnings of ca. €1,300.

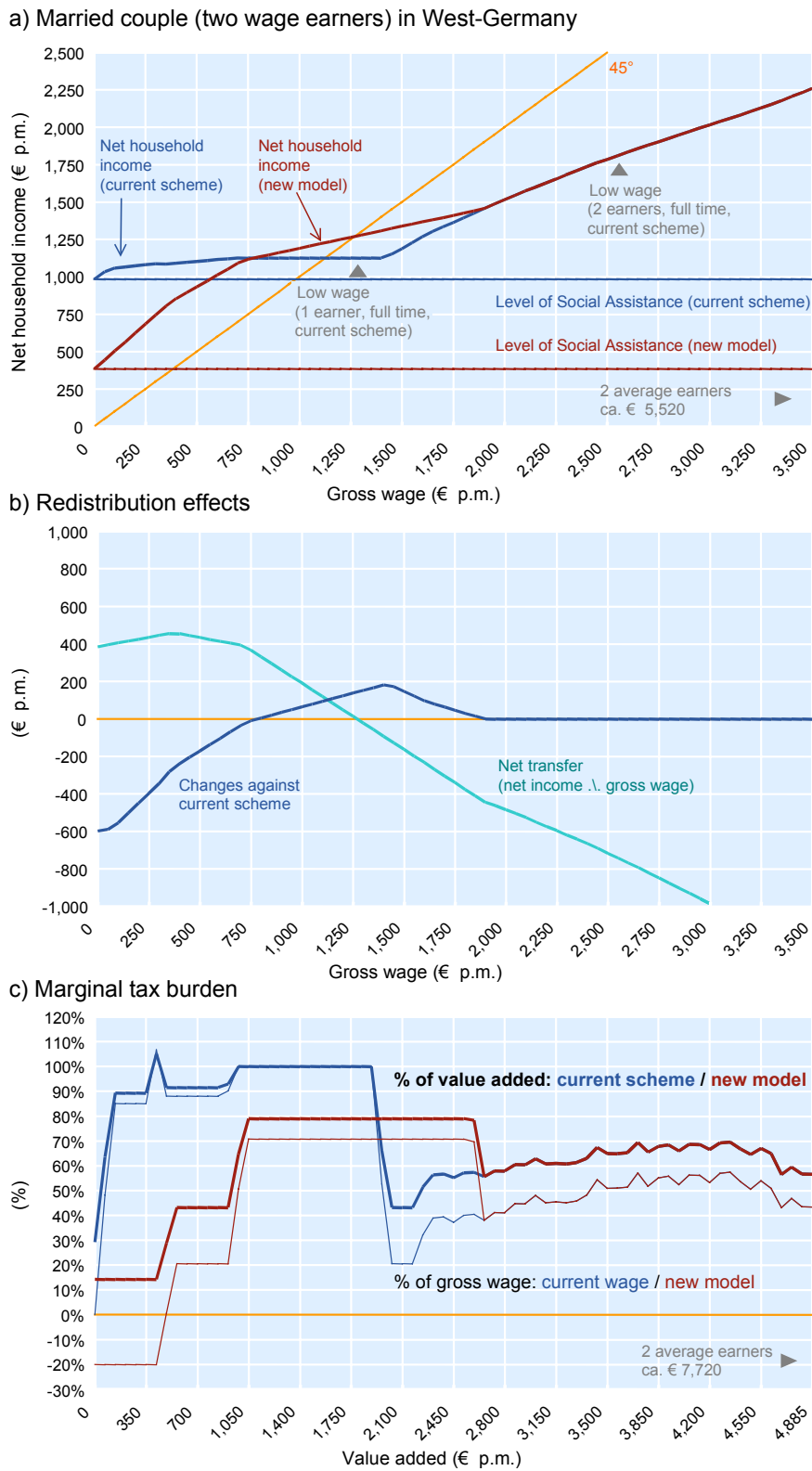
⁴⁹ According to the *Statistisches Bundesamt* (Federal Office of Statistics), *Fachserie 16, Reihe 2.3*, October 2001, average monthly gross earnings of a wage earner in the producing sector, commerce, maintenance and repair of automobiles and durable consumer goods and the banking and insurance industries in Germany were €2,665 for 2000. The projected average for 2002 is ca. €2,760.

Fig. 3.3 The new model for welfare benefits



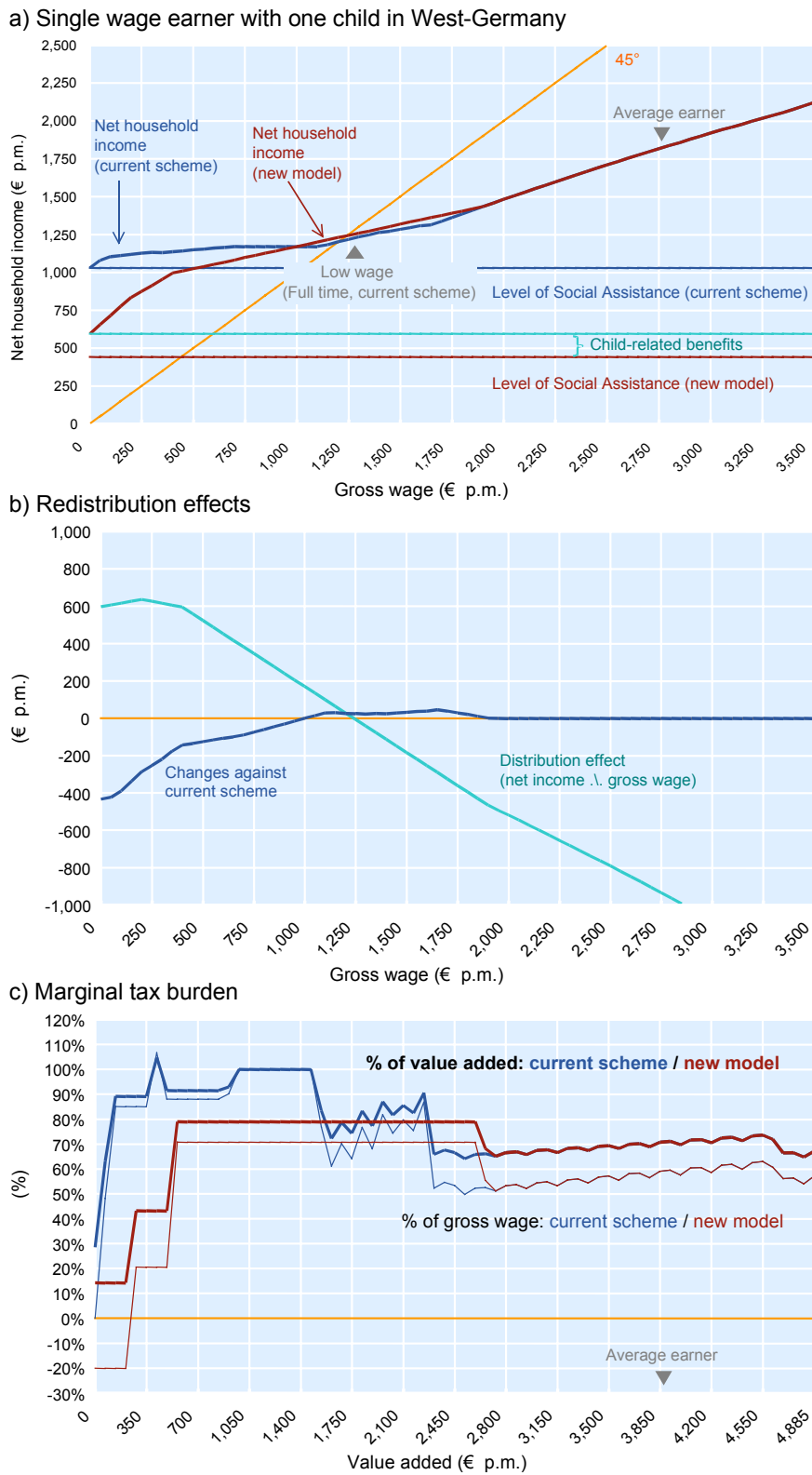
Source: Ifo calculations (on methodology: see Figs. 1.5 and 1.6).

Fig. 3.4 The new model for welfare benefits



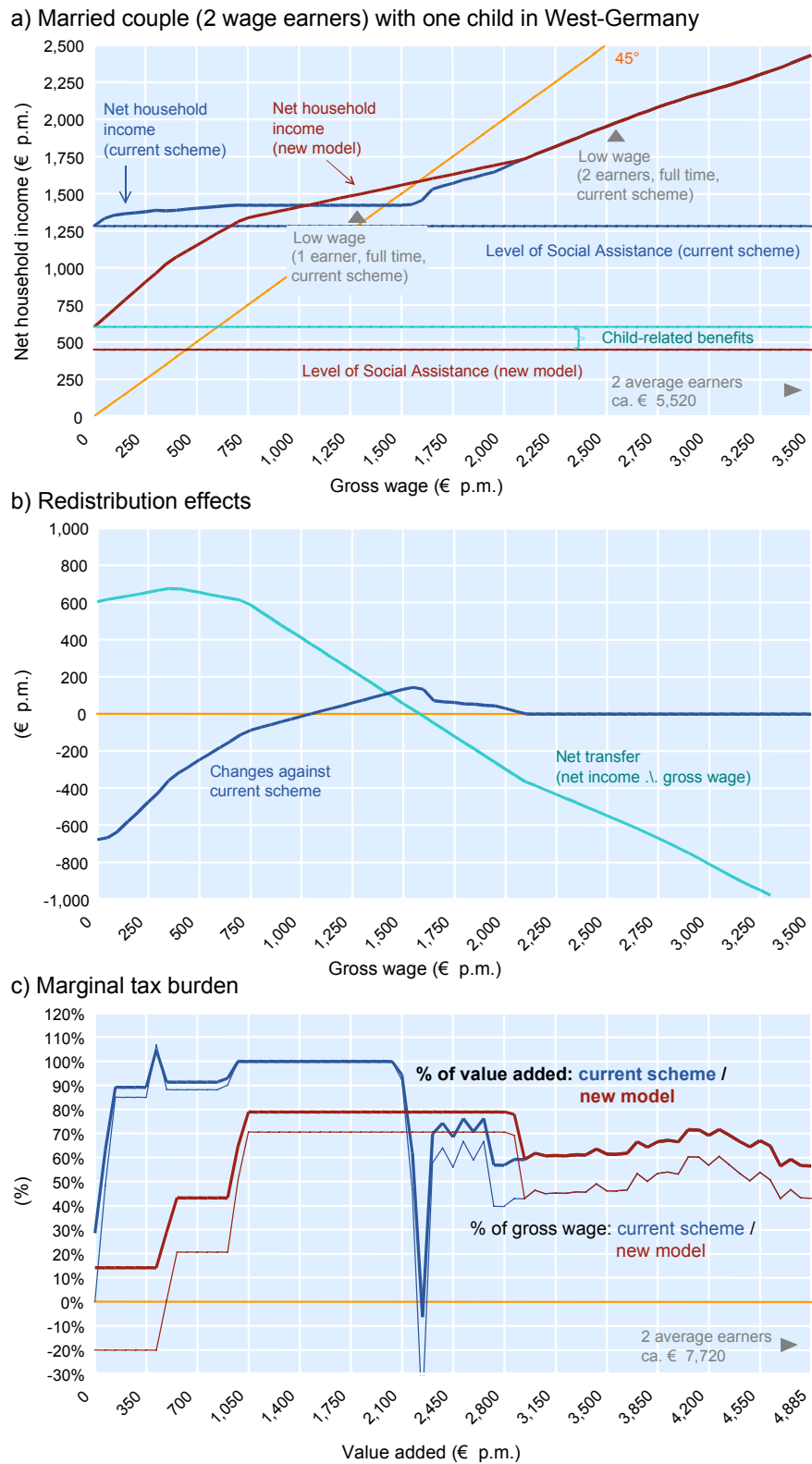
Source: Ifo calculations (on methodology: see Figs. 1.5 and 1.6).

Fig. 3.5 The new model for welfare benefits



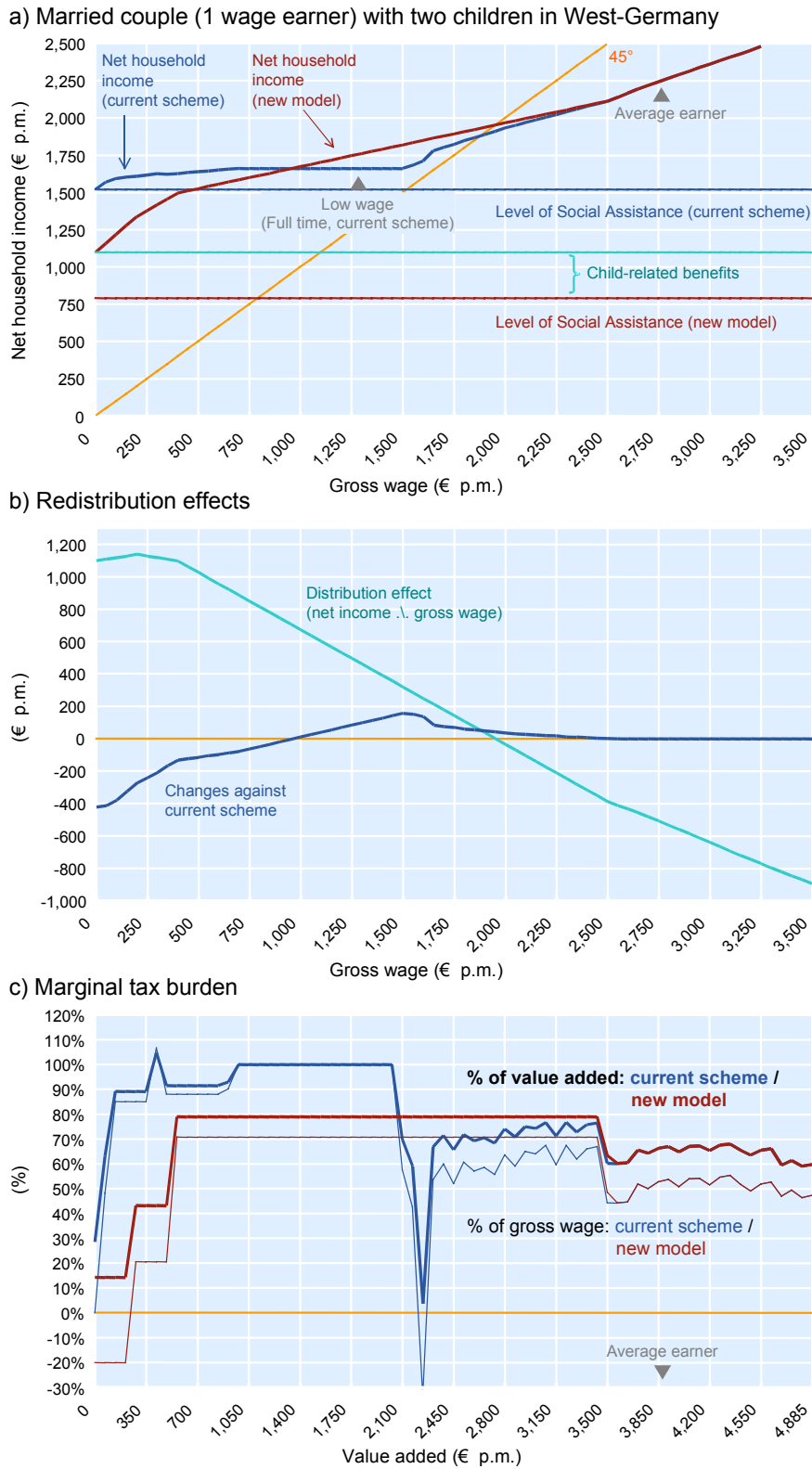
Source: Ifo calculations (on methodology: see Figs. 1.5 and 1.6).

Fig. 3.6 The new model for welfare benefits



Source: Ifo calculations (on methodology: see Figs. 1.5 and 1.6).

Abb. 3.7 The new model for welfare benefits



Source: Ifo calculations (on methodology: see Figs. 1.5 and 1.6).

All calculations shown in Figures 3.3 to 3.7 apply only to the cases where there is at least one employable person in a household (based on the conditions outlined above). Deviations from the status quo can only exist then. For example, singles with one child under three years or married couples where one partner is non-employable due to illness and the other is responsible for childcare are not affected by the reform. Whether or not all employable members take advantage of receiving an income at the previous social assistance level through employment organised on a community-level is basically up to every household individually.

For households in eastern Germany there are analogous comparisons. The reduced social assistance level for employable individuals without employment is somewhat lower due to the lower housing costs in the new states (Table 3.1).

Tab. 3.1 Reduced social assistance (base rate) for employable individuals not working in West and East Germany

Type of household	West Germany	East Germany
Single wage earner	293 €	233 €
Married couple (1 wage earner)	614 €	543 €
Married couple (2 wage earners)	385 €	322 €
Single wage earner, one child	442 €	377 €
Married couple (1 wage earner), one child	680 €	598 €
Married couple (2 wage earners), one child	450 €	377 €
Married couple (1 wage earner), two children	790 €	705 €
Married couple (2 wage earners), two children	559 €	481 €

Source: Ifo calculations.

The income thresholds for the introduction and reduction of the wage tax credit in eastern Germany remain unchanged when compared to western Germany. Depending on the development of the previous net household income, there is, however, a shift in gross earned income where the reduction area ends (in this area the maximum marginal tax burden for gross wages reaches 70%.) The marginal tax burden then sinks to the usual German level between 40 to 65% and the reform no longer affects the disposable household income for a given wage.

In this reform proposal it is basically clear what the effects will be on the incentives to work and the amount of time spent working (part-time, full-time, overtime). Although

no precise estimates can be made,⁵⁰ it can be expected that there will be a major incentive for all employable individuals with no other sources of income (support from relatives or other individuals, illegal work in the shadow economy etc.) to get a job. This incentive is due to the reduction of the social assistance level combined with a wage tax credit grant. At the same time, the extremely low marginal tax burden for low wages will exercise a certain pull toward employment in the regular labour market.

A pessimistic evaluation of the effects of the reform would be justifiable if it is assumed that in the new system, many of those previously unemployed will choose a job with only limited earnings that brings them up to the income threshold where the reduction area begins for the tax credit (Figures 3.3 to 3.7). This would be a gross wage of app. €400 per month for a single wage earner and €720 for two wage earners in the same household. The Ifo model is constructed to ensure that in every case, the corresponding net household income adds up at least to the level of social assistance for unemployed individuals which is guaranteed under the condition of full-time community employment. The working hours these earnings represent depends on individual productivity and the wage rates for low-skilled work that will come about through the intended expansion of the low-wage sector. Based on the estimates of wage effects shown in the next section, not even half-day jobs would be necessary to reach this income level.⁵¹

This factor demonstrates the nature of the Ifo model. In the future, welfare recipients should not be in a worse position than today, although certain individual performance will be expected. Whoever takes a job in the private sector can come up to the social assistance level to date even with a half-day job and whoever does not find this kind of job can receive the same amount with full-time employment offered by a community supervised loan employment agency. Working full-time in the private sector will lead to a net income much higher than the social assistance level to date. The reform proposal of the Ifo Institute does not lead to cutbacks in the social system, but provides for a clear improvement in the income situation of the individuals affected. It offers a way out of the poverty cycle.

⁵⁰ The relationship between gross wages and net household income will change too much. Particularly in the area of work income below the level of social assistance to date, hardly any conclusions can be drawn regarding the expected changes in earning behaviour when individuals are confronted with completely new budget constraints. The same is true for the reactions of employable social assistance recipients to the new community employment obligation if they are unable to find employment in the regular labour market.

⁵¹ According to these estimates, a gross wage of €400 is equal to working time of about 15 to 17 hours a week (see next section).

In the reduction area of the tax credit, the gross wage is subject to a cumulative marginal tax burden of maximum 70%. This value is clearly under the level of transfer withdrawal rates for the present social assistance system and only a little above the effective marginal tax burden of ca.60% for average earners in Germany. An incentive for a further expansion of employment is ensured.

However, the fact that these marginal tax burdens are still very high cannot be denied. This impression is validated by the amount of the marginal tax burden of value added in partial diagram c, that includes employer contributions and value-added tax. According to this, the marginal tax burdens of the average German jobholder are at 65% (the highest internationally) without the reform, and in the reduction area marginal tax burdens reach 80%. These values are by no means satisfactory. They appear in a somewhat better light if one takes into account that the old social assistance system has a marginal tax burden of 100% in the reduction area and that the reform proposal of the Mainz Model, as shown in Figure 2.2, has a marginal tax burden of 110%. A general reduction of the tax and fiscal burden, particularly of social security contributions, is absolutely necessary. When this is done, the marginal tax burden in the reduction area of the tax credit proposed by the Ifo Institute will also go down. An analysis of reforms that go even further is beyond the task that the Institute assigned itself in this analysis.

In comparison to the present situation and despite these limitations, there are major positive incentive effects resulting from this reform. These can be seen in the curves of panels b) in Figures 3.3 to 3.7 in their deviation from the status quo. The difference between the starting point of the curves and their value with a particular gross income indicates the additional fiscal incentive to earn this gross income through individual effort. All diagrams show that this incentive is very strong. When self-earned gross income of €500 per capita is used as an example to gauge the distance, then the following effects can be seen:

- €307.70 for employable singles (Figure 3.3),
- €331.30 for two employable married people without children (Figure 3.4),
- €307.70 for an employable single with one child (Figure 3.5),
- €331.30 for two employable married people with one child (Figure 3.6) and
- €307.70 for one employable married person in a family with two children (Fig. 3.7).

This then is the difference in net income that results from the Ifo reform proposal by comparison to the present social system, when someone earns €500 through his own

exertions instead of not working. The amounts are not small. Probably there will be considerable movement in the market for low-skilled individuals after the reform.

This is the case even if a qualifying remark must be made: A reform proposal that would bring about a reduction of the withdrawal rate in the very low income area has to deal with the fact that, in a certain income sector beyond the point where social assistance of the old variety phases out, there will be a light increase in the marginal tax burden in comparison to the previous system.⁵² This problem can hardly be avoided. Although the burdens in this income sector are not prohibitive, they can lead to certain reductions of working hours of the individuals affected as opposed to the status quo. The Ifo proposal intends to see that this sector and the changes in household income going along with it plus the marginal tax (and fiscal charge) quota stay as small as possible. With the restrictions given, the best possible compromise will be sought between the rivalling reform goals.

3.7 Wage adjustments, employment and growth effects

Since the reform proposal removes the minimum wage level set up by the present social assistance system, unemployment in the low-wage sector should be eliminated and only some frictional unemployment should remain. Starting with this theoretically sound hypothesis, we will attempt in this section to estimate what sorts of wage reactions come about and identify the determinants of the employment potential in the low-wage sector as a basis for the estimates.

The manpower potential that can be mobilised for the low-wage segment of the regular labour market is composed of registered unemployed, participants in employment-creating and structural-adjustment measures and employable social assistance recipients not yet included. Essentially individuals with low qualifications, i.e. without completed vocational training, come into question.⁵³ Individuals registered as unemployed and

⁵² According to panels a) in Figures 3.3 to 3.7, this sector begins at the point where the net income curve after the reform is farthest over the net income curve before the reform. It ends where both net income curves meet again.

⁵³ According to the data presented in Chapter 1, 37% of all registered unemployed individuals are low skilled in this sense. This quota is used here not only for registered unemployment sub-groups – recipients of unemployment benefits and unemployed individuals who don't draw benefits – but also for participants in active labour market programmes (ABM and SAM). With formally qualified unemployment assistance recipients, it can as a rule be assumed that their qualifications are essentially worthless after at least one year of unemployment and that they can only find employment short- and middle-term in the low-wage sector. In the group of employable social assistance recipients from 18 to

participants in labour market policy programmes can be assumed to be employable. Sick and disabled individuals as well as those in training or continued education are excluded. Limitations on employability due to having to stay home (caring for children) will also be considered, but there will be more stringent rules concerning the age and number of children being cared for. As opposed to the Federal Office of Statistics classification, all individuals between the ages of 18 and 64 (instead of 18 and 59) will be included.

An overview of the presently unused manpower potential can be found in Table 3.2. When the figures are purged of social assistance recipients who draw unemployment benefits or unemployment assistance at the same time, then there is a total number of ca. 4.5 million employable individuals between 18 and 64. The larger percentage presently receives welfare benefits; a smaller percentage receives no benefits or is employed in active labour market policy measures. From these groups, 2.7 million individuals can be counted as belonging to the group with minimum qualifications who could possibly be employed in the low-wage sector. Getting them back into regular employment is a primary concern of the Ifo proposal.

Unemployment benefit recipients and participants in labour market policy measures who have completed an apprenticeship or have other higher qualifications probably play a temporary role in the expansion of the low-wage sector aimed at. Their re-entry into the labour market after a longer period of unemployment may only be possible through employment that doesn't correspond to the level of their formal qualifications. They will be able to get back into permanent employment with higher professional demands if the negative incentives of high wage replacement rates and other restraints on more employment in Germany are removed.⁵⁴ Additional reforms that aim primarily at overcoming unemployment in other labour market segments and especially result in higher flexibility of collective wage agreements and changes in dismissal protection for regular employment can by no means be ruled out. Here they are outside the sphere of interest in the reform proposal being considered.⁵⁵

64 years, 63.7% have minimum qualifications (including individuals whose professional qualifications are unknown). Also included are recipients of additional social assistance who are formally qualified but assumed to have devaluated qualifications as unemployment assistance recipients. There is little known about the length of non-employment of any other formally qualified social assistance recipients.

⁵⁴ The proposed abolition of unemployment assistance that not only keeps the general minimum wage level at the present social assistance level but also fixes even higher reservation wages for qualified wage earners is crucial to the mobilisation of a part of this group.

⁵⁵ It should be made clear that all unemployed individuals, qualified or unqualified, are to be subject to the same legal conditions under the Ifo reform proposal. Even employable social assistance recipients

Tab. 3.2 Non-utilised potential work force for employment
in the low-wage sector of the German labour market

	Total (aged 18–64 years)	of which: Potential work force for low-wage jobs
Registered unemployment:	3,865,424	2,347,804
• Recipients of UI benefits	1,694,576	626,993 *
• Recipients of U assistance	1,456,663	1,456,663
• Receiving no benefits	714,185	264,248 *
Participants in ALMP programmes:	278,828	103,166
• <i>Arbeitsbeschaffungsmaßnahmen</i>	174,914	64,718 *
• <i>Strukturanpassungsmaßnahmen</i>	103,914	38,448 *
Employable recipients of Social assistance:	941,786	659,643
∧. Individuals already accounted for:		
Recipients of UI benefits	76,207	39,140
Recipients of U assistance	144,474	144,474
Receiving no benefits	380,022	195,979
Potential work force:	5,086,038	2,731,121
∧. Search unemployment (20 %)		469,581 *
No. of jobs needed for full employment:		2,261,540

Sources: *Bundesanstalt für Arbeit* (Federal Labour Office),

Statistisches Bundesamt (Federal Office of Statistics), Ifo calculations (* estimated).

The estimates in Table 3.2 are based on the premise that there will be a certain level of long-term “frictional unemployment” in the low-wage sector as in other labour market segments, which may only be temporary in every individual case but as a whole constitutes a permanent condition. The existence of this hard-to-calculate phenomenon makes it seem unrealistic to bring about the employment of the total manpower potential available for this sector at a given point in time.⁵⁶ If the percentage of (registered) unem-

with vocational qualifications will be required to start community employment if they wish to draw benefits up to the previous social assistance levels. As a consequence of additional labour market reforms, the largest percentage of these individuals should then start regular employment in the regular labour market. The possible costs of employing qualified manpower in the second labour market will be factored out of the following fiscal calculations in order to keep the various problems separate and explore primarily the effects of the reform proposed.

⁵⁶ As a rule of thumb it is often assumed today that one quarter of the present unemployment quota of almost 10%, in other words, 2.5% is an indication of “full employment”. This stipulation seems arbi-

ployment in the low-wage sector resulting from continuously starting and stopping work is estimated at 20%,⁵⁷ then it can be assumed that around 2.26 million new jobs could be created through a change in the basic conditions for labour supply and demand in the low-wage sector.

The major question is: Which wage changes are necessary to allow the development of an additional demand of this scale for low-skilled work? Concretely the question should read: “By what percent do the present wages for low-skilled wage earners have to change in order to create 2.26 million additional low-wage jobs?” For greater anticipated employment changes this question can be answered with the help of the formula

$$\Delta \ln w = \frac{\Delta \ln B}{\eta}$$

in which η is the wage elasticity of employment demand (taken as a constant), w the wage rate and B employment in the low-wage sector. The Δ before a variable indicates the change of (just) this variable.⁵⁸ In the literature on the wage elasticity of employment demand, there are various empirically based studies or studies based on theoretical considerations. They concentrate on different single effects that influence the overall wage and employment adjustments, relate to different time horizons within the course of adjustment and have to do with the various labour market segments and countries. Different concepts of elasticities are usually distinguished:

trary, since in the 1960s an unemployment rate of less than 1% was considered normal. Since the search for low-wage jobs shouldn't last very long due to the relative unimportance of specific job training as long as such jobs are available, then the frictional unemployment in the low-wage sector should be lower than in the labour market as a whole.

⁵⁷ This is still a rather high value that would tend to lead to an under-estimation of possible employment effects of the proposed reform measures. It is assumed that the number of frictional unemployed individuals remains unchanged, but not necessarily their identity over time. When calculating the fiscal effects tied to these estimates, one has to consider that individuals affected by search unemployment will be entitled to receive unemployment benefits almost without exception due to the much lower average length of their unemployment.

⁵⁸ The general formula for an adequate employment demand curve is $B = A w^\eta$, in which A is an arbitrary scale parameter derived from the form of the production function, the capital stock and its adjustments as well as the state of technical knowledge. Since the anticipated elasticity η is based on estimates which were only made for small, somewhat “marginal” changes of the relevant indicators, for lack of better data generalised conclusions have been drawn that apply only in a limited sense to changes of a magnitude not to be observed in reality.

- an elasticity which, at a given level of output, relates to the substitution of capital through labour or of qualified through unqualified labour and turns out to be relatively small;
- an elasticity which, given the current stock of capital invested, captures both substitution effects and scale effects and is much higher due to increased production resulting from wage reductions;⁵⁹
- an elasticity which takes into account that, over and above this, wage reductions make an increase in invested capital worthwhile and this in turn increases the demand elasticity even more.⁶⁰

In addition, it is possible to differentiate between elasticities after the time lapse between wage reductions and the reaction of the firms. The short-term possibilities for absolutely necessary technical substitution processes are low, but the more time that goes by, the greater the reactions.

In any case, only the data for the second and third of these values is important for the question examined here, since there would certainly not be an exodus of capital after a wage reduction. Table 3.3 gives an overview of the most important findings on wage elasticity. It remains partially unclear which of the elasticities is being referred to in the estimates and how much reaction time there is. The estimates in the order of magnitude of 2 refer to mid- and long-term reactions that take place based on a given amount of capital employed. The lower values refer to the short periods and elasticities of the first type.

Unfortunately it is not clear if the estimates have any thing to do with the employment effects within homogeneous quality classes of labour as would be necessary theoretically. By not mentioning this point, the existing estimates give the impression that the

⁵⁹ In terms of linearly homogeneous production functions, this elasticity, when it includes the whole labour force, equals the quotients from elasticity of substitution between labour and capital and the partial production elasticity of capital. Since the latter is in the area of app. 0.3 and the former app. 0.6, then there is a designated value for demand elasticity of approximately 2. If a subset of a homogeneous labour market is examined, then the elasticity is greater on account of the small number of reference figures and if a subset complementary to another subset is examined, then the elasticity can be less.

⁶⁰ In a simple neo-classic model of open economies, “extremely long-term” can mean that the wage elasticity of employment demand is infinitely high. The relative scarcity of employment and capital or any other production factors is then defined in international standards. Under these circumstances, efficient technology available to every economy determines the factor prices. And through variations in wage rates in individual economies, there is then full employment with the “right” choice of factor price relation or otherwise unemployment of 100%. In reality the equilibrium mechanisms identified in this way are noticeable, but due to diverse frictions and continuous new shocks, the adjustments never end.

necessary homogeneity is only assumed. It can therefore be suspected that the estimates partially refer to the demand effects of a marginal reduction of wage costs without the implied reduction of the intra-marginal wage costs that could be expected with homogeneous classes.

As a result, the picture delivered by the estimates mentioned is rather unclear. To make things simpler concerning the mid- and long-term relevant elasticity, a “middle” value for the wage elasticity of employment demand of -1 will be assumed.⁶¹ As the rule of thumb for the estimates, one per cent wage reduction in the low-wage sector will bring about one per cent more employment.

Tab. 3.3 Wage elasticity of labour demand: estimates

Source	Estimate related to...	Result
Franz and König (1986)	Manufacturing (D)	-0.96
Burgess (1988)	Manufacturing (UK)	-1.85
Nickell and Symons (1990)	Manufacturing industry (US)	-1.92
Sinn (1992)	Total economy (D)	-2.00
Zimmermann and Bauer (1997)	Low-skilled individuals (D)	-0.85
Riphahn, Thalmaier and Zimmermann (1999)	Low-wage sector (D)	-0.6
Buslei and Steiner (1999)	Low-wage sector (D)	
	• Persons: Males	-0.61
	Females	-0.19
	• Hours worked: Males	-0.67
	Females	-0.45
Schneider et al. (2002)	“Mini jobs” (D, < €325 p.m.)	-2.04
	Low-wage sector (D, €325–910 p.m.)	-1.14

Source: Compiled by the Ifo Institute.

The rule of thumb assumes that employment adjustment would not be limited through slower or weaker reactions of employment supply, but with a given employment supply would depend alone on the reaction of the demand side. Based on the assumption that

⁶¹ What speaks for a relatively low elasticity is the fact that the low-wage sector has a complementary relationship to the rest of the economy, for a relatively high elasticity the fact that only a partial segment of the labour market is being considered. A given wage reduction that brings about a specific amount of additional employment leads to an even larger percentage increase in employment the smaller the subset of the labour market is that it applies to. See European Economic Advisory Group at CESifo (2002, p. 78). The empirical questions that arise in this context are by no means resolved.

the present employment in the low-wage sector (*B*) can be approximately documented through the number of wage earners without completed vocational training subject to social security contributions (2000: 4,640,000 individuals)⁶² while the increase aimed at (ΔB) is obtained from the figures in Table 3.2, then a reduction of the present lowest wage rates within the low-wage sector of approximately one third (32.9%) is necessary to create the 2.26 million jobs that should come into existence on a continuing basis.

If the current hourly wage for less-qualified workers is set at approximately €8.70 on the basis of these estimates,⁶³ then it has to be reduced to €5.80. With full-time employment of app. 150 hours a month, the gross monthly wage will be ca. €870 and this amount will be increased through the new wage tax credit (depending on the type of household). The net household income would be between €830 (single wage earner) and €1,635 (married couples with a single earner and two children).

The effects of the reform on macroeconomic growth are as important as the employment effects. A total of just under 2.3 million potential workers for whom there is mid-term additional employment in the low-wage sector can be equated to an increase of 6% in the total number of wage earners. Since these are minimum qualification and low-paying jobs, their contribution to the national product is below average. At the same time the growth effect is appreciable.

The starting point for the evaluation of an increase in macroeconomic output coming from additional wage earners is the value added earned by them, or the wage bill including employer contributions to social security and the value added tax. If the total manpower potential were absorbed by the regular labour market, an aggregate wage income of just under €22 billion from the additional wage earners in the low-wage sector and an additional value added of €30.7 billion traceable to labour as one of the factors of production could be anticipated.⁶⁴ This is the lower limit for the actual additional

⁶² See *Statistisches Bundesamt* (Federal Office of Statistics), *Fachserie 1, Reihe 4.2.1*, 1999, p. 18.

⁶³ This estimate is based on data from the *Bundesministerium für Arbeit und Sozialordnung* (Federal Ministry of Labour and Social Affairs; 2002, Tab. 5) and WSI (2001). It attempts to use an average for low-wages geared more to actual earnings than to a negotiated wage rate and accommodates through this the lower wage drift in the service sector by comparison to the manufacturing sector.

⁶⁴ The same calculations are the basis for these estimates as for the subsequent determination of the fiscal effects from the Ifo reform proposal. With a complete integration of the manpower potential of 2,26 million individuals into the regular labour market, social security contributions will come to €9,069 million out of the payroll of additional wage earners amounting to €21,959 million with a 41.3% accumulated employer/employee rate of contribution to social security (See Table 3.7, Scenario 1). Not included in the payroll are the employers' contributions themselves (20.65%) and cumulative value added tax (16%). When these items are included, the additional value added to the market prices derived from the work factor totals ca. €30,732 million.

value added, since complementary factors (return to capital and wage income for qualified work) have to be added to the increase of income gained. Based on a simple estimate, this comes out to yearly welfare gains of €38.4 billion.⁶⁵ This is equal to an increase in the gross domestic product of about 1.9%. This additional surge in growth occurs only once in the process of expanding the low-wage sector but can be spread out over several years. It raises the growth path level and with it long-term economic performance. Each year the gross domestic product will increase by 1.9% more than it would have without the reform. With a long-term interest rate of 4% in real terms or only with a static calculation, this implies a present value of long-term welfare gains of just under half of the current German national product or €1,000 billion. This figure shows very clearly what dimensions are actually involved in the creation of a low-wage sector in Germany

3.8 Changes in the distribution of income

The reform of the social assistance system explained in the previous sections has complex distribution effects that are determined by the reaction of the wage rate and by granting a new wage tax credit for employees in the low-wage sector. How individuals or households will be affected by the reform depends in the first place on whether they were social assistance recipients or already employed in the low-wage sector.

Employable social assistance recipients will be employed either in the regular labour market where their decreased wages can be increased through the tax credit to above the current level of social assistance or they can take up community employment and receive exactly the current social assistance rate. They will receive greatly reduced entry-level benefits only if they refuse government organised employment. Those who opt out would in most cases be individuals who have other sources of income (outside support, illegal work, investment income etc.) that is not included in the calculations here. Those who were already employed in the low-wage sector before the reform will have to accept wage reductions that accompany the expansion of this labour market sector.

⁶⁵ Assuming an iso-elastic employment demand of (with $\eta = -1$) that at the same time indicates the slope of the value added of additional work used, then the integral under this curve can be estimated as follows: Since employment in the low-wage sector will almost double and the wages (at least of the new jobholders) will be reduced by about one third in comparison to the previous wage rate, the marginal value added of the “first” new entrants will be half as much as that of the “last” entrant. If a simplified version of the triangular formula is used (despite the crooked run of the curve) to determine the percentage of value added which is not included in total gross payroll with the employer’s shares of the social security contributions and indirect taxes, then amount of €30.7 billion increases by an additional quarter.

Individuals whose income was not very much above the previous level of social assistance will be most affected, since it can be assumed that their performance level will be very similar to that of the new entrants coming in. Furthermore, it is likely that the income of this group will decrease by about 33% (assuming an unchanged total number of man-hours worked). For wage earners whose income diverges the most from the previous level of social assistance due to their higher productivity and whose performance level cannot be substituted for by the new jobholders, there will be only a minor income loss of 2.4%. When all 11 income categories (created for the sake of calculation by dividing the low-wage sector into categories) are averaged together, there is an income reduction of 16.5%. This is the equivalent of half the amount of the reduction of the lowest gross wages in the low-wage sector (33%) necessary for the creation of 2.26 million new jobs. The majority of incumbent jobholders affected by the wage reduction will have the same opportunity as new entrants to take advantage of the wage tax credit. Through this they will be compensated to a great extent for the wage reduction that can be expected from the new welfare-to-work approach. In terms of distributional effects, incumbent jobholders taking advantage of the wage tax credit is indispensable for the Ifo model to function.

A simplified overview of distribution effects can be gained when the changes are analysed in the income of several household types. For example, former social assistance recipients new to the labour market will receive a gross income of €870 a month for full-time employment (150 hours a month) with a gross hourly wage of €5,80. For a previously employed wage earner who had earned €1,300 per month to date, his/her gross income will be reduced to €1,110 per month through the expansion of the low-wage sector. This middle range, low-wage earner could expect a wage reduction of about 15%.

To calculate changes in net household income, taxes and social security contributions have to be deducted from gross income and the children's allowance and tax credits added. Table 3.4 clearly shows that the transition into paid work provides financial advantages for all former social assistance recipients. Depending on the type of household, there is a difference in net household income of around €90 to €420 per month before and after the reform. Moreover, this implies that there is a large enough wage difference between community and regular full-time jobs which (with increased labour demand) will provide an important incentive to give up a government-supplied job as quickly as possible for one available in the regular labour market.

The situation is somewhat different for individuals who were already employed in the low-wage sector before the reform. Table 3.4 shows that in all households with one wage earner, inclusion in the system of wage tax credits offsets the wage reductions brought about by the reform for the most part. Singles and single parents with one child would lose about €30 a month of their net household income. For households with two wage earners both employed full-time, the income would sink anywhere by €140 to €210. The major reason for this is the anticipated wage reduction for individuals already working due to the expansion of the low-wage sector and not the decrease in transfer entitlements. In the examples used above, the sum of two (full-value) gross earned incomes was ca. €2,600 before the reform and ca. €2,200 after the reform. As such it remains in the reduction area of the tax credit or outside of it, even when both sets of wages are earned in the low-wage sector. The combination of assumptions used here, specifically the idea of full-time employment of both partners in family households, is fairly extreme. The tax credit can still develop its compensatory effect almost completely through a combination of full-time employment of one partner with part-time employment of the other.

Tab. 3.4 Income effects of the reform for various types of households
(direct subsidies and wage adjustments)

	Net household income (€ per month)				
	Former recipients of Social assistance			Formerly employed	
	before the reform	after the reform: employment...		before the reform	after the reform
		in the regular labour market	publicly organised		
Single without children	624	830	624	932	900
Single parent with 1 child	1,029	1,133	1,029	1,237	1,203
Married couple (1 wage earner)					
– without children	984	1,151	984	1,127	1,221
– with 1 child	1,282	1,370	1,282	1,425	1,441
– with 2 children	1,520	1,635	1,520	1,663	1,705
Married couple (2 wage earners)					
– without children	984	1,408	984	1,838	1,638
– with 1 child	1,282	1,627	1,282	2,011	1,800
– with 2 children	1,520	1,890	1,520	2,172	2,031

Assumptions: Full-time employment for all wage earners living in the household, either in the regular labour market or in jobs publicly provided; before the reform, hourly wages in the low-wage sector of the regular labour market are set to 8.70 €; after the reform, they are taken to be 7.40 € for those already employed and 5.80 € for former recipients of social assistance who enter the labour market.

Source: Ifo calculations.

The former recipients of unemployment assistance whose benefit entitlements could have been higher before the reform than the old level of social assistance will not be examined here. As a rule recipients of unemployment assistance will receive a lower net household income after the reform. A worse placement financially can only be excluded for low-skilled recipients of unemployment assistance who receive social assistance in addition (before the reform). The other recipients of unemployment assistance will probably at first be worse off financially, but by starting low-wage jobs they will have the chance to earn higher income later. Through the opening of the regular labour market to the long-term unemployed and individuals without vocational qualifications, there are additional advantages, i.e., learning effects, establishment of social contacts, increased self-esteem and avoidance of the means test. The reinstatement of unemployment benefit entitlement and the acquisition of pension claims are also improvements that are not reflected immediately (if at all) in net household income.

3.9 Fiscal effects

In calculating the fiscal effects from the Ifo reform proposal, the burdens on the budget which come about primarily through the new wage tax credit for wage earners in the low-wage sector will be compared to the relief coming from additional receipts from social security contributions and income tax of additional wage earners (new entrants). Moreover, the costs of community employment will be considered.

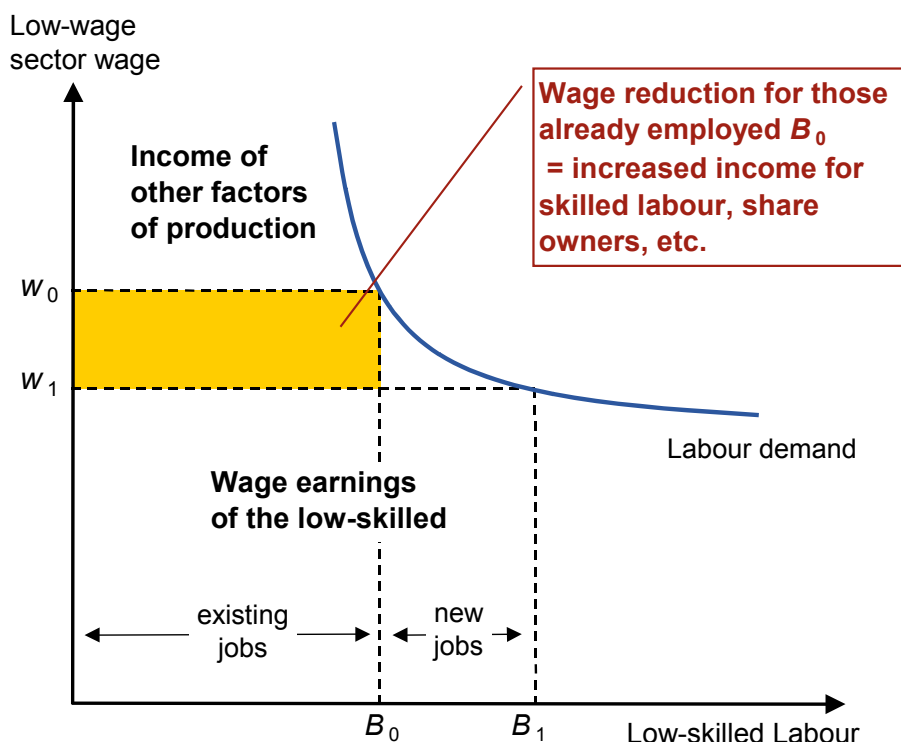
The direct costs and earnings will be included in all accounting. Moreover, the effects from adjustments in gross wages of incumbent jobholders in the low-wage sector will be added to the charge. Their gross wages will be affected by the integration of previously unemployed individuals in the low-wage sector of the regular labour market. As mentioned in the previous section, these wage reductions will turn out to be all the greater the greater the similarity between the kind of labour performed by the existing employees and that of the newly employed, or the smaller the difference between the wages at the beginning and the level of old social assistance. Low wages not near the social assistance level will probably be paid to individuals who perform at a higher level than those finding jobs through the reform and the abolition of the minimum wage going with it. Their wages will only be reduced a bit whereas wages slightly over the level of old social assistance will be reduced more. We estimate that the amount of the wage reduction for incumbents will make up an average of 50% of the wage changes necessary to create the additional 2.26 million low-wage jobs. This means that the wages of individuals already employed will decrease by an average of 16.5%.

To simplify the calculation and remain on the safe side with the estimates, several effects have to be factored out that, taken by themselves, could offer relief for the federal budget. None of the following will be taken into consideration: the indirect effects of Federal budget relief, the reduction of Federal Labour Office functions due to the decrease in unemployment and the value added tax revenue increase due to an increase in value added. In addition, the costs for the required extension of childcare facilities will not be included in the calculation.

The reduction in taxes and social security contributions resulting from wage cuts for incumbent jobholders will not be examined in determining the fiscal effects. The wage cuts will lead to an increase in income of complementary productive factors in exactly the same amount because of the increase in the marginal product in terms of value of these factors. This is merely a redistribution from substitutive to complementary productive factors, among which is higher-valued employment. In looking at the situation more closely, we can assume that this redistribution leads to a shift but not a reduction in government revenues. If there is any change in total revenue it will be in the direction of an increase since the beneficiaries will be located higher in the progressive income tax scale and probably have a larger percentage increase in their tax burden than low-wage earners who will lose income as suppliers of substitute performance. Regardless of this, individuals whose income decreases because of the reform probably will be able to take advantage of the tax credit and this implies a net burden on the budget.

The shift in income for incumbent jobholders is illustrated once again in Figure 3.8 using a homogeneous sub-segment of the low-wage sector. The value added goes up due to the employment increase in this segment from B_0 to B_1 , by the whole area under the demand curve (while the marginal productivity declines). Wages decrease from w_0 to w_1 . Wage payments will decrease for wages earners employed before the reform despite the unchanged value added in their sector. Correspondingly, the income of complementary factors, for example, qualified labour, and the profits for businesses rise by exactly the same amount as the wage losses of incumbents. The relevant area $(w_0 - w_1) B_0$ is coloured in the graph. With this there is an increase in tax revenue and social security contributions elsewhere.

Fig. 3.8 Distribution effects of wage reductions for wage earners already employed in the low-wage sector



Source: Ifo calculations.

The question of how many welfare recipients not previously employed will take up employment, with social security contributions, that is not classified as side-line employment is central to estimating the fiscal effects. Three assumptions will be examined while possible changes in the hidden manpower reserves will not be taken into account. Under assumption 1, all 2.26 million unemployed individuals with minimum qualifications would be absorbed in the regular labour market. Under assumption 2, 1.8 million (80%) of the total manpower potential would find regular jobs, 300,000 would take up community employment and 150,000 would decide not to work. Under the most improbable assumption 3, only 1.4 million (60%) would find jobs in the regular labour market.

The fiscal burdens of the Ifo proposal are caused in the first place by the wage tax credit.⁶⁶ Tax credits will be given to both incumbent and new jobholders within specific household income limits that vary according to household category. To calculate how

⁶⁶ In addition there are some minor charges from additional social assistance grants, but the volume cannot be compared to additional social assistance of the old type.

many incumbent jobholders can take advantage of the tax credit, it is necessary to determine how many wage earners in Germany can be assigned to several household categories with an specific tax credit scale. These figures are based on household and family statistics of the Federal Office of Statistics. The household structure of wage earners in the micro-census is applied to the total number of wage earners subject to social security contributions and civil servants, together 29.0 million in 2000 (Table 3.5).⁶⁷

Tab. 3.5 Fiscal costs of the wage tax credit for incumbent and new jobholders

Type of household ^a	Total employment (thsds.) ^b	Jobholders entitled to receive a wage tax credit (thsds.)	Wage tax credit (€ mill.)
Incumbent jobholders			
Singles	8,138	898	1719
Single parents	1,650	526	763
Married couple (1 WE, no child)	1,808	475	1,294
Married couple (1 WE), 1 child	929	350	877
Married couple (1 WE), 2 children	2,168	1,098	3,276
Married couple (2 WE, no child)	4,556	286	780
Married couple (2 WE), 1 child	2,936	250	652
Married couple (2 WE), 2 children	6,850	583	2,281
Total	29,035 ^c	4,466	11,642
New jobholders			
Singles	688	688	1,619
Single parents	161	161	604
Married couple (1 WE, no child)	123	123	615
Married couple (1 WE), 1 child	69	69	374
Married couple (1 WE), 2 children	162	162	994
Married couple (2 WE, no child)	344	207	867
Married couple (2 WE), 1 child	218	170	662
Married couple (2 WE), 2 children	495	385	1,994
Total	2,262	1,966	7,729
a) WE: wage earner.			
b) As of 2000.			

Source: Ifo calculations.

Next, to determine which percentage of wage earners does not exceed the relevant income limits, the distribution of household income for different household types will be

⁶⁷ Statistisches Bundesamt (Federal Office of Statistics), *Fachserie 1, Reihe 3*, pp. 37, 41 134, and 144–145, *ibid.*, *Fachserie 1, Reihe 4.2.1*, 1999, p. 17, as well as *ibid.*, *Wirtschaft und Statistik 10/2001*, p. 801.

estimated using the distribution of gross earnings for wage earners subject to social security contributions from 1995.⁶⁸ This distribution is assumed not to have changed its structure up to 2001; nevertheless, the income limits were updated with the growth rate of gross earned income (8% for the period between 1995 and 2001).⁶⁹ Moreover, the household income of incumbents should decline as a result of competition from new entrants by an average of 16.5% (assumption 1), 14% (assumption 2) or 11.3% (assumption 3). For a married couple where both are wage earners it is assumed that both earn the same income so that the calculation of the wage tax credit can be based on the total household income.⁷⁰ On the basis of household income distribution calculated in this way, 4.5 million incumbent jobholders should be able to take advantage of the wage tax credit (Table 3.5).⁷¹ The costs of the tax credit for various household types can be calculated with the help of the particular distribution of households based on household income and the individual course of the tax credit scale). They total €11.6 billion for incumbent jobholders (Table 3.5).

Calculation of the wage tax credit for new entrants is similar to that for incumbents, but there is a major difference. Owing to the proposed reform of social assistance, the gross wage will decrease at the lower end of the wage scale. According to the elasticity estimates cited, the minimum wage should decline by 33%. As a result, entrants will, on average, earn a gross income reduced even more than that of the incumbent jobholders in the low-wage sector (whose income will go down by an average of 16.5% since many cannot be replaced by the new entrants). Because of this, the distribution of their household income will deviate from that of the incumbents.

Taking this change into account, the distribution of gross earned wages of incumbent jobholders (see above) will be used as the basis, but at the same time it will be assumed that the new entrants do not earn more than 1,370 Euro per month due to a shift in the distribution function. The costs of the tax credit are by analogy based on the household structure of the entrants and the individual scale for the tax credits according to household type. For entrants, they would amount to €7.7 billion although not all entrants can

⁶⁸ *Statistisches Bundesamt* (Federal Office of Statistics), *Fachserie 1, Reihe 4.2.2*, 1995, p. 17, as well as *ibid.*, *Fachserie 16 (Lohnstrukturhebung 1995), Heft 1*, pp. 29 and 277.

⁶⁹ *Statistisches Bundesamt* (Federal Office of Statistics), *Fachserie 18, Reihe 3, 4* Quarter 2001.

⁷⁰ This leads to an overestimation of fiscal costs since by matching a lower and a higher income, almost all households with two wage earners earn such a high income that there is no longer any wage tax credit entitlement.

⁷¹ Since the wage tax credit is not enough to come up to the new level of social assistance if earned income is too low, in such instances additional social assistance will have to be paid. The same assumptions underlie this calculation as for the tax credit.

claim the tax credit since many married couples with two wage earners will exceed the maximum household income (Table 3.5).⁷²

The total costs for the tax credit based on assumption 1, that is with a maximum employment effect in the regular labour market, are estimated at a total of €19.4 billion which is 0.96% of GDP. In the USA the EITC was 0.3% of GDP in 1999. In Great Britain the WFTC is ca. 0.6% of GDP (OECD 1999, p. 156).

Additional fiscal burdens could arise if only a portion of the manpower potential finds regular work. The rest could either perform community work and receive benefits at the level of social assistance to date or not work and be entitled to greatly reduced benefits. In the case of community employment, the costs are a combination of social assistance benefits averaging €7,490 per person per year and labour and material costs of community employment companies, or loan employment agencies. Current averages taken from the expenditures of the sponsoring agencies for participants in ABM or similar programmes that could be used for relevant cost estimates can only be found with difficulty. The information available⁷³ indicates that €5,000 per person per year is not unreasonable. Higher amounts have also been estimated, however.⁷⁴ Under the circumstances it will be assumed that, on average, €7,500 per person per year will have to be calculated for community employment programmes and that social assistance given without employment will have to be reduced to €4,112 per person per year.⁷⁵

The fiscal burdens connected to the Ifo proposal can be relieved in two ways. The first of these are social security contributions (employer/employee shares) and wage taxes that the new entrants have to pay. In determining these additional public revenues, we assume that entrants will distribute themselves into gross earned wage classes in the same way as was anticipated in the calculations of the tax credit for entrants. Secondly, there will be more relief in the form of savings in social assistance, unemployment benefits and assistance as well as in ABM and SAM as recipients lose entitlements when they take up regular employment in the low-wage sector.⁷⁶ We assume that the

⁷² Additional social assistance will be treated accordingly.

⁷³ Schultz (2002), Schöb (2002) as well as Spitznagel and Bach (2000).

⁷⁴ Project costs for the "Siegen Model" for long-term unemployed are estimated at €11,230 per participant per year (Empfter and Frick 1999, p. 100).

⁷⁵ A weighted average is assumed based on household type.

⁷⁶ According to the Ifo proposal, unemployment assistance benefits plus active labour market measures like ABM and SAM will be dropped. In addition, employable social assistance recipients will no longer receive benefits under the old conditions. The total savings arising from these changes in the law will not be considered in our calculations, but only those that are connected to the withdrawal of unemployed individuals with minimum qualifications from the social security system. Recipients of

expenditures in the individual entitlement sectors will decline in proportion to the percentage of individuals with minimum qualifications among the respective benefit recipients.⁷⁷ Through the savings in unemployment benefits, unemployed individuals with minimum qualifications will only be entitled to below-average benefits⁷⁸ so that the savings through their departure will be less than when an average benefit recipient withdraws from the social security system. The results of the estimates can be found in Table 3.6. Through the reform of the welfare system, there will be savings totalling €16.3 billion (assumption 1).

Tab. 3.6 Fiscal Savings: Social Assistance, Unemployment Benefits, Unemployment Assistance, Active Labour Market Policy Programmes (*ABM* and *SAM*)

Row no.	ITEM	Social assistance	UI benefits	U assistance	<i>ABM</i>	<i>SAM</i>	total
1	Expenditure 2001 (€ mill.)	9,156 ^a	28,584 ^b	8,938 ^b	2,976	871	
2	Recipients 2000 (thsds.)	2,567 ^c	1,695	1,457 ^c	204	110	
3	Potential work force for the low-wage sector (thsds.)	660 (1,049) ^d	627 (298) ^c	1,457	65	38	
4	3 : 2 (%)	40.9	17.6	100.0	31.9	34.5	
5	4 × 1 (€ mill., scenario 1)	3,745	2,415 ^f	8,938	949	300	16,347
6	4 × 1 (€ mill., scenario 2) ^g	3,745	1,926	8,938	949	300	15,858
7	4 × 1 (€ mill., scenario 3) ^g	3,745	1,441	8,938	949	300	15,373

a) Total expenditure 2001 (9,518 € mill.) \. Supplementary social assistance paid to employed individuals (362 € mill).
b) Expenditure \. Social insurance contributions.
c) 2,677 thsds. \. Employed individuals receiving supplementary social assistance (110 thsds.).
d) In brackets: No. of children of welfare recipients.
e) In brackets: Potential work force minus search unemployment (329 thsds.); it is assumed that 70 % of those in search unemployment are receiving UI benefits, while 30 % are not entitled to receive any benefits at all.
f) It is assumed low-skilled recipients of UI benefits are entitled to receive 48 % of average benefits. Fiscal savings are thus 48 % of average savings on transfers (2,415 € mill. = 48 % of 5,031 € mill.).
g) Low-skilled recipients of UI benefits who do not work are entitled to go on receiving their benefits.

Source: *Bundesanstalt für Arbeit* (Federal Labour Office), Ifo calculations.

unemployment assistance with completed vocational training will be classified as having minimum qualifications due to their loss of skills as a result of long-term unemployment. Recipients of unemployment benefits will continue to receive them if they can find no regular employment.

⁷⁷ See an earlier section for a calculation of the manpower potential.

⁷⁸ The amount of unemployment benefits for recipients with minimum qualifications has been calculated from data provided by the *Bundesanstalt für Arbeit* (Federal Labour Office) on the structure of recipients of unemployment benefits by the amount of benefits received (September 1998). *Bundesministerium für Arbeit und Sozialordnung* (Federal Ministry for Labour and Social Affairs; 2000, p. 118 ff.).

In addition to both of these main savings areas, there will be additional budget relief since incumbent jobholders can no longer receive additional social assistance as they did before. In 1999, 150,000 wage earners (65,000 full-time and 85,000 part-time) received additional social assistance (Haustein 2001, p. 377). A percentage of them, 40,000 part-time wage earners, would have fallen under side-line employment not included here. The remaining wage earners with compulsory social security contributions (for lack of better statistical information) can be assumed to have social assistance entitlement at the level of the net entitlement for a full-time or part-time single person of €259 or €297 per month.⁷⁹ With this there will be additional savings of €362 million per year.

Table 3.7 compares the total fiscal burdens of the three options. If according to assumption 1 it is possible to integrate all 2.26 million unemployed into the regular labour market, this would lead on balance to fiscal savings of €6.2 billion per year. Additional charges due to the wage tax credit amounting to €19.4 billion are counterbalanced by relief through additional social security contributions of €9.1 billion and savings in social benefits of €16.3 billion. Even if it were only possible to get regular jobs for 1.8 million unemployed people (assumption 2), the public authority would still be able to save €2.8 billion. There will be a minor fiscal cost if only 60% of the manpower potential find a regular job (assumption 3).

The fiscal effects have been calculated based on somewhat restrictive assumptions. For example, the higher net income of the new entrants leading to an increase in value-added tax and further indirect effects was not considered. In addition, in the calculations above, a direct transition to a new state of equilibrium was assumed. Adjustment processes that last longer would result in a year-to-year-change in the balance sheet of fiscal burden and relief until the equilibrium situation examined here is reached. As a rule it can be expected that the budget effects will not be so favourable at the beginning, but improve over time as a growing number of individuals find a way into better employment in the private sector.

⁷⁹ Calculations based on micro-data files of a representative 25% sample of recipients of social assistance (*Statistisches Bundesamt/Federal Office of Statistics 2000*).

Tab. 3.7 Fiscal Effects (€mill.)

Budget item	Scenario 1	Scenario 2	Scenario 3
Expenditure			
Wage tax credit (incumbent jobholders)	11,985	11,128	10,304
Wage tax credit (new jobholders)	8,281	5,817	3,720
Social assistance with publicly provided jobs	—	2,247	4,516
Overhead costs publicly provided jobs	—	2,250	4,523
Social assistance without working	—	370	744
	20,266	21,812	23,807
Revenues and Fiscal savings			
Social insurance contributions (new jobholders)	9,069	7,795	6,283
Income taxes (new jobholders)	653	560	467
Reductions of welfare benefits	16,347	15,858	15,373
Reductions of supplementary social assistance paid to incumbent jobholders	362	362	362
	26,431	24,575	22,485
Total	6,165	2,763	-1,322
<p>Scenario 1: The total work-force potential of 2.26 mill. individuals takes up employment in the regular labour market. Assumed reductions of wages: 33 % / 16,5 %.</p> <p>Scenario 2: 1,81 mill. individuals (80 %) are absorbed by the regular labour market, 300.000 individuals enter publicly provided jobs, 150.000 individuals do not enter employment. Among the latter 90.000 (60 %) are receiving reduced social assistance benefits, 60.000 (40 %) are entitled to receive UI benefits. Assumed reductions of wages: 28 % / 14 %.</p> <p>Scenario 3: 1,36 mill. individuals (60 %) are absorbed by the regular labour market, 603.000 individuals enter publicly provided jobs, 301.000 individuals do not enter employment. Among the latter 181.000 (60 %) are receiving reduced social assistance benefits, 120.000 (40 %) are entitled to receive UI benefits. Assumed reductions of wages: 22,6 % / 11,3 %.</p>			

Source: Ifo calculations.

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