

# Book Review

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**Journal of Income Distribution**

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*Redesigning the Welfare State: Germany's Current Agenda for an Activating Social Assistance*, Sinn, H.W., C. Holzner, W. Meister, W. Ochel, and M. Werding. Cheltenham, UK/ Northampton MA, USA: Edward Elgar Publishing Ltd., 2006, 224 pages, ISBN 1 84720 077 X, £55.00.

This book gives an account of two avenues for reform of the German welfare state. The first avenue is the one already well under way under the name of Hartz IV, the commission under the presidency of Peter Hartz installed by former Chancellor Schröder in 2002. The second avenue is the route to be followed, according to a group of mainly labour economists linked to the German economic research institute, Information und Forschung (IFo), at the University of Munich. In assessing the merits of the book, it will prove to be helpful here to use the metaphor of a sick patient. The patient is not so much the German economy at large, but the lower end of the labour market, that of the market for low-skilled work.

As good medical practitioners are supposed to do, the authors start the book with a careful diagnosis of the impact of Germany's lower-tier, welfare state provisions on the labour market for those with no or only minimum qualifications. Despite shortening the entitlement durations of unemployment insurance benefits and the less generous and means-tested unemployment assistance enacted under the Hartz legislation, caseloads are still rising. The same applies for the number of recipients of a third type of benefit, the safety net of social assistance, with a withdrawal rate of between 85 and 100 per cent. From 2005 onwards, Hartz has merged unemployment assistance and social assistance, modelled on social assistance alone, which implies a further curtailment of welfare. Another symptom is a flourishing shadow economy, owing its very existence to the tax and transfer system. Although estimates must be treated with care, a rough conjecture is that in 2004 the informal sector accounted for about 16 per cent of the Gross Domestic Product and employed 9 million people. A third symptom not to be dismissed is that the lowest pay scales in collective labour agreements are virtually never used, despite an enormous reservoir of unemployed but employable low-skilled workers.

How do the authors explain the patient's symptoms? One factor is the poverty trap. Accepting a low-wage job does not bring a higher net income for social security recipients due to the high withdrawal rate and income-dependent supplementary benefits. In technical terms, the reservation wage for the unemployed is set by the level of the social security benefit. From the labour demand side, employers

realize that jobs with a value added below this reservation wage will not be filled. The social assistance thus sets a wage floor, leading to a rather compressed wage structure, with low-wage dispersion and a lack of jobs against low pay. In sum, the diagnosis is that the labour market for low-skilled workers does not clear. The Ifo recipe is to fully restore equilibrium on this labour market segment.

I think the great merit of the book is its consistency in working out what is required to cure the patient – to restore the labour market equilibrium – and in showing, at the same time, why the policy package of Hartz IV does not come up to the mark. The Ifo-recipe contains three ingredients. First, the level of social assistance benefits will roughly be halved. This is necessary to enforce a significant reduction in the reservation wage. Second, the income of those accepting jobs against low pay will be supplemented by means of Earned Income Tax Credit (EITC) type wage subsidies. Third, for those willing and employable but unable to find work in the regular labour market, the government (*in casu* the municipalities) will act as employer of last resort, by organizing community jobs or placing these individuals in the hands of profit-oriented temporary employment (temp) agencies, which in turn assign them to client firms. Whether doing community service or performing a job mediated by the temp agency, income will not be higher than the current social assistance benefit.

In a way, the treatment offered amounts to an Americanization of the low-wage sector but with more income support than is customary in the United States. As the authors make clear in inserted commentary boxes within the main text, their recipe is inspired by developments, besides the EITC for low incomes, going on in both the United States, e.g., the *Wisconsin Works* workfare projects, and the United Kingdom, to a lesser extent. As said, the great merit of the book is that the authors do not hesitate to spell out what is required really to restore a market clearing labour market for the low skilled. To give some figures, subtracting frictional unemployment, about 3.2 million extra low-wage jobs are required, against 6.6 million workers already employed in the low-wage sector. Using a labour demand elasticity of -1, restoring full employment requires a reduction of about one third in the hourly wages paid, from €8.7 down to €5.9.

The authors therefore fully acknowledge that a desperate disease requires a desperate remedy: summing up, the level of social assistance must be halved, a full-fledged system of community jobs has to be launched to block the option of sitting at home on a benefit and going once a week to the job centre to see that no job has come along, and wages in the low-wage sector are to be set back to market clearing levels. One would expect that in prescribing such a dosage, much attention is paid to possible negative side-effects. In my view, the authors are more at pains to show comparatively the beneficial effects of their preferred treatment versus the Hartz alternative than to tell honestly why the treatment eventually may fail (there are many countries without a generous welfare system and no minimum wages but

still suffering high unemployment), or even if it succeeds, to spell out fully the possible accompanying inconveniences.

Admittedly, some of the expected difficulties are briefly addressed in the book. For instance, one likely effect of state-provided jobs or low-rate, assigned jobs found by temp agencies in client firms for benefit recipients, who, while working, are still entitled to a full social benefit, is the displacement of existent jobs, whether private or in the regular labour market, through unfair competition. The authors feel reassured that because of the imposed duty to work, a serious blow will be given to the informal economy, to such an extent that the emergence of new regular jobs, formerly in the informal sector, will more than compensate for the displacement effects. Another issue is the phenomenon of 'creaming': usually only the most qualified benefit recipients are selected by the temp agencies to be mediated towards regular work. This is avoided because the municipalities will define the pool for which temp agencies are invited to tender. Finally, it is acknowledged that the use of the wage subsidy in the form an EITC will inevitably raise the effective marginal tax rate of middle-income earners.

The crucial question is of course whether the patient will subject itself to the prescribed treatment. I think not, and maybe the patient has good reasons to refuse this shock therapy. The policy might work in regions with modest levels of unemployment, but the package will really be stretched to its limits in regions of East Germany with unemployment rates among the low skilled of more than 50 per cent. There are limits to the number of jobs that can be provided by temp agencies in depressed areas as well as to the range of meaningful activities to be done by social security recipients, in the form of community service, in order to retain their benefit (imagine a small village of say 1000 inhabitants, where day-after-day from 9 to 5 about 100 persons are supposed to perform meaningful community activities). Maybe the package would be more acceptable and convincing if accompanied by measures that not only put the pain and costs of solving the problem on the most vulnerable (with the danger of 'blaming the victim') but also demand painful offers from higher income earners and government itself (notably the functioning of job centres and the Federal Labour Office).

The package seems, in this latter respect, to be unbalanced. Relying on welfare will become much less attractive because of the disutility of being inserted into community work in order to keep a full benefit and being at the mercy of the private view of a municipal case worker on the deservingness of your being on welfare. This will deteriorate the bargaining position of all, including the incumbent, low-skilled workers against employers. Against every new low-wage job created, two persons will see that the wage of their current job drops by a third. As the analysis of the long run effects of the reform makes clear (Section 5.7), this sharp drop in wage earnings for incumbent workers in the low-wage sector will end up as higher income for complementary factors in production - the higher skilled and capital

owners - so without any supplementary measures some of the costs incurred by the patient are a net benefit for others.

Between the lines, the authors suggest that they also have policy recommendations for other segments of the German labour market, but this goes beyond the scope of this book, focussing on activating social assistance.

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