



# Germany's Social Assistance Program: The Dilemma of Reform

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***Germany's social assistance program is the subject of intense national debate. Its large and rapidly growing costs do not make fiscal consolidation easy and, more important, it aggravates Germany's most pressing economic problem: structural unemployment.***

**S**OCIAL assistance is a key plank in Germany's comprehensive welfare system. All German residents (including non-nationals) who have no source of income are entitled to receive social assistance benefits. Income support is also available to supplement earnings, pensions, or unemployment benefits that fall short of a level necessary for a basic, "dignified" standard of living.

Spending on social assistance has risen two and a half times as fast as GDP over the past two decades, complicating Germany's efforts at fiscal consolidation. But the main problem lies deeper: social assistance may be distorting work incentives and exacerbating Germany's structural unemployment problem. Most of Germany's unemployment (10.6 percent in May 1996) is seen as structural in origin. When recipients begin to work, they almost immediately lose all or

part of their benefits. The withdrawal of benefits is a kind of implicit taxation, which, combined with explicit taxation on earnings, may discourage low-income workers from seeking employment.

## Growing expenditures

Expenditures on social assistance in Germany have soared over the past two decades (Chart 1), primarily because of a large increase in the number of recipients. By 1994, nearly 2.5 million people were collecting social assistance. But the real value of benefits has also increased significantly. The average monthly allowance for an adult is between DM 900 and DM 1,050 (\$600–\$700), and benefits may be higher for senior citizens, the physically disabled, and expectant mothers. Children receive 50–90 percent of the basic adult allowance, depending on their age.

International comparisons are difficult to make. However, a recent comparative study by seven ministries of labor in the European Union shows that for a typical recipient, the German benefit level—measured by the average percentage of earnings replaced by social assistance (the replacement rate)—is significantly higher than in the United Kingdom; roughly comparable to that in Finland, France, and the Netherlands; and lower than in Denmark and Sweden. The work incentive problem stemming from high effective tax rates is similar in all these countries, however.

## Recipients

One striking feature of the social assistance program in Germany is a decline in

the average age of recipients. For nationals, the average age has fallen from 41 to 33 since 1972. This decline was due not to an increase in the share of children, who receive their own basic allowance, but to a decline in the proportion of pensioners. The proportion of recipients of working age has increased substantially, from 39 percent of the total in 1972 to 56 percent in 1994.

Single women make up 34 percent of adult recipients—the largest group; 26 percent of recipients are single men; and 22 percent are single women with one or two children. The widespread impression that social assistance goes mainly to single parents or supplements low pensions for senior citizens is therefore incorrect. The main recipients are single adults without children (60 percent), most of them of working age. Thus, the arguments below, particularly the calculation of effective tax rates, concentrate on this group.

## The welfare trap

Some recipients qualify for some social assistance after finding work because their earnings are so low. Others, however, lose all benefits because their incomes are too high for them to qualify. In both cases, the combination of explicit taxation from the income tax code and implicit taxation from the withdrawal of benefits has a sizable impact on disposable income.

The German income tax code was revised in 1996 following a Constitutional Court ruling that none of the income needed for minimum subsistence, assessed at DM 12,000 per year for a single person, could be taxed. Exempting low incomes from tax

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was also seen as a way to boost work incentives. Such a positive effect on labor supply cannot be expected for social assistance recipients, however, because the withdrawal of benefits means that their overall effective tax burden remains very high.

Social assistance benefits are adjusted with changes in net monthly earned income (gross income less social security contributions, taxes, and an allowance for employment expenses equivalent to around 10 percent of gross income), as follows:

- Less than DM 130: workers are entitled to receive full benefits.
- Between DM 130 and DM 1,000: social assistance payments are reduced by 85 percent of additional net income. In other words, a DM 100 increase in net earnings raises disposable income by only DM 15—an implicit tax rate of 85 percent.
- Between DM 1,000 and DM 1,150: social assistance payments are reduced by the full amount of the increase in net income, and the implicit marginal tax rate is 100 percent.

- More than DM 1,150: workers are no longer eligible for social assistance.

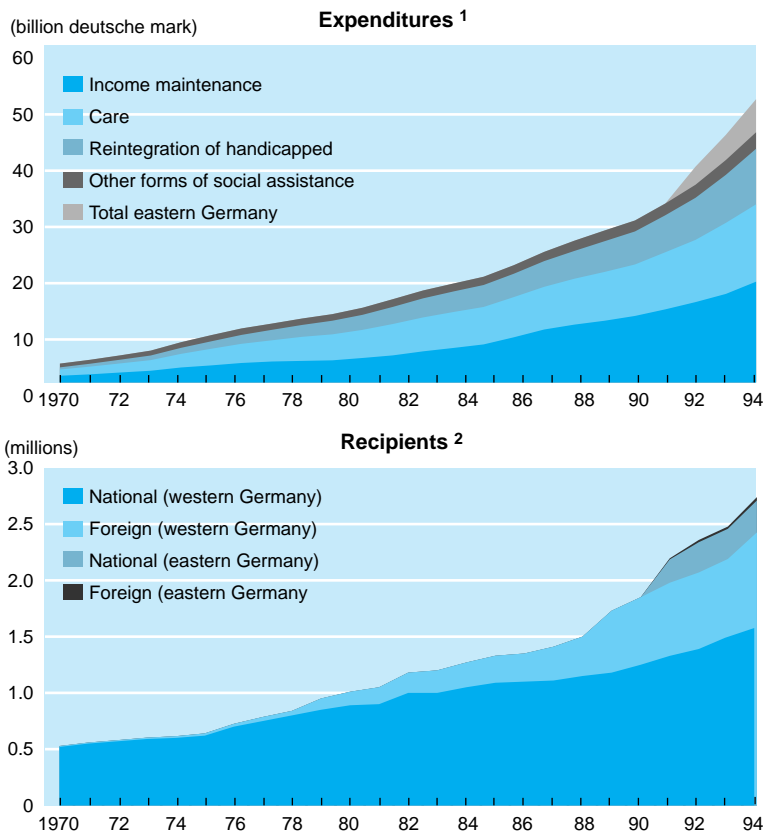
In addition to losing all or some of their benefits when they take up employment, workers with a gross monthly wage of at least DM 580 also become subject to social security contributions and income tax (see table). When these deductions are added to the loss of benefits, the total marginal tax burden on the earnings of low-income recipients of social assistance is 73 percent, on average. In the monthly income bracket between DM 145 and DM 580, for example, the tax burden is 76.5 percent. The total marginal tax burden rises to almost 80 percent for monthly earnings between DM 580 and DM 1,440. It reaches 90 percent for the DM 1,440–1,650 gross income bracket because benefits are completely withdrawn, aside from the allowance for employment expenses (e.g., transportation and clothing). The marginal tax burden drops to 46 percent for workers with gross earnings of DM 1,650 (DM 1,150 net) or more, who are ineligible for social assistance.

Even though Germany's tax reform exempts all gross monthly incomes below DM 1,440 from income tax, the total marginal burden for social assistance recipients is still a staggering 73 percent. Lower taxation in this income bracket leads to higher after-tax income—which means the loss of a greater proportion of benefits. As a result, the tax and benefit system discourages Germans from taking up low-paying jobs or part-time work while they are receiving social assistance, creating a "welfare trap."

### Exiting social assistance

What are the incentives to give up social assistance? What are the realistic job alternatives for workers, and how do they compare with social assistance benefits? These questions are implicitly recognized in the *Lohnabstandsgebot*—the principle that benefits must be lower than wages, in keeping with the view that social assistance is meant to encourage people to get regular jobs. The government commission that regularly reviews the difference between benefits and wages uses the average net earnings of unskilled blue-collar workers in industry as the primary low-end benchmark wage, which it has found to be higher than the social assistance benefits to which single people, couples, and couples with up

Chart 1  
Germany's social assistance program, 1970–94

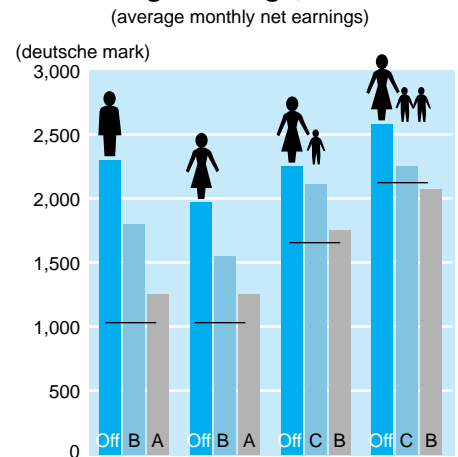


Source: Statistisches Bundesamt, *Zeitreihen zur Sozialhilfe*, July 1996.

<sup>1</sup> Detailed categories for western Germany only.

<sup>2</sup> Income maintenance only. Although support to asylum seekers has not been paid out of the social assistance budget since 1994, it is included here to make recent figures comparable with historic figures.

Chart 2  
Western Germany: Social assistance entitlements and potential wage earnings, 1996



"A" = Apprentice in retail or crafts sector.  
 "B" = Retail sector: unskilled employee.  
 "C" = Services sector: low-skilled employee/crafts sector: unskilled worker.  
 "Off" = Official benchmark wage (unskilled worker, industry).

Source: Statistisches Bundesamt, *Lohnstatistik*, and author's calculations.

Note: The horizontal lines are the social assistance entitlements for the groups indicated in the chart.

## Marginal explicit and implicit taxation as a function of gross monthly wage income, 1996

Gross income (deutsche mark) (1)	Social security contributions (percent) (2)	Marginal income tax (percent) (3)	Net income (deutsche mark) (4)	Net income less employment expenses (deutsche mark) (5)	Withdrawal of social assistance benefits as percentage of income		Effective marginal tax on gross income <sup>1</sup> (percent) (8)
					Net income (6)	Gross income (7)	
<145	0.0	0.0	<145	<130	0.0	0.0	0.0
145–580	0.0	0.0	145–580	130–522	85.0	76.5	76.5
580–1,440	19.8	0.0	465 <sup>2</sup> –1,160	420–1,040	85.0	59.7	79.5
1,440–1,650	19.8	26.1	1,160–1,280	1,040–1,150	100.0	44.1	90.0
>1,650	19.8	26.2	>1,280	>1,150	0.0	0.0	46.0

Sources: Ministry of Finance, Ministry of Labor and Social Affairs, and author's calculations.

Note: Columns 2,3, and 6 are derived from the schedules for social security contributions, income tax, and benefits withdrawal, respectively. Column 7 shows benefit withdrawal rates as a function of gross income. Column 8 combines these elements into an effective marginal tax rate.

<sup>1</sup> Total effective marginal tax burden, consisting of social security contributions, marginal tax rate, and percentage by which gross income is reduced with withdrawal of social assistance benefits.

<sup>2</sup> Social security contributions are due on total gross income. Therefore, immediately above the threshold level of DM 580 gross, net income is actually lower than under the threshold level.

to three children are entitled (Chart 2). The commission has therefore concluded that the gap between wages and social assistance benefits is generally wide enough.

This conclusion and the particular wage selected as the benchmark are both open to question, however. By using as its main benchmark an economy-wide average wage in industry, the commission is probably overestimating the wages to which most recipients of social assistance can aspire, for a number of reasons.

First, the industrial sector pays the highest wages and is not an easy sector to enter for workers who have been unemployed for long periods. Former social assistance recipients may find it easier to get jobs in the services, retail, or crafts sectors; wages in these sectors might therefore make better benchmarks. Second, an economy-wide average wage is based not on entry-level wages but on the earnings of workers with an average number of years of employment in a given company—and earnings strongly increase with the number of years of employment in the same firm. As wage statistics show, earnings for workers who have been employed the longest by a given firm are 40 percent higher than entry-level wages for unskilled workers, and are 60 percent higher for white-collar workers. However, recipients of social assistance are likely to be earning entry-level wages when they enter or re-enter the workforce. Third, taking up full employment is not the only alternative—and probably not even the most relevant one—for a person on social assistance. Many recipients may seek gradual entry or re-entry into the labor market, be it in part-time jobs, in apprenticeships, or on a contractual basis.

The picture looks very different if these factors are taken into account. The services sector, for example, turns out to be a rather unattractive alternative to social assistance. At a gross wage of DM 2,300 per month, an average entry-level wage in the services sector, net income would be approximately DM 1,560—just DM 500 more than the social assistance entitlement.

Leaving social assistance for a regular job—rather than an apprenticeship—is least attractive for women. In a full-time regular job in the retail sector, for example, monthly earnings would be only about DM 500 higher than social assistance benefits. If a woman has a child, the difference between social assistance and earnings narrows to DM 300 per month, because tax relief plus cash benefits for the child are lower for working mothers than the social assistance benefits provided to unemployed mothers. A woman with two children who takes a job may even see her disposable income go down.

In sum, the official benchmark wage for measuring the wage-benefits difference is “insider” oriented. It reflects whether a person in an average full-time job—an insider—has an incentive to quit his or her job voluntarily and file for social assistance. More relevant for the question of exiting social assistance, however, is the “outsider” perspective: what wages can recipients of social assistance—people without jobs—hope to earn? In many cases, wages and benefits are so close that there is practically no incentive to get a job.

### Reform constraints

Reform of social assistance is subject to many constraints, making it very complex.

The system must be needs-based; benefits must be generous enough to allow for a decent standard of living; the system must only temporarily support those who are capable of working and help them find their way (back) into the workforce—while supporting, indefinitely, workers unable to find jobs. These constraints have important implications for the schedule of benefits withdrawal. Roughly speaking, full support for the needy with absolutely no other source of income means monthly benefits of around DM 1,100—and there may be no benefits for those with sufficient incomes (meaning incomes above DM 1,100). The result: a 100 percent effective marginal tax rate. Whether or not recipients work, disposable income is always DM 1,100.

To increase work incentives, benefits would have to be reduced—or provided to those with net monthly incomes over DM 1,100 so that earnings from work would boost disposable income. Both options face political opposition, the first because it could be regarded as undermining full support for the needy, the second because it could be regarded as extending eligibility to those who are not in need and as increasing the permanent cost of social assistance.

### Possible steps to reform

Nevertheless, two measures could be taken (and are actually being discussed) to help the social assistance system achieve its aim of fully supporting those in need while encouraging recipients who can work to do so:

- Withdrawing benefits over time—say, three months after a recipient starts a new job. The main reason recipients do not look for work is that working does not raise their

disposable incomes by much. Moreover, taking up employment may entail search and setup costs (often before income goes up), and daily expenses may also increase once people go back to work. Withdrawing benefits slowly would make it easier for social assistance recipients to cover these transition costs and see—at least at the beginning—a clear “work bonus” in the form of an increase in disposable income. In the long run, this measure should not necessarily increase the fiscal burden of social assistance if it is effective in motivating recipients to enter the labor market.

The potential for moral hazard—the risk that recipients may take up and then deliberately quit employment to get benefits again—is probably small (and could also be legislatively prevented). Experience shows that there are virtually no incentives for workers to quit and enter the social assistance system: they lose social status, reduce their net earnings, and also forgo potential increases in earnings. In fact, people usually enter social assistance because of adverse circumstances (e.g., unemployment, divorce from the wage earner, long illness). Thus, efforts should be focused not on discouraging people from entering the social assistance system but on finding ways to encourage recipients to exit.

- Making child allowances consistent for low-income workers and social assistance recipients. Although the 1996 tax reform increased cash benefits for children, they are still considerably lower than the allowance under the social assistance system. For example, the head of a low-income household with two children receives a monthly cash benefit of up to DM 936 for the children if collecting social assistance—but only DM 400 if working. This problem is similar in other European Union countries; it implies that the replacement rate can increase by 30–40 percentage points with one or two children and, for low-income earners in some Scandinavian countries, can even exceed 100 percent.

The idea behind these substantial differences in child benefits is clear: recipients of social assistance are assumed to have no resources at all for their dependent(s) and therefore receive a full cash benefit for them. Regularly employed workers, by contrast, are assumed to have sufficient resources, so that the tax allowance is intended merely to supplement income. But, given the low wages for women who enter, for example, the services or retail sectors, this is not always the case.

Reconciling the differences between social assistance benefits for children and

allowances for children under the tax law—for example, by increasing the tax allowances and cash benefits for single parents, in particular those with older children—will increase the gap between the net position of a family or a single earner with children and a recipient of social assistance. The German government planned to take measures to increase child benefits, but put the plan on hold because of the need to lower the fiscal deficit to meet the Maastricht criteria for entry into the European Monetary Union. The measures were targeted at publicly sharing a greater part of the costs of rearing children. The external effects an increase in child benefits would have—by widening the gap between regular earners with children and social assistance recipients—further justify such measures and might even offset some of the budgetary costs. In particular, an increase could significantly help single women with children to take up employment. **F&D**

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*For references and further discussion, see Christian Thimann, 1995, “Effective Taxation of Social Assistance Recipients in Germany and the Consequences of the 1996 Tax Reform,” IMF Working Paper No. 95/120.*

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