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Article

Social Welfare Reform

CESifo Forum

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Sinn, Hans-Werner (2000) : Social Welfare Reform, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 01, Iss. 4, pp. 25-26

This Version is available at:

<https://hdl.handle.net/10419/166065>

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DICE REPORTS¹

SOCIAL WELFARE REFORM

The stronger German economy has led to a decline in unemployment. This, however, cannot disguise the uninterrupted trend towards greater unemployment in Germany since the 1970s, especially among the less qualified. This unemployment means a loss in GDP and is a major social tinderbox. Since millions of eastern Europeans will enter the German labour market after EU expansion, problems are inevitable. The labour market needs structural reforms, and social welfare reforms are certainly the most important.

German social welfare is tantamount to a minimum wage floor that prevents the creation of new jobs. No one is willing to work for wages below the level of welfare benefits. And no business will hire anyone whose wages exceed labour productivity. People whose labour productivity falls below welfare cannot find jobs for this reason. They are caught in the poverty trap.

The effect of social welfare is based on its wage substitution function, but this need not be so. Instead of providing payments for idleness, the state could insist that beneficiaries have some market income, so long as family or medical circumstances do not prevent this. This type of welfare has been practised in the United States for many years under the Earned Income Tax Credit programme. In Germany the state cuts welfare payments by seventy pfennig to one mark when the welfare recipient earns a mark on his own. In the U.S. the government provides an additional 40 cents for every dollar earned, up to a particular level.

The German social welfare system fixes a lower limit for wages. The American system makes wages flexible in the lower regions. If Germany adopted the U.S. welfare system, the conflict in Germany between the goal of a minimum standard of living and private-sector employment would be eliminat-

ed. Illicit work would lose its appeal and people would be prepared to work for lower wages since only the proof of their own earnings would entitle them to welfare benefits. In America the lowest wages are about 30 percent of the average wage; in Germany they are about 70 percent. It is no wonder that the U.S. has experienced a job miracle and that Germany has lost jobs.

American social welfare differs from the Germany's not only in its incentive structure but also in the level of the protection provided. Despite state support, the income of the less qualified is considerably lower than in Germany. To avoid the problem of the American working poor, the system must be much more generous than in the U.S. This has the additional advantage that the lowest collectively bargained wage rate will begin to erode more quickly, which will allow the creation of jobs for the less qualified. A general boost in growth would occur, and the distributable amount of goods and services would increase. Social policy performance would probably also improve. Those to be helped would have two incomes instead of one and with welfare and own earnings would have more income than before at the same level of state social welfare expenditure.

Inherent in the U.S. system is the harsh treatment of those who could but refuse to work. This harshness is not contrary to the goal of helping the less qualified in a dignified way. On the contrary, this system is in a better position to reach this goal. The German welfare system makes people feel useless, encourages idleness, and creates habitual patterns for children who grow up in these circumstances. Neither a Christian-democratic nor a social-democratic philosophy demands that assistance to the less qualified be conditional on idleness. It is hard to believe that this is the way the system still works.

A transition to an earned income tax credit may not be smooth. For this reason welfare benefits should be lowered gradually and the money saved should be used for supplemental wage payments.

¹ DICE = Database of Institutional Comparison in Europe (www.cesifo.de).

The needy should be gradually moved from their TV armchairs to the shop floors where their income should be bolstered.

The problem with the transition lies in increasing the acceptance of low-wage jobs in the private sector without at the same time forcing the needy who cannot find jobs into financial hardship. To solve this problem, the state must offer limited employment so that everyone is provided for and no one can claim that jobs cannot be found. The wages for these jobs must be low enough so as not to compete with private-sector employment and high enough to ensure a suitable overall income.

Whoever doesn't work although able to can expect only limited help from the state. Whoever takes on a state job can receive in addition a wage that would lift him to the level of current welfare benefits. Whoever finds a job in the private sector receives both a wage and a wage supplement that increases his total income to a level above that from a state job. These are the ground rules for a new, incentive-creating welfare system that lets people free themselves from the poverty trap. This is the only way to make the labour market fit for the new economy, for globalisation and for EU enlargement.

Hans-Werner Sinn