Title: Labour Supply Effects of Low Wage Subsidies in Germany
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Abstract
The number of welfare recipients in Germany has been continuously growing over the past 20 years. There is evidence that a substantial fraction of the welfare recipients is employable, but in fact only a minority of them is actually working. One explanation for this fact is that the German social welfare system creates disincentives to start low paid work due to a relatively generous level of welfare benefits combined with high marginal tax rates on labour earnings below the poverty line. As a result, reservation wages of welfare recipients are raised above the level achievable on the labour market, in particular for low-skilled and older workers. Indeed employable welfare recipients are concentrated among these groups.

Recently, the federal and the state level governments put forward various proposals to overcome the existing disincentives to low-wage employment. The general aim of the proposed measures is to maintain the current level of social welfare benefits, but to make work more profitable by providing a non-targeted, open-ended subsidy of payroll contributions to social security if labour income falls below a certain threshold. The paper evaluates the impact of the wage subsidies under debate, on employment as well as on federal budgets. To analyse the employment decision on the micro economic level, we use a discrete choice model of household labour supply, which we estimate from data of the 2000 wave of the German Socio-Economic Panel. Based on the estimated parameters, the potential labour supply effects of the various reform proposals are simulated. The simulation results are then used to assess the fiscal implications of the different policies on the macro level.

Our results show that the proposed wage subsidies are insufficient to raise the labour supply of current welfare recipients substantially. This means that the monetary incentives are too small to overcome the disincentives induced by the welfare system. An increment in the subsidy rate could of course increase the employment effect, but this turns out as a very costly policy due to a huge deadweight loss – the wage subsidies are predominantly paid to workers who are already in employment in the status quo. We also find that the debated measures would not change the overall volume of employment. The extra labour supply of welfare recipients is balanced by current workers reducing working hours.

To provide a guideline to more appropriate policy reform, we finally illustrate that the low-wage sector is stimulated more effectively, and that net fiscal savings are achieved, if social welfare payments are linked to a work requirement for employable beneficiaries.

Keywords: labour supply, wage subsidies, non-convex budget set
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