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Social Welfare Reform and the Low-Wage Labor Market in Germany – What Works, and What Doesn't? *)

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Abstract:

Various social and labor market reforms, such as the reduction of unemployment benefits and social assistance, the substitution of these transfers by "in-work" benefits, and stricter work requirements, have been suggested in the German economic policy debate with the aim to increase employment in the low-wage sector thereby reducing unemployment among low-skilled workers. This paper shows that, although pointing into the right direction, these reforms as implemented by the German government's "Agenda 2010" will not have the intended impact on the labor market because they do not properly address the incentive problems inherent in the German welfare state. I propose a coherent social welfare reform which would increase work incentives for unemployed people with low earnings potential. It is shown that the proposed reform would lead to a marked increase in employment in the low-wage sector of the German economy without resulting in an unsustainable increase in social expenditures.

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1 From Welfare to Workfare – A Solution to the German Unemployment Problem?

Among economists and the general public alike, the view has increasingly become popular that relatively generous income support programs for unemployed people have contributed to the high level of unemployment in Germany.[1] There are basically two arguments for this belief: The first is that, due to the small difference between net income from full-time employment in a low-wage job and the level of social assistance for certain household types, there is no or very little financial incentive to take up work in the regular economy. In other words, the benefit withdrawal rate for social welfare recipients is simply too high, and this negative incentive effect is reinforced by high social security contributions and income taxes which already set in at relatively low earnings. The other argument refers to the role of social welfare in sustaining a relatively high market wage: the social minimum effectively sets a lower wage floor for low-skilled labor. Although the basic problem according to both views is really the relatively high level of social welfare, the first view stresses the supply side, whereas the second emphasizes the demand side of the market for low-skilled labor. Of course, both sides of the labor market are affected, and these arguments are complementary rather than substitutes for each other.

Various approaches have been suggested in the literature and in the economic policy debate to make work financially more attractive relative to non-work. At the one extreme, there are policies which "wield the stick" of time-limited welfare entitlement and strict work requirements. These instruments have played a major role in the US welfare reforms of the 1990s (Blank 2002, Moffitt 2003), but also in some European countries, like Denmark, Sweden and the United Kingdom (see EEAG 2003). At the other extreme, there are reforms mainly relying on the "carrot" of earnings-related subsidies for people with low earnings potential. As discussed below, this may be administered by reducing the benefit withdrawal rate of social welfare, subsidies to social security contributions, a negative income tax on low earnings, or a combination of these instruments. The Earned Income Tax Credit in the United States and the Working Family Tax Credit in the United Kingdom are well-known examples of earnings-related subsidies. There is also an intermediate approach which combines the carrot of earnings subsidies with the stick of a reduction or even a complete cut of social welfare for those who choose not to work. The US welfare reform of the 1990s and the "New Deal" in the UK are recent examples of such reforms (see, e.g., Blank 2002, Blundell 2000).

[1] Recent prominent subscribers to this view include Sinn et al. (2002), the German Council of Economic Advisors (Sachverständigenrat 2002), the Scientific Council of the (former) Federal Economics Ministry (Wissenschaftlicher Beirat 2002), and the European Economic Advisory Group (EEAG 2003).

In Germany, too, there have recently been various proposals to reform social welfare with the intention to increase work incentives in Germany, thereby reducing unemployment of low-skilled workers and increasing employment in low-wage labor markets. One of the most controversial issues in the recent German debate relates to the alleged disincentive effects of social assistance and unemployment assistance. These programs, which constitute the German version of "social welfare", provide means-tested income support at a socially defined minimum income without a pre-specified time limit. There has recently also been some discussion on time-limits of social welfare and the enforcement of strict work tests in Germany, and several communities have been experimenting with time limits and strict work requirements (see Feist and Schöb 1998, Sinn et al. 2002).

The recent reform steps of the German government under its so-called "Agenda 2010", such as subsidized social security contributions on low earnings ("Mini-Jobs"), and the proposed integration of unemployment assistance and social assistance, are intended to increase employment in the low-wage sector of the economy. However, as I will argue in this paper, the government's Agenda 2010 as implemented so far is not likely to achieve its intended aims. With the exception of the reduction of entitlement periods for unemployment benefits, the government's reforms seem unlikely to have a strong impact on unemployment in Germany. The reasons for this pessimistic view are, first, that the social welfare and the mini-job reforms do not set proper work incentives and, second, there is no effective work test reinforcing the potentially positive effects of these reforms.

To set the scene for the discussion of social welfare reforms in Germany, the next section presents some theoretical background on the relationship between earnings-related subsidies, work incentives and employment in low-wage labor markets. The focus is on the financial incentives and various labor supply responses induced by the introduction of an earnings-related subsidy on top of social assistance. In section 3, I will briefly summarize and evaluate the main reforms under the German government's Agenda 2010 aimed at reducing unemployment and increasing employment in the low-wage sector of the economy. These include the reform of unemployment compensation and social assistance, stricter work requirements, and the recent mini-jobs reform. In section 4, I will present a more radical welfare reform proposal for Germany and present empirical results on its expected work incentive, labor supply and employment effects. The concluding section 5 summarizes implications for economic policy derived from the preceding analysis.

2 Earnings-Related Subsidies, Work Incentives, and Employment in Low-Wage Labor Markets

In the German debate on social welfare reforms earnings-related subsidies have been suggested to improve work incentives and as a means to increase employment in low-wage labor markets (for recent summaries see, e.g., Buslei and Steiner 2003, Zimmermann 2003). Proponents of earnings-related subsidies expect them to improve financial incentives to take up low-wage jobs. To some extent, these proposals have been motivated by the experience with the *Earned Income Tax Credit* (EITC) in the United States.[2] The EITC is a subsidy (a negative tax) on low earnings which depends on the level of earnings and on the number of children. In the year 2001, the subsidy rate for a family with two children and earnings below 10,020 US$ was 40%, the maximum subsidies thus amounted to about 4,000 US$; for earnings between 10,020 and 13,090 this subsidy remains constant. For earnings exceeding this latter amount, the subsidy is withdrawn at a rate of about 21%. This so-called phasing-out region ends at earnings of 32,121 US$ when the subsidy has been completely withdrawn (see Moffitt 2003: 132).

With about 55 million people supported by the EITC at a total cost of US$ 26 billion in 2000, the EITC is now the largest social program in the United States. The large number of supported people is often considered prima facie evidence for the effectiveness of EITC type earnings subsidies. However, theoretical and empirical analyses do not necessarily support this view, as discussed below.

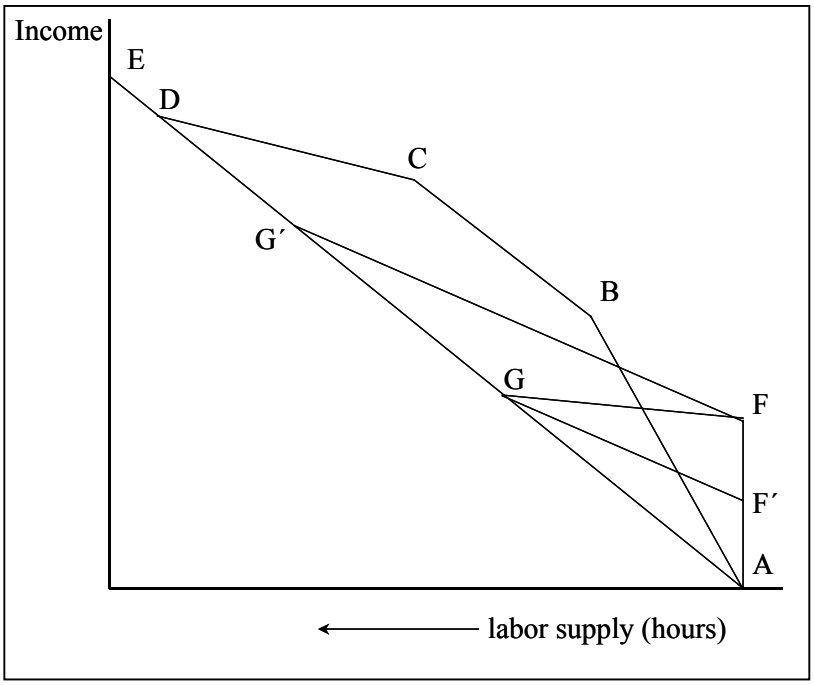
2.1 Social Assistance and Earnings-Related Subsidies

Economic analysis of the effects of social assistance and earnings-related subsidies on work incentives generalizes the household's budget constraint of the standard neoclassical leisure-income choice model by explicitly introducing these transfers into the model (see, e.g., Moffitt 2002). Figure 1 illustrates the basic arguments. Assuming for simplicity that there are no other taxes or transfers on gross earnings, the budget constraint of the household in the absence of social assistance and the earnings-related subsidy is given by the line AGE. The budget segment ABDC represents an EITC type earnings subsidy with the three ranges mentioned above, with the segment CD representing the phase-out range. The budget segment AFG represents a social assistance program with a relatively high social minimum and a very high social assistance withdrawal rate of, say, 90%. Assuming that social assistance is not

[2] A similar earnings subsidy called the Working Families Tax Credit (WFTC) has recently also been introduced in the UK (see Blundell 2000, Blundell et al. 2000).

included in the calculation of the earnings subsidy, the total marginal tax (withdrawal) rate relevant for an individual's labor supply decision is the sum of the rates of the two programs. Since the earnings subsidy implies a negative tax rate at low levels of earnings, an individual entitled to social assistance and working at the first phase of the EITC faces a low marginal tax rate because the benefit withdrawal rate is reduced by the amount of the EITC rate. In case of a 90% social assistance withdrawal rate and a wage subsidy on low earnings of, say, 40%, the overall withdrawal rate or marginal tax rate (negative tax and social assistance withdrawal rate) would be 50%.

Figure 1: Social assistance and earnings-related subsidies



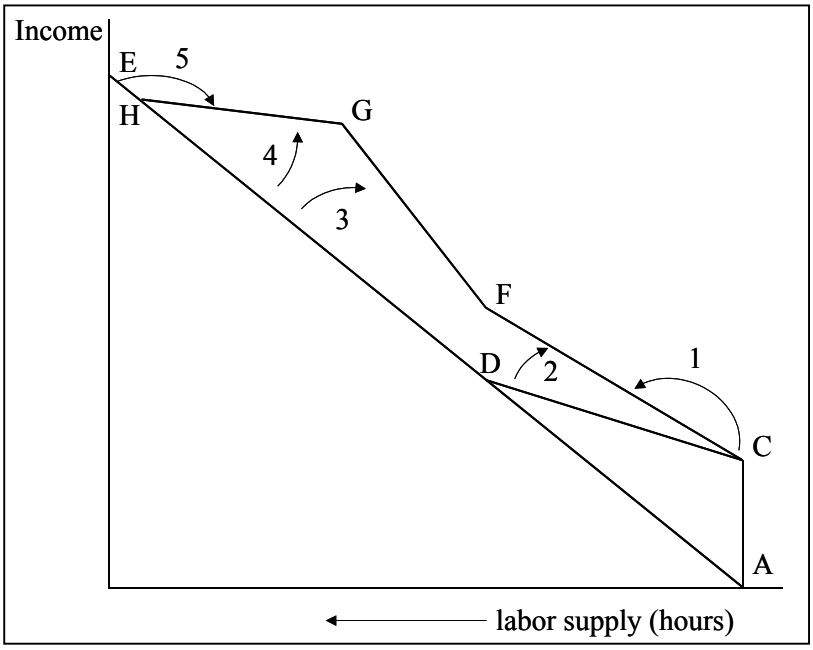
To increase work incentives it is often proposed to reduce the social assistance withdrawal rate. As illustrated in Figure 1, however, a substantial reduction of the witdrawal rate is only feasible if the social minimum is simultaneously reduced substantially (from F to F', say). Otherwise, the transfer range would extend well up into the phase-out region of the earnings-related subsidy, i.e. to point G' in Figure 1 (the lines F'G, representing a withdrawal rate of, say, 50%, and FG' are drawn to be parallel). This would not only be very expensive in budgetary terms, but would also imply a relatively high cumulative marginal tax rate on earnings in the phase-out range. Assuming a withdrawal rate of 20%, say, on the earnings-related subsidy in this range and a 50% social assistance withdrawal rate, the cumulative marginal tax rate on earnings below G' would be 70%.

These calculations assume that social assistance is not taken into account in the calculation of the earnings-related subsidy. If this was not the case, there would be little financial incentives to take up work for someone eligible to social assistance, depending on the respective withdrawal rate. If it approached the value of 1, as it is the case in Germany, entitled individuals would have no financial incentives at all to expand working hours.

2.2 Work Incentives and Labor Supply Effects

The complex non-linearities in households' budget constraints introduced by the existence of means-tested social assistance and earnings-related subsidies induce a variety of labor supply effects typically ignored in popular discussions on the labor market effects of social reforms. Some of these effects are illustrated in the following figure (see, e.g., Moffitt 2002 for a more detailed discussion).

Figure 2: Work incentives and labor supply



Similarly to the previous subsection, the budget segment ACD represents the social assistance scheme, where the respective benefit withdrawal rate determines the slope CD. The budget constraint ACFGH represents the combined effects of social assistance and an EITC of the type defined in the previous subsection. As drawn in the figure, social assistance is assumed to have been completely withdrawn when the end of the phase-in range of the earnings subsidy (represented by the segment CF) is reached. Hence, it is assumed that at low earnings (within the phase-in range) social assistance is not taken into account in the calculation of the earnings subsidy. Net household income within the phase-in region therefore increases by a

factor of (1 – cumulated tax rate), where the cumulated tax rate has been defined above. If social assistance was completely withdrawn in case of positive earnings, the budget segment CF would coincide with the line CD.

The labor supply responses induced by the introduction of an EITC on top of a social assistance scheme are illustrated in Figure 2. The arrows indicate that, depending on an individual's initial position on the budget constraint, the effect of introducing an EITC may go in either direction. For individuals initially entitled to social assistance and not working at all, and thus located at point C, the labor supply effect is unambiguously positive (arrow 1). For individuals located somewhere along the segment CD the effect could be either positive or negative. If the negative income effect dominates the positive substitution effect the individual will reduce her supply of working hours (arrow 2). For individuals already working beyond the phase-in range of the EITC the labor supply effect is also ambiguous (arrows 3 and 4). It will also depend on an individual's initial location on the budget constraint before the policy change. Finally, people already working beyond the phase-out range of the EITC may reduce their working hours to become eligible for the subsidy (arrow 5).

The net effect of the introduction of an earnings-related subsidy in addition to a means-tested social assistance scheme is therefore ambiguous in sign. It will depend on the parameters of the two programs, the distribution of the population along the different ranges of the EITC, and households preferences for income and leisure.

The analysis of labor supply effects induced by the introduction of an earnings subsidy or changes in social assistance rules becomes even more complex if labor supply decisions in couples households are determined as a joint decision. In addition to the effects mentioned above, an earnings subsidy affects the division of spouses' labor supply in such a way to take the greatest advantage of the subsidy. This effect depends on household preferences and the detailed structure of the tax-benefit system (see Steiner and Jacobebbinghaus 2003, Steiner and Wrohlich 2004).

An important implication of the described incentive and labor supply effects of earnings-related subsidies and social assistance schemes is that any change benefiting the currently unemployed will also indirectly affect people currently not entitled to the program and induce them to change their behavior in such a way to benefit from it. This, in turn, will imply increasing costs of the program which have to be financed by higher taxes, thereby leading to further labor supply distortions. Because of these effects, the EITC and similar programs aimed at improving work incentives may be inefficient. Their desirability depends

on the relative weight allocated to the various groups in calculating social welfare (Moffitt 2002, Saez 2002, Homburg 2003).

There seems also to be little reason for being too optimistic about the positive policy issue of the size of the labor supply effect of earnings-related subsidies. According to various empirical studies the work incentive and labor supply effects of these programs seem to be rather limited, partly due to the compensating effects discussed above. Some of these studies indicate that the expansion of the EITC since the mid 1980s has increased participation rates and hours worked of single parents, whereas labor supply of married women seems to have been reduced; the net effect on total working hours has been estimated to be positive but rather small (Eissa and Hoynes 1998, Meyer 2002, Hotz and Scholz 2003). Similarly, the introduction of the WFTC in the UK is estimated to have slightly increased labor force participation of single mothers but reduced employment of married women. Overall, the net effect of the WFTC on labor supply has been estimated to be a modest 30 thousand persons (Blundell et al. 2000).

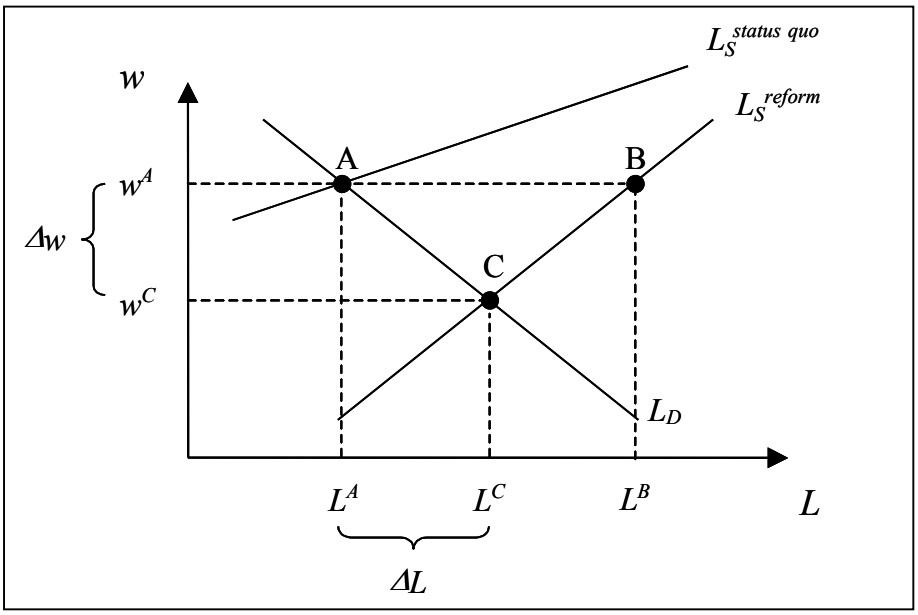
2.3 Wage Adjustment and Employment

In the previous section, as in most of the discussion on potential labor market effects of social reforms, it has implicitly been assumed that the additional supply of labor will be matched by an increase in the demand for labor. Given the relatively small estimated total effects of the EITC and the WFTC, this might be a reasonable approximization. However, if a welfare reform does result in a substantial increase in the supply for labor, real wages have to fall so that labor demand increases sufficiently.

This is illustrated in Figure 3, where the positively sloped labor supply curve is drawn under the assumption that the social welfare reform increases the supply for labor at any given gross real wage. As drawn in the figure, this effect is particularly strong for those with a relatively low earnings potential. If the labor demand curve was perfectly elastic, market wages would stay constant at w^A and the employment effect would be given by the increase in labor supply, i.e. the distance AB.

However, allowing for a negatively sloped demand curve for labor, the increase in the supply of labor will only be absorbed by increased demand if the market wage falls. As illustrated in Figure 3, in the new equilibrium given by point *C*, the gross wage has fallen to w^C and employment has increased less than in *B* due to the adjustment of labor supply to the wage reduction. For a given shift of the supply of labor, the required wage reduction is determined by the size of the wage elasticity of labor demand: the larger (in absolute value) the labor demand elasticity, the larger the employment effect.

Figure 3: Labor supply, employment and wage adjustment in the low-wage labor market



Empirical estimates of own-wage elasticities of the demand for unskilled labor as reported in the literature vary substantially, but a value of –1 can be considered an upper-bound (see, e.g., Fuchs, Krueger and Poterba 1999, Franz 2003, chapter 4.4.2). My own estimates for Germany are somewhat below this value, and also differ by gender and whether they refer to total hours or persons (Steiner and Jacobebbinghaus 2003, Appendix 3, Table A2). However, if labor supply is rather inelastic, differences in the wage elasticity of labor demand will have little impact on the employment effect of the social reform anyway (see Figure 3).

Empirical estimates of (uncompensated) wage elasticities of labor supply as reported in the literature also vary greatly (Fuchs, Krueger and Poterba 1998, Blundell and MaCurdy 1999). Except for married women, for whom the within-period labor supply wage elasticity has been estimated to lie between 0.2 and 0.5 in most studies, labor supply seems to be rather inelastic in most countries. For Germany, my own estimates show that wage elasticities with respect to hours worked range between 0.40 for west German wives to 0.10 for husbands, and are somewhat smaller for singles. Similar differences are also observed with respect to participation elasticities (see Steiner and Jacobebbinghaus 2003 Appendix 3, Table A2, Haan 2004).

These relatively small labor supply elasticities imply that financial incentives to take up work have to be substantial in order for a social reform to have a great effect on labor supply and employment in low-wage labor markets.

3 The „Agenda 2010“ – Will It Work?

Shortly before the last election in 2002, the so-called *Hartz Commission* on behalf of the then incumbant German government presented various reform proposals aimed at “cutting unemployment by half" (Hartz Kommission 2002). Some of these proposals for a fundamental reform of the German labor market were taken up by the so-called “Agenda 2010” of the re-elected government. In the following, I briefly present and critically evaluate the most important of these reforms which aim at improving work incentives and increasing employment in the low-wage labor market.[3]

3.1 Unemployment Compensation and Social Assistance Reform

The government’s Agenda 2010 contains several reform proposals concerning unemployment compensation and social assistance which have become law in the meantime. Before this reform, unemployment compensation in Germany consisted of the unemployment benefit and unemployment assistance. Whereas the unemployment benefit is insurance-related and intended to replace previous earnings, unemployment assistance is tax-financed and means-tested, but nevertheless related to previous earnings. The means test applied for unemployment assistance under status quo regulations is also less strict than for social assistance which constitutes the basic safety net of the German welfare state (for a more detailed description see, Steiner and Jacobebbinghaus 2003, Appendix 1). Whereas unemployment benefits are time-limited, there is, in principle, no time limit for unemployment assistance and social assistance as long as the means test is passed and the formal work requirement (see section 3.2 below) is met.

Entitlement periods for unemployment benefits currently vary between 12 and 32 months for people aged above 57 years. An important reform under Agenda 2010 concerns the shortening of the unemployment-benefit entitlement period to 12 months generally and to 18 months for all unemployed persons over 55 starting from 2006. In the medium term, this will lead to a marked reduction of long-term unemployment, as long benefit-entitlement periods are a major reason for the high level of long-term unemployment in Germany, especially among older workers (see Steiner 1997, 2003).

Another important reform under Agenda 2010 concerns the integration of unemployment assistance and social assistance. The entitlement to unemployment assistance

[3] A critical evaluation of other reforms of the Agenda 2010 less directly relevant to the topic of this paper is presented by Steiner (2004); these reforms include organizational reforms of the Federal Employment Agency, employment protection legislation, subsidies for setting up one-person firms (“Ich-AG”), and the regulation of the crafts.

for an unlimited period after the exhaustion of unemployment benefit is another important factor for the high level of long-term unemployment in Germany (Steiner 1997, 2003). According to the planned reform, persons currently living on either unemployment assistance or social assistance but deemed able to work – everyone who can work at least three hours a day – will be entitled to a new benefit being referred to as "unemployment benefit II". For those not able to work at least three hours a day, there will still be social assistance. The new "unemployment benefit II" contains a supplement to the current level of social assistance that takes account of the number of family members. In addition, recipients may obtain a wage subsidy for a limited period of up to two years if they take up a job. People entitled to this new benefit will also have access to advice and job placement through new *job centers* still to be established.

The unemployment assistance reform will reduce long-term unemployment among those who would have been entitled to it under current regulations. The reform is unlikely to strengthen work incentives for recipients of social assistance, however. Since the amount of the new unemployment benefit II is intentionally set to exceed the social assistance level, which is still means tested and almost completely withdrawn in case of own earnings, the already small gap between non-work and in-work net income shrinks even further, thus also reducing work incentives. In other words, the reform tends to increase the already extremely high benefit-withdrawal and marginal tax rates (in some cases considerably above 100%), and this will have negative effects on the number of hours worked for already employed people.

To improve work incentives for currently unemployed people the reform includes a wage subsidy granted to unemployed people who take up jobs in the low-wage labor market if considered "suitable" by the official in charge at the newly established job centers (see section 3.2). This subsidy should be limited to a period of two years. It will, therefore, only have permanent effects on unemployment if the productivity of those receiving this subsidy increased sufficiently over time to compensate for the withdrawal of the subsidy at the end of this two-year period. Whether or not this may happen seems doubtful, to say the least.

3.2 Work Requirements

The Agenda 2010 and the accompanying changes in the law also include some regulations concerning stricter work requirements for „employable" persons. The idea is that the introduction of a work requirement in terms of a minimum number of working hours will increase the effective supply of labor. The threat is that the new "unemployment benefit II" can be cut or be even completely withdrawn if the unemployed declines "suitable" job offers. In this case, the persons would fall back on social assistance provided the respective means

test is passed. In principle, even social assistance could be cut if "suitable" job offers were declined.[4]

At the time of writing (March 2004), it is still not clear what "suitable" will eventually mean. There is currently some discussion that a job offer should only be deemed "suitable" if it comes with some sort of minimum wage. But even if the work requirement regulations remain as intended by the law, this is unlikely to change anything substantial regarding the effectiveness of the currently existing work requirements. On paper, these are already quite restrictive. However, in practice these work requirements have turned out to be rather ineffective because the labor office or social assistance unit has to prove the welfare recipient's unwillingness to take up work. Although there are cases where communities have linked social assistance payments to a strict work requirement by way of a full-time public-works job (see, e.g., Feist and Schöb 1998, Sinn et al. 2002), this is still the exception rather than the rule.

Lack of job offers at the administration's disposal is generally considered to be the main reason for the small number of temporary reductions or terminations of social welfare payments to recipients suspected not to be willing to take up work. The reason is that the administration fears to have to prove the case in court. One possibility would be to offer all recipients of social assistance who claim to be willing to take up but not able to find a regular job a public-works job at relatively unattractive terms. This, however, is not intended by the reforms of the Agenda 2010.

Instead the government hopes that more intensive job brokerage by the newly established *Personal Service Agencies* (PSA) may act as an effective work test for those drawing unemployment benefit II. These agencies are to be run privately on a subsidized basis or by the Federal Employment Service offices and are charged to give advice to unemployed persons and help them with their job-finding efforts. Initially, the German government expected the number of people attached to PSA to reach roughly 50,000 for 2003 as a whole. If this relatively number is not increased substantially PSA are unlikely to fulfil more than a marginal role in acting as a "work test".

3.3 The „Mini-Jobs" Reform

In addition to the selective wage subsidy referred to in section 3.1 above, the Agenda 2010 also proposed a subsidy of social security contributions (SSC) levied on so-called mini-jobs. Before the mini-jobs reform in April 2003, there was a lower earnings threshold of 325 €, up

[4] On the theoretical labor supply and welfare effects of work requirements see, e.g., Akerlof (1978), Besley and Coate (1992), and Homburg (2003), Moffitt (2002).

to which earnings were not subject to SSC on the side of the employee provided her weekly working time did not exceed 15 hours. The employer paid social security contributions of 22 percent of the employee's gross wage. Above the threshold of 325 €, the whole amount of earnings was subject to the normal rate of SSC, which is about 21 percent for employees and the same rate for employers. Earnings under the threshold were exempt from taxation in case the employee had no other income. Above that threshold, full taxation set in.[5]

The mini-jobs reform abolished the hours restriction, expanded the range of exempted earnings up to a threshold of 400 € per month, and introduced a SSC subsidy on monthly earnings between 401 and 800 €. Within this range, SSC start at 4 percent and then increase linearly up to the normal rate of 21 percent at the end of the bracket. Above 800 €, SSC are due on the whole amount of gross earnings. Employers have to pay SSC of 25 percent of the employee's wage for earnings up to 400 €.[6] Between 401 and 800 €, employers pay the normal rate of 21 percent. Earnings up to 400 € are taxed by a flat rate of 2 percent.

Presumably, the mini-job reform was intended to increase employment of persons with low earnings potential. However, eligibility to the SSC subsidy does not depend on a *minimum* number of working hours. Hence, people, like pensioners and students, who want to work only a few hours at a relatively high hourly wage benefit from the subsidy as well as people with low earnings capacity. There is little financial incentive to take up a mini-job for people receiving means-tested benefits because of the extremely high social assistance withdrawal rate under status quo conditions (see section 4.2). Furthermore, for married couples the marginal tax rate may become very high due to the interaction of the SSC subsidy with the tax system (Steiner and Wrohlich 2004). A negative labor supply effect of the mini-jobs reform could arise if already employed people reduced their working hours to take advantage of the SSC subsidy and preferential tax treatment of the new mini-jobs. Overall, it seems rather uncertain whether the mini-jobs reform will contribute to the political goal of reducing unemployment in Germany.

This pessimistic view on the potential labor market effects of the mini-jobs reform is also confirmed by the results presented in Steiner and Wrohlich (2004) and summarized in Table 1 below. Theses results, based on a behavioral microsimulation study, show that the

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5 Actually, there shortly existed another legislation between March 2002 and March 2003, called the "*Mainzer Modell*", which was also meant to subsidize SSC and was initially intended to be terminated by 2006. Under this scheme, the subsidy also depended on family status and the number of children, and social assistance was not withdrawn for people holding such jobs..

6 For people employed by private households, the employers' SSC are only 12 percent of the employee's wage.

total participation effect is estimated to amount to only about 53 thousand persons, which corresponds to roughly 36 thousand full-time equivalents. The total hours effect, however, is negative, since those people who are already working reduce their working hours; this negative conditional hours effect amounts to 37,500 full-time equivalents. Therefore, in terms of full-time equivalents, the overall labor supply effect of this reform is slightly negative.

Table 1: Estimated labor supply effects of the "Mini-Jobs" reform (in thousands)

		Number of persons additionally participating after the reform	Total hours effect (per week)	Hours effect due to additional participation (per week)	Conditional hours effect (per week)
Couples	Women	42	-409	957	-1,367
	Men	9	412	381	31
Singles	Women	2	-82	58	-140
	Men	0	0	0	0
Total		53	-79	1,396	-1,476

Source: Adapted from Steiner and Wrohlich (2004).

These estimates do not include the additional labor supply from students, pensioners and people who may be induced by the reform to take up a second job. Accounting for this type of marginal employment as well, the total labor supply effect of the mini-jobs reform is, therefore, likely to be positive. However, from a labor market perspective a mini-job reform which increases employment of pensioners and students at the cost of reducing total employment of the "main" labor force can hardly be considered a success.

3.4 A Preliminary Assessment

In implementing its Agenda 2010 the German government has introduced some reforms which point into the right direction as their intended chief target is to combat major causes of the problem of long-term unemployment. The introduction of time limits for the entitlement to unemployment benefits by 2006 will reduce long-term unemployment in the medium term. The unification of unemployment assistance and social assistance will reduce unemployment among those who would have been entitled to unemployment assistance under the previous status quo. This reform is unlikely to help much to strengthen work incentives for recipients of social assistance, however. It seems also unlikely that the new Personal Service Agencies will act as an effective work test. The mini-jobs reform may lead to a slight increase in employment in the low-wage sector, but this will come with substantial deadweight loss and an reduction in total working hours of the main labor force.

4 A Social Welfare Reform Which Might Work

In the following, I present a reform proposal which, by avoiding some of the described shortcomings of the Agenda 2010, might lead to a reduction in unemployment and an increase of employment in low-wage labor markets, although at some economic costs. I will first describe the reform proposal in some detail, then discuss the financial incentives induced by the reform proposal, and finally summarize results from a behavioral simulation study on the labor supply, employment and fiscal effects of the proposed reform.

4.1 The Reform Proposal

The proposed welfare reform contains the following three basic components[7]:

(i) The integration of social and unemployment assistance into one social welfare payment with entitlement conditional on the means test currently applied to social assistance.

(ii) The level of social assistance for "employable" persons who choose not to work is reduced substantially. All people receiving social assistance are offered a full-time public works job at the current social assistance level.

(iii) Incentives to take up work shall be improved by a combination of a reduction of the social assistance withdrawal rate and an earnings-related tax credit.

The first component of this welfare reform proposal is probably the least controversial one, at least among economists. Since social assistance and unemployment assistance are both means tested social welfare payments, there is really no reason to differentiate between the two. Furthermore, a major aim of welfare reforms is to reduce long-term unemployment which has been shown to be strongly affected by the availability of unemployment assistance (see Steiner, 1997, 2003a).

A significant reduction of the social assistance level for "employable" persons who *choose not to work* would also be not very controversial, in principle, since already compatible with existing law. The problem rather is to define what "employable" means, and how a conclusive work test can be implemented. In fact, there is no operational generally accepted definition of "employability". Here, people will be defined as employable if they are aged between 18 and 65 years, are not severely disabled, are not in full-time education or on maternity leave. From this group, one person per household is excluded if children below the

[7] This reform proposal, as initially suggested by Steiner (2002), is described in more detail in Steiner and Jacobebbinghaus (2003). Related proposals have been suggested by Sinn et al. (2002), the Scientific Council of the Federal Ministry of Economics (Wissenschaftlicher Beirat 2002), the German Council of Economic Advisors (Sachverständigenrat 2003), and Zimmermann (2003).

age of 14 years or severely disabled persons living in the household are taken care of. For households with at least one employable person the level of social assistance including housing costs is reduced to about 70% of its previous level if a job offer is rejected.

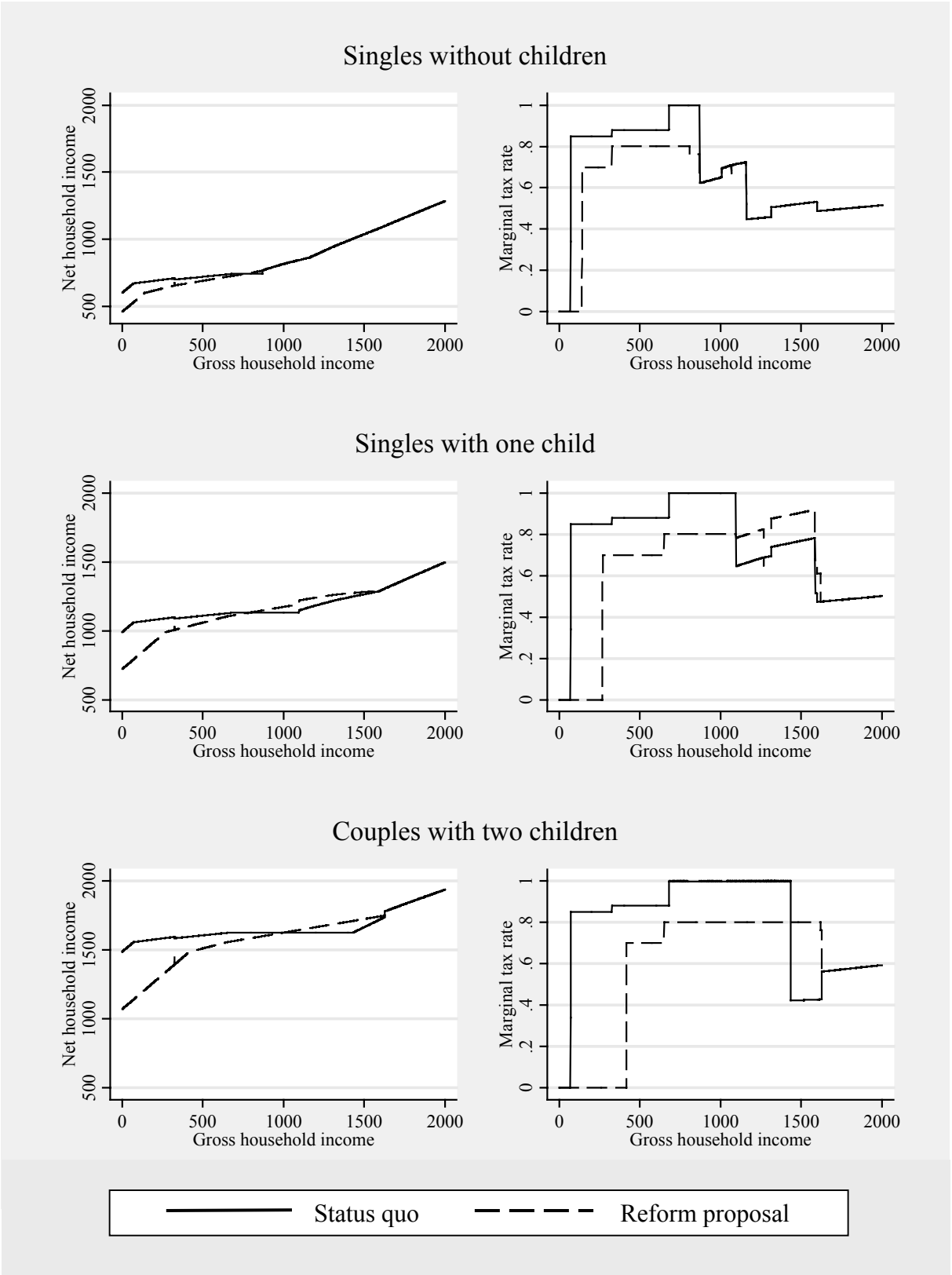
In order to improve work incentives, the social assistance withdrawal rate is cut to zero until earnings reach the social assistance level under the status quo. In other words, every € earned remains untaxed until the current social assistance level is reached. Individual earnings exceeding that level are taxed at a rate of 70%. Furthermore, similarly to the government's mini-jobs reform described above, SSC on low earnings are subsidized at a degressive rate; for singles (couples), the tax credit covers a degressive share of the employee's SSC up to monthly earnings of 820 (1,620) €. In the calculation of social assistance the tax credit is accounted for as earned income. Therefore, people facing the social assistance withdrawal rate of 70% most of the tax credit is compensated for by the reduction of social assistance. The resulting implicit marginal tax rates for various household types are discussed in the next section.

4.2 Improved Work Incentives

The total number of households potentially affected by the analysed welfare reform would amount to almost 2 million, or about 12% of all households in our sample. Counting both heads of households and their partners about 2.7 million or roughly 10% of the respective population would be affected by the welfare reform.[8] About 8% of all households would have less income due to the reform, but for about 4% of all households income would increase. For a large share of households the loss of unemployment assistance under the social reform would be compensated for by social assistance. The average reduction of unemployment assistance in the amount of about 450 € per month therefore translates only into a modest reduction in the level of social assistance of about 30 € in west Germany and about 50 € in the east. Figure 4 illustrates the implications of the reform proposal with respect to net household incomes and marginal tax rates and compares them with the current system for various household types (for the details of the calculations see Steiner and Jacobebbinghaus 2003).

[8] For a more detailed description of differences between east and west Germany and between various household types see Steiner and Jacobebbinghaus (2003, table 1).

Figure 4: Gross earnings, net household income and marginal tax rates under the current system and under the reform proposal



Source: Steiner and Jacobebbinghaus (2003).

As shown in the upper part of Figure 4 for *singles without children*, due to the substantial reduction of the social minimum net household income after the reform would always lie below the income level under the status quo until gross earnings reach 870 €, where the two lines coincide. The upper-right panel of Figure 4 shows that up to that earnings level the marginal tax rate under the reform is always below the one for the status quo, and this difference is about 20 percentage points in the range between 680 and 870 €.

The middle part of Figure 4 shows that *single parents with one child* could increase their net household income after the reform by expanding their labor supply: between 785 and 1,620 € gross earnings post-reform net household income would be substantially higher than under the status quo. Marginal tax rates after the reform would be substantially below current levels over a substantial rate, and the maximum marginal tax rate would never reach 100%, in contrast to the current system. However, between 1,100 and 1,620 € marginal tax rates after the reform would be somewhat higher than under the status quo. This is a direct implication of the now markedly lower marginal tax rates in the lower part of the earnings distribution.

In the lower part of Figure 4, the implications of the reform proposal for a *couple with two children* are illustrated. The emerging picture is similar to the one described in the previous paragraph. Net household income increases with rising gross earnings of the household over the range of 1,010 and 1,630 €. Over a wide range, marginal tax rates under the reform are substantially below those prevailing under the status quo. Post-reform marginal tax rates reach the maximum at 80% compared to 100% under the status quo.

To summarize, the described welfare reform would improve incentives to take up work, especially for larger households and single parents. By reducing the social minimum substantially for persons who choose not to work, the marginal tax rate on low earnings can be significantly reduced without shifting the cut-off point for social welfare too far to the right of the earnings distribution. However, the significant reduction of the marginal tax rate at the lower end of the earnings distribution implies that for larger households and single parents the marginal tax rate under the reform is higher than under the status quo over some range of the earnings distribution.

4.3 Labor Supply and Employment Effects

Simulation results for the labor supply and employment effects of the proposed reform are summarized in Table 2 (*c.f.* Steiner and Jacobebbinghaus 2003, table 2). Numbers in the first column of the table show that the analysed welfare reform would induce an overall increase in labor supply of about 390 thousand persons. This would also be the employment effect under the assumption of a perfectly elastic labor demand curve (see section 2.3). The employment

effect calculated on the basis of empirically estimated labor demand elasticities and downward flexible wages amounts to about 320 thousand people. As mentioned above, the relatively small difference between these two effects can be explained by the rather low empirical labor supply elasticities prevailing in Germany.

Simulation results in Table 2 show that the employment increase would be mainly concentrated on west Germany. Given the much higher unemployment rate in East Germany, the relatively small labor supply effect there may seem surprising, but can be explained by the relatively small labor supply elasticity of east German wives. In west Germany the labor supply response is distributed fairly evenly between couples and singles, whereas labor supply effects differ by gender within these two groups. For east Germany, differences between the various groups are too small for any meaningful interpretation.

Table 2: Effects of the proposed social welfare reform on labor force participation (ΔS) and employment (ΔE) – in 1,000 persons

	$\Delta S = \Delta E$ (no wage adjustment)	ΔE (with wage adjustment)
West Germany	322	266
Couples	164	137
Men	108	95
Women	56	42
Singles	158	129
Men	53	46
Women	106	84
East Germany	69	57
Couples	36	30
Men	17	14
Women	20	15
Singles	33	27
Men	6	5
Women	28	23
Germany	391	323

Source: Adapted from Steiner and Jacobebbinghaus (2003).

According to the proposed welfare reform, employable people not working in a private sector job can avoid a reduction of social assistance if they take up a public-works job. Steiner and Jacobebbinghaus (2003) try to estimate the expected number of people taking up such a job. The idea is to compare an household's utility evaluated at the working hours the household has to work in order to receive the current social minimum with the same household's utility

evaluated at zero working hours and the respective level of the social minimum as stipulated by the reform. Simulations show that in about 1/3 of about 800 thousand households whose social assistance level would be reduced under the welfare reform either the household head or the spouse would take up a public-works job to avoid the reduction of the social assistance level. Hence, about 2/3 of all affected households would choose not to take up a full-time public-works job and accept the reduction in the social assistance level. This contributes substantially to the positive net balance of the budgetary effects of the welfare reform proposal which amounts to yearly net savings in social expenditures of almost 10 billion € (for the details of the calculations see Steiner and Jacobebbinghaus 2003).

5 Implications for Economic Policy

The starting point of this paper was the recent discussion of social welfare reforms with the aim to increase work incentives in Germany, thereby reducing unemployment of low-skilled workers and increasing employment in the low-wage sector. The dilemma of the German welfare system is the impossibility to retain the high level of the social minimum (for larger households) relative to the average level of earnings, increase incentives to take up low-wage job by reducing the benefit withdrawal rate for social welfare and, at same time, constrain fiscal costs within sustainable limits.

The reason for this fact is that, given a relatively high social minimum and a fairly compressed earnings structure, a social welfare withdrawal rate substantially below 100 percent as it would be required for improving work incentives, implies either significantly higher marginal tax (withdrawal) rates over some part of the earnings distribution or the extension of social welfare eligibility to households with relatively high earnings, or a combination of both. Since the various groups in society are affected quite differently by these reforms, the choice between these unpleasant alternatives depends on the distributional weights assigned to each group. There is no first-best solution to this problem which makes no group worse off.

Given the reduction of long-term unemployment is the main political goal of a labor market and social policy reforms, the German government's Agenda 2010 points into the right direction. However, with the exception of the reduction of entitlement periods for unemployment benefits, the reforms so far implemented by the government under its Agenda 2010 seem unlikely to have a strong impact on unemployment in Germany. The reasons for this pessimistic view are, first, that the social welfare and the mini-job reforms do not set

proper work incentives and, second, there is no effective work test reinforcing the potentially positive effects of these reforms.

In this paper, I have presented a welfare reform which might work better than the social reforms of the government's Agenda 2010. The proposed reform has the following components: (i) the integration of unemployment assistance and social assistance; (ii) a substantial reduction of the social assistance level for "employable" persons who choose not to work; (iii) improved incentives to take up work by a combination of a reduction of the social assistance withdrawal rate and an earnings-related tax credit. The empirical results presented in this paper show that the proposed welfare reform would increase employment in the regular labor market by about 300 thousand persons. Another 300 thousand persons entitled to social assistance can be expected to take up a public-works job in order to avoid cuts in the social assistance level.

The introduction of the welfare reform proposal presented here would also lead to a substantial reduction in net social expenditures. The lion's share of these savings comes from the integration of unemployment assistance into social assistance and the reduction of its level for those not willing to take up a regular or public-works job. Even taking into account the reduction in tax receipts induced by the decline in market wages, the net budgetary effect of the welfare reform will remain substantial. This may even be true if the financial costs for providing public-works jobs for those who are willing to take up but do not find jobs in the private sector are taken into account, depending on how the public-works sector would be organized.

The expected positive effects of the reform proposal come at some economic costs, however. First, the provision of subsidized public-sector jobs for a relatively large number of social assistance recipients, which is likely to be a prerequisite for the political acceptability of the work requirement included in the reform proposal, implies an expansion of the already large public sector. Furthermore, by distorting labor supply decisions of people currently not entitled to social welfare, work requirements may be economically inefficient. Second, the reform proposal also implies that marginal tax rates will increase in some part of the earnings distribution, distorting labor supply decisions of already employed people. Given that there are both losers and winners as well as potential efficiency losses, a decision on the introduction of the proposed social reform has eventually to be based on value judgements.

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