

# Subsidising Social Insurance Contributions in the Low-wage Sector: Lacking in Precision and too Expensive

The risk of becoming unemployed is particularly high for the low-skilled. Moreover, the chances of an unskilled unemployed person re-entering employment is also significantly lower. As a rule low skills mean low productivity, which evidently means that it is often not worthwhile for firms to employ them at the given wage level, particularly in phases of rapid structural change. In order to improve the labour market chances of the low-skilled, while at the same time ensuring that they have an 'adequate' income level, the so-called 'benchmarking group' that forms part of the Alliance for Jobs<sup>1</sup> is considering a proposal for degressive subsidisation of social insurance contributions for employment relationships generating a low monthly income. This concept poses a number of problems. It favours already existing employment relationships (dead weight effects), it requires a very substantial resource input, and will be of little help in assisting the long-term unemployed to find work; only targeted support measures will be effective here. Moreover, the distributional effects are not adequately congruent with the measure's goals in terms of helping those in need. Given that experience has been gained with such models in France and the Netherlands, experiments in Germany are not expected to be successful.

## Economic policy analysis of the model promoted by the Friedrich Ebert Foundation

The members of the benchmarking group that forms part of the Alliance for Jobs consider structural problems relating to the low-skilled as a major cause of unemployment. It is suspected that, in the case of such workers, the cost of their labour (including indirect labour costs) is higher than their expected productivity,

<sup>1</sup> Translator's note: the tripartite consultations currently under way to coordinate action by government and the social partners.

making it unprofitable for firms to employ such people. With regard to labour supply, it is pointed out that people with low skills who are currently out of work can derive an income – from (means-tested) social benefits, that is not necessarily inferior to that earned by taking up employment ('welfare trap').

If, for people at the lower end of the income scale, part of the contributions to the social insurance funds ('indirect labour costs') were paid by the state in the form of a subsidy, the jobs in question would be more attractive to both employers and workers. It would once again become profitable for the employer to take on the low-skilled, while at the same time net wages would be increased; this would make paid employment more attractive to the low-skilled, as net income would be significantly higher than transfer income. This would also remove the main argument for cutting transfer benefit levels – a step repeatedly called for in some quarters – which would lead to a significant increase in the number of low-income households.

The area of simple and personal services is frequently seen as having a considerable potential for additional employment. It is on this assumption that the frequent demands for a low-wage sector in Germany are based, whereby such demands fail to take account of the fact that the hypothesis of a 'service gap' in the area of simple activities is based largely on the inadequate statistical measurement of 'marginal employment relationships'.<sup>2</sup>

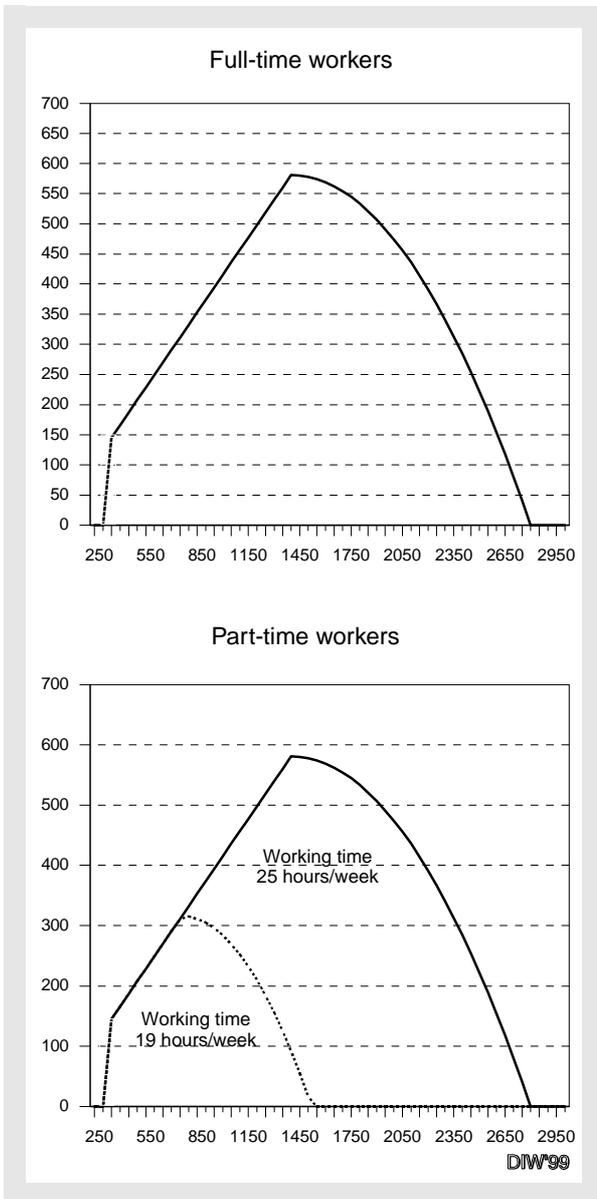
## Basic features of the FEF Model

The model for the subsidisation of social insurance contributions was sketched out by the *Zukunftskommission* (Future Commission) of the Friedrich Ebert Foundation (FEF),<sup>3</sup> which subsequently entered the political arena in Germany as the 'FEF Model', as put forward by the benchmarking group under the title: 'Degressive subsidisation of social insurance contributions'. A number of variants have been proposed. Here a 'medium variant' is considered, in which the social insurance contributions for all workers are assumed entirely by government up to a monthly full-time earned income of DM 1400 (below a negligibility ceiling of DM 300 no subsidy is paid). Up to twice the level of this subsidy limit, i.e. up to DM 2800

<sup>2</sup> John Haisken-De New et al., *Economic Bulletin*, vol. 34, no. 9, September 1997.

<sup>3</sup> Translator's Note: The FEF is the foundation of the Social Democratic Party (SPD). See the final report of the *Zukunftskommission: Wirtschaftliche Leistungsfähigkeit, sozialer Zusammenhalt, ökologische Nachhaltigkeit. Drei Ziele – ein Weg*, Bonn 1998, pp. 266 ff.

Figure 1  
**Subsidisation of  
 Social Insurance Contributions**  
 in DM/month at income thresholds of DM 1400 to 2800 /month



Source: DIW calculations.

per month, the government subsidy is degressively reduced to zero (cf. figure 1). Part-time workers are entitled to the subsidy on a pro rata basis, assuming a standard working week of 35 hours; no additional subsidy is available for overtime.<sup>4</sup> Under such a model firms' labour costs would be reduced, while at the same time employees' net wages would be higher. It is assumed that the subsidy does not lead to a reduction in gross wages in the low-wage sector.

## Effects on the demand for labour

Unambiguous and stable estimations of the demand elasticities for low-productivity workers are not available for Germany. Zimmerman and Bauer<sup>5</sup> and Buslei *et al.*<sup>6</sup> have calculated that wage-cost elasticities for the low-skilled range between orders of magnitude of  $-0.85$  to  $-0.20$ .<sup>7</sup> In the low income sector (up to DM 1400 per month), the FEF model would reduce labour costs by a maximum of 20.75%. Depending on the elasticity of demand assumed to apply, the additional demand for low-skill labour so induced would represent between 50 000 and 220 000 new socially insured jobs. This calculation does not allow for the negative macroeconomic effects that may arise in financing the programme.

## Incentives to take up employment

The proponents of wage subsidies point out that, because of the inadequate gap between earned and transfer income, many, if not most, recipients of means-tested transfer benefits (and probably also of socially insured unemployment benefit) are unwilling to take up poorly paid jobs, because net earned income is, they claim, scarcely higher than the social transfers available. It is generally accepted, though, that the extreme case – in which the social benefit is higher than net earned income – applies only to households with a large number of children in which only one person is working.

<sup>4</sup> In formal terms the model can be expressed as follows: Whereas in the case of full-time employees the social insurance contribution is reimbursed in full up to the first threshold value (1), the level of subsidy granted is reduced degressively for income that is above the first threshold value (2), and is zero on reaching the second threshold value.

$$(1) \text{ SubFT}_1 = 1,0 \times \text{SI contribution}$$

$$(2) \text{ SubFT}_2 = \left( 2 - \frac{\text{monthly earnings}}{\text{1st threshold value}} \right) \times \text{SI contribution}$$

For individual working hours of less than 35 hours per week, the subsidy is only paid on a pro rata basis to actual working time (PTF)

$$(3) \text{ SubPT} = \left( 2 - \frac{\text{monthly earnings}}{\text{1st threshold value}} \right) \times \text{SI contribution}$$

$$(3a) \text{ PTF} = \frac{\text{weekly working hours}}{35}$$

<sup>5</sup> Klaus Zimmermann and Thomas Bauer, 'Integrating the East – The Labour Market Effects of Immigration', in S.W. Black (ed.), *Europe's Economy Looks East – Implications for the EU and Germany*, Cambridge 1997, pp. 269-306.

<sup>6</sup> Hermann Buslei *et al.*, *Beschäftigungseffekte von Lohnsubventionen im Niedriglohnbereich*, Report commissioned by the Hans-Böckler Foundation, Mannheim 1999.

Although it cannot be precluded that there are people who prefer lower social benefits without the need to work to a slightly higher net income from paid employment, it is unlikely that this is true of the majority of means-tested benefit recipients, because unemployment tends to be associated with serious, negative subjective effects.<sup>8</sup> The net earnings gap does not apply, in any case, to the 'hidden unemployed' (not receiving benefit) who would be willing to take up work on the basis of a wage subsidy; here the higher net income is the sole incentive to work. The same is probably also true of some of those currently working in the 'black economy'.

If 'low-skilled' is defined in terms of whether a person currently out of work can expect a wage that would be entitled to a wage subsidy under the FEF model,<sup>9</sup> according to the data derived from the German Socio-economic Panel (GSOEP), this group represents a potential of 2.8 million people. Of these, around 640 000 were previously unemployed, more than 630 000 were not registered unemployed but with close links to the labour market, and around 1.5 million were not registered and had only tenuous labour market links. This potential labour supply is far higher than the additional labour demand that can be expected from the wage subsidisation (50 000 to 220 000 jobs).

## Effects on employment

Allowing for both demand side and supply side effects, the *Zentrum für Europäische Wirtschaftsforschung* (ZEW – Centre for European Economic Research)<sup>10</sup> concludes, on the basis of a study into this question, that the increase in employment resulting from the wage subsidisation would amount to between 50 000 and 180 000. The 'Federal Institute for Research on Employment' (IAB) estimates the number of jobs created at around 160 000. As a basis for estimating the fiscal effects, in the following an additional 150 000 jobs are assumed to be created. With reference to experiences in other countries (see box), and the almost complete ineffectiveness of wage subsidies for specific groups of the

<sup>7</sup> For example, a labour-cost elasticity of -0.5 implies an increase in employment of 5% if labour costs are reduced by 10%.

<sup>8</sup> Cf. Liliana Winkelmann and Rainer Winkelmann, 'Why are the Unemployed so Unhappy? Evidence from Panel Data', *Economica*, vol. 65, 1998, pp. 1-15.

<sup>9</sup> To this end a 'wage function' was estimated, based on the 'human capital' of persons not in employment in the SOEP sample, in which sex, age, educational level and work experience are entered as explanatory variables.

<sup>10</sup> Hermann Buslei *et al.*, (see FN 5).

unemployed (especially the elderly),<sup>11</sup> even the lowest estimate for new jobs (50 000) does not appear unrealistic, at least in the short run. Hence the following calculations can be considered to be based on relative optimistic employment assumptions.

It is difficult to forecast which group of those not currently in work would take up the new jobs. Yet the structure of the new workers is of importance in estimating the net fiscal costs. If they are not formerly registered unemployed and drawing benefit, then, unlike in the case of the registered unemployed, few significant savings can be expected in social security spending. In the following it is assumed that the ratio between registered and non-registered unemployed persons is the same as that recorded for new recruitments of those previously out of work in 1996 and 1997, i.e. that 53% were previously registered unemployed, 47% previously 'hidden unemployed'.

## Costs of the FEF model

In order to calculate the fiscal implications of the model, the estimated volume of subsidies must be offset against the benefits on the revenue side resulting from additional social insurance contributions and taxes (income and value-added tax).<sup>12</sup> Additional income tax revenue would be obtained if the subsidy was taken into account in calculating the tax-free allowance for expenditure that makes provision for the future (*Vorsorgepauschale*). It is assumed that the wage structure does not shift in the short run, i.e. in particular that wages are not reduced.

On the introduction of the model, of those currently in employment around 2.3 million full-time workers and 2.5 million part-timers would be entitled to a subsidy. For this group alone, expenditure of around DM 14.35 billion would be required (cf. table 1).<sup>13</sup>

<sup>11</sup> On this issue see Werner Karr, 'Kann der harte Kern der Arbeitslosigkeit durch einen Niedriglohnsektor aufgelöst werden?', *IAB-Kurzbericht*, no. 3/99.

<sup>12</sup> In interpreting the results it is to be noted that they were calculated on the basis of a sample (namely the SOEP). A consistent characteristic of samples is that they exhibit a so-called 'confidence interval'. This means that, for purely sample-technical reasons, the results presented below do not accord exactly with the calculations made by the IAB on the basis of the overall employment statistics; they are, however, very close to these results. Overall, all the simulations paint the same picture. Cf. Stefan Bender and Helmut Rudolf, 'Kosten eines gestaffelten Zuschusses zu den Sozialversicherungsbeiträgen', *IAB-Werkstattbericht*, no. 8/1999. All the calculations were made using the SOEP data from the 1997 survey. The wage level was adjusted to allow for 1998 wage trends and the social insurance contributions were calculated in accordance with the legal position as of 1 April 1999.

In France wage cost subsidies, which were introduced in 1993 and have been successively expanded since then, have attained even greater political importance than in the Netherlands. Initially, employers were exempted from social insurance contributions for family allowance (*allocations familiales*) for their low-wage workers; as of 1995 they received support in the form of a degressive reimbursement of their social insurance contributions; on 1 October 1996 the two measures were combined for the sake of simplicity. The reimbursement of employer social insurance contributions (initially of FF 1166 for a worker earning the monthly minimum wage, implying a 12.4% reduction in overall labour costs)<sup>1</sup> is available on a degressive basis from the minimum wage to a wage 1.33 times the minimum wage (SMIC). It applies to around 5 million workers. For specific regions and industries higher reimbursements are available, for earnings up to twice the minimum wage (equivalent to a 20.8% reduction in overall labour costs). By 1996 government spending on the scheme totalled FF 40 billion, making it, in terms of cost, the most important labour market policy spending item.

Various estimates have been made of the labour market policy impact of the measures to reduce labour costs in the low-wage sector in France. Depending on the mode of financing, the CSERC (Employment Council), for instance, arrives at between 10000 and 50000 newly created or maintained jobs within five years for every FF 10 billion spent per annum. The DARES division of the labour ministry comes, on the basis of optimistic assumptions, to a figure of around 60000. Given total spending of FF 40 billion, this implies, depending on the estimated effectiveness, to between 40000 and 240000 jobs.<sup>2</sup> In a study by the French Council for Economic Analysis<sup>3</sup>, Malinvaud has calculated possible orders of magnitude for the effects of the measures over a ten-year period. Depending on the assumptions made, the net effect could lie between 50000 and 300000 jobs. Each job incurs costs of up to around DM 90000 per annum. These estimates allow for the negative feedback effects of the scheme's financing (in the case of Malinvaud via the increase in VAT) on growth and employment.

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<sup>1</sup> Cf. M. Goye and A. Gubian, 'Les allégements de cotisations employeurs sur les bas salaires, Bilan de la politique de l'Emploi en 1996, *Dossiers de la DARES*, no. 5-6, Paris 1997, p. 188.

<sup>2</sup> Cf. M. Goye and A. Gubian, (FN 19), p. 191).

<sup>3</sup> Conseil d'Analyse Economique, *Rapport E. Malinvaud, Les cotisations sociales à la charge des employeurs: analyse économique*, esp. p. 90/91.

Positive fiscal effects result only if new jobs are created by the subsidy. In the DIW simulation it was assumed that 150000 new jobs are created. Of these, around 80000 people were previously registered unemployed, 36000 are classified as 'hidden unemployed I' and just under 35000 as 'hidden unemployed II'.<sup>14</sup>

If the wages these new workers can be expected to earn on recruitment are calculated with the help of their

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<sup>13</sup> If trainees and apprentices were included, additional subsidisation of around DM 9 billion would be required. If schoolchildren and students, most of which are on low income – were also incorporated, the costs would rise by a further DM 1 billion.

<sup>14</sup> The definitions are as follows: persons from "hidden unemployment I" want to take up employment in the short term, whereas those from "hidden unemployment II" are only looking for work in the medium term. Experience shows, however, that in practice even large numbers of people from the second category gain employment in the short term.

personal skill characteristics,<sup>15</sup> it is possible to calculate the additional gross costs of subsidising social insurance contributions: they amount to around DM half a billion per annum. To be set against this are the government's savings in expenditure on unemployment benefit, (means-tested) unemployment assistance, and maintenance payments for those on training and retraining; on the basis of the SOEP, these are estimated at around DM 770 million p.a.<sup>16</sup> In addition, supplementary revenue of DM 780 million in social insurance contributions and DM 170 million in wage and income tax would be

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<sup>15</sup> Only those persons are 'converted into' workers who, based on their personal skill characteristics, can be expected to earn an income that does not exceed the upper ceiling of the subsidy zone (i.e. DM 2800 per month). The expected wages were calculated using a standard earnings regression (corrected for selection bias).

<sup>16</sup> This analysis ignores savings on minimum social benefit (particularly for those new employees previously hidden unemployed).

Table 1  
**Costs of Degressive Subsidisation of Social Insurance Contributions**

Costs and number of employees benefiting

	FEF model DM 1400 to 2800 in DM billion p.a.	Number of employees benefiting in millions
Western Germany		
Full-time	2.98	0.97
Part-time	4.86	2.10
Eastern Germany		
Full-time	5.23	1.34
Part-time	1.28	0.39
Germany, total	14.35	4.0
Additional costs for the inclusion of the following employed groups:		
Schoolchildren and students	0.85	0.33
in-plant trainees	8.85	1.85
family workers	0.70	0.35

Sources: Socio-economic Panel; 1997 Microcensus; DIW calculations.

expected (cf. table 2). Overall, the 150000 new jobs would lead to savings of just under DM 1.5 billion p.a.

The potential additional revenue derived when the subsidies paid to workers – DM 7 billion p.a. – are consumed, generating additional VAT revenue, was also calculated.<sup>17</sup> If it is assumed that the group in question can be expected to consume virtually all of the additional income, this implies additional VAT receipts of around DM 0.75 billion p.a.

Calculating the net fiscal effect without considering circular knock-on effects, additional revenue and savings to the value of around DM 2.2 billion are to be offset against the subsidy volume of more than DM 14 billion. The overall net costs are thus in excess of DM 12 billion. This is equivalent to costs of around DM 80000 per job created per year. This figure is significantly higher than the gross income earned in each of these jobs. In terms of the effects on income distribution, too, the FEF model is unsatisfactory. Only 8% of the subsidies paid to those already employed (dead weight effect) would benefit low-income households; conversely, 6% would go to households with more than 1.5 times average earnings at their disposal.

The studies on the subsidisation of low wages rarely consider how such a programme might be financed and the knock-on effects this implies. Yet the mode of financ-

ing is decisive for the employment effects. If the costs are financed by expanding public borrowing, additional employment, on top of the employment effects indicated, would be generated by the multiplier-accelerator. If, on the other hand, it is financed by cuts in other spending areas – which is more likely – this can be expected to generate negative employment effects.

## An effective strategy

In drawing up an effective labour market and employment policy it is important to distinguish between the fight against (long-term) unemployment, on the one hand, and raising employment rates, on the other. Experience shows that employment policy measures that raise the volume of overall employment tend to bypass the long-term unemployed. The evidence seems to show that cuts in labour costs will not lead to success in integrating this group, because the indirect costs to employers of recruiting the long-term unemployed are often very much higher than the subsidy. Experiences in West Germany at the end of the 1980s also show, however, that low-skilled unemployed persons – provided they are not long-term unemployed – benefit especially from an economic upturn.

This shows that the best employment policy programme, especially for the low-skilled, is a stable economic upturn. Generalised wage subsidies, of a more or less permanent nature, for low-earners, by contrast, are costly in fiscal terms, because their employment effects are likely to be limited to the order of 150000 new jobs.

If the proposal made by the benchmarking group were realised, it would mark only a small step towards solving the employment problems facing the low-skilled. Targeted measures to promote the employment of the long-term unemployed are to be preferred. The broad-based establishment of government-backed temporary employment agencies to place the long-term unemployed in work could be helpful in this context.

The financial incentives for such firms must be set in such a way that it pays them to place a long-term unemployed person in employment. In order to ensure that this is achieved on a broad basis, German central government should, as in the Netherlands, shoulder a proportion of the costs, which are currently borne solely by local government. Also required is closer cooperation between social security offices and the public employment service.

To the extent that low-paid employment leads to low incomes for wage-earners with families, it makes much more sense to offer subsidies, conditional on a low household income, in the form of 'Earned Income Tax

<sup>17</sup> Assumptions were made on the expenditure structure of disposable income based on information derived from the 1993 income and consumption sample.

Table 2  
Costs of Subsidisation<sup>1</sup> and Expenditure Savings<sup>2</sup> for Recruitments in Low-wage Sector

	Employees	Costs of subsidisation <sup>1</sup>	Expenditure savings <sup>2</sup>	Increased social insurance contributions	Increased tax revenues		Balance of costs and financial benefits
					Wage tax <sup>6</sup>	VAT <sup>7</sup>	
	Number	DM bill./year					
All non-employed <sup>3</sup>							
Total	150 000	506	768	787	173	241	-1 463
Registered unemployed	79 500	272	768	523	127	33	-1 179
Hidden unemployed I <sup>4</sup>	36 000	124	0	167	27	106	-176
Hidden unemployed II <sup>5</sup>	34 500	110	0	97	18	102	-108

<sup>1</sup>Subsidisation of social insurance contributions for people recorded unemployed in 1997 on the basis of simulated earned income, excluding those younger than 20 or older than 55. — <sup>2</sup>Savings on unemployment benefit, (means-tested) unemployment assistance, and maintenance allowances for further training and retraining. — <sup>3</sup>Of all those entering employment in 1997 three groups of non-employed (at the time of the previous year's survey) were formed. The model calculation assumes that the structure of the non-employed in new recruitments was the same after 1997 as in 1996/97. — <sup>4</sup>Economically inactive persons wishing to take up employment immediately or within one year. — <sup>5</sup>Economically inactive persons wishing to take up employment but not during the next two years.

<sup>6</sup>According to the wage-tax table for 1999; single. — <sup>7</sup>On wages of those previously economically inactive or subsidies to the unemployed (based on a differentiated expenditure structure).

Sources: Socio-economic Panel 1997; DIW calculations.

Credits' (EITC) than generalised wage subsidies. As experiences in the USA have shown, an EITC system could also help to ensure that the burden of a full social insurance obligation is borne in a socially acceptable way.<sup>18</sup>

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<sup>18</sup> Scholz, John Karl, 'The Earned Income Tax Credit - Participation, Compliance, and Antipoverty Effectiveness', *National Tax Journal*, vol. 47, pp. 63-87.