

# Subsidizing Low Earnings: German Debates and U.S. Experiences

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## Summary

*Promoting employment at low earnings figures prominently in several debates on how to make the German social welfare system more prone to job creation. In the U.S., about 15% of all civilian jobs are subsidized via the Earned Income Tax Credit, a transfer program that refunds income taxes beyond the amount actually paid. This article explores the lessons to be learnt from U.S. experiences with extensive earnings subsidization. Its potential role in the German system is rather different and more limited. However, earnings subsidies may be useful as a device to remove certain obstacles to labor force participation, which need not necessarily be on the supply side of the labor market but may also be found on the demand side.*

### 1. German debates on a role for earnings subsidies

High and persistent unemployment has nurtured debates on how to create or sustain jobs for members of the labor force who are most at risk to become and stay unemployed. They belong to basically three groups: low-skill workers, elderly workers, and predominantly female jobseekers who are severely time-constrained, mostly due to child care related duties.

For what follows, it is important to keep in mind that the employment barriers for these groups are not necessarily to be found in the characteristics and the behavior of the unemployed themselves, i.e. on the supply side of the labor market. For instance, there is anecdotal evidence that German employers are extremely sensitive as regards even short spells of unemployment or an employee's frequent change of jobs. If so, marginal, low-skill workers as well as child-raising women may not even get a chance to offer their services because personnel officers discriminate against applicants who did not enjoy continuous employment in the past. An analogous, demand side argument applies to elderly workers who have lost their lifetime jobs in the course of restructuring. If there is a pool of younger workers to draw upon, there is simply no need for employers to think about reintegrating elderly workers with just another ten years to spend in the company. Again, it is then highly selective labor demand that creates a "problem group" of the labor market.

However, recent debates on how to deal with the problem of high and persistent unemployment have almost ex-

clusively concentrated on the supply side of the labor market, both for the diagnosis and the recipe. At least four strands can be discerned:

- For quite some time, an overly generous social welfare system has been identified as the main cause of persistent and high unemployment. It is maintained that unemployment benefits and social assistance are too high to make work attractive, especially for heads of a household with children. The following table 1-1 bears witness to the fact that the margin between the income in low-wage employment and cash assistance out of work becomes rather narrow as the number of children rises. This is indicative of there being an implicit norm that a child shall not suffer from poverty, irrespective of its parents' inability to earn a more splendid living is self-inflicted or not.

In view of this diagnosis, the immediate remedy is to increase the margin between disposable income at low wages and cash assistance ("*Lohnabstandsgebot*"). In practice, that usually means to ask for a lower level of as-

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Table 1-1:

**Disposable household income compared to cash assistance**

Status	Number of children (years of age)	Disposable income from low-wage employment <sup>a)</sup> (DM)	Cash assistance (DM) <sup>b)</sup>	Cash assistance as percentage of disposable low-wage income
Single	0	1,849.49	625.00	33.8
Single	1 (< 7 y.)	2,246.48	1,196.00	53.2
Married couple	2 (8–14 y.)	2,751.03	1,971.00	71.6
(one earner)	2 (15–18 y.)	2,751.03	2,053.00	74.6

<sup>a)</sup> Unskilled worker in manufacturing (tax bracket III), West Germany, as of January 1998. — <sup>b)</sup> No housing assistance included.  
Source: Statistical Bureau (Statistisches Bundesamt), Cologne Institute of Business Research (Institut der deutschen Wirtschaft Koeln) (1998).

Table 1-2:

**Household income in case of low-wage employment (single with two dependent  
children, PPP-DM as of August 1998)**

	Cologne	Texas
<b>Gross income<sup>a)</sup></b>	2,057.62	2,057.62
./i. income tax	0	119.31
./i. social insurance contributions	433.13	157.41
<b>= Net income</b>	<b>1624.49</b>	<b>1780.89</b>
+ residual cash assistance incl. rent subsidy <sup>b)</sup>	458.68	527.41
+ tax credit (EITC)	0	612.45
+ child care allowance ( <i>Kindergeld</i> )	440.00	0
+ maintenance allowance ( <i>Unterhaltsvorschuss</i> )	239.00	0
<b>Disposable income</b>	<b>2,762.17</b>	<b>2,920.76</b>
<i>Compared to:</i> cash assistance without employment	<b>2,384.00</b>	<b>1,007.82<sup>c)</sup></b>

<sup>a)</sup> Monthly income for full-time employment at an hourly wage of DM 11.88. — <sup>b)</sup> DM 378.17 is deductible in Germany (*Freibetrag*), compared to DM 1445.40 in Texas where deduction is limited to a maximum of one year, however. — <sup>c)</sup> TANF benefits plus cash equivalent of food stamps.  
Source: Cologne Institute of Business Research (Institut der deutschen Wirtschaft Koeln) (1998).

sistance but not for an increase in low wages.<sup>1</sup> An alternative means would be to increase disposable income from work, namely by subsidizing low earnings. This would not necessarily require to lower the level of product wages relevant to employers.

- Another variant of the diagnosis that an overly generous social welfare system is the culprit has been forwarded by pointing to high fixed costs of employment. A large proportion of non-wage labor costs is considered to be particularly inimical to low-wage employment. In Germany, these non-wage costs consist mainly of social insurance contributions, since it is unconstitutional to tax low earnings up to a level that is deemed necessary for a minimum standard of living. The following table 1-2 compares direct and indirect labor costs of a representative low-wage worker in Germany and in the U.S. The study from which this comparison has been taken contributes to a policy agenda that is sympathetic to employers' interests. However, the basic message is uncontroversial, namely that indirect, i.e. non-wage labor costs are sub-

stantial and that social insurance contributions are more relevant than taxes for low earnings.

In recent years, there have been several proposals to combine wages below the present minimum wage floors with transfers borne by the government.<sup>2</sup> One was part of the Christian Democratic Party's electoral platform in 1998, and a particularly generous one (as regards the government transfer component) stems from the employers' association under his President Hundt. All these "*Kombilohn*"-proposals had in mind to effectively compensate for social insurance contributions at low income levels. This would have selectively undone the rise in social insurance contributions legislated by the Kohl administration to finance in particular unemployment benefits and pensions of East Germans in the aftermath of German unification. That is, social insurance contributions rose

<sup>1</sup> See Pohl (1998) for discussion.

<sup>2</sup> Jerger/Spermann (1997) provide an analysis of various proposals.

Table 1-3:

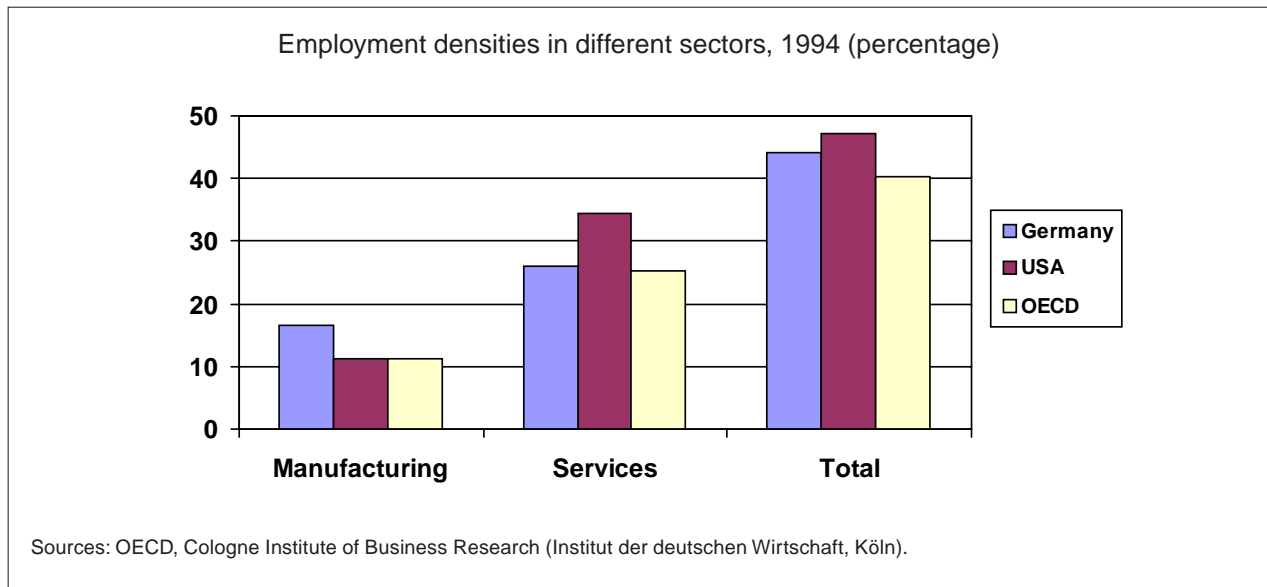
**Long-term unemployment**

		United States	Germany
Unemployment rate <sup>a</sup>	1986	6.9	7.6
	1996	5.3	9.0
Long-term unemployment rate as of total <sup>a</sup>	1986	8.7	48.3
	1996	9.5	47.8

<sup>a</sup>) 1986 figures for Germany are for West only, 1996 figures for unified Germany. Long-term unemployment is defined as 12 months or more out of work.

Source: OECD (1998).

Chart 1-1:



from 15.9 percent of GDP in 1989 (West-Germany) to 19.0 percent in 1997 (united Germany), while taxes fell from 23.8 percent to 21.8 percent during that period.<sup>3</sup> The various proposals differ as regards their effect on product wages, i.e. whether they propose to subsidize just the employee's contributions or those of the employer as well.<sup>4</sup>

- Some have identified the persistence of unemployment as the one policy issue to be tackled. Persistence is seen as resulting from a rapid devaluation of human capital that sets in as soon as workers lose their jobs. They are thus likely to stay unemployed the longer the spell of unemployment already lasts. It is then argued that the long-term unemployed are hard to reintegrate into the labor market at current wage floors. The following table 1-3 shows that there has indeed been a high incidence of long-term unemployment in Germany even before unification.

The recipe in this case is to design transfer programs specifically for the long-term unemployed. For instance, a

Targeted Negative Income Tax or "Einstiegsgeld" has been suggested by Jerger/Spermann (1997) and will now be tested by way of a social experiment in selected districts at the state level (Baden-Wuerttemberg). It provides for a temporary earnings subsidy of a former long-term unemployed who may thus accept a temporarily lower pre-transfer wage rate.<sup>5</sup>

- There is a last argument which generalizes the case for more downward wage differentiation. It suggests that it is not only reintegration of the long-term unemployed which calls for a lowering of wage floors but also the creation of jobs in the service sector. The production of services is, generally speaking, more labor-intensive, at least those that substitute for household production such as catering, cleaning, or child care. Thus, stagnating

<sup>3</sup> Bofinger/Fasshauer (1998), 521.

<sup>4</sup> Cf. "Arbeitsamt und Länder sollen Geringverdiener unterstützen" Handelsblatt (14.12.1999).

<sup>5</sup> Spermann (1998), 7.

employment figures are seen as a result of too little downward wage differentiation that hinders the generation of this kind of service sector jobs. The following chart 1-1 indicates, that there is less employment in the service sector in Germany compared to the U.S. or the OECD average.<sup>6</sup>

It is this diagnosis that backs policy proposals pursued by the present red-green coalition. The roundtable *Alliance for Jobs* ("Buendnis fuer Arbeit"), a corporatist venue of representatives from the government, the unions and employers' associations, has agreed on an experiment with subsidizing a low-wage sector. This agreement is a geographically confined, time-limited realization of what the *Benchmark group* within the Alliance for Jobs had proposed earlier on a larger scale and with the explicit goal to promote service sector jobs, namely wage subsidies delivered via a tax credit for employers.<sup>7</sup>

These four strands of debates on German unemployment obviously converge on what they see as the solution of the problem. They call unisono for a subsidization of low wages. Seen from the perspective of the recent welfare reform in the U.S., this amounts to a shift from non-work cash assistance to in-work benefits such as earnings subsidies. The economic rationale of earnings subsidies then is to remove obstacles on the supply side of the labor market as the inhibiting forces, although the different strands differ as regards the specifics of this main obstacle. The proposed shift would thus enhance the efficiency of the economy, because it puts underemployed resources to work and compensates for a distortionary tax system to finance social insurance.

In principle, such in-work transfers or selective employment subsidies are also compatible with a demand side explanation of unemployment alluded to in the beginning of this section. But then the rationale of an earnings subsidy would be to solve information problems, i.e. to bribe employers by making unemployed jobseekers to accept lower earnings than other jobseekers. Formerly unemployed persons would thus get the chance to build an employment history with the company during which the employee could reveal the "true" value of his or her labor services. The rationale is thus not to enhance efficiency in a traditional sense by bringing the product wage of a former unemployed closer to his or her supposed marginal product. On the contrary, if it is a kind of bribe for employers, an earnings subsidy implies to pay different (real) wage rates for the same labor service which is economically inefficient. However, such inefficiency may be partly or wholly offset by a gain, namely that such a temporary measure could help to overcome specific market failures.

If employment is determined by firms' labor demand, an earnings subsidy would necessarily imply that some low wage workers are driven out of their jobs and replaced by a temporarily cheaper one. Yet, to the extent that long-

term unemployment imposes social costs, the resulting rise in labor turnover is an intended outcome, the very result to be achieved. Thus, a demand side rationale for earnings subsidies makes amply clear that the incidence of a shift towards in-work benefits falls heavily on all workers in the low-wage sector.

## 2. The rationale of the EITC in U.S. workfare

The U.S. social welfare system provides a rich study ground for the effects of a radical shift away from non-work cash assistance to extensive earnings subsidization. The Welfare Reform Act of August 1996 introduced a model of public assistance in the U.S. that came to be known as workfare. Besides "ending welfare as we know it", it is supposed to "make work pay".<sup>8</sup>

One cornerstone of this welfare overhaul that led to a system of workfare is the Earned Income Tax Credit (EITC) which has become the largest cash assistance program in the U.S. It is an in-work assistance program, namely a tax refund for working low-income households which may result in a transfer if the taxes to be payed are lower than the disposable household income to be guaranteed. In 1998, it was estimated that a bit less than 19 million heads of households, or about 45 million persons, benefit from a cash transfer under the EITC.<sup>9</sup> It has replaced traditional welfare not only in numbers of recipients but also in total outlay, which was "Aid to Families with Dependent Children" (AFDC) before August 1996 and "Temporary Assistance To Needy Families" (TANF) after reform (table 2-1).

The EITC was originally introduced in 1975 to correct for the impoverishing effects of income taxation, i.e. to make the tax system effectively more progressive. But it assumed significance only after the program has been vastly expanded in the second half of the eighties and again in the beginning of the nineties. This expansion was meant to cope with a severe and worsening working poor phenomenon.<sup>10</sup> In the context of the U.S. welfare overhaul, this tax credit is often interpreted as an instrument to

<sup>6</sup> Although the DIW (1998) has convincingly argued that this is to a large extent just a matter of statistics, not of substance.

<sup>7</sup> Streeck/Heinze (1999).

<sup>8</sup> I have described this model of public assistance more comprehensively in Schelkle (2000).

<sup>9</sup> These 19 million subsidized jobs are 14.7% of all civilian jobs of which there were 129 million in 1996.

<sup>10</sup> The poverty rate among all workers, including those without children, was nearly 20 percent higher in 1996 than in 1979. Some 15 million people (of which 8.8 million were children) lived in a working-poor family in 1996. The poor working parents had a combined average of 41 weeks of employment, i.e. welfare eligibility was not primarily due to long-term unemployment, cf. Johnson/Lazere (1998), 3.

Table 2-1:

**Traditional cash assistance (AFDC/TANF) compared  
to an earnings subsidy (EITC)**

FY	AFDC/TANF recipient families (1000s) <sup>a)</sup>	EITC recipient families (1000s) <sup>b)</sup>	Avg. (monthly) annual AFDC/TANF benefit per family (\$) <sup>c)</sup>	Avg. (monthly) annual EITC refund per family (\$) <sup>b)</sup>
1993	4,981	15,117	(373) 4,476	(86) 1,028
1994	5,046	19,017	(376) 4,512	(93) 1,110
1995	4,876	19,335	(377) 4,524	(112) 1,342
1996	4,553	18,525	(374) 4,488	(117) 1,400
1997	3,946	18,652	(379) 4,548	(120) 1,443
1998	2,783	18,788	./.	(123) 1,473

<sup>a)</sup> Source: Administration for Children and Families, U.S. Dept. of Health and Human Services (<http://www.acf.dhhs.gov/>). — <sup>b)</sup> Figures are projected for 1995-1998, preliminary for 1994. Source: House of Representatives (1998, table 13-14). — <sup>c)</sup> Figure for 1997 is maximum TANF benefit for a family of 3 in the median state. Source: House of Representatives (1998, tables 7-6, 7-47).

“make work pay”.<sup>11</sup> It is a tax refund that amounts to a transfer or a negative tax. Thus, an in-work benefit such as the EITC is now seen as an instrument to overcome supply side barriers for employment.

“Making work pay” in the sense of creating labor supply incentives has two meanings: first, to encourage participation in the labor force; and, second, to encourage an additional supply of working hours to the extent that makes a transfer recipient self-sufficient in the long run. At first sight, the goal to “make work pay” seems to be just one insofar the first is an immediate precondition for the second and long-term objective of workfare. But economically, these two decisions of a household contemplating its labor supply have to be distinguished because the EITC affects them differently.

The EITC is supposed to stimulate both decisions of a household. As regards the decision to participate in the labor force at all, it does so by definition since it is an in-work benefit. That is, contrary to a Negative Income Tax (NIT), it does not guarantee a minimum income independent of the employment status. So, if the EITC does influence labor force participation at all, it should do so in the intended sense.

Moreover, and again in contrast to its “parent” NIT-approach, it does create positive incentives to supply more working hours in the beginning. This is in the phase-in range of income, where an EITC rewards each dollar earned with an additional 7.65, 34 or 40 cents subsidy, depending on the number of children (none/one/two or more). Or to be precise: It does create what economists call a positive substitution effect, namely by raising the price of leisure in terms of consumption which a household has to give up by not working.

However, the income effect works against this incentive to work more: As income increases due to more work, a

household can afford to enjoy more leisure and thus would like to use its increased purchasing power not only to buy consumption goods but also to spend time free of work. This income effect constantly works against the incentive to supply additional working hours if leisure is what economists call a normal good (of which one wants more as income rises).

In the phase-out range where the credit is effectively reduced (at a rate of 7.65/15.98/21.06 percent respectively, again depending on the number of children), the EITC schedule creates a negative substitution effect: it effectively taxes each additional dollar earned by withdrawing the credit. This reinforces the negative income effect and creates a disincentive for the supply of additional working hours. The following chart provides an overview of these effects and their combinations as the earnings of a household increase.

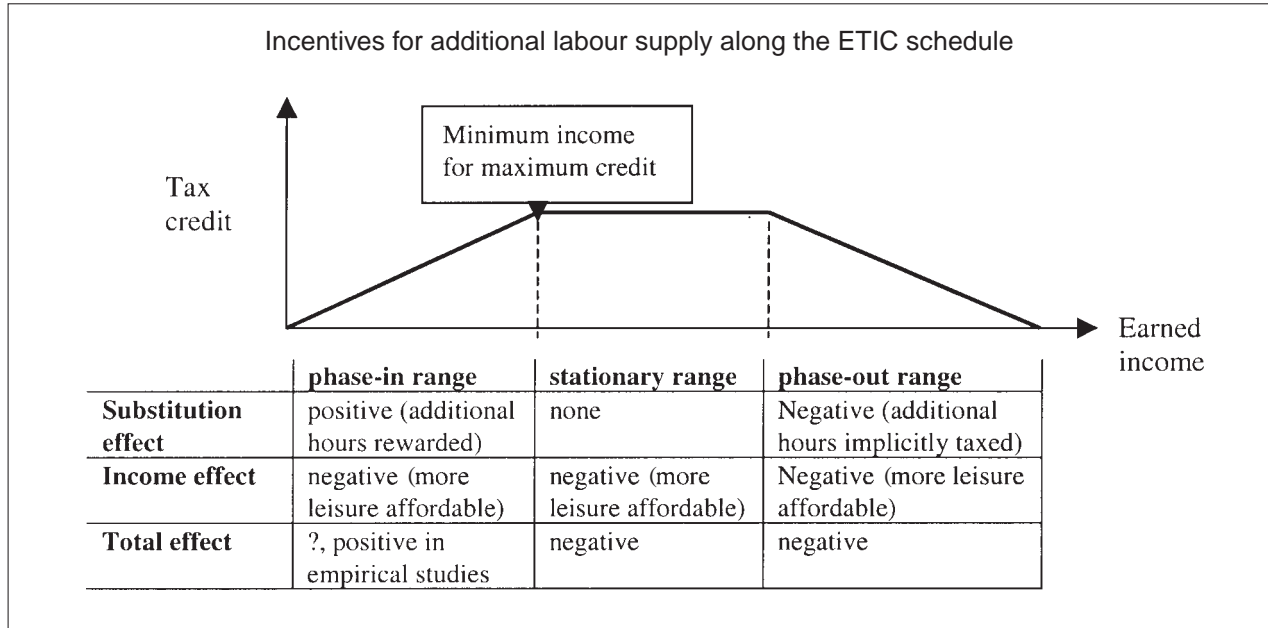
Thus, in the stationary range where households just get the maximum credit as well as in the phase-out range where the credit is withdrawn, the EITC is (marginally) discouraging. This is an inevitable feature that in principle cannot be repaired because a means-tested benefit, by its very nature, has to be reduced as the recipient reaches the income threshold that is considered to provide sufficient means.

However, the disincentives may set in after the household has achieved full-time employment at the minimum wage and after it earns an income that lifts the household out of poverty. So, how do the income thresholds, after which disincentives set in, relate to working hours at the minimum wage and the income required to pass the poverty line?

<sup>11</sup> Acs et al. (1998). Trabert (1999) provides an excellent (German) overview of research on this strategy of making work pay via a combination of transfer and wage income.



Chart 2-1:



What table 2-2 shows is that incentives stop and disincentives set in before full-time employment is reached. More importantly, disincentives set in mildly at the beginning of the stationary range when the respective type of household has not yet moved out of poverty as measured by the federal standard. And they set in massively at the beginning of the phase-out range when households have just barely passed that poverty threshold. These are problems of design, not of principle, however, because an adjustment of income thresholds could correct this.

A number of empirical studies confirm what theory leads one to expect. The effect on participation is positive while marginal incentives for those already in work are negative. Studies which distinguish the two meanings of “making work pay” do find a net increase in hours worked, namely of 1.4%.<sup>12</sup> That is, the work hours of new entrants tend to overcompensate the loss of hours due to reductions of working time by those who are already in the labor force. Marginal labor supply to be negative has been found by studies that simulate a situation with EITC and compare it to one without.<sup>13</sup> They find those working to offer 2.1 percent less labor after the introduction of the EITC. This result also holds for studies that evaluate changes in the EITC parameters which all estimate negative overall effects on hours worked.<sup>14</sup> These negative effects are of different magnitude, strongest for married women who tend to be secondary earners. Finally, simulations in a computable general equilibrium model generates basically the same results, not only for the U.S. but also for Germany, Sweden, and the U.K.<sup>15</sup>

Therefore, it seems safe to say that the EITC is not a labor supply incentive in the second sense relating to the marginal supply of working hours that would make households self-sufficient. An EITC as a way to hand out transfers to working households is *not encouraging* more labor supply but is just *less discouraging* than conventional tax and transfer systems where one dollar of earned income offsets one dollar of cash benefits (i.e. a 100 percent marginal tax).

Why does this show that the supply side interpretation of the EITC is wanting? Basically for two reasons: If the traditional interpretation were right, the EITC would *be the wrong instrument* for the very purpose of workfare which, to repeat, is to induce recipients to become self-sufficient and leave the workfare rolls.<sup>16</sup> And if the traditional interpretation were right, the EITC would be a *very expensive instrument* to contrive welfare recipients to work and enhance their chances to become self-sufficient. One study estimates that even if all of the observed 1.4 percent increase in working hours (i.e. of new entrants and already working households) were due to the EITC increase, the

<sup>12</sup> Cf. Eissa/Liebman (1995). Mayer/Rosenbaum (1999) contains a detailed analysis of how the EITC, Medicaid, and numerous welfare changes between 1984-1996 affected the labor force participation decisions of single mothers. They find that the EITC accounts for over 40 percent of the unexpectedly high increase of this group’s labor force participation.

<sup>13</sup> E.g., Hoffman/Seidman (1990).

<sup>14</sup> For instance, Holtzblatt/McCubbin/Gillette (1994), Eissa/Liebman (1995), and Eissa/Hoynes (1998).

<sup>15</sup> Bassanini/Rasmussen/Scarpetta (1999).

<sup>16</sup> Blank/Card/Robins (1999) 4–5.

Table 2-2:

**EITC income thresholds and work incentives, 1998**

	EITC income thresholds <sup>a)</sup> (\$)	Work equivalent at minimum wage of \$5.15 per hour	after-tax income <sup>b)</sup> (\$)	percentage of poverty standard <sup>c)</sup>
single, one child	6,500	32 weeks of 40 hours	8,274	74
	12,260	more than full-time	12,794	114
	26,473	more than full-time	21,519	191
single, two children	9,140	44 weeks of 40 hours	11,959	91
	12,260	more than full-time	14,369	109
	30,095	more than full-time	24,407	186

<sup>a)</sup> 6,500/9,140 are thresholds of minimum income for maximum credit, 12,260 is the threshold of phase-out beginning income, 26,473/30,095 are thresholds for EITC eligibility. — <sup>b)</sup> Subtracting tax liabilities (federal income tax, after taking standard deductions into account, and the employee's share of the payroll tax of 7.65%) and adding the (maximum) EITC. — <sup>c)</sup> In 1998, the U.S. Census poverty standard for a single parent with one child was \$11,235 and \$13,133 for a single parent with two children. It is an absolute poverty standard.

Sources: Internal Revenue Service <http://www.irs.ustreas.gov/>; Bureau of the Census <http://www.census.gov/main/>; own calculations.

expansion had generated 124,600 new labor force participants at a cost of constant (1992-) \$23,000 per entrant.<sup>17</sup> Yet, a work requirement and a higher minimum wage would have done the trick of making recipients work and making work pay at no obvious fiscal cost. The traditional view is thus hard-pressed to reconcile the expansion of the EITC with even a weak rationality assumption on behalf of the legislators. It is safer to say that the expansion of the EITC served a traditional social policy objective, namely poverty relief. The novelty is only that poverty relief appeared in the disguise of input subsidies for low-wage production.

The evidence on how much the EITC contributes to making work pay is thus mixed to say the least. The EITC seems to induce labor force participation but this is already taken care of by a general work obligation included in the Reform Act of 1996. By its very nature, however, the EITC does not provide incentives for labor supply to reach self-sufficiency even if (a big if) that were only a matter of labor supply decisions. This is inherent in workfare. In this system of social assistance, the eligibility criterion for receiving transfers is to have a job or at least to prepare for getting a job. Thus, the number of actual recipients must be confined by means-testing. It can hardly be made dependent on prior social insurance contributions since that would require low wages to be at a level high enough to ensure a minimum standard of living net of contributions. Such a level of low wages is not easily reconciled with a general work obligation. With such a work obligation in place, the level of low wages must be determined by atomistic wage-setting while the government provides for a minimum standard of living for those in work. In this sense, the EITC provides incentives to go on workfare and to stay there.

### 3. Lessons for a German EITC

In this final section, I will explore the four cases for an earnings subsidy in German debates based on what has just been reported about U.S. experiences with such an earnings subsidy, namely the EITC.<sup>18</sup> I start with the two cases that seem to me untenable.

- An earnings subsidy could increase the margin between low-wage income and non-work cash benefits, thus making work pay.

In the last section, it has been pointed out that the EITC makes work participation pay but creates disincentives beyond the phase-in range of income. If this program were designed to generate a margin between non-work assistance and low-wage income, it would have no phase-in range at all but start with a lump-sum transfer to anybody who takes up a defined work activity. However, this would eliminate all incentives to offer additional labor time, i.e. beyond the amount specified to qualify for the lump-sum transfer.

Against the background of this German debate, it is interesting to recall why the EITC has been expanded by the Bush- and the Clinton-administration. It has been expanded, for one, to cope with a widespread working poor phenomenon. The U.S. market regime is characterized by weak collective representation of labor market parties and virtually unregulated labor markets. This stands in stark contrast to product and financial markets which are fiercely regulated and where all kinds of associations and

<sup>17</sup> Eissa/Liebman (1995), 32.

<sup>18</sup> Cf. Wagner (1999) for a complementary, but more general discussion of earnings subsidies.

lobbies represent the interests of individual members. Combined with a demand-led, rather liberal immigration regime, this furthered high and rising incidence of poverty among working households. The EITC is meant to alleviate that poverty.<sup>19</sup>

The EITC has been expanded, second, as part of the fundamental welfare overhaul which introduced a general work obligation on beneficiaries. The earnings subsidy bridges the gap between a means-tested welfare system and a contribution-based social insurance system: the EITC is means-tested like traditional welfare, on the one hand, but a tax refund, on the other, thus treating each recipient as a potential contributor to the system. The rising importance of the EITC has made the U.S. social welfare state more universal, less stigmatizing in its approach. And yet, establishing eligibility for transfers via labor force participation has added to that pressure for downward wage differentiation. The resulting wages do not move an average family out of poverty. Thus, heavy reliance on the EITC fits into the workfare model of social assistance but contributes to a workfare trap at the same time.

In view of this, a narrow margin between low wages and non-work cash assistance does not necessarily indicate that the German social welfare system needs retrenchment. On the contrary, one could easily argue that while American public assistance does not even lift working households out of poverty, the German “Sozialhilfe” is comparatively effective in combatting poverty of children. That effectiveness comes at a price, namely the corresponding work disincentives for parents.

This is what tables 1-1 and 1-2 reveal: a German adult without children gets hardly more social assistance than a U.S. citizen, namely DM 1,100 compared to (PPP-)DM 1,000. But the U.S. citizen gets so little even if there are two or more children in the household while in this case social assistance rises substantially for a German.<sup>20</sup> Obviously, the norm of the American system is to force even single parents into work by holding down public assistance since working parents are considered to provide better examples for their children. The norm of the German system is to enable parents to raise their children even if they are not gainfully employed.

- An EITC can increase wage differentiation as perceived by employers which induces the creation of service sector jobs.

The EITC has been in place since 1975 but became a significant program of public assistance only during the last decade. I.e., the process of deindustrialization and the rise of the service sector in the U.S. has proceeded without any support from this program. To reiterate, the EITC has on the contrary been expanded to cope with the downside of deindustrialization, namely falling real wages for the lower two quintiles (i.e. 40 percent) of the

income distribution and rising poverty among employed workers. Thus, the EITC is supposed to “make work pay” in an economy already dominated by the service sector. The German debate tends to put the argument for an EITC upside down. It calls for “make working poor possible” to further a *Dienstleistungsgesellschaft* yet to come.

From a purely economic point of view, the case for more service sector jobs is less obvious than the popular plea would make one believe. Even if it is granted for the moment that there is much less employment in the service sector in Germany compared to the U.S., this argument amounts to a call for changes in relative wages such that comparative advantages for production and trade arise in different sectors than at present. This change in the pattern of comparative advantage is meant to deliberately increase the amount of work necessary to generate a certain amount of income or value added, thus to make income generation more labor intensive. This is contrary to a secular process by which rising labor productivity requires less and less labor time and less and less manual work to produce a specified amount of goods, typically the goods to fulfill material wants (food, clothing, and personal hygiene). This frees up time and income for other purposes, such as recreation and education, entertainment and travelling. Both, having to work less and spending time with more enjoyable activities, is the welfare gain or increase in living standards that comes with rising labor productivity. Activities such as recreation and entertainment offer new job opportunities, so there is no dearth of work, even if the new jobs would not require as much aggregate labor time as the ones that are lost in the process. This makes the implicit call for a reversal or halt of this process even more dubious since it cannot even point to the fact that without such a reversal there would be no jobs in the foreseeable future.

The case under scrutiny raises a very basic issue, namely what is the efficient amount of wage differentiation in an economy? If the absorption of the labor supply of former welfare recipients requires an inefficient degree of downward wage differentiation, the savings in direct transfer payments have to be offset against the income losses inflicted on all low-income households.<sup>21</sup> It seems to me that wage differentiation in the U.S. has gone too far to be still called economically efficient. The EITC subsidizes labor inputs into productions for which there is not

<sup>19</sup> Although the parameters have not been set so as to be quite consistent with that goal (cf. table 2-2).

<sup>20</sup> To be precise: A U.S. citizen without children gets no cash assistance under TANF (or AFDC in former times). And it is only since 1994 that a childless worker can get a tax refund under the EITC, cf. House of Representatives (1998), Table 13-12.

<sup>21</sup> Solow (1998) points this out with respect to the U.S. welfare reform in general.



enough readiness to pay in commodity markets — not enough in the sense, that the proceeds from selling the produce are less than required to earn those a living who produced it. Low wages are just made individually bearable by subsidizing roughly 15 percent of jobs. This seems to me inefficient in an economy that has productive capacities to push each of its members far beyond subsistence as indicated by the U.S. median or average per capita income.

I will now take up the two more plausible cases for an earnings subsidy in Germany, again by drawing conclusions from the U.S. experience.

- An EITC may be partially useful for reintegrating the long-term unemployed because a tax credit conveys less stigma.

The EITC is an earnings subsidy to the employee, not a wage subsidy to the employer. Beforehand, wage subsidies seem to be an even more immediate way of lowering the product wage relevant for labor demand than earnings subsidies. But as U.S. experiences since the seventies have amply demonstrated, their take-up rate is disappointingly low.<sup>22</sup> Most researchers ascribe this to a stigmatizing effect which makes an employee reluctant to tell a prospective employer about this opportunity while employers tend to interpret the availability of a subsidy as a signal of the prospective employee's inferior work capacity.

Even the EITC as perceived by recipients seems not entirely free of stigma. At least that would be one plausible explanation why very few recipients opt for monthly payment of this tax refund which would have to be applied for by the employer. Instead, 95% receive it as a lump sum at the end of the fiscal year which their employers need not know.<sup>23</sup> This may sound surprising since workfare in general, a tax refund in particular, is meant to convey less stigma than traditional welfare. However, there are two kinds of stigma:<sup>24</sup> It may be due to the representative "taxpayer's resentment", who is unwilling to pay for a public good which he or she does not consume. Or it may be due to "statistical discrimination", i.e. the feeling that those on welfare are "not like us". While a tax refund or a work obligation for transfer recipients may help with respect to the latter cause for stigma, it does not necessarily eliminate the taxpayer's resentment, in particular if this kind of public assistance is as expensive as the traditional handing out of welfare checks. In other words, the EITC is not stigmatizing only if it is given as an earnings subsidy to combat a pervasive working poor phenomenon.

In Germany, an earnings subsidy is to be applied to persons for whom this stigmatizing effect is of less relevance. Being long-term unemployed, i.e. out of the labor force for

more than a year, is an obvious information to any employer and itself the stigma. A temporary earnings subsidy for both employee and employer could thus be offered as a time-limited contract of risk sharing. The time horizon should be long enough for the employee to get some training-on-the-job and for the employer to find out about the respective worker's capabilities. If it was all the employer's prejudice against an applicant with no continuous job history, i.e. a problem on the demand side, the employer would have the advantage of temporarily lower costs for a given quality of services. If the employee needs indeed some time to build up human capital again, as the prevalent supply side case suggests, the subsidy would fund such training-on-the-job. That is, a temporary earnings subsidy for the long-term unemployed could be justified on both grounds.

It is obvious that preventing misuse and windfalls from this kind of temporary lowering of wage costs for employers is not an easy task. On the other hand, rather stringent requirements will lead to low take-up. Displacement of other low-wage workers cannot be excluded. In practice, it is probably workers' councils (*Betriebsräte*) whose collaboration and monitoring will be required to prevent misuse.

There is also an issue of horizontal equity, namely that those with a lasting spell of unemployment, if back in a job, may be better off with the subsidy than those with continuous low-wage employment. If the measure is designed with a supply side diagnosis in mind, horizontal inequity is close to inevitable in order to provide the necessary incentives.<sup>25</sup> Considerations of this sort merely underscore the case for the strictly time-limited transfers.

- An earnings subsidy could lower fixed costs of employment which fall particularly heavy on low wage jobs.

The EITC in the U.S. lowers costs of employment as far as they are tax-induced. But these are not important for German low-wage earners since income up to a certain threshold, defining the social minimum of existence, must not be taxed. However and somewhat inconsistently, social insurance contributions must be fully paid by low wage earners as well, namely like taxes as a percentage of gross wages. As table 1-2 demonstrated, it is social insurance contributions of more than 20 percent that count for higher fixed costs of low wage employment in Germany than in the U.S.

<sup>22</sup> E.g. Bishop/Kang (1991).

<sup>23</sup> Walker/Wiseman (1997), 411; Smeeding et al. (1998) explore different hypotheses concerning this behavior.

<sup>24</sup> See Besley/Coate (1992) for a most interesting substantive and analytic discussion.

<sup>25</sup> This seems to be one problem that haunts the proposal of Jerger/Spermann (1997).

An earnings subsidy like the EITC, being a negative tax, could compensate for the share of wages that has to be paid into various social insurances nevertheless. In effect, this would amount to subsidizing the social insurances by tax money. This kind of tax subsidization of a formally contribution-based system has become quite common in recent years, in particular with respect to pensions. An earnings subsidy extended as a contributions refund would make the German tax-cum-social insurance-system more progressive again.<sup>26</sup>

The advantages of such a measure are obvious if compared with the recent approach to deal with that problem, namely to stipulate income thresholds below which earnings are exempt from social insurance contributions (so-called 630 DM-jobs). Before reform in April 1999, these jobs were not only exempt from contributions but were also exempt from social protection.<sup>27</sup> They were a selective measure which benefited primarily secondary earners. In contrast, an EITC-style earnings subsidy would not exempt employers from their part of social insurance contributions while they would eliminate the exorbitant marginal deductions of those who want to go back to work after a spell of living on public assistance. It would thus help to remove the trap that 630 DM jobs used to be for both employer and employee.<sup>28</sup>

One has to admit, however, that this is a rather roundabout way of compensating for a potentially regressive impact of financing the social welfare system in Germany. Social insurance contributions could be much lower if they were not used to finance unemployment benefits and pensions for those who have never contributed to the system, i.e. for ethnic Germans from the former Soviet republics, for East Germans, or for women who abstained from gainful employment because they raised children.<sup>29</sup> Such pensions should be financed by taxes raised on all incomes, wages and incomes of self-employed earners or civil servants alike. Even a switch to general tax financing of social insurances would be less detrimental to employment and fairer. This would take into account that the pay-as-you-go-financing of pensions does no longer ensure equivalence of contributions and benefits and that long-term unemployment is a social cost not to be borne by wage-dependent labor alone. Yet, a political majority for such a radical step is not perceivable in the near future.

In sum: I do see a role for earnings subsidies, albeit different and much more limited than in the U.S. This is because the problem for which an EITC is supposed to be the (or part of the) solution is so different. The foregoing analysis of German debates and U.S. experiences points to a poverty-unemployment tradeoff which is tilted towards poverty in the U.S. and towards unemployment in Germany. By such a tradeoff I do not mean a stable relationship along which policymakers can choose their

preferred point ad libitum. But at any point in time there seems to be an inverse relationship between poverty and open unemployment and it is first and foremost labor demand that is constitutive for this tradeoff. The responsiveness of firms' labor demand to lower wages determines how steep the poverty-unemployment tradeoff of a shift towards in-work benefits is going to be. Namely, how much do wages for low-skill labor services have to fall in order to find demand for them?<sup>30</sup> The tradeoff also depends on the degree to which new entrants may substitute the work of those already employed. This will decide how much displacement of other low wage workers will occur if recipients of public assistance are contrived to enter the workforce. If substitutability is high, this would just mean a personal redistribution of poverty with uncertain gains in employment. Present debates in Germany seem to downplay this role of labor demand.<sup>31</sup>

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<sup>26</sup> In 1996, the average tax rate for very low income households (with mean annual earnings of 19,204 DM) was 26.6 percent, for low income households (28,814 DM) it is 29.6 percent, for low to middle income households (35,539 DM) the average rate is 32.4 percent, and for middle to high income households (58,947 DM) it is 36.7 percent. The data is based on the German socio-economic panel. The average tax rate in the U.S. is generally lower but more progressive (for very low income 16.8 percent, for low income 20.6 percent, low to middle income 23.3 percent, and for middle to high income 29.9 percent). All figures are from Bassanini/Rasmussen/Scarpetta (1999), App.B. I suppose that the German tax and transfer system is effectively even less progressive, if not regressive, because the rise in social insurance contributions affected primarily middle to lower incomes, i.e. wage-dependent labor.

<sup>27</sup> The present red-green coalition has stipulated that employers pay the usual rate of social insurance contributions below that level of DM 630, namely 10 per cent of the wage paid into health insurance and 12 per cent into old age insurance. Contributions to health insurance do not provide for additional coverage, while contributions to old age insurance establish eligibility for pensions in the future.

<sup>28</sup> Bofinger/Fasshauer (1998), 523.

<sup>29</sup> Bofinger/Fasshauer (1998), 522, estimate that almost one third of social insurance contributions (184 billion DM out of a total of 604 billion DM in 1995) were used for financing such "versicherungsfremde Leistungen". Meinhardt/Zwiener (1997) come up with a somewhat lower, but still substantial estimate which, depending on the assumptions, amounts to between 68 and 143 billion DM in 1995.

<sup>30</sup> Solow (1998), pp.30-31, thinks "it is fair to say that the measured responsiveness [of labor demand] is disappointingly small." For an extensive account of labor demand studies, see Hamermesh (1993), ch.3. What he calls his best "guesstimate" amounts to -0.3 in an (absolute) interval of [0.15; 0.75]. That is, if real wages fall by 10 percent, a 3 percent rise in demand for labor is to be expected. This elasticity seems to be somewhat lower for skilled labor, higher for unskilled labor.

<sup>31</sup> This also applies to the ambitious and valuable exercise of Bassanini/Rasmussen/Scarpetta (1999) that tries to establish general equilibrium effects of an EITC in four economies but confines the analysis to the supply side.

These concluding remarks on a poverty-unemployment tradeoff are not meant to discourage experiments with earnings subsidies. On the contrary. The long-term unemployment problems in Germany are so depressing and the distortions introduced by the former government to finance

German unification so manifest that controlled experiments with new approaches seem more than justified. My remarks are just a call for being cautious in expecting too much from such proposals, especially if they are designed only with a view on the supply side of the labor market.

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## Zusammenfassung

*Die staatliche Förderung eines Niedriglohnssektors spielt in verschiedenen Debatten über den Zusammenhang von Arbeitslosigkeit und Sozialstaat in Deutschland eine Rolle. In den USA werden rund 15% aller zivilen Erwerbsarbeitsverhältnisse durch ein Steuerrückerstattungsprogramm, den sog. Earned Income Tax Credit, subventioniert. Dieser Beitrag untersucht die Lehren, die aus diesen US-amerikanischen Erfahrungen mit extensiver staatlicher Förderung der Niedriglohnbeschäftigung zu ziehen sind. Der Stellenwert solcher Einkommenssubventionen für Niedriglohnverdiener dürfte in Deutschland anders zu begründen und in der Reichweite begrenzter sein. Allerdings könnten Lohnsubventionen durchaus dazu dienen, bestimmte Hemmnisse der Erwerbsbeteiligung zu beseitigen, insbesondere auch solche, die ihr auf der Arbeitsnachfrageseite der Unternehmen entgegenstehen.*