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## Making Work Pay: U.S. American models for a German context?

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March 2003

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# **Making Work Pay:**

## **U.S. American models for a German context?**

Laura Chadwick  
Jürgen Volkert

March 2003

*This paper examines efforts to make work pay, concentrating on U.S. American and German policies and experiments. We are specifically interested in fleshing out the relevance of U.S. American models for a German context as well as the special characteristics of the German situation which do not allow a mere „copying“ of the models.*

*There is no established negative income tax in Germany, but current experiments are being conducted, in order to assess how successful incentives could be in lowering the high levels of welfare caseloads and easing the transition from welfare to work. High unemployment rates and guaranteed social assistance (and unemployment insurance) have caused a German version of the poverty trap, where few incentives exist for people to find work.*

*This paper examines the normative, political and economic situation of each country with specific experiments and studies of tax credits. The U.S. American early negative income tax (NIT) experiments in the 1970s, the present day Earned Income Tax Credit (EITC), and two recent experiments to make work pay are discussed. The historical, political and economic context of Germany is evaluated for a possible earned income tax credit, and fledgling tax credit experiments that are currently being conducted in Germany are discussed.*

*A negative income tax is defined in this paper as a cash payment to individuals and families from respective governments that acts to subsidize personal income up to a predetermined level. There is a minimum benefit level, a marginal tax rate and a break-even point. The higher the benefit level and the break-even point, the more a negative income tax will cost the government (Zimmerman 1995).*

*Before describing specific tax programs, we first outline the country's welfare state developments with respect to financial incentives for work. The following is a closer consideration of the U.S.-American and German public assistance and tax systems. The U.S. and Germany have very different welfare regimes and negative income taxes should inevitably fit into the respective welfare structures in different ways, fulfilling different goals.*

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# 1 Overview

## 1.1 U. S. overview

Before World War II, the tax system in the U.S. was class-based and lower income families were generally not taxed. After the war, in order to finance war debt, the tax system was extended to many more people, exemptions were reduced and deductions curtailed. At the same time the cost of living was rising. As early as 1946 in this receptive atmosphere, where tax exemptions were too low to protect a minimal existence and many people were paying taxes, the idea of a negative income tax as suggested by George Stigler was conceivable. In addition to the failure to increase personal exemptions in the late 1940s, worsening conditions were exacerbated for workers as they were pushed into higher tax brackets by inflation in the 1950s. It was only in the 1960s, after poverty rates had climbed, and after other solutions to mitigate high tax rates and low exemption levels had failed, that a negative income tax became more popular and there was a more developed idea of what a negative income tax would look like and might hope to achieve (Ventry 1999).

In 1962, the same year that Michael Harrington's pioneer book on American poverty, "The Other America" was published, the American economist Milton Friedman fleshed out his concept of a negative income tax in his book "Capitalism and Freedom." This book examines a negative income tax that would pay cash to lower classes but provide progressive tax rates that would not extend too high into the upper income brackets. In the American capitalist spirit, this negative income tax was not a guaranteed income and according to Friedman would not in any way interfere with the market (Friedman 1962).

As a negative income tax was being discussed to solve the country's growing poverty problem, Friedman's solution was very much in line with American values, which hold small government, individual rights and "freedom" as central. Friedman thought a negative income tax would let the welfare system be absorbed into the internal revenue service, which would mean less government. He preferred a uniform tax system where, if progressive taxation was necessary, it extended downward in the income distribution, and where benefits were provided in cash instead of services, to leave people with freedom of choice regarding how they spend their money. Progressive taxation was not to extend far upward in the income distribution, so that individuals would not be "penalized" for their hard work (Ventry 1999).

In the mid to late 1960s, Friedman's version of a negative income tax and also a guaranteed minimum income were discussed separately but also simultaneously in government policy packages. The Office of Economic Opportunity and President Johnson's 1965 Income Maintenance Task Force put forth proposals. In 1969 President Nixon based his Family Assistance Plan (FAP) welfare reform package on these two measures. A primary reason for the failure of all of these measures to become law was concern about possible work disincentives (Ventry 1999). Evaluations were needed.

In 1972-74 some first experiments were conducted on the negative income tax. These experiments found that there was strong evidence of a small amount of labor force withdrawal among families who were participating, primarily among secondary workers in the household and not

the main breadwinner. There was also little evidence to indicate a significant change in family income between these families and the control groups (Hefernan 1972).

Support for a pure negative income tax declined, but policy makers still searched for ways to help the poor, yet also avoid work disincentives. The Earned Income Tax Credit (EITC) was introduced in 1975. It is similar to a negative income tax, except that there is no minimum benefit level. Instead, workers receive the credit on every dollar they earn up to a specified amount, and then the credit is taxed away as earnings continue to increase. In the 1980s and 1990s there was again a growing problem of poverty, and the support and budgets for the EITC grew. Government spending on the EITC grew from \$1.3 billion in 1975 to \$2.1 billion in 1985. In 2001 the budget for the EITC grew to over \$30 billion (Budget of the United States Government, Fiscal Year 2003). Probably the rapid expansion in the early 1990s reflected the political as well as the economic environment. The gap between rich and poor was exacerbated and Democrats, who generally advocate government social programs, were elected into office.

The Budget Reconciliation Act of 1990 expanded the earned income tax credit. In 1993 President Clinton further expanded the EITC in the Omnibus Budget Reconciliation Act, increasing the maximum credit rate available and the income level at which individuals can qualify for the credit, and also allowing low-income taxpayers without children to receive the credit for the first time. The EITC was supported by both Republicans and Democrats at least until 1995, when Republicans proposed to reduce it. New objections offered by Republicans to an expanded EITC were 1.) a limited effectiveness in creating work incentives, 2.) a failure to target low-income workers, 3.) rampant fraud and abuse, and 4.) marriage disincentives (Greenstein 1999).<sup>1</sup>

The debates in the U.S. regarding an EITC have not really changed over the years. The EITC was created to encourage work, reduce means-tested features of the welfare system (and the resulting stigmatizing effect), and reduce the heavy administrative costs normally associated with other traditional social assistance programs. It was one way to help reduce poverty, but certainly not the panacea. Tied to employment, an EITC does not cure poverty problems in particular situations where work is not available or not feasible, i.e., when an individual is disabled or has to care for young or sick dependents at home. However, the EITC provides incentives to work underscored with distinctly American values. This program has enjoyed considerable support when couched in terms where the policy promotes self-sufficiency (for individual rights and freedoms), promotes family values and provides an opportunity to "move-up" out of poverty. These values are probably one reason for its general success in the legislature up until recently.

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<sup>1</sup> Indeed (other) problems exist for the EITC: not every one who is eligible applies or knows about the program. Workers can only receive the credit when they submit a "schedule EIC" at the time they file their taxes. Workers can receive benefits as a supplement to their regular paychecks (the "advance payment program") or at the end of the year, after they file their tax return. By law, employers are supposed to inform their workers about this program and offer them the supplement program if they wish. Yet many people still do not know about this program (Center for Community Change 1999).



In the late 1980s and early 1990s Americans again became concerned about welfare programs. Welfare roles expanded, and research showed that some people were dependent on welfare for long periods of time, instead of using it as a temporary aid during times of economic stress. To encourage experimentation within the welfare system, the federal government approved “waivers” that allowed states to ignore some rules and change some practices. Two states introduced programs that are directly relevant for the German negative income tax experiments: Wisconsin and Minnesota. Both programs tried to encourage work and to make work pay by providing monthly cash payments to supplement the earnings of low-income workers.

## 1.2 German overview

Financial work incentives in Germany have existed since the end of the Second World War for the blind and disabled to cover their higher costs in maintaining jobs. Financial incentives for integration into the job market for other groups were not considered necessary, because German social assistance has relied heavily on each recipient’s obligation to work. During the rebuilding of Germany after W.W.II, work vacancies could not be filled fast enough in the boom, and guest workers were actively sought from other countries. In the East, employment also expanded and vacancies in the workforce were partly ameliorated by the active recruitment of women (Trappe 1995). Social assistance was not reconsidered until the mid 1970s in the west when many people fell into unemployment. At first there was an expansion of welfare, but the successive economic downturn in the eighties and early nineties was harder for the state to bear. Costs for “Hilfe zum Lebensunterhalt”, only one part of social assistance, went from about half a billion Euro in 1965 to almost 2 billion Euro in the mid 1970s, 4 billion Euro in 1985 and 9 billion Euro in 1995. In 2000 the total costs for “Hilfe zum Lebensunterhalt” reached about 10 billion Euro. The other social assistance “Hilfe in besonderen Lebenslagen” went from almost 1 billion Euro in 1965 to 3 billion in the mid 1970s, 7 billion Euro in 1985 and almost 14 billion Euro in 2000.<sup>2</sup> These increases were primarily due to more recipients, and not because of increased benefits (Volkert 1999, Wenzel 1995).<sup>3</sup>

The last decade has shown very little economic improvement in Germany and the uncertain economic situation has probably been one reason for the considerable reforms of social assistance and unemployment insurance in the 1990s (Sturm 1996). Generous unemployment benefits were first restricted by reduction of time limits, with the result that many recipients slipped from the unemployment rolls to the public assistance rolls. In 1990 a change in the calculation of welfare assistance led to a reduction of welfare payments. According to the Federal Social Assistance Act (Bundessozialhilfegesetz) the state was responsible for providing unconditional universal social security to its citizens, but in the 1990s work and social assistance became more interdependent. In 1993 the Federal Government introduced penalties when social recipients refused to work. A year later, the law reemphasized that willingness to work was now a requirement for social assistance. This law gave the social assistance offices an option to create job opportunities for their social assistance recipients to find permanent work or to test their willingness to work. (§20, Abs. 1 BSHG).

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<sup>2</sup> See Haustein (2002), p. 133.

<sup>3</sup> In the following we are referring to the „Hilfe zum Lebensunterhalt“ if the term „social assistance“ is used.

During the mid 1990s social assistance was no longer just a rehabilitation program but developed into a mechanism for controlling willingness to work (Herweg 1999). In July 1996, powers were given to the welfare office which made them responsible for penalizing recipients who refused to take up offered work. When welfare recipients did not take up work, the welfare offices were told that they "must" reduce payments (§ 25 BSHG).

In response to the critique that social assistance pressured recipients to work but did not make work attractive after pay reductions, social assistance reform in 1996 also slightly raised the level of take-home earnings. Working social assistance recipients and their take-home earnings became the focal point for the first concept of a negative income tax a year later in 1997. Since then, experiments and simulations of a negative income tax have been conducted with varying results in Germany. The main concerns of German policy makers have been the costs of a German tax credit program, which part of the government would bear the costs and how such a program could fit politically and culturally into the German system. The cost of a negative income tax would be inherently high because it would have to compete with far-reaching support networks of social assistance in order to make work more attractive. Since a considerable share of employment wages are set at predetermined levels that curtail the danger of becoming "working poor", any tax credit payment above the set wages would reach into middle class wage levels, which would be a high cost for the German government.

Public service expenditure in Germany is also structured on two levels, which makes for complicated calculations for how a negative income tax would be financed. Unemployment insurance is paid to individuals by the federal government, but welfare is distributed from the city and district governments. The federal and local governments are already struggling to make their caseloads of recipients the other's responsibility. Thus, a negative income tax could potentially cause even more conflict as to who would be responsible for these extra tax credits (Wilke 1999). The two political ideals of universal social rights and work security, which are the building blocks of much of German policy, fit uneasily into a negative income tax policy. Even from the beginning, the Sozialstaatsprinzip, which prohibits unequal treatment of citizens, proved a stumbling block for the research of the negative income tax. When researchers first proposed to study financial incentives in social assistance, members of the federal administration were strictly against such a research design, on the grounds that it might be illegal to treat individuals unfairly, if some could take home tax credits while others could not.

A reinforcement of the work security ideology is also not clear in negative income tax discussions. Unlike in the U.S., where negative income taxes were created to correct low wages and insufficient exemptions, a negative income tax in Germany would be established with current set wage levels, which are set high enough to prevent a massive working poor problem. As politicians discuss the creation of more jobs in the German economy and a reduction of wage levels ("Billigjobs"), a negative income tax could be speculatively used to provide a cushion for the general lowering of preset wage levels. The German welfare system has undergone subtle changes in its welfare regime philosophy and has come to emphasize work as a requirement for assistance. Categorization of welfare recipients has also become more pronounced. Mechanisms for controlling welfare recipients have increased. While social assistance is still considered a right and poverty prevention is desirable, changes in the concept of redistribution are

apparent. No longer is social assistance just a way to cover life risks for unemployment, old age, etc.; it also emphasizes the recipient's own responsibility for his or her situation. While in the 1970s there was less stress on either the stick or the carrot in Germany (Leibfried 1978), the discussion of a negative income tax today reflects more interest in promoting self-initiatives by social assistance recipients in combating their unemployment.

The latest proposal to promote self-initiative and to get a little closer to the U.S. incentives comes from the German Council of Economic Experts (2002/2003). In their recent report this group of Germany's leading economic advisors to the federal government argues in favor of a very fundamental reform by combining a reduction of social assistance payments by 30% for recipients who are able to work but are not entering the labor market, more incentives to work in social assistance (lower implicit tax rates) and public employment opportunities. This recent proposal is discussed in more detail in a later section.

## **2 Incentive programs: experiences and simulations**

### **2.1 U. S. Experience**

Three sets of policy experiments in the United States are relevant to the German negative income program: the negative income tax experiments of the 1970s, the Earned Income Tax Credit, and two recent programs to make work pay.

#### *2.1.1 U.S. Negative Income Tax<sup>4</sup>*

As part of the War on Poverty, United States policy makers searched for a program to replace the welfare system, which people increasingly felt was an ill-coordinated and inefficient way to help the poor. Costs increased dramatically during the 1960s, yet the poverty rate remained sizable. One particular problem was the fact that the main welfare programs did not provide benefits to two-parent families. Another concern was that high effective tax rates discouraged work effort and increased welfare dependency. The idea of a negative income tax program gained support, but people were worried that providing aid to able-bodied heads of families would substantially reduce labor supply.

To answer this question, the United States conducted four negative income tax experiments in the late 1960s and 1970s. The negative income tax program that the U.S. envisioned involved providing a maximum benefit to families with no other income, and reducing that payment for each dollar of other income received by the family. The New Jersey Experiment was conducted in urban areas of New Jersey and Pennsylvania from 1968 to 1972. It enrolled 1,357 families for a treatment period of three years. The Rural Experiment was conducted in rural areas of Iowa and North Carolina from 1969 to 1973. It enrolled 807 families for a treatment period of three years. The Gary Experiment was conducted in Gary, Indiana (an urban area) from 1971 to 1974. This experiment enrolled 1,780 black families for a treatment period of

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<sup>4</sup> This section draws heavily from the Final Report of the Seattle-Denver Income Maintenance Experiment, 1983.

three years. The largest and longest experiment was the Seattle-Denver Experiment (SIME/DIME) conducted in Seattle and Denver from 1971 to 1982. It enrolled 4,800 families, and tested different lengths of treatment: three years, five years, and 20 years.

The four experiments varied in the maximum income level eligible for enrollment, the level of guaranteed income, the tax rate, and the grant breakeven level. The maximum income level for enrollment ranged from 150 percent of the U.S. poverty line to 325 percent. The guaranteed income level (the amount a family received if they had no other income) ranged from 50 percent of the U.S. poverty line to 140 percent. The rate at which benefits were reduced ranged from 30 percent to 80 percent. The experiments were careful to reimburse all other taxes so the families actually faced the experimental tax rate. The grant breakeven level (the amount at which the grant became \$0) ranged from 100 percent of the U.S. poverty line to 280 percent.

In total, the four negative income tax experiments cost \$225 million (in 1984 dollars), of which \$63 million was direct payments to families. For all four experiments, roughly one-third of the families were single-headed families and the other two-thirds were two-parent families. More detail on the families that participated is available for the Seattle-Denver Experiment, which was by far the largest of the four experiments. In the Seattle-Denver Experiment, 42 percent of the families were headed by a single adult, and 58 percent of the families were headed by a couple. Families with income up to 325 percent of the poverty line were eligible for enrollment, although people with the highest incomes were used as controls only.

The negative income tax experiments had a definite impact on labor supply. Supporters were pleased to find little evidence of a massive withdrawal from the labor force. Yet all four experiments found decreased labor supply. Robins (1985) compared estimates from the four experiments that were based on the most similar sample selection criteria, time period, and variable specification. He found that husbands, on average, reduced labor supply by about two weeks of full-time employment, while wives and single female heads reduced labor supply by about three weeks of full-time employment.

Another aspect that the negative income tax experiments studied was the impact on marriage and divorce rates. People were concerned that the traditional welfare system, which mainly only provides benefits to single mothers, discouraged marriage and encouraged divorce. In contrast to expectations, analysis of the data from SIME/DIME found that married couples that received the negative income tax were one-third *more* likely to get divorced than the couples that did not receive the benefits (SRI International, 1983).

### *2.1.2 U.S. Earned Income Tax Credit*

The Earned Income Tax Credit (EITC) was first enacted in the United States in 1975, more to offset the cost of payroll taxes for low-income Americans than as an explicit anti-poverty policy. The program is structured in a way that aids poor families while encouraging work, and has generally received support from both sides of the political spectrum. As a result, it was expanded in 1986 and 1990 under Republicans, and again in 1993 under Democrats. The 1993 expansions were fully phased-in by 1996.

The EITC's role in reducing poverty comes from the fact that it is a refundable tax credit: if the amount of a family's credit exceeds its income tax liability, the family receives a check for the difference from the Internal Revenue Service (the U.S. tax authority). Since people with low income often do not owe taxes, a nonrefundable credit (which can only be used to offset taxes owed), is usually not very helpful.

The EITC encourages work because only households with earnings are eligible to receive it. The size of the credit initially rises as earnings increase, by 34% of earnings for families with one child, and 40% of earnings for families with two or more children. The maximum benefit for tax year 2001 was \$2,428 for families with one child<sup>5</sup>, and \$4,008 for families with two or more children. The maximum benefit was available for families with one child with income in the range of \$7,100 to \$13,100, and for families with two or more children with income in the range of \$10,000 to \$13,100. The credit phases out at the rate of 15.98% for families with one child, and 21.06% for families with two children, such that the credit is \$0 for families with one child earning more than \$22,281; the credit is \$0 for families with two or more children earning more than \$32,121. The 1993 expansions of the EITC made families without children eligible, but the credit is very small (the maximum credit was \$364 in 2001). Since 1987, the EITC is indexed so that it keeps pace with inflation annually.

In 1999, 19.3 million taxpayers claimed the earned income credit, at a total cost of \$31.9 billion (Campbell and Parisi, 2001). The total amount refunded to low-income taxpayers was \$27.6 billion. No comprehensive study of the costs and benefits of the EITC exists. However, Dickert, Hauser and Scholz (1995) estimate that a movement of 500,000 families from welfare to work would reduce spending on these families by an estimated \$2 billion a year net of the increase in EITC payments to these families, and that the 1993 EITC expansions would induce about 500,000 families to move from welfare to work.

Taxpayers with adjusted gross income less than \$15,000 received 69% of the benefits of the EITC, so it is fairly effectively targeted on low-income Americans. Liebman (1998) estimated that 78 percent of EITC beneficiaries had no more than a high school education in 1990, and 41 percent did not have a high school diploma. Single women with children were approximately 48 percent of the EITC eligible population in March 1992 (Eissa and Liebman 1993). Single parents received about 70 percent of the \$25 billion in EITC in 1996 (U.S. House of Representatives, Green Book 1996, pp. 808-809).

Researchers have examined the effect of the EITC on poverty and labor supply. Regarding poverty, it is clear that the EITC has an effect. One study found that the EITC lifted 4.6 million people in working families out of poverty in 1996, including 2.4 million children (CBPP 1998). Another study estimates that the EITC reduces poverty among young children by nearly one fourth (NCCP 1998). One reason why the EITC has been effective is its high take-up rate: Scholz (1994) estimates that 80 to 86% of eligible taxpayers receive the EITC. This

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<sup>5</sup> In 1999, the U.S. poverty threshold for a family of three was \$14,129; the threshold was \$18,104 for a family of four. The median income for a family of three was \$52,883; for a family of four it was \$62,233 (U.S. Census Bureau).

is much higher than the 62-72% estimated AFDC participation rate (public assistance for families with children) and the 55-66% food stamp participation rate (Blank and Ruggles, 1993).

The results are more ambiguous regarding labor supply. This is partly because the predictions are also more ambiguous, since economic theory predicts that whether workers increase or decrease work effort should depend on whether they are in the subsidy, flat or phase-out range of the credit. For individuals who are not working, the substitution effect associated with higher after-tax wages provides an incentive to enter the labor market. For individuals with incomes in the subsidy range, the income effect associated with the subsidy provides an incentive to work less, while the substitution effect encourages people to work more. In the flat range of the credit, there is only an income effect, which provides an incentive to decrease hours of work. In the phase-out range, the substitution and income effects reinforce each other and both provide an incentive to decrease hours of work. Scholz (1994) estimated that 79% of EITC recipients would have incomes that fall in the flat or phase-out range of the credit in 1996, which could lead to a reduction in the labor supply of low-income workers.

A few empirical studies have explored changes in labor supply due to the EITC. Eissa and Liebman (1996) found that labor force participation among single women with children increased by up to 2.8 percentage points between 1984-1986 and 1988-1990 (from a base of 73 percent). This time period was before the largest expansions in the EITC occurred. The authors did not find any effect on the *hours* of work of single women with children who were already in the labor force. Meyer and Rosenbaum (1999) find that the EITC explains 63 percent of the increase in employment of single mothers from 1984 to 1996. Eissa and Hoynes (1998) examine the effects of the EITC on the labor supply of married couples. They find that the EITC expansions increased married men's labor force participation slightly but reduced married women's labor force participation by over a full percentage point, leading to an overall reduction in family labor supply and pre-tax family earnings among married couples. Although many people think this is a problem, some think there could be advantages to having a parent reduce labor supply, especially if they spend the extra time with their children.

There is also some concern that the EITC may affect decisions about marriage. If a low-earning mother (who is eligible for the EITC) marries a low-earning man, their combined earnings may make them ineligible for the credit. On the other hand, if a single mother with no income (who is not eligible for the EITC) marries a low-earning man, the family may become eligible for the credit. The U.S. Congress is currently considering efforts to remove marriage penalties from the EITC, but this may prove an expensive proposition.

### 2.1.3 *Making Work Pay*

#### 2.1.3.1 Minnesota Family Investment Program<sup>6</sup>

The Minnesota Family Investment Program (MFIP) was started in 1994. MFIP combines financial incentives to encourage and support work, and mandatory participation in employment-focused services for long-term welfare recipients. MFIP's rules ensure that families are always better off working than not working. The benefits provide larger work incentives for part-time than full-time work. Recipients can continue to receive supplemental benefits until their income reaches approximately 145 percent of the poverty level. For recipients who work, their welfare grant is 20% higher than the regular grant, and benefits are only reduced by 62 cents for every dollar instead of the dollar-for-dollar reduction under Minnesota's regular program at that time. In addition, MFIP requires single parents who have been on welfare for two years or more to develop and follow a plan for self-sufficiency. Two-parent families that have received welfare for 6 of the past 12 months are also required to participate. Long-term recipients had to work at least 30 hours per week or participate in other work preparation or training programs.

An important aspect of MFIP was that it covered child care, transportation, and work-related expenses for program participants. Finding decent, affordable child care is often a large barrier for welfare recipients in the United States (and also in Germany). Findings from the MFIP program suggest that the strong economy in Minnesota made it easier for people to go to work.

Applicants for the regular welfare program, Aid to Families with Dependent Children (AFDC), were randomly assigned to the control AFDC group or the experimental MFIP group. Approximately 15,000 families were randomly assigned between April 1994 and April 1996. Each family in the sample was followed for three years.

The effects of MFIP were measured at different times. Results based on the 4<sup>th</sup>, 5<sup>th</sup>, and 6<sup>th</sup> quarters after random assignment (one year to eighteen months) show substantial differences between the experimental and control groups. The employment rate was 12 to 17 percent higher for the experimental group, and earnings were \$150 to \$264 higher, per quarter. Because benefits were also higher, total income was \$261 to \$402 higher for the program group. These results were all statistically significant at the 5 percent level or higher. Although it had significant effects, a program such as MFIP did not solve all problems. About half of all MFIP program group members did not work during the follow-up period.

MFIP results were even stronger for some specific subgroups, including single parents in urban areas who were long-term recipients. For these participants, the proportion employed was 40% higher (52% vs. 38% for the control group). Family income was 13% higher, earnings were 27% higher, poverty was 16% lower, and welfare payments were 8% higher. Al-

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<sup>6</sup> This section draws heavily from Miller et al. (1997), and from Miller et al. (2000).

though 16% less of the program group was in poverty, 71% of the families in the MFIP group were in poverty - thus although MFIP may make people better off when they work, it did not dramatically improve the financial situation. Results for participants in rural areas were less impressive, perhaps because the labor market was generally less favorable.

The MFIP experiment included a group that received the financial incentives, but for whom work was not mandatory. Comparing the outcomes between this group and the experimental group shows that both the carrot of extra benefits and the stick of mandatory work requirements contributed to the increase in work. For example, in the 5<sup>th</sup> quarter, employment was 15% higher for the full-MFIP group, and 7% higher for the incentives only group, suggesting that roughly 8% of the impact was due to the mandatory requirements. Regarding earnings, the incentives-only program had little or no impact on earnings.

In contrast, the MFIP program for new applicants did not require people to work full time or participate in other work-readiness activities. The program for applicants was not as successful in increasing work or earnings.

MFIP had the strongest effects among single mothers who were long-term welfare recipients. These differences persisted through the three-year follow up. Employment was 35% higher for single mother long-term recipients in the MFIP group versus the control group. Earnings were 23% higher for this group. Furthermore, MFIP participants were 48% more likely to be employed for 9 to 11 of the 11 quarters that people were followed (nearly three years).

Work effort and earnings increased among the program participants. Unlike earlier welfare to work programs that reduced benefits as earnings increased, total income for the program participants also increased under MFIP. Yet these results are costly, since welfare receipt and total benefits paid increased under the program. For single mother long-term recipients, government costs increased on average by \$2,000 per family. These families were also on average \$2,000 better off than their AFDC counterparts, as a result of increased earnings and increased benefits.

#### 2.1.3.2 Wisconsin New Hope<sup>7</sup>

The New Hope Project was a community-initiated, work-based antipoverty program operated in two low-income areas in Milwaukee, Wisconsin from August 1994 through December 1998. New Hope enrolled adults who lived in one of the two targeted areas who planned to work at least 30 hours per week and had income at or below 150% of the federal poverty level. The adults in the experimental treatment group were provided with job search assistance, including access to paid community service jobs, an earnings supplement, affordable health insurance, and subsidized child care. In the United States, lack of access to health insurance or child care is often a large barrier to leaving welfare, since welfare recipients are covered by Medicaid, the public health program for low-income Americans.

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<sup>7</sup> This section draws heavily on Bos et al. (1999) and Brock et al. (1997).



Unlike MFIP, people in New Hope had voluntarily applied to participate, so New Hope participants might generally be more likely and motivated to work. 1,362 adults applied to New Hope. They were randomly assigned to a New Hope program group or a control group. There were 678 adults in the program group. Participants had to work at least 30 hours per week to receive New Hope's benefits. They could be eligible for up to three years. The benefits were phased out such that a participant always experienced at least a \$.30 rise in total income for each \$1 increase in earnings (total implicit tax rate no higher than 70%).

Although the Milwaukee economy in general was doing quite well during the program period, the two neighborhoods in the experiment had high levels of unemployment. Forty-three percent of the sample lacked a high school diploma or GED. Many participants reported that the help and encouragement offered by their project representative was as important as the financial benefits offered by the program.

If participants could not find full-time work after searching for eight weeks, they could interview for a community service job that paid the minimum wage. Participants could work in community service jobs for a total of 12 months over a three-year period. Each position lasted a maximum of six months, and participants could work in two community service jobs (for a total of 12 months). Participants in community service jobs (but not regular jobs) could also attend up to 10 hours of school or training each week and get paid for this time, as long as they also worked at least 30 hours in their work assignments.

The New Hope evaluation followed participants for two years. 1,086 sample members completed the two-year follow-up survey, which included such information as hours of work and monthly changes in employment status. The results show that New Hope increased employment and earnings for sample members who were not already employed full time at random assignment. The increases were largest during the first year of follow-up and were largely driven by people using New Hope's community service jobs. New Hope did observe some reductions in work effort, mainly by people who were working more than 40 hours per week reducing their hours.

For the overall sample, the program group had higher levels of employment than the control group by between 4 and 11 percentage points in each of the eight follow-up quarters. Community service jobs played an important role; in every quarter, fewer program group members than controls were employed in unsubsidized jobs. Thirty-two percent of all participants in the treatment group used a community service job at some time during the two-year follow-up period. If employment and earnings from community service jobs are excluded, the differences between the control group and program group are no longer statistically significant. Program group members had an "ever-employed" rate that was 5.5 percentage points higher than control group members. Earnings for program members were only significantly greater in the first year (by \$583). Yet due to the EITC and the New Hope earnings supplements, the poverty rate for program members was between 5.6 and 7.8 percentage points lower than for the control group. Like MFIP, however, New Hope was no panacea: between 66 and 74 percent of the program group was in poverty during the two years.

New Hope's impacts were strongest for people who were not already employed full-time at random assignment. Within this group, the results were strongest for people who had one of the following potential barriers to work: low level of education, responsibility for young children, an arrest record, lack of recent job experience, and having been fired from one's last job. The differences between the program and control group were statistically significant for the group with one potential barrier, and almost never statistically significant for the groups with more than one barrier. New Hope program members who were AFDC recipients worked significantly more quarters than their similar control group members.

New Hope was an expensive program. Program services for the two years cost \$9,056 per program group member. 26.2% of the total was for child care subsidies, which were the most expensive component of the program (but also perhaps the most important for enabling people to work). The program was more cost effective for people who were not employed full-time at random assignment. Since Germany's experiment is for the long-term unemployed, it is likely to have results more similar to those for people who were not employed full-time at random assignment. The earnings supplement was \$126 per month for those receiving it, which was 10% of the total cost. Community service job wages accounted for 10.4 percent of total program costs. As with MFIP, it is easier to measure the short-term costs of the program than to measure any long-term benefits.

The importance of community service jobs in the New Hope experiment suggests that Germany may need to consider providing subsidized work for people who cannot find a private-sector job, especially considering Germany's comparatively high unemployment rates.

#### *2.1.4 Lessons from U.S. Experience*

Financial incentives as well as guaranteed minimum income are important topics in the German political debate and process, both of which have been discussed in the U.S. However, the German discussion is mainly driven by national arguments and hypotheses, although the U.S. experiences of the last 30 years provide a number of interesting aspects that should be realized in the German context.

Summarizing the overview of the U.S. programs since the 1970s the most important results are:

- Financial incentives for recipients of social assistance can be a successful way to improve labor market participation
- Such a strategy to make work pay can also help to fight poverty
- Single mothers have turned out to be a main target group for such a strategy
- Financial incentive programs can reduce stigmatizing effects as well as administrative costs
- The recent MFIP and New Hope experiments have shown that education and training and the question of optimal child care for single parents are very important issues for the success of the experiments.

Some prerequisites have been crucial for the success of financial incentives:

- Deadweight costs as well as the overall financial burden are heavily dependent on the range of increases versus decreases of labor supply
- Labor force participation should increase, while decreases in labor force participation should be minimized
- High participation rates are very important for the success of any financial incentive program
- Incentive programs in social assistance should consider all factors which determine the effective tax rates of gainfully employed recipients of social assistance: most important is the share of pay which leads to a reduction of social assistance but also reductions in other social payments (for example housing subsidies) or the additional burden caused by social security contributions
- Financial incentives should be effectively targeted on low-income groups
- Financial incentives should keep pace with inflation
- The concept as well as the evaluation should bear in mind the possible social consequences of the programs, which might discourage marriage or encourage divorce
- Labor supply of married couples should not decrease due to declining labor force participation of secondary workers
- Fraud and abuse are critical aspects of incentive programs

With respect to these U.S. experiences we will now discuss the main elements of German social assistance as well as its shortcomings and first approaches to making work pay for German recipients of social assistance.

## **2.2 Concepts and simulations for Germany**

### *2.2.1 German social assistance: Making work pay?*

A main principle in German social assistance is the "principle of subsidiarity": each recipient of social assistance has the duty to look for and accept any job that is available. Recipients who refuse a job offered by the social administration will be punished by a 25% reduction in their social assistance. Permanent unwillingness to work can lead to a loss of the entire social assistance grant. These measures are used by an increasing number of social administrations in Germany to ease the burden on the tax payers who are financing German social assistance (Kirchmann/Klee 1999).

The subsidiarity principle also serves as a rationale to reduce social assistance payments for Germans with earned income. Recipients trying to combine labor market incomes and social assistance can hardly improve their financial situation if they are not able to live without social assistance as soon as they enter the labor market.

**Table: Status Quo in Germany**

General Status Quo (and Status Quo for Single Mothers)

Net Pay per month		Reduction of Social Assistance Payments
All	Single mothers	
0-73 €	0 – 97 €	No reduction
>74-560 €	98 – 490 €	85% (single mothers: 75%) of net pay
> 560 €	> 490 €	100% of net pay

Since July 2002 a recipient of German social assistance receives about 293 € a month plus individual housing costs. In 1998 the total average social assistance for single recipients in Germany was about 1,100 DM, while families with two children got about 2,600 DM. These amounts included housing costs of DM 450 for a single person and DM 800 for a family with two children, which have to be paid out of social assistance (Statistisches Bundesamt 1999b, 39). If recipients get a job, they can keep their new net earnings up to 73 € a month (see table). For any € more than 73 € which they receive in the labor market, their social assistance is reduced by 85 Cents. If the recipient earns more than 73 € despite the marginal reduction (or tax) rate of 85%, the maximum amount which can be gained by the recipient is 146 € (73 €) per month. Additional net income is deducted in full from the individual social assistance. Recipients cannot improve their financial situation by more than 148 € (74 €) if they (do not) accept a marginal implicit tax rate on net earnings of 85%.

In some German regions like Baden-Württemberg, single mothers face somewhat lower implicit rates of taxation. 97 € per month can be kept with no reduction in benefits, then 75% of the additional income is deducted until the maximum increase in disposable income of 194 € per month is reached. Yet single mothers reach the maximum amount of earned income which is not completely deducted even earlier than other households due to the lower implicit rates of taxation: earned income exceeding 490 € per month is fully deducted.

These German regulations have led critics to the thesis, that work does not pay for recipients of social assistance in Germany and that the recipients have only three economically unsatisfying options as long as they do not earn enough to become completely independent of social assistance:

- Not to work at all as long as no jobs are offered by the social administration
- To work without an opportunity for substantial improvements of their own financial situation
- To substantially improve their own financial situation by working in the shadow economy.

At the end of 2000 among all 2.7 million recipients of social assistance more than 900,000 were estimated to be employable, but only 142,000 have been working at least in a part-time

job.<sup>8</sup> Critics argue that labor market participation of people receiving German social assistance could be higher and the tax burden lower with stronger financial incentives. Some actual approaches with stronger financial incentives shall be discussed.

### 2.2.2 *An EITC for Germany?*

Since the existing employment-conditional tax credits or benefits in the United States have, on balance, had a positive effect on labor supply the question arises whether such a concept could be a promising way to strengthen labor market incentives in Germany. A concept like the EITC has recently been discussed and proposed for Germany in order to strengthen work incentives in social assistance (Sinn 2001, 2000).

The OECD (1997, 74 f.) has approximated the U.S. EITC, giving a credit of 25 per cent of gross earnings up to one third of median earnings. They modeled a plateau between one third and half of average production worker's earnings and a phase-out at 20 per cent of gross earnings. Among currently employed Germans, 29 per cent of those affected would be in the phase-in region with falling marginal effective tax rates (METRs), 21 per cent in the plateau region (constant METRs) and 50 per cent in the phase-out region (increasing METRs).

For those Germans already employed before the reform the incentive effects will reduce overall labor supply. If unemployed people found jobs at a low wage, such as the earnings of the lowest decile, replacement rates would fall significantly for 234,000 workers. Those unemployed Germans would have much stronger incentives to find a job. However, 200,000 people without jobs would face lower incentives, because their spouses would be eligible for the benefit if they did not work, but not if they did. The higher the assumed wage of those entering employment, the more the disincentive effect would dominate the incentive effect.

The main difference between the U.S. and the German situation is the narrower earnings distribution in Germany. This would make many more people eligible for the credit and most of them would find themselves in the phase-out region with high METRs. Therefore disincentives for those already working would be more serious than in the United States. Furthermore a German EITC would be much more expensive than in the United States, if it had a similar structure relative to median earnings. The OECD estimated that such a German EITC would cost DM 12 billion.

It seems to be necessary to account for the narrower earnings distribution in Germany by general incentive programs with more limited incentives or by targeted incentive programs with strong incentives. An overview of both strategies shall be given in the following.

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<sup>8</sup> See German Council of Economic Experts (2002/2003), p. 253.

### 2.2.3 *General Negative Income Taxes – A Non-Starter for Germany*

In the early 1990s a very broad discussion with a variety of proposals, estimations and simulations began in Germany. German Liberal Democrats (F.D.P.) tried hard to enforce a kind of general negative income tax, which they called "Buergergeld" ('citizen's money'). The implementation of different variants of a negative income tax has also been discussed in other German parties.<sup>9</sup>

Meanwhile a number of studies have shown fundamental problems with such a concept. A commission of experts ("Expertenkommission Alternative Steuer- und Transfersysteme" 1996) evaluated the German prerequisites and the existing studies of such a concept in order to decide whether a negative income tax could be a promising alternative to reform the German tax and transfer system.

Apart from conceptual problems it could be shown that a 50% negative income tax, which implies that the grant break even level (and probably the amount where taxation starts) will rise substantially, would have to distribute transfers to an additional 10 million employees who did not previously receive transfers (Spermann 1996b).<sup>10</sup> For these new recipients, income and substitution effects would cause disincentives and reduce employment even if elasticity of labor supply in the relevant German income section can be shown to be almost 0 (for men) or at least very low (for women). These negative employment effects countervail the incentives and expected positive employment effects for unemployed persons and lead to an unknown total employment effect.

Again the main problem for such a general incentive concept is the narrow German income distribution. This is the main reason for the high number of additional people who would be entitled to transfers after the implementation of a negative income tax and the main cause for the substantial additional costs that have been calculated for such a concept. Depending on the concrete concept, cost estimates for a 50% negative income tax varied between at least additional net costs of DM 40 billion up to DM 270 billion. Even with a less generous negative income tax rate (with transfer reductions of 66%), additional net costs would have reached DM 17 billion, an amount that was higher than the total sum that was spent for social assistance (Hilfe zum Lebensunterhalt).<sup>11</sup> If a comparable less generous variant (with transfer reductions of 70%) were financed by taxes, marginal income tax rates would have to be eight percentage points higher. These developments would be contrary to optimal taxation and lead to high additional costs with at least undetermined employment effects. Therefore the Experten-Kommission (1996) decided against the plans of a general negative income tax but nevertheless recommended finding other ways to strengthen labor market incentives for social assistance. In the following years the discussion about a general negative income tax for Germany diminished more or less and made way for new concepts that concentrated more precisely on reforms of the German social assistance. These concepts are discussed in the next section.

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<sup>9</sup> See for example Scharpf (1993) and the overview in Hochmuth/Klee/Volkert (1995).

<sup>10</sup> The total sum of German employees is about 36 million, ca. 27 million people work in jobs with full social security coverage.

<sup>11</sup> Becker (1996), Statistisches Bundesamt (1998, 4).

#### 2.2.4 *Improving general labor market incentives – some estimations for Germany*

In 1997 the German Federal Ministry for Health, which had been responsible for social assistance,<sup>12</sup> and in 1998 the German Association of Employers (BDA)<sup>13</sup> considered much less ambitious concepts with slightly stronger incentives compared with the status quo.

Trabert et al. (1998) estimate the employment effects and costs of such a reform based on a micro econometric model and data from the labor market in Sachsen-Anhalt (East Germany). They estimate increased labor supply among the group of unemployed recipients of social assistance which leads to an additional labor supply of 540 people among the 7,121 for whom data were available. 120 persons might find a job and lead to cost reductions of 1.5 million DM (767,000 €) per year. Recipients of social assistance who are already working would be entitled to keep more of their earnings and cause additional costs of about 2.0 million DM (1 million €). New recipients of social assistance who were already working and not eligible before the reform cause additional costs of DM 4.3 million (2.2 million €). Despite, on balance, positive labor market effects, Trabert (1998) points out that additional costs for people who are already working substantially exceed the savings from additional employment.

Kaltenborn (1998) also estimates employment effects and costs caused by the plans of the German Federal Ministry of Health for Germany. Using micro-data from the German Socio-Economic Panel he finds a very limited positive employment effect for Germany: in 1995 only 900 additional persons would have entered the labor market, while the costs of the Federal plans would have reached 500 million DM. For the German Employer's proposal Kaltenborn estimates only slightly more positive employment effects of 3,800 persons in East- and West-Germany due to the slightly higher incentives. However the estimated costs produced by that limited employment effect reach 2.7 billion DM.<sup>14</sup>

The simulations show the difficulty that, in Germany, general financial incentives have to be limited in order to avoid high financial as well as substantial deadweight costs. But with these very limited incentives no substantial employment effects seem to be possible. The main problem is that – due to the narrower earnings distribution – general financial incentives reach a lot of people who are already working, which worsens employment effects and leads to rising costs.

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<sup>12</sup> A family with two children receiving social assistance who were entering a job (with full social security) should be allowed to keep approximately DM 162 plus 21.60 DM per child and month without deductions. A family with two children who received a sum of social assistance payments of about DM 2,599 per month in 1998 (Statistisches Bundesamt 1999b, 39) would be allowed to keep DM 205.20 of their labor market earnings per month (instead of DM 135 in the status quo) without any deductions.

<sup>13</sup> The plan was to reduce social assistance reductions of employed recipients from 85-100% to 70-90% of their earnings.

<sup>14</sup> Buslei and Steiner (1999) have worked with simulations for a concept which describes a reduction of earnings from social assistance which – above an unchanged amount of 135 DM per month free of reductions – begins with 70% implicit tax rate rising gradually to 100%. The positive employment effects are similar to those estimated by Kaltenborn and reach a maximum employment effect of 10,000 persons. Buslei and Steiner (1999) have not calculated the financial costs of their models.

Two strategies are feasible in such a situation:

1. To widen the German income distribution in order to ease the financial burden of such a general concept: for example by reducing social assistance benefits for employable but unemployed recipients of social assistance. The proposal of the German Council of Economic Experts (2002/2003) has proposed such a strategy in its latest annual report.
2. To give strong incentives to a target group of unemployed who might cause lower (deadweight) costs. Such targeted incentives have been the focus of the first experiments with labor market incentives for recipients of social assistance in Germany.

We will first look at the latest proposal of general incentives published by the German Council of Economic Experts (2002/2003). Afterwards we will turn to the first concrete experiences with targeted labor market incentives.

#### *2.2.5 The Proposal of the German Council of Economic Experts: Less social assistance, more incentives or public employment agencies for employable recipients*

The first element of this proposal is a reduction of German social assistance payments by 30% for employable recipients who have not entered the labor market. The intention of these cuts is to allow lower wages for unskilled workers and thus to widen the German income distribution.

Moreover fiscal savings generated by these cuts are needed for financing the second element, a considerable improvement of work incentives by reducing the implicit tax rates on earned income. The table shows the details:

#### **Implicit tax Rates for single persons in German Social Assistance according to the German Council of Economic Experts (and in the Status Quo)**

<b>Net Pay per month (Status Quo)</b>	<b>Reduction of Social Assistance Payments</b>
0-73 € (0-74 €)	No reduction
> 73 € (>74 €)	60% (85%) of net pay
( > 560 €)	(100% of net pay)

While the amount of earned income which is not taxed at all remains the same (73 €), the implicit tax rates for earned income of more than 73 € are substantially reduced from 85% to 60%. Moreover the Council argues in favor of a higher maximum of additional earned income of 493 € (instead of 143 € in the status quo). This would eliminate the phase with 100% taxation in the status quo: according to the proposal the maximum would be reached at 1,000 € of earned income. However even before – with an earned income of 970 € - social assistance



payments are completely phased out according to the Council's proposal. The Council is hopeful that these incentives might also make the recipients move up the income ladder and become independent of social assistance.

The third element consists of public employment agencies which shall provide a job of 35 hours a week for those who are willing to work but cannot find a job. The public employment agencies would pay the recipients 30% of their social assistance payments: in the end these people could reach the present level of social assistance by working 35 hours a week.

The Council does not specify the net costs of its proposal. They use 1.5 billion € due to the lower implicit tax rates and social security payments. However the costs of public employment agencies might also sum up to a considerable amount. Nevertheless the Council is hopeful that a balanced budget might be reached by further cuts in unemployment benefits.

The proposal of the German Council could be successful in light of the positive experiences of New Hope with a combination of work incentives and public employment opportunities. However there are a lot of open questions about the labor market and fiscal effects. Such a fundamental reform might therefore be hard to enforce in the next years.

In the meantime first experiments with targeted financial incentives, the second of the feasible strategies, were started in Germany in 2000. Their conceptual framework and the first concrete experiences shall now be discussed.

### **3 "Einstiegsgeld": A targeted negative income tax (TNIT) for long-term unemployed**

The mentioned general incentive program proposed by the Federal Ministry of Health has never been realized. In 1998 Social Democrats and the Green Party refused to approve these plans, which would have been necessary in the German Federal Council. Instead a waiver was approved which allowed all German Bundeslander to ignore some existing regulations and start experiments with stronger employment incentives. Based on this waiver an experiment with a targeted negative income tax was started in Baden-Wuerttemberg in 2000.

#### **3.1 The basic concept**

The concept of targeted financial incentives that has been the conceptual background of recent German experiments<sup>15</sup> has been elaborated by Alexander Spermann.<sup>16</sup> It consists of three major elements:

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<sup>15</sup> The experiments have been part of the project "Einstiegsgeld in Baden-Wuerttemberg" (1999-2002) and have taken place in the cities of Freiburg, Karlsruhe and Mannheim and in the rural districts Alb-Donau, Boeblingen, Esslingen, Rhein-Neckar, Tuebingen and Waldshut. The project has been planned and evaluated by the Institute for Applied Economic Research Tuebingen (IAW).

<sup>16</sup> See Spermann (1996, 1997, 1998, 1999, 2001).

1. Target group: Only people who have not been working for a longer time are eligible
2. Substantially improved financial incentives for members of the target group, who find a job on their own
3. Each recipient gets financial incentives for a limited period

An example shall illustrate the concept:

1. Target group:

The target group consists very often of recipients of social assistance who have not been working for at least a year. This definition includes long-term unemployed as well as single mothers.

2. Improved financial incentives:

73 € of the individual earnings are always free of any benefit reductions. If the recipient earns more, 50% of gross income remains free of reductions (instead of 15% of net income in the status quo). To benefit from the improved financial incentives recipients have to continue to be eligible for social assistance even with their labor market incomes.

3. Limited period:

The better financial incentives are only available for one year in order to avoid long-term violations of horizontal equity and to give people incentives to leave the low-income sector and become independent of social assistance.

### **3.2 Goals of the concept and evaluation**

Like all incentive programs, targeted negative income taxes like the "Einstiegsgeld" can be expected to increase labor supply for those unemployed recipients of social assistance who are eligible. However, in comparison with general labor supply incentives, lower deadweight losses and fewer disincentives might occur because:

- there are no new recipients of social assistance
- gainfully employed recipients of social assistance are not members of the target group and are not eligible

If substantially more recipients start working due to the stronger labor supply incentives, public savings would become possible. It is the task of the evaluation to determine labor market effects and answer the question of whether higher labor market participation can be achieved.

A precise evaluation of labor market projects that allows comparisons with similar projects in other countries requires randomized experimental and control groups. While these methods are a kind of (sometimes obligatory) standard in the United States, they are hardly ever found in Germany. In the first project TNIT ("Einstiegsgeld in Baden-Wuerttemberg") the responsible ministry also saw problems with control groups because of ethical aspects. However, based on information about the U.S. experiments which required control groups as a criterion for funding, and together with two interested cities, decision makers could be convinced to allow an exact evaluation in those cities and districts which would decide to implement experimental

and control groups. In the end the cities of Freiburg and Mannheim decided to establish experimental and control groups.

Almost 2,500 persons have participated in experimental and control groups in Freiburg and Mannheim. In Freiburg 754 recipients have been randomly assigned to the experimental group and 754 to the control group. In Mannheim 446 recipients are in the experimental and 543 in the control group. The final results of the analysis of program and control groups will be available in 2003.

### **3.3 First results, open questions and limitations**

At the beginning of the experiments in Germany a number of initial questions still remained open; for some of them more information is available in the meantime, while others still remain unclear:

#### *3.3.1 First results<sup>17</sup>*

One of the main arguments against TNIT has been the hypothesis that there would not be sufficient labor demand in Germany for a labor supply incentive program. Critics argued that incentives alone would not lead to any additional employment in Germany. Instead after 2.5 years, despite a very problematic labor market, 761 persons in the Baden-Wuerttemberg experiment have started working. This is a share of 13% of the entire target group.<sup>18</sup> It should be remembered that the target group is a group of long-term unemployed and long-term beneficiaries of social assistance, people who are likely to have more difficulties with labor market integration than the average recipients of social assistance. Thus we may find that a lack of employment opportunities is not such a dominant problem in Germany that it would make incentive programs ineffectual.

Moreover two thirds (68%) of all jobs taken by members of the experimental group have been covered by social security. Therefore the fear that recipients might be pushed into precarious jobs has not been confirmed during the experiment. The importance of social security covered jobs is similar among the groups: 78% of jobs taken by two parent families are covered by social insurance, while 66% of jobs taken by single mothers and 59% of jobs taken by single individuals are covered by social insurance.

Since most U.S. programs target single mothers, it could be helpful to discuss experiences and strategies in both countries in order to ensure access to child care, which is of crucial importance for the remarkable number of single mothers among the recipients of social assistance in both countries.<sup>19</sup> Almost one out of three German single mothers receives social assistance. The share of single mothers among all recipients of social assistance reaches almost one quarter.<sup>20</sup>

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<sup>17</sup> We are referring mostly to the more detailed analysis in Dann et al. (2002a).

<sup>18</sup> See Dann et al. (2002), p. 73.

<sup>19</sup> In 1998 1,286,900 households received social assistance in Germany. Among them were 332,965 single mothers and 10,399 single fathers with children not older than 17 years.

<sup>20</sup> See Andress (2000).

The question was whether German single mothers could find a (part-time) job that makes them independent of the comparatively high social assistance. It was unclear if their working time budgets were too constrained such that a permanent subsidy might be necessary. In this first German experiment single mothers in the experimental group are responding to the incentives substantially more than other recipients in the experimental group. After 2.5 years the majority (56%) of all recipients who have started to work and thus receive the targeted negative income tax have been single mothers although the income subsidies are available for anybody who has received social assistance for more than one year. Thus single mothers are clearly over represented in the group of individuals that has changed their behavior in response to the experiment. The experimental group in the city of Mannheim shows an even more extreme response to the financial incentives: while only 15% of all recipients in the experimental group are single mothers, the share of single mothers among the recipients of TNIT is more than three times as high (50%).

Obviously, the targeted negative income tax has turned out to be highly attractive particularly for single mothers. In this respect, the German results are similar to the U.S. results, which show high participation rates of single mothers in incentive programs.

U.S. incentive programs are very often motivated as remedies against the phenomenon of the working poor. Today, poverty among workers is less of an issue in Germany. Instead, poverty in Germany is often combined with very low labor market participation. U.S. program effects on poverty might be of special interest in the German debate about increasing employment by using productivity oriented wages, thus creating a new low-wage labor market.<sup>21</sup> Results from the U.S. experiments indicate that participants often do end up working more, but are also generally unlikely to completely escape social assistance. This may be due to the low wages paid in many U.S. jobs.

After the first 2.5 years in the German TNIT experiments 583 former participants had left social assistance after less than 12 months, participated for one year or given up the program. Among them 298 remained employed, 169 managed to get into a job which makes them independent of social assistance, mostly because of a rise in earned income, and 196 were no longer employed.<sup>22</sup> Even if the majority of all former recipients who are still working could escape social assistance there are a considerable number of people in Germany who are working without being able to leave social assistance after the experiment.

Moreover at the beginning of the experiment the concern was raised whether recipients who have not been able to leave social assistance after one year in the labor market would quit their jobs because of the restrictive benefit reduction rules. This hypothesis that all recipients might quit their jobs after one year has not been confirmed in the experiment. After 2.5 years, among those who did not receive the subsidies but still depended on social assistance, 41% were still employed.

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<sup>21</sup> See Sachverständigenrat (1999/2000) and Arbeitsgruppe Benchmarking (1999).

<sup>22</sup> For 89 of these 583 participants no adequate data has been available.

Despite the positive results with participants who have been in the program for one year the number of participants who gave up their employment within these 12 months is relatively high. 34% or 267 persons have quit their jobs during the first year.

Moreover the presuppositions and the motivation of the social administration turned out to be a crucial factor for the success of the program. Incentive programs are fairly unusual and unknown among German recipients of social assistance. Therefore incentive programs can only have success if members of the social administration inform and assist their clients intensively in order to realize high take-up rates of social incentive programs. Consequently there has been no or only very limited success in districts where the administration did not have the time or the willingness to implement incentive programs efficiently by a very active and ambitious information policy. In some districts time restrictions occurred because of reorganization processes in the administration. In other cases a higher priority of "traditional" concepts did not leave enough time for a successful realization of the new program.

Resistance against incentive programs has been experienced in districts that thought that the new measures might threaten the existence of traditional strategies, which tended to be more labor intensive than a mere incentive program. Finally the narrow income distribution turned out to be an obstacle even for the motivation of administrators: particularly when the recipients of social assistance would earn the same or more than administrators due to the income subsidy of TNIT.

### *3.3.2 Incentive programs: U.S. background and German consequences*

A question that has not been answered by the first German experiments was if programs targeted at long-term unemployed recipients would cause new recipients to wait until they qualify as long-term unemployed and thus become a member of the target group for financial incentive programs. U.S. experience from the MFIP project indicates that this has not happened in the U.S. context.

U.S. experiences show that financial incentive programs can reduce administrative costs as well as stigmatizing effects. Therefore not only labor market effects and financial burden/ savings of these programs should be evaluated. Other "soft" factors such as reduced stigmatizing effects, improved motivation, etc. should also be part of the evaluation and require adequate interview techniques in the next experiments.<sup>23</sup>

Recent experiments like MFIP and New Hope have shown the need for education and the importance of training measures for recipients of social assistance. This seems to be a conceptual limit for any incentive-oriented program in the United States as well as in Germany.<sup>24</sup>

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<sup>23</sup> Higher motivation as a result of incentive programs is already evident for single mothers: 92% of the unemployed single mothers who have been interviewed during the experiment see the TNIT as a positive and useful measure. As the main reason for their judgement most of them stated a higher motivation to start a job. Main obstacles for German single mothers are – according to their responses – a lack of flexible child care in Germany, insufficient qualification and not enough part-time jobs; see Dann et al. (2002b), p. 173 f.

<sup>24</sup> The German "Einstiegsgeld in Baden-Wuerttemberg" is confronted with the fact that among those recipients in Baden-Wuerttemberg whose educational level was known, 70% of the recipients had no more than a

New Hope experience indicates that financial incentives for recipients of social assistance have the highest probability of success when directed to people who are relatively close to the labor market and do not suffer from more than one barrier to work like a severe lack of education, psychic problems or diseases and drug addiction. Incentive programs are not an alternative but a complementary element to welfare to work (Hilfe zur Arbeit) programs like training and other measures that help make recipients ready to successfully enter the official labor market. On the other hand the motivation of people who (have to) join welfare to work programs might increase by the perspective that their chances to work within an attractive incentive program rise if they should not be able to enter the regular labor market immediately after the end of their welfare to work program.

Moreover MFIP as well as the TNIT in Germany have shown that German incentive programs need to take into consideration not only the financial benefits but also the importance of sufficient time, help and encouragement offered by the project representatives.

Furthermore Wisconsin's New Hope has indicated that Germany may need to consider an optimal combination of subsidized work and incentive programs directed to the regular labor market. In Germany the prerequisites of such a strategy have substantially improved since 1996 when a reform of social assistance gave communities more possibilities to create subsidized work programs. Kirchmann/Klee (1999) show that the number of these programs has increased substantially and can be found in a wide range of jobs. Meanwhile about 400,000 Germans are employed in such programs.<sup>25</sup> The German Council of Economic Experts' latest proposal to reform German social assistance can be regarded as such a strategy, although a number of potential shortcomings and open questions remain.

Due to the narrower income distribution in Germany it is much more difficult to secure crucial prerequisites of general incentive programs, such as an overall increase in labor force participation. Thus, employment effects of these general programs are likely to be more limited and more expensive in Germany than in the United States. A "copy" of an EITC can therefore not be recommended in Germany. Moreover some economists – like the German Council of Economic Experts in their recent annual report – argue that the level of social assistance has to be reduced in order to improve work incentives and to ease the financing of an incentive program.

Labor supply of married couples has sometimes decreased because incentives have been based on household labor market incomes. In Germany these effects should be avoided by designing the incentives based on the individual labor market incomes. Based on the American experience the "Einstiegsgeld in Baden-Wuerttemberg" has been designed in a way that the same benefits are available to every working member of the household.

The importance of high participation rates for the effectiveness of financial incentive programs is another experience gained from U.S. experiments. In the current German experiments incen-

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lower secondary school leaving certificate. 13% did not have any school leaving certificate, 59% had a lower secondary school leaving certificate. The majority (55%) of recipients had no occupational training (Dann et al. 2002a).

<sup>25</sup> Deutscher Städtetag (2001), p. 7.

tives mostly are available without a formal application as soon as recipients report that they have found a job. However German take-up rates may be limited by lack of knowledge of the program, so an active information policy of the social administration and regular interviews with the target group of the experiment are necessary. Another obstacle may be the limited general participation and take-up rates in German social assistance. Studies which explore this question for Germany indicate that the non-take-up rate of German social assistance might be more than 50%. Particularly high non-take-up-rates are found among employed persons who are not receiving additional social assistance although they would be entitled to it.<sup>26</sup> Although a considerable number of eligible elderly people do not receive social assistance, it is important that people and especially families with relatively low wages are informed about their right to receive social assistance and perhaps the special incentives. This issue needs to be resolved for social assistance in general, not just for an isolated incentive strategy.

High effective tax rates in the United States have turned out to be the result of a variety of factors such as the increasing reduction of social assistance with rising labor market incomes and cuts in social payments (housing subsidies, etc.) or the additional burden caused by social security contributions. Current experiments in Germany have tried to avoid additional burdens caused by cuts in other social payments like housing subsidies ("Wohngeld").

The German Federal Government has implemented social security subsidies in order to develop stronger incentives for people with low income to take jobs that are fully liable to social security. The so-called "Mainzer Modell" is designed to subsidize/increase the net pay of employees, thereby motivating people to work in regular jobs. However, for the roughly 1 million recipients of German social assistance who could work, such a program will not be very attractive as long as 85 - 100% of the subsidized higher net pay will still have to be transferred to the social administration which reduces social assistance by these amounts.<sup>27</sup>

What Germans can learn from the U.S. experiments is that these approaches should be combined in order to establish a fully consistent concept: the German Targeted Negative Income Tax (Einstiegsgeld) might benefit from additional incentives for jobs with full social security coverage while the Bündnis fuer Arbeit programs need an incentive program like the Einstiegsgeld if they shall not lead to an exclusion of employable recipients of social assistance, which constitutes a substantial part of low-income Germans. The interaction of both approaches is documented by the fact that some recipients of Einstiegsgeld have already changed their marginal part-time jobs with weak and incomplete social security ("geringfügige Beschäftigung") into part-time jobs with full social security coverage. This indicates that the existing lack of incentives due to high social assistance reduction rates prevents recipients of social assistance from working more time in secure jobs (Kirchmann/Spermann/Volkert 2000).

Moreover distributional impacts of incentive programs should be considered in order to effectively target the programs to low-income groups and to maintain vertical equity. The concept of the Targeted Negative Income Tax implies a target group potentially consisting of low-income individuals. However it has to be controlled how people with considerable problems

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<sup>26</sup> See Kayer/Frick (2000) and Riphahn (2000).

<sup>27</sup> Arbeitsgruppe Benchmarking (1999).

finding and maintaining a job can get additional help (by subsidized work, training, individual programs, etc.) in order to avoid a "creaming" of single mothers and rather competitive recipients with an isolated incentive strategy alone. Distributional aspects could become a very serious problem if those Germans with the lowest incomes – recipients of German social assistance – would not be reached by the Federal Mainzer Modell because of the remaining high or prohibitive reduction of increased net pay.

In order to avoid a loss in real income, U.S. experiences indicate that financial incentives should keep pace with inflation. In Germany the official indexation of social assistance payments has not been applied recently. This can have consequences for incentive programs as long as the amount recipients of social assistance can earn without a reduction of their benefits is defined as a percentage of the social assistance benefit for one person. These problems could be solved with a more consistent indexation of German social assistance benefits.

Social consequences of programs, such as discouraging marriage or encouraging divorce, have been studied in the United States, but have hardly reached the German discussion about financial incentive programs. These effects should therefore be kept in mind while evaluating the programs.

Fraud and abuse have turned out to be critical aspects of incentive programs in the United States. Therefore it will have to be discussed in Germany how the new programs can be controlled efficiently. Existing U.S. procedures and studies might be helpful in that context.

#### **4 Final remarks and research perspectives**

This paper tried to explore if and how U.S. experiences can contribute to the current German debate and first experiments about financial incentives for recipients of social assistance. There can be no doubt that there are substantial differences between both countries, such as differences in values, political background and process, labor markets and income distributions, etc. Furthermore even the basic goals of concrete financial incentive programs differ substantially between Germany (with limited poverty rates, high unemployment and dominant employment goals) and the United States (with high employment and poverty rates and dominant distributional goals).<sup>28</sup>

These fundamental differences make it impossible to "copy" concepts like the EITC or a negative income tax for the German situation. However their results are of interest for both countries. For German researchers and politicians U.S. experiments can indicate which kind of concepts perform well within a broader income distribution. It makes sense to analyze cost and employment effects in order to decide whether similar experiments would be promising given the much narrower German income distribution and the necessity to minimize (deadweight) costs and disincentives and search for strong positive employment effects. The resulting Ger-

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<sup>28</sup> For a discussion of these normative differences see Sen (1999).



man strategies might also be of interest for U.S. researchers and politicians because ways to reduce costs and deadweight losses, and optimize positive employment effects should also be relevant even within the broader U.S. income distribution where these challenges are somewhat less crucial.

However, despite all fundamental differences between both countries perhaps the most interesting result of our investigation is that there are quite a number of common problems which lead to very similar small-scaled, decentralized strategies in both countries (MFIP, New Hope, TNIT/Einstiegsgeld). It would be extremely interesting to follow and analyze these special programs during the experiment in order to get information about possible improvements and to compare the final results.

Lack of education and child care are major obstacles for financial incentive strategies in both countries. It would be useful to further compare and analyze innovative concepts of education and training that are most important for the success of these strategies in Germany and the United States. Moreover recent results from Wisconsin indicate the importance of an optimal mix of financial incentives and subsidized work. In Germany where the number of subsidized jobs for recipients of social assistance has increased substantially in the last three years and where first experiments with financial incentives have been started it would be highly desirable to know more about relevant U.S. experiences. This would require a forum for German and U.S. researchers and politicians to learn about the experiences in the other country, which might help to further develop strategies.

A fundamental prerequisite for any reliable results and especially for bilateral comparisons is an evaluation based on program and control groups. In Germany this prerequisite has not been met in the past. However in a recent German experiment such a research design could be implemented which allows a comparison of U.S. and the respective German programs. Unfortunately the Federal Buendnis fuer Arbeit approaches with social security subsidies are not evaluated with program and control groups. Results are therefore not too informative and cannot be compared with U.S. experiments. Moreover it is not possible to identify and avoid stigmatizing effects that have occurred in similar U.S. experiments.

If these methodological prerequisites can be met in Germany in the future, comparative studies for both countries are a promising way to further develop existing national transfer programs, which might be of great interest for researchers as well as for politicians.

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