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## The low wage debate in Germany: are there ways out of the poverty trap?

Germany is debating how to restructure its low-wage sector. Yet, nobody should expect employment miracles from these reforms; they are more about making German society more decent and just. Not even the best labour-market reforms can replace a proactive employment policy.

**Michael Dauderstädt**

For many years, Germany has seen an increase not only of long-term unemployment, predominantly amongst those with low skill levels, but also of the extent of low-wage employment. The idea of the social state enshrined in Germany's constitution as well as economic reason call for employment and labour-market policies that combine the wise utilization of the employment potential with decent wages and salaries.

### Full employment through wage dispersion?

Lasting mass unemployment is obviously the core economic and social problem in Germany. Neoclassical economics used to offer a simple diagnosis and therapy whereby unemployment happens if and when there is a gap between the wage ex-

pectations of the unemployed and the productivity expectations of the employers, i.e. if and when the claimed wages are too high, whereas the envisaged productivity is too low, primarily as a result of low or outdated qualifications. The solution would be – so the neoclassical approach implies – lower wages and, at the very best, qualification updates to be achieved in the medium-term. These theoretical explanations were often underpinned empirically by references to the USA and Great Britain where the wage dispersion is said to be higher and therefore unemployment lower, whereas in Germany the wage dispersion is lower, but unemployment higher, as a consequence of high standards of social security and strong trade unions.

As plausible as this simplistic explanation appears to be at first glance, upon more thorough examination the underlying theoretical assumptions and the empirically measurable facts turn out to be deficient. A worker's productivity is largely dependent on demand. Physical productivity (output/working hours) depends on the capital stock used, with any investment only being worthwhile if there is sufficient demand. The decisive monetary productivity (added value/working hours) depends on the prices

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Michael Dauderstädt is Director of the FES Division for Economic and Social Policy.

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that are themselves dependent on demand. Here is an example: if the price for wood goes up as a result of high oil prices, then the woodcutter's productivity would rise as well. In such case, it would be worthwhile to invest in the capital equipment of his job (power saw instead of axe) and thereby to increase the physical productivity as well as to employ a basically worse woodcutter (with a lower physical productivity) at a normal wage level or an equally productive woodcutter at a higher wage level<sup>1</sup>. But the empirical data also tell a different story: Scandinavian countries enjoy higher employment rates and lower unemployment figures despite (?) strong welfare states and trade unions and an accordingly narrow wage dispersion. The wage dispersion in the USA or in Great Britain is incidentally not considerably wider than in Germany and is probably only a reflection of a wider dispersion of qualifications amongst the working population. What is probably responsible for the low wages at the bottom end is rather the supply pressure that is caused by mass unemployment than a supposed equilibrium between marginal productivity and the market wage.

### The German low-wage sector

There is already a large low-wage sector in Germany that has considerably increased since the late 1990s, primarily in eastern Germany. 19% of all persons in full-time employment are on low wages, if one defines two thirds of the average wage as the low-wage threshold (i.e. € 1,637 gross per month). Whereas the percentage is 14.9% in the West, the East has a rate of 36%, i.e. more than double. If, however, the threshold values are calculated separately, these two percentage figures are again much closer to each other. If part-time employees and those working only few hours are taken into account, then this rate goes up further, although it includes - albeit to a limited extent - employees earning relatively high wages, but working few hours.<sup>2</sup>

But the expansion of the low-wage sector in Germany and the increasing wage dispersion associated with it<sup>3</sup> have by no means resulted in the hoped-for decrease of unemployment. If the short economic upswing around 2001 is disregarded, then employment failed to increase in Germany between 1998 and 2004. Primarily the proportion of the long-term unemployed and particularly of those with low skill levels continued to rise. It was not so much in the sector of regular employment requiring full social contributions that new jobs were created by hiring so far unemployed people, but rather in the area of subsidized part-time employment (mini-jobs etc.) which triggered the debate to which degree the latter jobs had replaced regular or informal employment. What is noticeable within the group of mini-job employees is the high proportion of housewives, pensioners and students who usually do not form part of the group of employees with low skill levels.

Labour-market and social policies since 1989 have, if anything supported this trend. The reunification strategy pursued by the Kohl administration initially put a massive burden upon the social-security systems by straining them with the costs incurred by German reunification. Unemployment insurance, whose insurance component funded by contributions had already shown signs of being overstretched by increasing mass unemployment since 1975, collapsed when it was forced to shoulder the burden of the exploding eastern German unemployment and the gradually increasing western German unemployment. Rising contributions to unemployment insurance increased the non-wage labour costs. A relative balance between the insurance component funded by contributions and the social component funded by taxes has only been re-established from 2007 onwards as a result of the agenda 2010 reforms. But increasing non-wage labour costs and easing measures for certain employment types have nevertheless accelerated the trend moving away from regular employment requiring full social contributions towards types of subsidized part-time employment .

<sup>1</sup> Until 1990, German Enterprises made just such investments in order to increase the productivity of low-skilled workers (See Winfried Koeniger und Marco Leonardi „Wage Inequality, investment and skills“ in Economic Policy, January 2007, S. 72-116)

<sup>2</sup> See Presentation Walwei (<http://fesportal.fes.de/pls/portal30/docs/FOLDER/BERATUNGSZEN-RUM/WIPO/Kochel/2007/walwei.ppt>) and Gerhard Bosch

/Claudia Weinkopf „Gesetzliche Mindestlöhne auch in Deutschland?“ FES Bonn 2006.

<sup>3</sup> See Ronald Schettkat „Lohnspreizung: Mythen und Fakten“ HBS Düsseldorf 2006.

## Models for re-organization

A number of proposals are currently being discussed that would, however, go beyond the scope of this short paper. Hence, only a few of the more important ideas of the *Kombi-Lohn* (or subsidized wage) and minimum-wage concepts, which represent opposite views, are to be reviewed here.

- **Current Policies:** These are made up of a patchwork of specific solutions. On the one hand, they attempt to establish an effective minimum wage through the level of basic security (unemployment benefit II<sup>4</sup>) and through the binding extension of collectively negotiated wages (e.g. building industry). On the other hand, they are designed to make low-wage jobs more attractive through different types of subsidies. The latter include, inter alia, the partially continued payment of unemployment benefit II in the event of employment (additional-earnings practice), job opportunities with compensation for additional expenditure (one-Euro jobs), exemption of mini-jobs from tax and contributions, a job starter's bonus, children's supplement and a progressive income tax. In addition, there is a host of regional *Kombi-Lohn* schemes, all of which permit income arising from employment whereby the tax and levies burden is reduced.<sup>5</sup>

- **Statutory minimum wage:** Large sections within the trade unions and the SPD are in favour of a standard statutory minimum wage of € 7.50 per hour. By way of an alternative, a lower minimum wage of € 4.50 (as put forward in the Bofinger-Walwei proposal explained below) is also being discussed, since many experts expect that a high minimum wage will make employment more difficult, especially for persons with low skill levels (e.g. young people). A scaled collectively negotiated minimum wage, which could be declared generally binding by a regulation for the affected industries or regions, could be another solution adapted to regional and sectoral labour-market situations.

<sup>4</sup> Translator's note: Unemployment benefit II is no longer tied to the former income of the recipient, but is around the same flat-rate level as the current social-assistance benefit.

<sup>5</sup> Vgl. Karen Jaehrling / Claudia Weinkopf „Kombilöhne in Deutschland: neue Wege, alte Pfade, Irrweg?“ FES Bonn 2006

- **Bofinger-Walwei:** The objective of this proposal developed for the government of Saxony has been to generate an increase of full-time jobs requiring full social contributions. Under the proposal, the incentives for part-time employment (opportunities to earn additional income, mini-jobs) are to be abolished or at least reduced. At the same time, low wages paid on employment resumption are to be exempt from taxes as well as from social-benefit payments in order to decrease the differential between transfer incomes and net wages. A minimum wage of € 4.50 is designed to prevent companies from pocketing subsidies by simply lowering wages and salaries.

- **Eekhoff:** The proposal *Schaffensdrang*<sup>6</sup> (or creative zest) starts from the premise that the unemployed seek employment not merely for a higher income and that there is an entitlement to state support only to prevent otherwise inevitable poverty. For this reason, (local) administrative bodies are to place unemployed people into jobs, without the employed earning any wages (save for the reimbursement of direct job-related costs such as travel expenses or clothing). This aspect is largely in conformity with the existing practices of the one-Euro jobs, whereby the employers pay a commission which is to be negotiated and fixed according to the expected productivity. The idea is that not only charity establishments, but also private enterprises are to act as employers.

- **Sachverständigenrat (the German "Council of Economic Advisers"):** This approach, which has also been suggested in a similar format by Prof. Hans-Werner Sinn of the ifo Institute of Economic Research, aims to reduce unemployment benefit II by 30% and to make taking up work more attractive by introducing harsher rules for the withdrawal of transfer payments and an insignificance threshold. At the same time, 700.000 jobs are to be offered in order to prevent a large number of unemployed from dropping into an otherwise predictable poverty.

- **CDU/CSU:** The existing allowance practice for low incomes under the Code of

<sup>6</sup> Vgl. Vera Bünnagel, Johann Eekhoff und Steffen J. Roth „Mit Schaffensdrang in Arbeit“, VBW Munich 2006

Social Law (no more than € 400) is to be tightened up in order to improve the incentives to take up a full-time job. It is also planned that low wages (no minimum wage though) would attract a subsidy (a so-called "job bonus") over a period of up to three years and of up to 40% of the gross wage to encourage employment of older (over 50) and younger (under 25) unemployed persons.

- **Bürgergeld (or citizen's money) /Basic income:** All citizens are to obtain an unconditional income funded by taxes, which is to replace the majority of the traditional income substitutes (pension, unemployment benefit, sickness pay, state welfare assistance), at least in the area of basic security. High costs, the removal of active support for professional integration and the lack of incentives to look for work are disadvantages.

### Prospects of re-organization

Any re-organization of the low-wage sector should aim at achieving the following social and economic-policy objectives:

- **Social justice:** The earned income of persons in full-time employment should be above the poverty line and enable those people to live a life that meets the socio-cultural standards in Germany. They should consequently not be forced to disclose other income they may have or their financial circumstances. The changeover from jobs not guaranteeing a secure existence to those guaranteeing a secure existence should be made easier.
- **Employment:** The obstacles to employing people, especially those with low skill levels, should be reduced by lowering labour costs for potential employers and also by a noticeable difference between transfer incomes (usually unemployment benefit II) and the net wage.
- **Prevention of windfall effects:** Any conversion of regular employment requiring full social contributions into types of subsidized part-time employment should be discouraged. What should also be avoided is that employment of members of rather wealthy households (e.g. the husbands or wives of successful self-employed persons, such as lawyers or physicians, for their work in the joint firm) is subsidized.

It is questionable as to whether all three objectives can be achieved during a re-organization of the low-wage sector. In fact, the majority of evaluations indicate rather modest employment effects. Instead, the focus should be on finding policies that make it easier to achieve the two other objectives. In order to do this, the effect of four "wedges" between the unemployment benefit and a potential earned income must be diminished; which enable windfall effects to arise and trigger socially unwanted results.

1. **"Social-security wedge":** Anybody receiving unemployment benefit II is automatically registered for social-security purposes. If and when employment is taken up, contributions of approx. 20% of the wages become due.

2. **"Child wedge":** Anybody receiving unemployment benefit II is automatically entitled to obtain child benefits as well as a supplement of approx. € 54 per child which is no longer payable, if and when employment is taken up.

3. **"Housing wedge":** Anybody receiving unemployment benefit II is automatically entitled to obtain in full the expenses for reasonable housing. If and when employment is taken up, only a flat-rate rent subsidy is payable.

4. **"Tax wedge":** This "wedge" is relatively speaking the least problematic, as income tax is already designed to rise progressively. An accurately tailored negative income tax could overcome these "wedges" which would see objective No. 1 accomplished. As to the administrative implementation, a careful review should take place to establish if the finance, employment or housing-allowance authorities are best equipped to execute the implementation. In any event, any re-organization needs to go hand-in-hand with a minimum wage in order to prevent massive tax-funded subsidies to companies with corresponding substitution effects. The fiscal expenditure will be largely determined by the level of the minimum wage. Irrespective of this, the most significant contribution towards the re-organization of the low-wage sector would involve a more successful education policy that would curb the number of young people with low skill levels who currently make up about 20% of each year of new job seekers.