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Effective Taxation for Recipients of Social Assistance in Germany
and the Consequences of the 1996 Tax Reform

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Abstract^{*)}

This paper explores the problem of effective taxation at the lower end of the income scale in Germany. For the recipients of social income maintenance --currently about 1.8 million nationals--effective taxation consists not only of the explicit taxation through the tax code but also of the implicit taxation through the withdrawal of benefits. The paper calculates effective tax rates for recipients of social assistance; it is shown that for labor incomes in the lower income range explicit and implicit taxation add up to a marginal burden of just under 75 percent on average.

The 1996 tax reform alleviates the explicit tax burden on low incomes, but it does not alleviate the total marginal burden on labor earnings of welfare recipients. It increases net incomes, but since the withdrawal of benefits increases with net incomes, too, the overall burden remains practically unchanged. Therefore, effective welfare traps remain prevalent; these could only be avoided through a reform of the system of social assistance and withdrawal. Constraints and possible steps for reform are discussed.

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Summary

The system of social income assistance is a much-debated issue in Germany because of both its implications for fiscal consolidation and its probable link with structural unemployment. Expenditures on social assistance have risen rapidly over the past two decades--2.5 times faster than GDP--and now constitute a substantial item on the expenditure side of public households. Therefore, a tight control of these expenditures could facilitate fiscal consolidation efforts. More important than the fiscal aspect, however, is the link of social assistance with Germany's most pressing economic problem: structural unemployment.

The analysis in the paper of the social assistance system shows that, in combination with the tax code, the system implies very high rates of effective taxation on labor earnings by social assistance recipients and might thereby adversely affect labor supply decisions. Explicit taxation from the tax code and implicit taxation from the withdrawal of benefits add up to a marginal burden of 75 percent on labor income that recipients earn while remaining on social assistance. These high rates of effective taxation will continue to prevail after the 1996 tax reform. Furthermore, given the high levels of benefits and the high rates of withdrawal, the incentives to exit the system and take up regular employment are low because the impact on net income will in many cases not be high enough to reward work efforts. This is particularly true when social assistance levels are compared not with average wage levels for workers in industry (as in the official benchmark), but with entrance wages in sectors such as the retail and services sector, which are more easily accessible to many recipients of social assistance.

There are tight constraints for a reform of the social assistance system: the principle of full support for the needy shall not be undermined, and introducing a system of negative income tax--which would alleviate the problem of high marginal burdens when switching from benefits to own earnings--would broaden eligibility and thereby be likely to increase fiscal costs. Within these constraints, however, the paper suggests two possible routes for reform. First, benefits could be withdrawn only after a delay in case regular employment is taken up. This would increase incentives for job search because it would make the initial impact of employment on net income more visible and also cover the adjustment costs that individuals are facing when switching from social assistance to regular employment. Second, the difference could be narrowed, at least for very low income earners, between the cash benefits for children under the tax code and the much more generous benefits of the social assistance system. For the large number of single-parent recipients with children, this reform would increase the pecuniary incentive to take up employment.

I. Introduction

The social income assistance program--a key plank in Germany's comprehensive welfare system--has expanded rapidly over the past two decades, with expenditures overtaking the defense budget in size in 1993. Controlling the growth of social assistance spending would, as a consequence, contribute considerably to ongoing fiscal consolidation efforts. But perhaps more importantly, reform of social assistance could also contribute in a potentially significant way toward alleviating Germany's most pressing economic problem: structural unemployment.

The link between social assistance and unemployment is widely recognized; what is debated, however, is the direction of causality. For some economists causality runs from unemployment to social assistance: the high level of long-term unemployment implies that many unemployed persons receive only relatively low unemployment assistance and may eventually also quit filing for jobs, in which case they are eligible for social assistance if own resources are insufficient. This view suggests the main causes for the rising number of social assistance recipients to lie in insufficient labor demand, given that unemployment and social assistance are involuntary. However, causality might also run in the other direction: high levels of benefits and high rates of withdrawal in case employment is taken up--i.e. high implicit taxation--reduce the incentive to search for jobs and may even push up minimum wages in the economy. This view focuses on the labor supply decision of social assistance recipients and suggests a need for reform also in the system of social assistance and implicit taxation.

This paper explores the validity of the second view and analyzes whether benefits are so generous and their withdrawal in case of labor income so rapid as to act as a disincentive to work for those at the low end of the income scale. Considerable evidence is found that this is indeed the case. Moreover, the 1996 tax reform, despite eliminating income tax on the very low paid, will do little to reduce welfare traps because benefit withdrawal schedules will continue to impose high marginal effective tax rates. 1/

The paper is organized as follows. Section II describes the structure and purpose of social assistance. Section III provides estimates of effective marginal tax rates for social assistance recipients and analyzes the impact of the 1996 tax reform. Section IV examines the economic incentives to leave social assistance in order to take up regular employment. Section V discusses possible reforms to social assistance. Conclusions are presented in section VI.

1/ The "1996 tax reform" (Jahressteuergesetz 1996) was approved after an exceptionally long parliamentary mediation process by both houses of Parliament in August and September 1995.

II. Social Assistance in Germany: Purpose and Development

Social assistance in Germany consists of two main programs: support for special circumstances, in particular for the re-integration of handicapped persons and for care ('Hilfe in besonderen Lebenslagen'), and support in case of temporary or permanent loss of income ('Laufende Hilfe zum Lebensunterhalt'). In the context of this paper, only the second element is of interest and, unless otherwise mentioned, the term social assistance will refer to this element. According to the principle of subsidiarity, it is the ultimate means of support that everyone with insufficient resources to make a living in Germany is entitled to, including non-nationals. Social assistance is needs based and individuals have a legal claim to receive social assistance, independent of whether they work or not. Strictly speaking, however, it is meant to be "help to work" in the sense that it ought to provide a basis from which an individual can and should try to obtain employment. 1/

Benefits consist of a basic allowance (DM 520 per month in 1994/95), an allowance for housing (DM 370 on average) and possibly one-time benefits (DM 140 on average). The average regular monthly allowance for an adult is therefore DM 890 (US\$600), or DM 1,030 (US\$700) including one-time payments. This is the lower bound of benefits for an adult. Benefits are higher for senior citizens, persons with physical disabilities, and for expectant mothers. Depending on age, benefits for children are 50-90 percent of the basic allowance for an adult.

1. Expenditures on social assistance

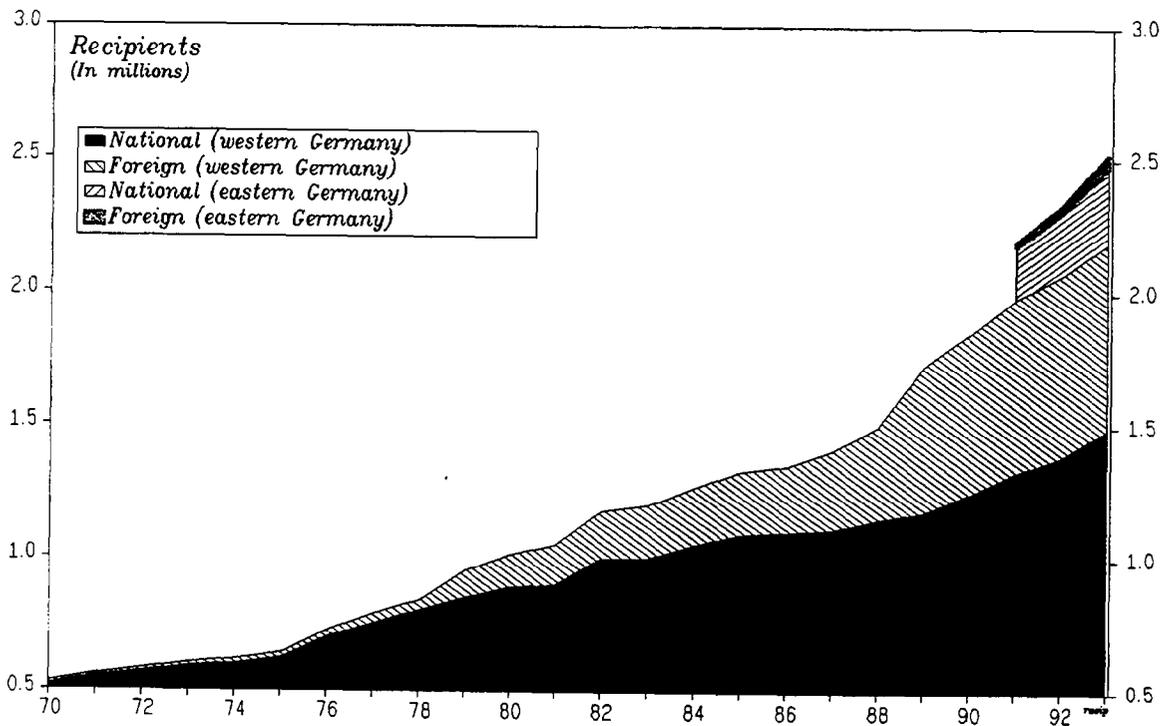
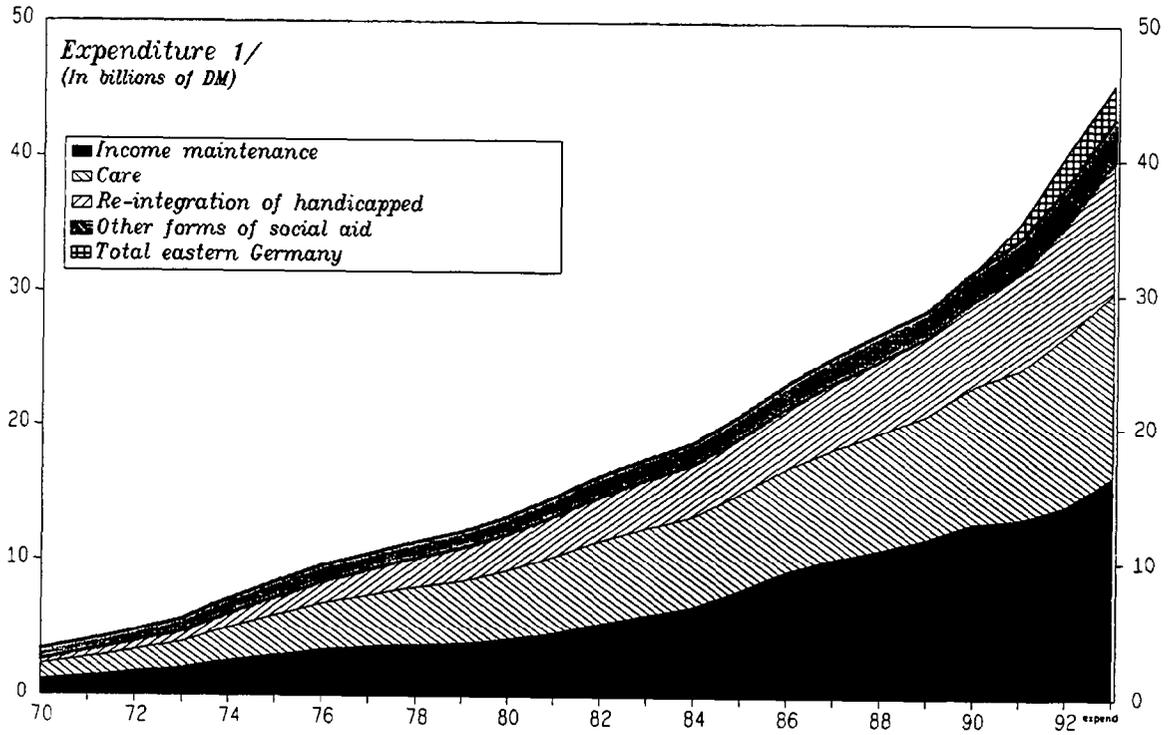
Expenditures on social assistance have soared over the last two decades (Chart 1, upper panel). While nominal GDP quadrupled from 1970 to 1990, total social assistance expenditures--including spending on those in special circumstances--went up by a factor of ten, and expenditure on social income maintenance alone went up by a factor of fifteen. Even though the basis for social assistance is a federal law [Bundessozialhilfegesetz (1962)], expenditures are borne by the Laender and local authorities. In total, the Laender spent 6 percent of their budgets on total social assistance in 1991 compared with 2 1/2 percent in 1970. 2/ The increase in expenditures is mainly due to a large increase in the number of recipients. However, increases in the real value of benefits per recipient have also contributed: deflated by the consumer price index, the basic allowance was in 1993 almost

1/ See BMA (1994, Chapters 19 and 20) for a comprehensive overview of the characteristics of social assistance. A very comprehensive treatment of the sociological problems of social assistance and poverty in Germany can be found in Hauser and Hübinger (1993), and in Leibfried and Leisering (1995).

2/ Erbe and Erbe (1993, p. 588).

CHART 1

Social Assistance: Expenditure and Recipients



Source: Statistisches Bundesamt, Fachserie 13.2, 1993; and Zeitreihen zur Sozialhilfe, September 1994; and author's calculations.

1/ Detailed categories for western Germany only.

50 percent higher than it was in 1970, and 20 percent higher than in 1983 when the present government coalition began its consolidation efforts. 1/

Eastern Germany represents a source of further potential increases. In 1993 social assistance expenditures per inhabitant in eastern Germany were only 38 percent of those of western Germany, owing mainly to a lower level of benefits, but also to a relatively lower number of recipients. 2/ Should the structure of benefits and recipients in eastern Germany eventually adjust to that in western Germany, social assistance expenditures in all of Germany would be another DM 2.5 billion (14 percent) higher.

2. Development of number and age structure of social assistance recipients

The number of recipients of social income maintenance has increased strongly in the past two decades with the number of national recipients in western Germany rising by 4.5 percent per year on average from 1970 to 1993 (Chart 1, lower panel). 3/ Thus, at end-1993 (latest available data), recipients (including foreigners) constituted by no means a small social group, comprising almost 2.5 million persons in Germany or roughly 3 percent of the population. Of these, 2.2 million recipients were in western Germany and 287,000 were in eastern Germany. The number of national recipients amounted to almost 1.8 million--1.5 million in western Germany and 260,000 in eastern Germany. All these figures refer to points in time (end of year). The total number of recipients throughout the year is substantially higher because of a high number of short-time recipients; during the course of 1993, for example, a total of 2.65 million nationals received social assistance.

One striking feature in the recipient structure is the decreasing age of recipients. For national recipients, the average age fell by eight years from 1972 to 1993: while in 1972 the average age of recipients was 41 years, it had fallen to 33 years by 1993 (Table 1).

1/ BMA (1994, p. 626).

2/ Statistisches Bundesamt, Zeitreihen zur Sozialhilfe, June 1995.

3/ Until recently, the figures for foreign recipients also included asylum applicants, who had historically been a negligible number, and who were supported out of social assistance. However, the surge in applications for asylum after 1991 led to a change in legislation in 1993, which shifted the support for asylum applicants to other funds. Since official statistics do not distinguish asylum applicants (who are not entitled to work) from other foreign recipients, a more consistent picture of developments in the numbers of recipients is provided by the figures for nationals.

Table 1. Age Structure of National Recipients

(In percent, unless otherwise indicated)

	<u>Age brackets (in years)</u>					Of working age <u>1/</u>	Average age (in years) <u>2/</u>
	<18	18-25	25-50	50-65	>65		
1972	34	3	18	16	29	25	41.0
1980	35	8	25	14	18	37	36.0
1993	36	8	33	13	10	45	32.9

Sources: Federal Statistical Office; Erbe and Erbe (1993, p. 592), Klanberg and Prinz (1983, p. 292); and author's calculations. Data refer to western Germany. 1/ 16-50 years. 2/ Assuming "under 18" = 12 years, "over 65" = 70 years, otherwise mid-interval.

The share of recipients of working age is of particular importance in the context of this paper. Almost one half of recipients at end-1993 (some 1 million nationals) were aged 16 to 50 years--itself a limited definition for working age--in contrast to only one quarter in 1972. Also the proportion of persons of retirement age has decreased sharply from almost 30 percent to 10 percent. The large and roughly unchanged proportion of under 18 year-olds reflects the fact that children of recipients are also counted in the statistics, and, indeed, receive a basic allowance of their own that is calculated as a fixed fraction of an adult's basic allowance. The issue of child allowances is discussed in detail in section V.

III. Incentives to Take Up Employment within Social Assistance

This section analyzes the incentives for social assistance recipients to take on work that does not pay enough for them to drop out of the social assistance system altogether (e.g., part-time or irregular work). In particular, it analyzes how the social assistance system interacts with the tax code; the results are high marginal effective tax rates. Effective marginal tax rates will remain high after the 1996 tax reform.

1. Explicit taxation from the tax code 1/

The most important event for tax policy in recent times has been a ruling by the Constitutional Court in 1992 that all income necessary as a subsistence minimum ought to be untaxed. As a consequence, the tax-free subsistence minimum of the tax code (previously DM 5,600) had to be brought in line with social law, according to which a level of around DM 12,000 (US \$ 8,200) was regarded as the subsistence minimum. The court allowed until 1996 to complete the necessary reform, but required that from 1993 onwards a preliminary solution be found that effectively left the social subsistence minimum untaxed. 2/

Therefore, three phases of taxation rules can be distinguished: the original tax code, effective until 1992; the interim stage, effective from 1993 to 1995; and the final reform stage, effective from 1996 onwards. The original tax code of 1992 implied an initial marginal tax rate of 19 percent on annual taxable income from DM 5,600 to DM 8,100. From thereon, marginal tax rates rose linearly to the maximum rate of 53 percent at an income of DM 120,000. For the interim stage, all taxable income up to the social subsistence minimum was made tax exempt, but since the government sought to restrict the drop in tax liability to the lowest income group, income above the tax-free subsistence minimum had to be taxed at high rates in order to catch up with the former liability schedule (Chart 2, upper panel). Accordingly, even though the overall level of tax liability was lowered at these income levels, very high marginal tax rates (up to 61 percent) applied to income just above the subsistence minimum (Chart 2, lower panel).

At first sight, the pattern of marginal tax rates in the interim stage appears to constitute a classical tax trap, defined to exist where marginal tax rates are unusually high at a particular income level. This was certainly the case in Germany from 1993 to 1995 for the DM 11,100 to DM 13,600 range of taxable income (approximately DM 16,000 to DM 19,100 gross income for a single earner) since marginal tax rates of the order of 60 percent are unusually high for this group--and were three times higher than the marginal tax rates faced by this group under the original tax code. 3/ However,

1/ In order to limit complexity of the issue, this section focuses on the group of single earners without children because they constitute by far the largest group among social assistance recipients (60 percent of recipients in 1993 compared with 25 percent who were single parents and 15 percent who were couples with or without children).

2/ See Thormählen and Specht (1993).

3/ The figures refer to 1994 and are slightly different in the other years because of nominal adjustments. In 1995, the picture has become somewhat more complicated. On the one hand, marginal tax rates in the "tax trap" region were reduced to 50 percent (see BMF, Finanzbericht 1994, p. 124). On the other hand, in this region the solidarity surcharge of up to 7.5 percent of tax liability was gradually phased in. The result was marginal tax rates between 50 and 53 percent.

the empirical importance of this tax trap should not be overstated as it only applied to a small income group for a transitory period which might have been too short to have a substantial effect on labor supply decisions.

The 1996 tax reform proposal eliminates these tax traps by allowing for a more gradually increasing tax schedule above the subsistence minimum laid down at DM 12,100 (Chart 2, lower panel). 1/ The initial marginal tax rate is 25.9 percent. Thereafter, marginal rates increase at a relatively low rate up to a taxable income of DM 55,700 at which point the schedule kinks upwards and becomes identical to the former tax schedule. 2/

2. Implicit taxation deriving from the withdrawal of benefits

The withdrawal of benefits as an individual earns outside income effectively represents a form of implicit taxation that is likely to affect labor supply decisions. Typically, withdrawal schedules consist of an earnings disregard that defines the maximum earnings allowed before benefits are reduced, a withdrawal rate at which benefits are withdrawn for incomes above the earnings disregard, and a maximum level of outside income at which benefits phase out entirely. The withdrawal schedule in Germany effectively--albeit in a more complex design--comes very close to this pattern (see also Boss, 1994).

As mentioned in section II, social assistance receipts (R) consist of a basic allowance of DM 520 (B), support for housing expenses of DM 370 (H), and one-time payments which are, however, irrelevant for the marginal withdrawal schedule:

$$(1) \quad R = B + H$$

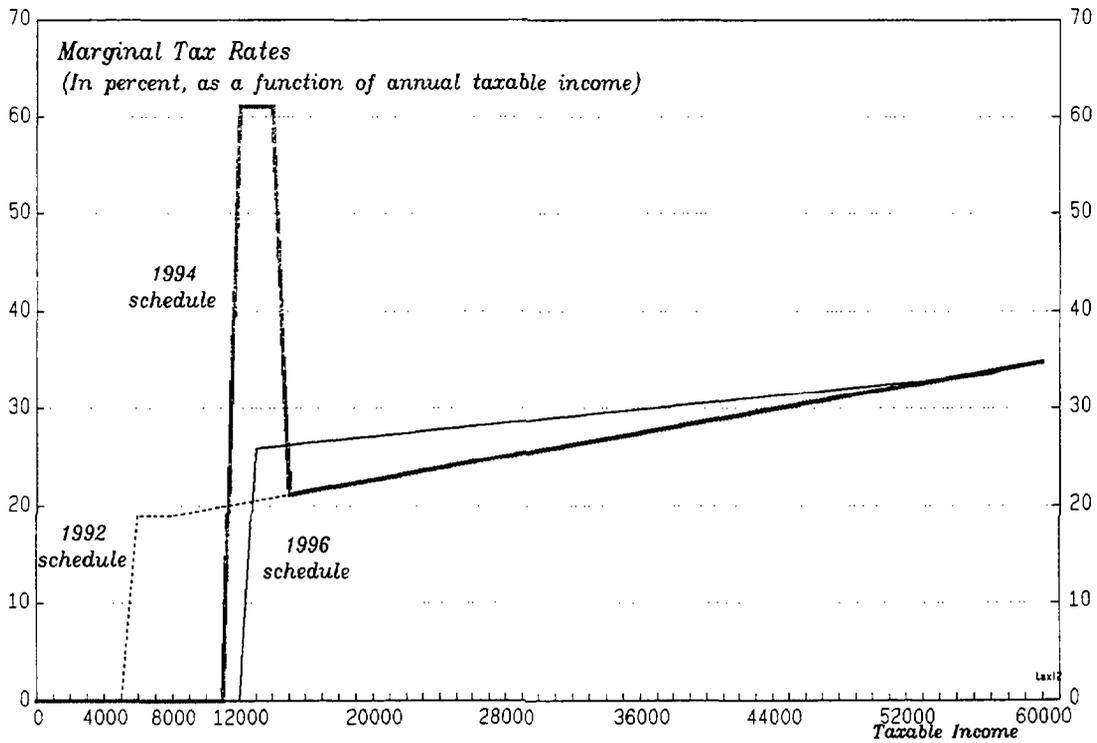
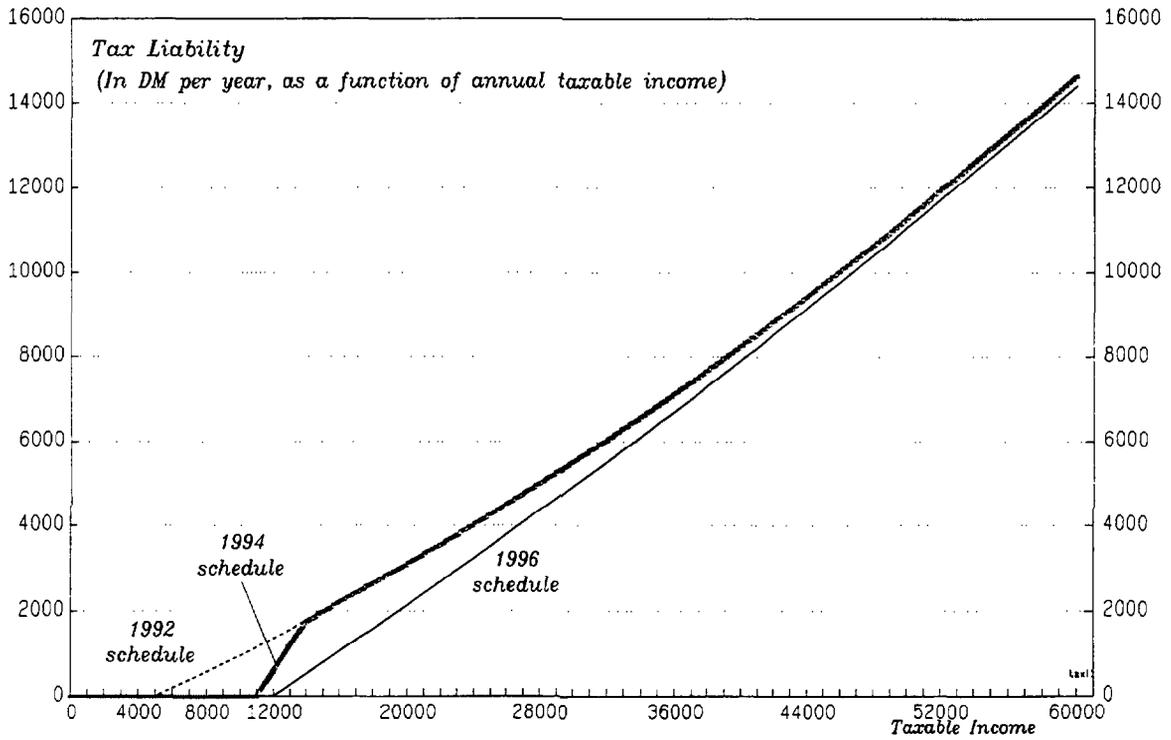
The rules defining how benefits change in case of outside income are based on a rather complicated set of regulations laid down in an attachment to the social assistance law. 3/ There are four key intervals of net labor income, N, (i.e., gross income net of social security contributions, taxes, and expenses in employment):

1/ As a result of the change, it is estimated that tax revenues would decline by DM 15.5 billion.

2/ The solidarity surcharge of 7.5 percent on tax liability, effective since January 1995 for a (yet) unlimited period of time, is not relevant for the lower income ranges because incomes up to a taxable income of DM 14,150 are exempt from the surcharge, and the full surcharge begins only at DM 16,310. See Solidaritätszuschlagsgesetz, art. 3.

3/ What is described below is based on up-to-date information provided by the Ministries of Finance and Labor in June 1995. See also Boss (1994).

Income Tax Schedules 1992 - 1996



Sources: Bundesministerium der Finanzen; Steuertabellen fuer die Bundesrepublik Deutschland; and author's calculations.

- For net labor income under DM 130 per month, no withdrawals are made: DM 130 (25 percent of the basic allowance, B) is the earnings disregard;

- For net labor income between DM 130 and DM 1,000 (rounded), social assistance receipts are reduced by an "appropriately adjusted" net income N' , so that social assistance receipts are: 1/

$$(2) \quad R = B + H - N'$$

To calculate the adjusted net income N' , the recipient may make a deduction for his or her work efforts consisting of a fixed component, equal to the earnings disregard, and a variable component of 15 percent of the amount by which net income exceeds the earnings disregard ($0.25 B$). Thus,

$$(3) \quad N' = N - [0.25 B + 0.15 (N - 0.25 B)]$$

Inserting (3) into (2) yields the total receipts R as a function of net labor income:

$$(4) \quad R = 1.2125 B + H - 0.85 N$$

Therefore, as can be seen from (4), the marginal rate of implicit taxation is 85 percent in this range; an increase of net earnings by DM 1 increases disposable income $R+N$ by only DM 0.15;

- For net labor income between DM 1,000 and DM 1,150, social assistance receipts are reduced by the full increase in net income and the implicit marginal tax rate is 100 percent;

- If net labor income exceeds DM 1,150 per month, no social assistance is provided.

3. The welfare trap: explicit and implicit taxation combined

The rate of implicit taxation through welfare reductions can be combined with the explicit tax burden--which would also include social security contributions (pension, unemployment, medical, and, since January 1995, long-term nursing care insurance)--to arrive at the effective taxburden. It is this full burden that drives a wedge between gross and disposable income and that is therefore relevant for the individual decision of whether to supply an incremental amount of labor for a given gross wage.

The effective wedge must be defined for several intervals because, in addition to the net-income-dependent withdrawal schedule of social benefits,

1/ The upper limit of DM 1,000 is calculated implicitly from the regulation stating that the deduction $N-N'$ may not exceed 50 percent of the basic allowance, B.

social security contributions and taxation begin at different levels of gross income. The order of calculation is as follows:

(1) Employees' social security contributions at a fixed fraction of 19.5 percent (1995: 19.6 percent, 1996: 19.8 percent) of entire gross income are due on income above DM 560 (1996: DM 580) per month. 1/

(2) Taxation begins at an annual taxable income of DM 11,050 in 1994 and at DM 12,100 for 1996. An employee can deduct from gross income 18 percent for private provisions (life insurance, private pension provisions), a lump-sum allowance of DM 2,000 for expenses in employment, and an allowance of DM 108 for non-provision related expenses. 2/ Therefore, taxation begins at approximately DM 16,040 gross income in 1994 and at DM 17,320 in 1996. 3/

(3) The recipient may, if in work, deduct expenses in employment (for transportation, clothing, etc.) "up to a reasonable amount" from his net income for purposes of the withdrawal calculation. These deductions are made for actual expenses only and must be accepted on an individual basis by the local authority. It is important to account for them because the withdrawal schedule is based on net income after these expenses. There is no general rule for the "reasonable" volume of expenses in employment. Generally, the tax code allows a lump sum of DM 2,000 per year for expenses in employment, or roughly 10 percent of net income in the lower income groups, and in the following analysis, it is therefore assumed that the recipient can similarly deduct 10 percent of net earnings as expenses in employment. If the remaining income net of taxes, social security contributions, and expenses of employment exceeds DM 1,150 per month, the individual can file no claim for social assistance.

The calculated marginal effective tax rates are very high and begin at a gross wage as low as DM 145 per month (Table 2). At that point, additional labor earnings are effectively taxed at 76.5 percent owing to the withdrawal of benefits: in other words, net income from an additional DM 100 gross

1/ To simplify the analysis here we abstract from the fact that from DM 560 to DM 610 the contributions are paid by the employer. In 1994, employees' contributions comprised 9.6 percent for pension insurance, 6.6 percent for medical insurance, and 3.3 percent for unemployment insurance. From 1995 onward 0.5 percent long-term nursing care insurance contributions also apply, but pension contributions were lowered by 0.3 percentage point, and medical insurance contributions by 0.1 percentage point. We assume a 0.2 percentage point increase in the (as yet undetermined) contribution rate for pensions in 1996. In addition, the contribution rate for nursing care insurance is likely to increase to 0.85 percent in mid-1996.

2/ These figures refer to single earners and may be higher for couples and heads of families.

3/ If the private provision is increased to 20 percent as currently under discussion, taxation would begin at a gross income of DM 17,750.

income is only DM 23.50. 1/ Furthermore, the total marginal burden rises with outside wages and only at a level of DM 1,790, where the claim to file for social assistance expires (because this level represents a net income relevant for social assistance of DM 1,150), does the marginal burden fall to just above 40 percent. On average (weighted by the relative size of the different earnings intervals), recipients of social assistance face a marginal burden on outside earnings of 75 percent.

Table 2. Marginal Explicit (Column 3) and Implicit (Column 7) Taxation as a Function of Gross Wage Income per Month in 1994 1/

Gross income [DM]	Social secur. contr. [%]	Marg. tax [%]	Net income [DM]	Net of empl. expenses [DM]	SAss. red.of net [%]	SAss. red.of gross [%]	Tot.marg. burden of gross <u>2/</u> [%]
< 144	0	0	144	130	0	0	0
145-559	0	0	145-559	131-503	85.0	76.5	76.5
560-1335	19.5	0	450-1074	405-967	85.0	59.9	79.4
1336-1593	19.5	61.1	1076-1153	968-1038	100.0	9.4	90.0
1594-1790	19.5	21.1	1154-1278	1039-1150	100.0	49.4	90.0
> 1791	19.5	21.2	> 1278	> 1150	0	0	40.7

1/ Columns 2, 3, and 6 follow directly from the schedules for social security contributions, taxes, and benefits withdrawal, respectively. Column 7 shows the implied benefit withdrawal rates as a function of gross income. The final column combines these elements into an effective marginal tax rate.

2/ Sum of social security contribution, marginal tax rate, and social assistance reduction (of gross).

4. The effects of the 1996 tax reform on the "welfare trap"

The 1996 tax reform will not alleviate the problem of very high marginal burdens on labor earnings for recipients of social assistance (Table 3). Even though the reform eliminates the tax traps above the subsistence minimum, it leaves the total marginal burden practically unchanged at almost

1/ If, as assumed, the individual has to bear expenses in employment of DM 10, disposable income will actually be only DM 13.50 higher. The calculation of the marginal burden, however, abstracts from this effect to achieve consistency in comparison with regular earners who also have to bear the expenses in employment.

73 percent on average. 1/ This is because the reduced taxation in this income bracket leads to higher after-tax income, which in turn implies a higher withdrawal of benefits (compare columns 7 in Tables 2 and 3). As a consequence, the tax and benefit system will continue to offer similar disincentives for taking up part-time or irregularly paid jobs yielding a gross income of less than about DM 1,650 per month. 2/

Table 3. Marginal Explicit and Implicit Taxation
as a Function of Gross Wage Income per Month in 1996

Gross income [DM]	Social secur. contr. [%]	Marg. tax [%]	Net income [DM]	Net of empl. expenses [DM]	SAss. red.of net [%]	SAss. red.of gross [%]	Tot.marg. burden of gross <u>1/</u> [%]
< 144	0	0	144	130	0	0	0
145-579	0	0	145-579	131-521	85.0	76.5	76.5
580-1443	19.8	0	465-1157	419-1041	85.0	59.7	79.5
1444-1650	19.8	26.1	1158-1278	1042-1150	100.0	44.1	90.0
> 1650	19.8	26.2	> 1278	> 1150	0	0	46.0

1/ Sum of social security contributions, marginal tax rate, and social assistance reduction (of gross).

IV. Incentives to leave social assistance and the "Lohnabstandsgebot"

The previous section addressed the question of the incentives for recipients of social assistance to supplement their social assistance benefits with own labor income. By contrast, this section discusses the net benefits of switching from social assistance to a regular job. This question is implicitly recognized in the Lohnabstandsgebot--the principle that social assistance benefits must be at a certain "distance" below wages in the economy in keeping with the view that social assistance is meant to act as a "help to work."

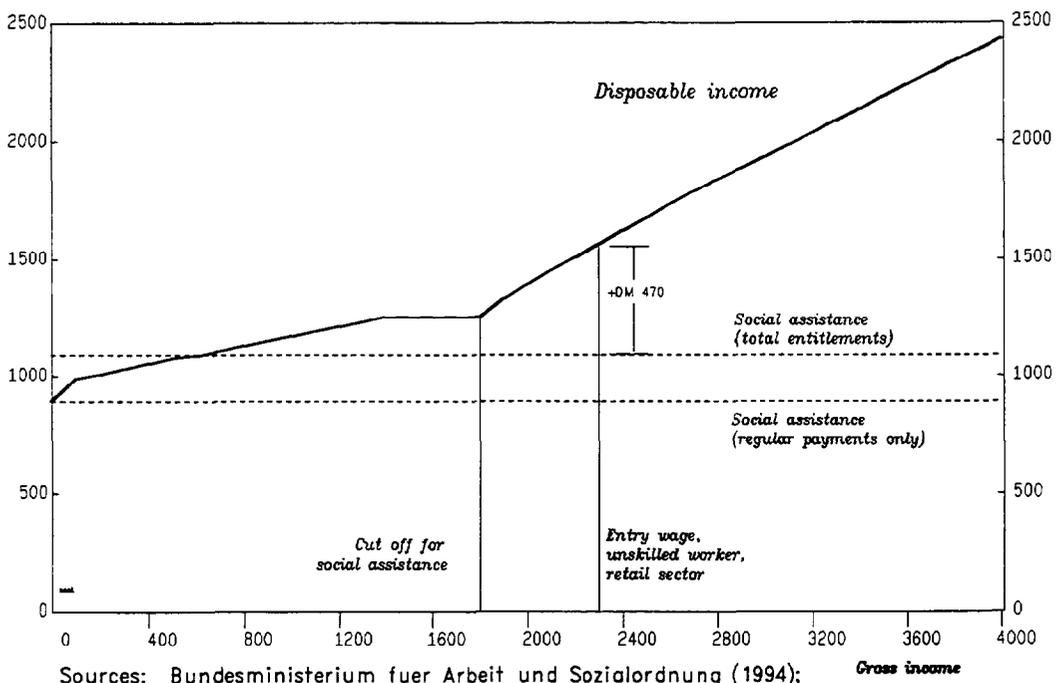
1/ The slight reduction of the burden is due to the increase in the earnings disregard for social security contributions from DM 560 to DM 580.

2/ The cut-off point for social assistance is lowered because tax liability has gone down with respect to 1994 (Chart III-2, upper panel). Hence, already at a gross income of DM 1,650 an employee has a net income of DM 1,150, where the entitlement for social assistance expires.

Of course, since there exists no measure of the average utility of leisure nor of the disutility of being dependent on social assistance (the "shame factor"), it is impossible to construct an "objective" measure of a sufficient gap between wages and social assistance. However, a comparison of total net incomes from work and from social assistance suggests that a social assistance recipient has to move quite far up the income scale before his or her net income lies considerably above the social assistance entitlement (Chart 3). At a gross wage of DM 2,300 (US \$ 1,560) per month, for example, which would be an entry wage in the services sector (average for men and women), net income would be approximately DM 1,560 or just DM 470 above the social assistance entitlement, which is a small reward for a work effort of 170 hours. 1/

CHART 3

Disposable Income as a Function of Gross Wage Income ^{1/}
(In DM per month)



Sources: Bundesministerium fuer Arbeit und Sozialordnung (1994);
and author's calculations.

^{1/} Disposable income includes social assistance up to a gross wage of DM 1800 per month and is net of income and church taxes and social security contributions.

1/ It is sometimes argued [see, for example, Hauser (1995)] that social assistance entitlements should be compared with net income plus social security contributions since these contributions represent a claim that is part of life-time earnings. However, given the far off and uncertain nature of this claim, in particular under a pay-as-you-go system, it is likely that the employment decision of a social assistance recipient will not include this claim and rather be more cash-oriented, directly comparing net incomes.

1. The Lohnabstandsgebot

The Lohnabstandsgebot principle itself is simple and uncontroversial. Putting it into practice, however, is much more difficult. In its current version, the principle states that for "a family with three dependents social assistance entitlements, including housing benefits, may not lie above the net wage of a low-income group, including child allowance and housing allowance." 1/ The principle therefore takes a five-person household as the reference group, but it is rather vague on which wage level to choose and does not state how large the benefit-wage wedge ought to be. This suggests that as long as there is some wedge, the principle is met. Current reform plans aim at establishing a minimum wedge of 15 percent. 2/

On a regular basis, a government commission assesses the size of this wedge by comparing the social assistance entitlement for different groups of recipients with two wage earnings positions: the average net earnings of unskilled blue-collar workers in industry and the average net earnings of low-skilled, white-collar employees. For all groups--single earners, couples, and couples with up to three children--the average wage lies above social assistance receipts each group is entitled to (Chart 4). The conclusion of the commission has therefore been: "The principle of a wedge between wages and social assistance benefits is generally met." 3/

Nevertheless, from an economic point of view, three questions remain: is the correct reference wage being used; is the "distance" sufficient; and has the correct reference group of recipients been identified?

2. Reference wage levels and recipient groups

In choosing the reference wage level, the commission rightly distinguishes between male and female earners because their actual earnings profiles differ greatly, and it takes a low-skill or unskilled wage level as the benchmark because the majority of social aid recipients have a lower education level and may have had their human capital depreciated during a possibly longer stay on social assistance. But other elements of the reference wage choice are more questionable--including the sector (industry), the number of years spent in the company (average for the economy),

1/ BMA (1994, p. 629).

2/ BMG (1995).

3/ BPA (1994).

and the age (again, average for the economy)--and suggest the reference wage level may be substantially too high. 1/

• Sector: The industrial sector is the sector with the highest labor productivity in the economy and the highest level of average wages. It is not, however, the sector with the greatest flexibility in taking up new workers. Furthermore, the high stress on productivity makes it not an easy sector to enter for persons with possibly long spells outside employment. Rather than the industrial sector, the services sector, the retail sector or the crafts sector would seem to be sectors which are easier to enter for former recipients of social assistance and therefore better benchmarks.

• Age: Earnings are generally increasing in age. Since social assistance recipients are on average younger than those in employment (in particular the age group of 18-30 is relatively large) official reference wages may overstate the potential earnings of recipients.

• Years within a firm: Earnings strongly increase with years spent in a given firm. This holds for blue-collar workers and--even more so--for white-collar employees. The most recent available, detailed wage statistics for the German economy show that for unskilled workers, the wages of the bracket with the greatest number of years within a given firm (more than 20 years) are almost 40 percent above entrance wages (less than one year within the firm); for white-collar employees they are 60 percent higher. 2/ Since, by definition, recipients of social assistance are new entrants to a firm, their wage receipts will be far overstated if an economy-wide average is used.

• "Gradual" entry into the labor market: Taking up full employment is not the only, probably not even the most relevant, alternative for a person on social assistance. Rather, the recipient might seek a gradual entry on the labor market, be it in a part-time job or on a contractual basis. These forms of employment are most common in the crafts sector, the services sector and the construction sector.

The picture is very different if these factors are taken into account. The retail sector, for example, turns out to be a rather unattractive

1/ For example, the main reference wage for a single man is that of a blue-collar industrial worker--see BMFS (1994, p. 25); or BPA (1994, p. 5). The net wage in this group was DM 2,530 per month in 1994, reflecting a gross wage of about DM 3,800. On top of this the employer has to pay social security contributions, so that total labor costs for this individual amount to DM 4,540 per month. It must be doubted whether a person who has been a recipient of social assistance possibly for many years will be able to "jump" to such a job level.

2/ Statistisches Bundesamt, Wirtschaft und Statistik, (4/1995); and Fachserie 16.3, various issues.

alternative to social assistance (Chart 4). 1/ And a single young person who decides to switch from social assistance to an apprenticeship in the retail or crafts sector, which implies switching from zero to 170 hours of work per month, would improve his net income by only DM 230 per month.

Exiting from social assistance to a regular job--rather than an apprenticeship--is least attractive for female recipients. In a full-time regular work position in the retail sector, for example, monthly earnings would be only approximately DM 500 higher than on social assistance. If the recipient has a child, the wedge between social assistance and labor income narrows to DM 300 per month because additional tax relief plus cash benefits for the child are much lower than the support received when on social assistance (this problem is discussed in detail below). With two children, taking up employment may even have a negative effect on disposable income.

In sum, the official benchmark for measuring the wage-benefits wedge is "insider" oriented. It reflects whether an incumbent of an average full-time job in the economy--an insider--has an incentive to quit his or her job voluntarily and file for social assistance. More relevant for the question of exiting social assistance, however, is the "outsider" perspective: what are the wage earnings that recipients of social assistance--people outside regular employment--can actually achieve? On this criterion, the wedge is substantially narrower and in many cases wages and benefits are so close that there is practically no incentive to take up employment. 2/

Moreover, focusing on the wage/benefit wedge for a family with three dependents, the Lohnabstandsgebot in its present form clouds the picture rather than clarifies it. The target group is practically irrelevant, accounting for merely 3 percent of recipients (Chart 5). The three main groups are in fact single women (34 percent), single men (26 percent), and single women with one or two children (22 percent). At first sight this suggests that the actual gap is larger than the gap reported under the Lohnabstandsgebot. This, however, does not hold any more once an actually achievable wage level is taken as the reference. Focusing on the relevant groups of single earners and single women with one or two children, and applying actually achievable reference wages, the following picture emerges.

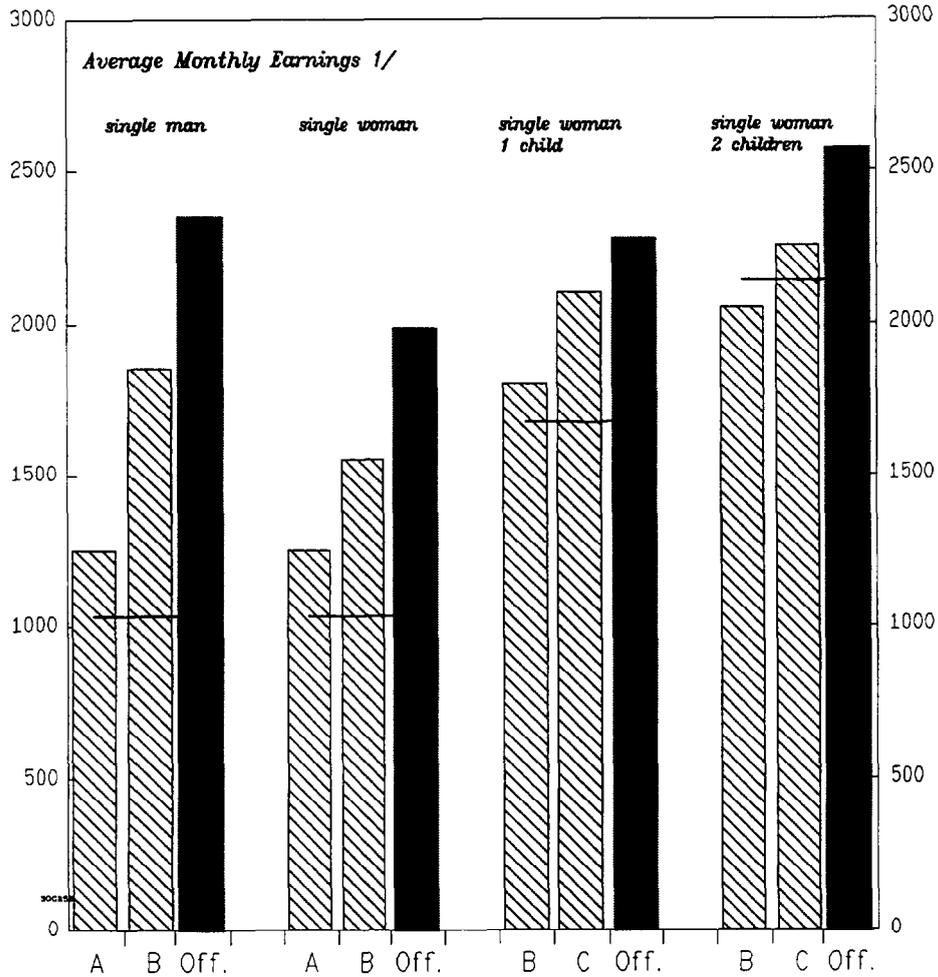
While single men have an incentive--albeit a small one with regard to some sectors--to take up employment, the incentive is narrower for female recipients, given lower wage levels for women on average. For single women with one child, average earnings for new entrants in an unskilled job in the retail sector are (including child allowances) only DM 100-200 higher than

1/ In Chart 4, the net earnings are averages of the group of newcomers in the firm and include child allowances, if applicable. Figures refer to western Germany.

2/ Nor is the 1996 tax reform likely to increase the wedge significantly given that the average tax reduction for those with taxable incomes between DM 12,000 and DM 30,000 will work out at DM 684 per year, or only DM 57 per month [(BMF (May 1995))].

CHART 4

Social Assistance Entitlements and Potential Wage Earnings (In DM per month; Western Germany)



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

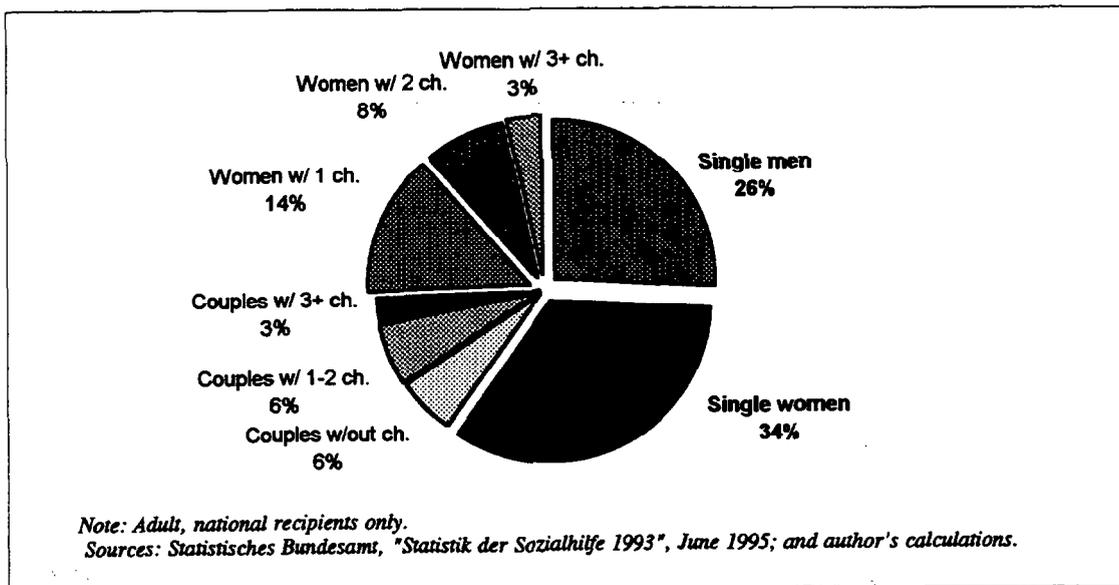
1/ First year earnings, net of taxes and social security contributions for:

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

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

social assistance entitlements, and only DM 300-400 higher for low-skilled employees in the services sector. For single women with two children the wedge reduces to DM 100-200 for service sector jobs and virtually vanishes or even becomes negative for retail sector jobs (Chart 4 above). 1/

Chart 5: Composition of Social Assistance Recipients (in 1993)



In conclusion, it is possible that the Lohnabstandsgebot may not be satisfied for many recipients--particularly women with children. Moreover, for many others, the net pecuniary benefits of working may be small and thus provide little incentive for taking a job.

1/ Divorce is thought to be a chief cause of the high proportion of women, who most often were not the earners in the family, filing for social assistance. However, a narrower wedge between entitlements and wages may also provide an explanation.

V. Reform of the Social Assistance System

The system of social assistance has many parameters, and few which have not undergone changes since 1983 (Table 4). All the changes, however, have not been sufficient to meet the aims of reform: to focus social assistance on the needy, to bring back into employment those who can work, and to keep the fiscal burden under control. Before turning to measures of reform, however, the constraints to reform need to be briefly discussed.

Table 4. Selected Reforms to Social Assistance Since 1983

1983: Increase in basic allowance limited to 2-3 percent a year until 1985.

1984: Housing allowance limited to the housing benefit that low income groups are entitled to (Wohngeld). Special supplementary allowance for single parents with 2 children under 16 years, for senior citizens, and for expectant mothers reduced from 30 percent to 20 percent of the basic allowance. Eligibility for expectant mothers, originally starting with pregnancy, changed to the 6th month of pregnancy. Eligibility for senior citizens, originally 65 years, reduced to 60 years.

1985: Price index of the consumption basket for the allowance, previously based on average prices in the economy, changed to the price index of the lowest quartile of the price ranges for the respective goods. Imputed allowance for household energy reduced by 10 percent.

1993: Increase in the basic allowance limited to 2-3 percent a year from 1993 to 1996. Eligibility for expectant mothers taken partly back to the 12th week of pregnancy and eligibility for senior citizens changed back to 65 years. Reshuffling of the age brackets for child allowances resulting in increased allowances for 7 year-olds and 14 year-olds, but reduced allowances for 11-13 and 18-20 year-olds.

1995: 1/ After 1996 increase in the basic allowance limited to the increase in net wages. Total benefits must lie at least 15 percent under net wage income for a 5-person household. Employers may receive subsidies for employing recipients. Recipients may receive extra benefits (reduced over time) if in work for up to 6 months. Refusing jobs deemed as acceptable by the authority leads to a reduction of total benefits of 10 to 15 percent.

Source: BMA (1994, Ch. 19); BMG (1995); Handelsblatt (24/5/95, p. 2).

1/ This is part of the social assistance reform drafted by the Government in July 1995 [see BMG (1995 p. 3); or Seehofer (1995, p. 233)]. The opposition-controlled upper house, however, has announced to reject the draft so that it could have to go through a parliamentary mediation process and a reform might not be approved before end-1995.

1. The constraints on reform

The reform of the system of social assistance is complicated by a number of constraints. Some of these constraints can be traced to the constitution and the principle of the "social state" [in particular (b) and (e) below], while others are necessary to make the system viable by restricting eligibility [in particular (a) and (c)]. 1/ The constraints for a reform of the social assistance system are:

- (a) the system shall be need-based;
- (b) it shall provide full support--meaning enough money to allow for a basic, "dignified" standard of living--for those who have no own resources or access to labor market income, and possibly their dependents; 2/
- (c) it shall provide no support for those who can make their own living;
- (d) it shall provide a basis for those recipients who are able to work to find their way (back) into employment;
- (e) it shall provide time-unlimited support for those who do not find employment.

Constraints (a) and (c) militate against a system of negative income tax or Bürgergeld which would be an integrated system of transfers and taxes. In such a system the status of individuals--whether net transfer recipients or net tax payers--would be determined by their income, not by their need. 3/ Also most proposals of a negative income tax foresee net

1/ For a brief description of the roots of social assistance and its links to the constitution see BMA (1994, Chapters 2 and 19).

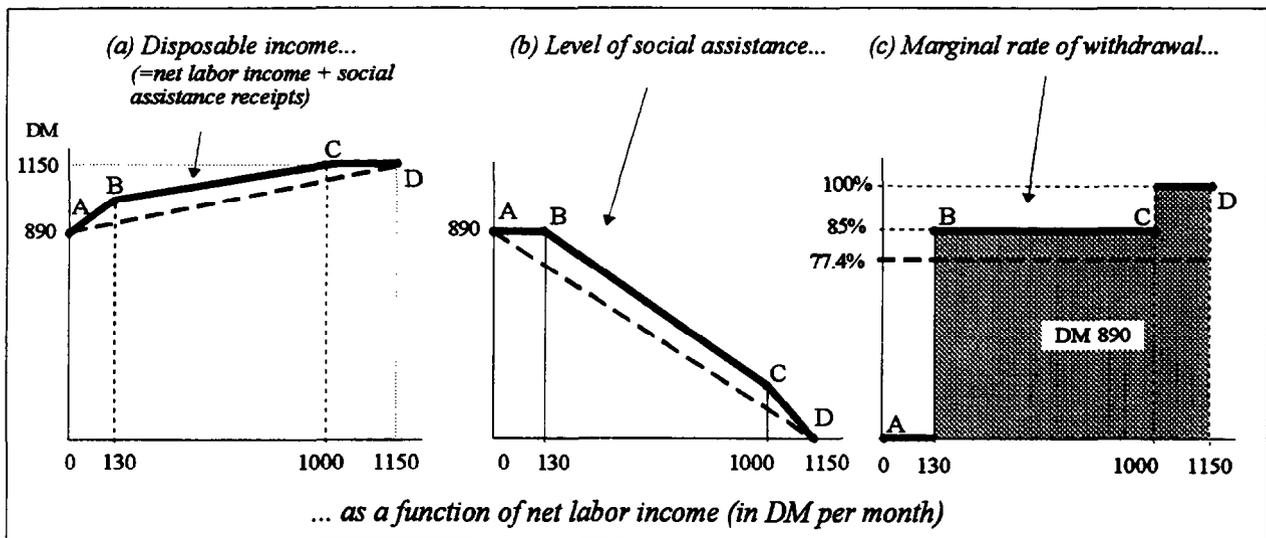
2/ This is sometimes referred to as a "socio-cultural" subsistence minimum to contrast it with a subsistence minimum necessary for sheer survival.

3/ It is sometimes argued that the 1996 tax reform effectively establishes such a system because taxation begins where transfers end. The main difference, however, is that there is no general eligibility for transfers for everyone whose income falls below the threshold level--but only for those who are needy. For example, people with wealth or with the possibility of support from family members would not be entitled to support under a need-based system.

transfers beyond the mere subsistence level, which would conflict with constraint (c). ^{1/}

The constraints also have important implications for the withdrawal schedule, which are highlighted in Charts 6a through 6c. Constraint (b) implies that, for own net income of zero, the social assistance schedule must be at a level sufficient for basic housing and living. This fixes point A (at a level of currently DM 890 per month for a single person) in Charts 6a and 6b. Constraint (c) implies that social assistance must be phased out for people who can make their own living. This fixes point D in Chart 6b (at a level of net income of currently DM 1,150). In order to avoid administrative costs for the recalculation of receipts in case of small incomes an earnings disregard is introduced (currently DM 130 per month). This fixes point B in Chart 6b. In order to avoid "perverse" incentive effects, the rate of withdrawal should at no point exceed 100 percent, which would make disposable income fall as net labor income rises. This fixes the upper bound for withdrawal rates at the 100 percent line in Chart 6c and implies that the provision of social assistance in Chart 6b should not decline at a rate steeper than -1. The fact that at an income of DM 1,150 all benefits must be withdrawn implies that the area under the withdrawal rate in Chart 6c must equal the maximum amount of benefits, i.e. DM 890.

Chart 6: Provision and Withdrawal of Social Assistance Benefits



^{1/} The government set up a commission on "Integrated Tax and Transfer Systems" in early 1995. First analyses are expected in the fall of 1995, but given the constraints mentioned in the text it may be doubted whether proposals in the direction of a negative income tax or Bürgergeld will be implemented soon.

The result is that the rate of withdrawal, given as the dashed lines in Charts 6b and 6c, will be 77.4 percent ($=890/1,150$) on average and, if it may not exceed 100 percent at any point, the room to lower it in any subinterval is also limited. Chart 6c shows the current actual withdrawal schedule with zero withdrawal for a very small income range, 85 percent withdrawal for the largest part of the range, and 100 percent for incomes just under the eligibility maximum. Therefore, given the constraints above, a high marginal burden on labor income within social assistance is unavoidable. In order to increase the incentives to take up employment, either the support level A has to be lowered or the support range D has to be extended. Both options seem politically infeasible, the first because it could be regarded as undermining the idea of full support for the needy, and the second because it could be regarded as increasing eligibility beyond those immediately needy and thereby increasing the fiscal burden of social assistance.

Nevertheless, there might be two steps of reform that bring the system closer to its aim, while remaining within the given constraints.

2. Scope for reform

2.1 Time-delayed withdrawal of benefits

The main incentive not to search for or take up employment is the small effect this will have on disposable income in many cases. What is more, there are search and setup costs, as well as possibly costly changes in daily habits connected with taking up employment. These costs, which in general will be higher the longer the spell outside employment has been, reduce the wedge between wages and benefits even further. What is even more detrimental for incentives is that these costs arise in many cases before the positive impact from employment on disposable income materializes. One way to alleviate this problem would be to withdraw parts of the social assistance benefits only after a delay--say, of three months--after employment is taken up. The main aim would be to help an individual to cover the transition costs and provide for, at least at the beginning, a very visible effect of employment on disposable income. Such a reform will decrease the social assistance burden in the long run to the extent that recipients will search for jobs who otherwise would not have done so, although for those recipients who would have taken up employment anyway, some benefits will be paid out longer than otherwise.

This reform would create potential moral hazard risks whereby recipients take up and quit employment on a cyclical basis. 1/ However, such risks are perhaps small. Experience shows that there are high hurdles for workers to quit and enter the social assistance system: they lose social status, reduce their net earnings, and also forego potential earnings increases. In fact, people mostly enter social assistance because of adverse circumstances (unemployment, divorce from earner, long illness, etc.); 2/ then, habits and consumption patterns adapt to social assistance levels and exiting becomes more difficult. Thus possible reforms need worry less about more people entering the system but more about how to make more recipients exit it. The time-delayed withdrawal of benefits may be one possibility to enhance exiting rates. In fact the bill which is to go through the parliamentary process late 1995 foresees cutting benefits but providing a time-degressive special allowance (Zuschuss) to cover adjustment costs. 3/ In essence this would be equivalent to the time-delayed withdrawal discussed here.

2.2 Consistency of child allowances in tax and social law for low incomes

The tax reform for 1996 makes the full subsistence minimum for children defined in the social law (roughly DM 6,000 or half the subsistence level of an adult) tax free. 4/ It recognizes, however, that the cash value of this allowance--the allowance multiplied by the marginal tax rate--is low for low and middle income earners. Therefore, the reform includes the option for households to receive either the tax allowance or a direct cash benefit. This cash benefit would be DM 200 per month for the first and second child, DM 300 for the third, and DM 350 for each thereafter. All low income households would be better off opting for the cash allowance.

Even so, the allowance would be considerably lower than the allowance in the social assistance system, which ranges from DM 260 to DM 468 depending on the age of the child (Table 5). For example, the head of an average low income household with two children would receive an allowance of between DM 520 and DM 936 for the children, depending on their age, if claiming social assistance compared with a cash benefit under the tax reform of DM 400 (and only DM 210 under present law) if working. The social assis-

1/ A more sophisticated version of this measure could consist of withdrawing 50 percent of benefits, while paying out 50 percent to the employer to provide an incentive to hire former social assistance recipients. This would come close to the Snower (1994) proposal for unemployment benefits. However, on the side of the employer more strategic behavior may be expected, leading possibly to a cycle of "hire and fire" to take advantage of the implicit labor subsidy.

2/ Statistisches Bundesamt, Fachserie 13.2, 1992, p. 16.

3/ See BMG (1995).

4/ See Bundestagsdrucksache (1995).

tance allowance is thus between 30 percent and 134 percent higher, depending on the children's age. In absolute terms the difference lies between DM 1,440 and DM 6,430 per year; the latter may well be more than 20 percent of the net income of a family in the low income bracket. What is more, the child allowances under social assistance, being calculated as fixed fractions of an adult's basic allowance, are indexed (to inflation or net wage increases) so they at least stay constant and may even increase in real terms. The allowances in the tax code, by contrast, are in general nominally fixed and therefore bound to decline in real terms. Even though a nominal increase is foreseen for 1997, any further increase will require discretionary policy action and means therefore less of a commitment than an explicit indexation.

Table 5. Child Benefits Under Social Assistance and Under the Tax Reform

(In deutsche mark per month)

<u>Age (years)</u>	Social assistance	<u>Tax Reform 1996</u>		
		1st and 2nd	3rd	4th+ child
Up to 7	260	200	300	350
8-14	338	200	300	350
15-18	468	200	300	350
19 and above	416	200	300	350

Sources: BMA (1994, p. 628); BMF, Pressemitteilung zum Jahressteuergesetz, August 1, 1995.

The idea behind these substantial differences in child benefits is clear: the recipient of social assistance is assumed to have no resources at all for his or her dependent(s) and therefore receives a full cash benefit for them. The regular earner, by contrast, is assumed to have, in principle, sufficient resources for him- or herself and dependents, so that the tax allowance is merely meant as a supplementary means of support. But given the rather low wages for women who enter, for example, the services or retail sectors this must not always hold true: the amount of resources necessary for the child which are not covered by the cash benefit may well absorb a large portion of the amount by which the single mother's net income exceeds her own social assistance entitlement, i.e. of her pecuniary benefit of working. This considerably reduces her work incentives if she has a job, or her search incentives if not.

Furthermore, while the social law takes into account the fact that the costs of raising a child increase with age (from 50 percent of an adult's allowance to almost a full adult's allowance for 15-18 year-olds), the cash

allowance for regular earners is not related to child age. Again, the incentive effects work against employment and in favor of social assistance. Moreover, the difference--up to DM 268 per child and month--is not a negligible amount, in particular for (young) female earners.

Reconciling these differences in child benefits between social and tax law (for example by increasing the tax allowance/cash benefits for single parents, in particular, with older children), will increase the gap between the net position of a family or a single earner with children and a recipient of social assistance. This may equally be a way to enhance horizontal equity between low income earners and social assistance recipients.

VI. Conclusion

The fact that the social assistance system has failed to meet its aim of being a "help to work" can be attributed to the low incentives it provides for recipients to take up employment. For one thing, the level of benefits is close to feasible labor earnings for this group--particularly for female recipients and single mothers, but also for men if the alternative to social assistance is an apprenticeship or a job in the retail or crafts sector, where earnings for work beginners are relatively low. In addition, the high marginal rates of effective taxation on minor labor market earnings--due to withdrawal of benefits--imply that part-time jobs or irregular jobs are practically crowded out by social assistance.

In principle, the 1996 tax reform, with its generous tax cuts at the lower end of the income range, could have substantial positive employment effects for regular earners because it increases the net return of working. However, this is unlikely to be the case for a large group of social assistance recipients whose high effective marginal tax burdens will be little affected. If positive employment effects are to materialize for this group, reforms to the system of social assistance itself will be unavoidable.

Given the tight constraints on reform, which inhibit any step that might undermine the principle of full support for the needy, and given the difficulty of filtering out the needy from those who voluntarily stay out of work, reform should focus on increasing the incentives for voluntary exits from social assistance to employment. The introduction of time-delayed withdrawals in case of employment and of greater consistency between child allowances in social law and the tax code, at least for very low incomes, may be two possible routes for reform.

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