



Thomas Walter

Germany's 2005 Welfare Reform

Evaluating Key Characteristics
with a Focus on Immigrants

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To my parents

Preface

This thesis was written during my time at the Centre for European Economic Research (*Zentrum für Europäische Wirtschaftsforschung, ZEW*) in Mannheim. It is based on the research projects Evaluation of the Experimentation Clause in Chapter 6c of Book II of the German Social Code, Research Area 3: Impact and Efficiency Analysis (*Evaluation der Experimentierklausel nach §6c SGB II, Untersuchungsfeld 3: Wirkungs- und Effizienzanalyse*) and Effects of Book II of the German Social Code on Persons with a Migration Background (*Wirkungen des SGB II auf Personen mit Migrationshintergrund*). Both projects were commissioned by Germany's Federal Ministry of Labour and Social Affairs (*Bundesministerium für Arbeit und Soziales*) to evaluate the German welfare reform of 2005 and were conducted by ZEW and several project partners, including the Institute for Work, Skills and Training (*Institut Arbeit und Qualifikation*) and TNS Emnid. The completion of the thesis would not have been possible without the support of a number of people to whom I owe many thanks.

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Mannheim, July 2012

Thomas Walter

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Chapter 1

Introduction

At the beginning of 2005, the German government enacted a substantial reform of the welfare system. This welfare reform was the final part of a series of four major reforms of the German labor market that came into force between 2003 and 2005 in response to a high and rising unemployment rate and the associated large expenditures on active and passive labor market policies.¹ The reform replaced the previously existing two-tier system of unemployment assistance (*Arbeitslosenhilfe*) and social assistance (*Sozialhilfe*) with a single welfare benefit called unemployment benefit II (UBII; in German: *Arbeitslosengeld II*). Along with the introduction of the new benefit, the reform redesigned the organization of welfare administration and increased job search requirements among welfare recipients, i.e. among individuals who are of working age and capable of working but who do not earn a sufficient living income and need financial support from the government in the form of welfare benefits. The ultimate goal of the reform was to increase the effectiveness and efficiency of labor market activation of welfare recipients (see Jacobi and Kluge, 2007). Thus, the German reform was similar to the welfare reforms conducted in other industrialized countries (e.g. in the US, in the UK, in Denmark, in Sweden, and in the Netherlands) during the last decades. Most of these reforms involved organizational changes and resulted in a shift from passive benefit payment toward an intensified activation of welfare recipients, with the objective of encouraging employment uptake and reducing welfare dependency (see Konle-Seidl, 2008 and 2009; and Huber et al., 2011).

In this thesis, I will evaluate two key characteristics of Germany's 2005 welfare reform that directly influence the way labor market activation of welfare

¹ These reforms have been implemented by four "Acts for modern Labor Market Services" (*Gesetze für moderne Dienstleistungen am Arbeitsmarkt*). They are now commonly known as the "Hartz reforms", named after the chairman of the commission proposing the reforms. Since the reform of the welfare system is the final of the four reforms, it is also referred to as the "Hartz IV reform". See Jacobi and Kluge (2007) for a description of all four Hartz reforms.

recipients is conducted. The first key characteristic is that the reform introduced two different organizational models for the labor market activation of welfare recipients. In the majority of the 439 German welfare districts², a centralized organization was established. Within these districts, the existing local employment office (LEO; in German: *Agentur für Arbeit*) of the Federal Employment Agency (FEA; in German: *Bundesagentur für Arbeit*) and the local authorities had to form a joint venture to constitute the new local welfare agency.³ In these ventures, the LEO and local authorities work together to help welfare recipients find employment. The LEO is responsible for the allocation of Active Labor Market Programs (ALMP), for job placement, and for the administration of basic welfare payments, whereas the local authorities manage financial support for housing costs and additional needs and offer counseling for specific obstacles to employment such as single parent status. The joint venture is under the direct supervision of the FEA. It can thus be considered a centralized welfare agency. The German term for a centralized agency is *Arbeitsgemeinschaft (ARGE)*.

By contrast, 69 of the 439 districts were allowed to establish a decentralized organization of welfare administration and to constitute their own decentralized welfare agency (in German: *zugelassener kommunaler Träger*, or *zkT*). In the decentralized agencies, the local authorities alone organize all aspects of labor market activation of welfare recipients. They are responsible for the entire activation process including counseling, the allocation of ALMP, job placement, and the disbursement of benefits. The FEA is not involved in any task. The 2005 welfare reform did not, therefore, implement a homogenous administrative setting. Rather, it put into operation two very different organizational models.

The second key reform characteristic is the enforcement of the principle of “supporting and demanding” (*Fördern und Fordern*) in the activation of welfare recipients across all welfare agencies, irrespective of the organizational model. The demanding component of this principle requires the welfare recipients do everything in their power to leave the welfare system as quickly as possible by taking up employment. In particular, welfare recipients have to actively engage in the job search, they have to accept any reasonable job offer, and they have to participate in ALMP if assigned by the welfare agency. These requirements are closely monitored, and, in case of non-compliance, benefit sanctions can be imposed, which reduce the monetary payments to the welfare recipients for a certain period of time. In turn, the welfare agency

² The welfare districts are called *Träger der Grundsicherung für Arbeitsuchende* in German. They are geographically similar to the political districts (*Landkreise* and *kreisfreie Städte*) and to the labor market districts (*Agenturbezirke*) of the Federal Employment Agency (FEA) but not identical in every single case. Throughout this thesis, the terms “welfare districts” and “districts” will be used interchangeably to refer to the *Träger der Grundsicherung für Arbeitsuchende*.

³ From 2005 onwards, the terms “(welfare) district” and “(welfare) agency” have functioned synonymously.

acts as a service provider to help welfare recipients find a way out of welfare dependency. This support is reflected by the counseling activities of welfare agencies (e.g. counseling on job search strategies or counseling on individual obstacles to employment) and, more importantly, by the provision of ALMP. This provision constitutes a remarkable change in German welfare policy. For the first time, all welfare recipients available to the labor market are a target group for potential participation in ALMP. A large number of programs are offered. The most widely used programs are so-called Temporary Extra Jobs (*Arbeitsgelegenheiten in der Mehraufwandsvariante*; commonly referred to as *Ein-Euro-Jobs*) and short-term training programs (*Trainingsmaßnahmen*). Temporary Extra Jobs offer temporary work opportunities in the public sector. German legislation stipulates that these jobs be of public interest and additional in the sense that they do not compete with regular employment. While Temporary Extra Jobs can last for up to six months, short-term training has a maximum duration of only twelve weeks. The content of short-term training is rather heterogeneous and can include job application training, the provision of general skills required for employment (e.g. computer courses) and the training of specific occupational skills.

Both key characteristics indicated above have aroused considerable public interest (see e.g. Eichhorst et al., 2010). This interest is also reflected in Book II of the German Social Code (*Sozialgesetzbuch Zweites Buch, SGB II*), the legal basis of the reform, which explicitly mandates the evaluation of these key characteristics and the evaluation of labor market activation of welfare recipients in general.⁴ According to chapter 1 of SGB II, labor market activation has to aim at integrating welfare recipients into self-sufficient employment, i.e. employment generating a sufficient wage such that no welfare benefits are needed any longer. In this thesis, my analyses are carried out from a microeconomic perspective and with respect to the aim of activation as noted in chapter 1 of SGB II. Specifically, I investigate the effects of the key reform characteristics on the individual probability of welfare recipients' finding self-sufficient employment. Due to the relative recentness of the reform and my analyses, I focus on short-run effects of up to one year.

Moreover, this thesis has a focus on welfare recipients with a migration background. Immigrants⁵ are highly over-represented in the German welfare system, but there is little data on their employment prospects. While about one in three welfare recipients has a migration background, the correspond-

⁴ To fulfill the legal evaluation requirements, the Federal Ministry of Labour and Social Affairs (*Bundesministerium für Arbeit und Soziales*) commissioned several research projects. The projects Evaluation of the Experimentation Clause in Chapter 6c of Book II of the German Social Code, Research Area 3: Impact and Efficiency Analysis (*Evaluation der Experimentierklausel nach §6c SGB II, Untersuchungsfeld 3: Wirkungs- und Effizienzanalyse*) and Effects of Book II of the German Social Code on Persons with a Migration Background (*Wirkungen des SGB II auf Personen mit Migrationshintergrund*) initiated the analyses presented in this thesis.

⁵ The terms "persons with a migration background" and "immigrants" will be used interchangeably in this thesis.

ing share in the population is only about 19% (see Bundesministerium für Arbeit und Soziales, 2009; and Statistisches Bundesamt, 2007). Given this over-representation of persons with a migration background on welfare, it is crucial to understand how labor market activation affects this group. This question is especially interesting in view of the ongoing public dispute in Germany about the difficult integration of immigrants into German society in general and into the labor market in particular (see e.g. the introduction to the volume edited by Knuth, 2010). A successful labor market integration could be a stepping stone on the way to a successful social integration. Consequently, the design of labor market activation and welfare policy might have a considerable impact on the integration pathway.

My analyses are based on unique data that have been specifically collected for the research questions presented in this thesis. The data comprise survey and administrative information on welfare recipients and information on welfare agencies, in particular their activation strategies and internal organization. They are described in detail in **chapter 2**. This chapter also provides a comprehensive description of the German welfare system and its 2005 reform.

Concerning the first key reform characteristic, the question arises of who should be responsible for the activation of welfare recipients. Should the activation be administered on the discretion of local authorities, or should the FEA be in charge? Rephrasing this question, one can ask whether welfare administration should be decentralized or centralized. **Chapter 3** is devoted to this question. It adopts a propensity score matching approach, in which individuals registered at decentralized welfare agencies are considered as the treatment group, and welfare recipients from centralized agencies form the control group. Treated and non-treated individuals are compared with respect to their likelihood of taking up self-sufficient employment. This comparison contributes to the literature by providing the first quantitative evidence on the effects of a decentralized versus centralized organization of welfare administration on individual employment outcomes.

Independent of the organization of welfare administration, strategical features of welfare agencies may affect success rates for integrating welfare recipients into self-sufficient employment. One such feature could be the sanction strategy of a welfare agency. Sanctions are a crucial element of the principle of demanding. One assumes that they foster compliance of welfare recipients with their duties during the activation process (see van den Berg et al., 2004). Even though the deployment of sanctions are determined by law, their use differs widely between welfare agencies. Some agencies sanction frequently, whereas others use this measure rarely. In **chapter 4** of this thesis, variation in sanction strategies and rates across welfare agencies is used to investigate whether an intensified use of benefit sanctions is an effective tool to speed up transitions from welfare to employment. For this investigation, an instrumental variable approach is applied to estimate the effect of a benefit sanction for those individuals who are not sanctioned in a welfare agency with a mod-

erate sanction regime but who will be sanctioned if the agency decides to change its policy and impose sanctions more frequently. This effect provides an estimate of the effectiveness of an intensified use of sanctions. The analysis acknowledges that welfare agencies play a crucial role for the imposition of benefit sanctions. To date, researchers have neglected the potential role played by these agencies.

Along with the principle of demanding, the second key characteristic of Germany's 2005 welfare reform is comprehensive support for welfare recipients by the welfare agencies. This supporting function of welfare agencies is mainly visible in the provision of ALMP, which are intended to increase the employment chances of individuals. Whether the intended goal is actually achieved is considered in **chapter 5**. This chapter estimates the employment effects of the most frequently used programs since 2005: Temporary Extra Jobs and four different short-term training programs. For the estimation, a dynamic propensity score matching approach is adopted that takes account of the starting point of program participation while persons are on welfare. The analysis has a particular interest in the following research questions: Are programs similarly effective for immigrants and native Germans, or do their effects differ? And, if differences in effects are observable between both groups, what are the causes of these differences? Are they due to observable differences in sociodemographic characteristics, or are they due to unobservable differences that must be attributed to immigrant status? In order to answer these questions, differences in treatment effects between native Germans and immigrants that result from the attachment of the individual to the immigrant group are identified on the basis of a matching estimator. Identifying causes of potential differences in treatment effects between natives and immigrants contributes to the existing literature on the effectiveness of ALMP in the German welfare system. Most researchers have so far ignored the question of effect heterogeneity.

Besides evaluating the effectiveness of Temporary Extra Jobs and short-term training programs, I also conduct fiscal cost-benefit analyses to investigate their efficiency from the perspective of the government that provides the programs (see **chapter 6**). Only combined information about the effectiveness and efficiency of programs allows for a meaningful discussion of policy recommendations on the use of ALMP. Depending on the effectiveness of programs, the government can obtain either positive or negative benefits. In the case of a positive impact of a program on the employment chances of an individual, the government benefits in terms of increased income tax payments and social insurance contributions. It also realizes savings on welfare payments and administrative costs. These positive fiscal benefits need to be compared with the operating costs of the program. If positive benefits outweigh costs, the program in question is considered to be fiscally efficient. The comparison of costs and benefits at different points in time allows one to measure how long it takes a program to pay off and how its efficiency over time compares with other programs. To perform the fiscal cost-benefit analy-

ses, the post-welfare wages of individuals who leave welfare for self-sufficient employment are estimated with a standard wage equation. Based on these estimates, fiscal benefits in terms of income tax and social insurance contributions are derived in accordance with the relevant tax legislation. In addition, savings on welfare payments and administrative costs are calculated, while program costs are obtained from the FEA. To the best of my knowledge, the efficiency of the most frequently used ALMP in the German welfare system has yet to be systematically evaluated.

Finally, **chapter 7** concludes this thesis by summarizing the results of the empirical analyses and discussing policy implications. In particular, the results will be considered with regard to current political proposals for improving the German welfare system.

Chapter 2

Background for the Empirical Analyses: Institutional Details and Data

This chapter lays the foundations for the empirical analyses presented in chapters 3 to 6. In section 2.1, a description of the main features of the German welfare system before and after the 2005 welfare reform is provided. Section 2.2 summarizes the macroeconomic conditions in Germany during this time period and presents selected figures on the German welfare system in particular for the post-reform period. In section 2.3, the data sources used for the empirical analyses are introduced.

2.1 The German Welfare System and Its 2005 Reform

Prior to the 2005 welfare reform, Germany was characterized by a two-tier system of welfare benefits. This system differentiated between individuals who had contributed sufficiently and individuals who had not contributed sufficiently to unemployment insurance (see Wunsch, 2005).⁶ In case of sufficient contributions unemployed individuals were entitled to unemployment insurance benefits (*Arbeitslosengeld*), which were granted for no longer than 32 months, and, after exhaustion of these benefits, to unemployment assistance (*Arbeitslosenhilfe*).⁷ Unemployment assistance was means-tested and proportional to former earnings. Claimants received 57% of their previous av-

⁶ Contributions of an individual were sufficient if the individual had been employed and had paid social insurance contributions for at least twelve months during the final three years before becoming unemployed. In February 2006, this qualification period was reduced from three to two years.

⁷ The general setting of unemployment insurance benefits was not targeted by the 2005 reform. In case of unemployment, persons with sufficient contributions to unemployment insurance can claim unemployment benefits for a limited period of time. The time limit depends on the time of contribution and age. Before January 31, 2006 the time limit varied between 6 and 32 months. The maximum duration was afterwards reduced to 18 months, but in January 2008 again increased to 24 months for persons age 58 or above. Unemployment insurance benefits are earnings related. They replace

erage net monthly earnings if they had at least one dependent child. Without dependent children, the replacement rate amounted to 53%. Unemployment assistance was funded from general taxes and was paid for a potentially unlimited period of time until retirement age (see Eichhorst et al., 2010).

Individuals who had not contributed sufficiently to unemployment insurance could only apply for social assistance (*Sozialhilfe*). This was a means-tested, monthly payment whose amount depended on the income and wealth of all household members (see Bäcker and Koch, 2004; or Clauss and Schnabel, 2008). It was not related to previous earnings and provided a basic income in order to guarantee the socio-cultural subsistence level. Social assistance did not require the claimants to be unemployed. The “working poor”, who could not live upon their own earnings, were eligible, too. Moreover, persons in retirement age who had no sufficient income from their pensions or other sources could apply for social assistance. Like unemployment assistance, social assistance was financed from general taxes (see Wunsch, 2005). However, the means-test for social assistance recipients was stricter and the payments, in general, lower than for unemployment assistance recipients (see Wunsch, 2005, and Eichhorst et al., 2010). According to Ochel (2005), in 2004 the average base payment of social assistance (not including additional benefits like payments for housing costs) for a single person amounted to 296 euros in West Germany and to 283 euros in East Germany. The average amount of unemployment assistance (excluding additional benefits) was 583 euros in the western part and 516 euros in the eastern part of Germany, respectively (see Bundesagentur für Arbeit, 2005). In cases where unemployment assistance was insufficient to reach the socio-cultural subsistence level, it was topped up with social assistance.

In addition to the different eligibility criteria, there were two different authorities responsible for the administration of benefits and the labor market activation of welfare recipients. The Federal Employment Agency (FEA), represented by its local employment offices (LEOs), had been in charge of unemployment assistance and was responsible for the labor market activation of unemployment assistance recipients and their job placement. For labor market activation, it could make use of nearly all Active Labor Market Programs (ALMP), which it also directed at unemployment insurance benefit recipients.

By contrast, local authorities were financially responsible for social assistance and in charge of the activation and placement of social assistance recipients. Yet there was only a rudimentary set of integration measures available to local authorities. In particular, local authorities had no access to ALMP of the FEA. Thus, the two-tier system of welfare benefits did not provide

67% of previous average net earnings for an individual with at least one dependent child. Without children, the replacement rate amounts to 60%. Unemployment insurance benefit recipients have to register with the local employment office (LEO), which is part of the Federal Employment Agency (FEA). The LEO is responsible for the labor market activation of its clients.

equal activation opportunities for unemployment assistance and social assistance recipients. While some local authorities used their limited activation means fairly well, others did not enforce a systematic activation approach (see Eichhorst et al., 2010).

The system also resulted in undesirable incentives. For instance, local authorities had an incentive to place social assistance recipients in temporary employment measures that were subject to unemployment insurance contributions. Participation in these measures created entitlements to unemployment insurance and unemployment assistance benefits and thus shifted the claimants from the local authorities to the FEA (see Eichhorst et al., 2010). Moreover, incentives for caseworkers at LEOs to integrate unemployment assistance recipients into employment were weak. Since the LEOs had been mainly financed by employer and employee contributions to unemployment insurance, their caseworkers concentrated their efforts on short-term unemployed receiving unemployment insurance benefits and neglected unemployment assistance recipients (see Tergeist and Grubb, 2006).

To remove these unintended incentives and to unify labor market activation of all welfare recipients, a reform of the welfare system was implemented in January 2005. The reform abolished unemployment assistance and social assistance and merged both types of benefits into a single program: unemployment benefit II (UBII, in German: *Arbeitslosengeld II*).⁸ Unlike unemployment assistance and like former social assistance, UBII does not depend on former earnings. UBII is means-tested, taking into account the income and wealth of all individuals living in the household⁹ of the claimant.¹⁰ To be eligible for UBII, persons have to be age between 15 and 64 and must be able to work for at least 15 hours per week. Current unemployment is not a prerequisite for UBII receipt. Individuals who work but who earn too little to have a sufficient household income are also eligible for the benefit. Since the means-test is conducted at the household level, all persons living in the household receive UBII provided that they fulfill the eligibility criteria. Those persons of a needy household who are not able to work for at least 15 hours a week and hence do not fulfill the eligibility criteria receive a so-called social allowance (*Sozialgeld*). This benefit is nearly identical to UBII but does not require claimants to actively look for a job and to participate in ALMP. Social allowance is predominantly paid to the children of UBII recipients age less than 15 (see Eichhorst et al., 2010). In this thesis, I will focus on UBII recipients.

⁸ The name UBII was created to distinguish the new welfare benefit from the unemployment insurance benefit, referred to as unemployment benefit I (UBI).

⁹ For the legal definition of the term *household*, I refer to chapter 7 of Book II of the German Social Code (*Sozialgesetzbuch Zweites Buch, SGB II*).

¹⁰ The means-test is similar to the one used for social assistance recipients, and is thus stricter than the means-test used for unemployment assistance recipients before the reform (see Bäcker and Koch, 2004; and Bruckmeier and Schnitzlein, 2007).

It is important to stress that welfare benefits (UBII, social allowance) are only granted to each individual of a household when all members of the household taken together are in need of governmental support. If one household member takes up employment and earns sufficiently, he or she must share his or her financial resources with all other household members to bring the household above the socio-cultural subsistence level. Governmental support in terms of welfare benefits is only subsidiary. In this sense, all households in the German welfare system form “communities with joint responsibility” (*Bedarfsgemeinschaften*).

At the beginning of 2005, the base payment of UBII (*Regelbedarf zur Sicherung des Lebensunterhalts*) amounted to 345 euros in West Germany and to 331 euros in East Germany. Since then the level of the base payment in East Germany has been adjusted to the level in West Germany, and the level in both parts of the country gradually raised – in order to compensate for inflation, with the base payment now totalling 364 euros. Thus, the base payment of UBII is less generous than unemployment assistance but more generous than social assistance. On top of the base payment, welfare payments also cover housing costs for rent and heating (*Bedarfe für Unterkunft und Heizung*) and social insurance contributions (*Zuschuss zu Versicherungsbeiträgen*). Further costs for additional needs (*Mehrbedarfe*) such as those that arise during pregnancy might be financed as well (see Kemmerling and Burttel, 2005).

In addition to unifying the benefits, the reform also demanded that all welfare services (benefit payments, counseling, labor market activation, etc.) be provided by a single responsible institution per welfare district, as opposed to the former system where the responsibilities were divided between the federal and the local level (see Eichhorst et al., 2010). Yet there was no political consensus on where the new welfare agencies should be established: within the system of the centralized FEA or at the local authorities. Ultimately, as a compromise it was decided to experiment with two different organizational models – the one centralized, the other decentralized – for a limited period of time and then settle for the more effective one.¹¹

It was agreed to apply a centralized organization in 370 out of the 439 German welfare districts. In these districts, the LEO and the local authorities formed a joint venture to constitute the new local welfare agency. This joint venture is under the direct supervision of the FEA. The FEA is in charge of the administration of the base welfare payments (base payment of UBII, social allowance, social insurance contributions), job placement, and the application of ALMP. In particular, guidelines of the FEA on the use of ALMP and the application of technical standards, e.g. computer software, are binding for joint ventures. Due to the influence of the FEA, the joint ventures

¹¹ This compromise has been codified in the so-called experimentation clause of chapter 6c of Book II of the German Social Code. A description of the experimentation clause with details of implementation, context, and policy results is provided by Deutscher Bundestag (2008).

can be considered as institutions acting under central directives. I henceforth refer to them as centralized welfare agencies.¹² Local authorities in the centralized welfare agencies are tasked with administrating payments for housing costs and additional needs. Moreover, they provide counseling in specific contexts such as single parent families, home care for elderly/disabled relatives or alcohol and drug addictions (see Wunsch, 2005).¹³

Of the 439 German districts, 69 were allowed to opt for a more decentralized organization of welfare administration and to constitute their own decentralized welfare agencies.¹⁴ In the decentralized agencies, the local authorities autonomously organize welfare administration. They are responsible for the entire activation process, including counseling, the allocation of benefit recipients to ALMP, job placement, and the disbursement of benefits. The FEA is hence not involved, and decentralized welfare agencies can decide on their own on how to activate the welfare recipients. The decentralized welfare agencies are legally and organizationally independent from central directives and guidelines.

Table 2.1 summarizes the main features of centralized and decentralized welfare agencies. In both agency types, the largest share of welfare payments is financed by the federal government; only a small fraction of overall expenditure – identical in all agencies – is taken from local budgets. Potential advantages and disadvantages of both agency types will be discussed in chapter 3.

The number of decentralized welfare districts (69) has been determined based on political considerations. It is equal to the number of deputies in the *Bundesrat*, the second chamber of the German parliament. Each federal state could have between three and six decentralized districts, depending on its number of deputies in the *Bundesrat*. Within each state, districts could apply to opt out of the centralized system. In cases of excess demand, the state government selected from the applying districts.

In several federal states, the maximum number of districts that could opt for decentralized organization was not exhausted. The vacant places could then be filled by the districts not selected from other states in the first round. Looking at the regional distribution of applications, it appears that the selection process was strongly influenced by political affiliations. In the federal states Lower Saxony (*Niedersachsen*) and Hesse (*Hessen*), where the conservative governments were strongly in favor of the decentralized system, 13 dis-

¹² A centralized welfare agency is called *Arbeitsgemeinschaft (ARGE)* in German.

¹³ A variant of the centralized model emerged in instances where the LEO and local authorities could not agree on forming a joint venture. In 19 out of 370 cases, both institutions continued to work separately in the district (*Grundsicherungsstellen mit getrennter Aufgabenwahrnehmung*). But because tasks are shared in a similar way as in the case of the centralized model, this thesis does not differentiate between these two types in its empirical analyses.

¹⁴ The German term for a decentralized welfare agency is *zugelassener kommunaler Träger (zkT)*.

Table 2.1: Main features of centralized and decentralized welfare agencies

	Centralized agencies	Decentralized agencies
Number of entities	370	69
Legal form	Part of the Federal Employment Agency (FEA), but separate legal entity	Part of local administration
Organizational affiliation	Joint venture between local employment office of the FEA and local authorities	Local authorities
Main source of financing	Federal government	Federal government
Standards of the FEA	Binding for job placement, provision of ALMP, monitoring of job search efforts	Not binding, although legal restrictions exist

Remarks: The numbers are based on the 439 German welfare districts that existed as of October 2006.

districts were allowed to opt out, even though these states only had 6 and 5 seats in the *Bundesrat*, respectively. In contrast, hardly any districts were proposed from the federal states Mecklenburg-Western Pomerania (*Mecklenburg-Vorpommern*) and Rhineland-Palatinate (*Rheinland-Pfalz*), both of which were run at that time by social democrats. Hence, the rules for selection resulted in a concentration of decentralized agencies in certain states (see WZB et al., 2008).

Despite the different organizational settings, the enforcement of all other reform aspects was identical throughout all welfare agencies in Germany. In particular, the principle of “supporting and demanding” (*Fördern und Fordern*), was enforced uniformly across all centralized and decentralized agencies. This principle of mutual obligations requires both the welfare recipient and the welfare agency to do everything in their power to help recipients find self-sufficient employment as quickly as possible. The rights and duties of both parties in the activation process are set out in a so-called “integration contract” (*Eingliederungsvereinbarung*), an agreement between the welfare agency and the benefit recipient containing obligations with respect to job search activities and participation in ALMP, as well as detailing the services provided by the welfare agency. This contract states the number of job applications the welfare recipient is supposed to write within the next few weeks and the number of job interviews he or she should manage to attend. It also specifies the counseling offers of the welfare agency the welfare recipient can call upon and the ALMP he or she must participate in.

Welfare agencies offer a wide range of different ALMP. These include above all so-called Temporary Extra Jobs (*Arbeitsgelegenheiten in der Mehraufwandsvariante*), short-term training programs (*Trainingsmaßnahmen*), long-term training programs (*Förderung der beruflichen Weiterbildung*), wage sub-

sidies to employers (*Eingliederungszuschüsse*), and start-up grants (*Einstiegs-geld*) (see Huber et al., 2011). Temporary Extra Jobs provide work opportunities in the public sector (see Thomsen and Walter, 2010a). The work assigned within this program must be additional in the sense that it would not be accomplished otherwise by existing public or private sector firms. Temporary Extra Jobs last for up to six months with a typical work load of 20 to 30 hours per week. By contrast, short-term training programs have a usual duration of one to three weeks and do not last longer than twelve weeks (see Kurtz, 2003). They consist of three different types of measures that can be offered either separately or in combination. First, short-term training programs are used to assess the suitability of participants in terms of skills, capability, and labor market opportunities for specific occupations. Second, they aim at improving the participants' job search abilities. And, third, they provide general skills and techniques required for employment. Long-term training comprises a more substantial human capital investment and focuses on the adaption of the professional skills and qualifications of participants to recent labor market requirements, e.g. to mitigate mismatches in times of structural change (see Huber et al., 2011). The programs typically aim at improving skills in the individual's profession, providing additional qualifications, offering a first professional degree or retraining. Program durations vary from a few months to up to three years. Wage subsidies are paid to firms that employ individuals facing competitive disadvantages on the job market during the first months of employment (see Bernhard et al., 2008, or Boockmann et al., forthcoming). They are meant to generate an incentive to hire such individuals by compensating employers for initial productivity gaps. Similarly, start-up grants are bridging allowances for taking up a low-paid job or for creating a private business and becoming self-employed. They are directly paid to the benefit claimants (see Wolff and Nivorozhkin, 2008).

All activation efforts of welfare agencies aim at integrating individuals into jobs that generate a sufficient income such that no welfare benefits are needed any longer. The income must be sufficient to bring all household members above the socio-cultural subsistence level. Activation by welfare agencies thus targets the household as a whole.

The integration contract is usually set up after the first meeting of a welfare recipient with his or her caseworker. The caseworker counsels and advises the welfare recipient and decides about placement in ALMP. If the caseworker detects non-compliance of the welfare recipient during the activation process, the welfare agency is legally required to impose a sanction by benefit revocation (see chapter 31, 31a, 31b and 32 of Book II of the German Social Code). But it is at the discretion of the welfare agency to impose a sanction. Welfare recipients are informed about the possibility of sanctions in the integration contract and each time they are assigned to a program. Yet there is no formal warning process when non-compliance is detected. Although a hearing of the benefit recipient before the imposition of a sanction is legally required, there is evidence that this requirement is not implemented in practice (see

Baethge-Kinsky et al., 2007), and welfare agencies may immediately impose a sanction. Sanctions have a duration of three months and can be imposed for various reasons. For minor non-compliances, such as the failure to properly report on job search activities to the welfare agency or not showing up for an appointment with the caseworker, benefits are cut by 10%. More severe infringements (lack of job search effort, refusal to accept a suitable job offer, refusal to participate in a program) lead to a benefit reduction of 30%.¹⁵ In case of repeated incidents of severe infringements within a year, a second (60% cut) or a third sanction (100% cut) can be imposed. For welfare recipients below 25 years of age, benefits can be reduced by 100% even for the first incident of non-compliance.

With the enforcement of the principle of “supporting and demanding”, Germany followed other industrialized countries (e.g. the US, the UK, Denmark, Sweden, and the Netherlands), which reformed their welfare systems somewhat earlier and which also put emphasis on mutual obligations in the activation process of welfare recipients (see Konle-Seidl, 2008). With respect to the organization of welfare administration, Germany’s system of centralized and decentralized welfare agencies is unique. All other countries have installed a unified administration of welfare, though their administrative structures vary. While local authorities are responsible for labor market activation of welfare recipients in Denmark and the Netherlands, welfare administration is part of the central government structure in the UK (see Tergeist and Grubb, 2006; and Konle-Seidl, 2009).

2.2 Selected Indicators on Macroeconomic Conditions and the Welfare System in Germany from 2000 to 2009

To put the 2005 welfare reform into perspective, this section will shed light on the macroeconomic conditions in Germany before and after the reform. In addition, it will provide selected descriptive statistics on the German welfare system with emphasis on the post-reform period. Even though the empirical analyses in chapters 3 to 6 will focus on the years 2006 to 2008, the post-reform statistics will be presented for the years from 2005 to 2009 to describe the welfare system as exhaustively as possible. As indicated, the statistics refer either to the entire welfare system or to centralized welfare agencies only. Unfortunately, reliable information for decentralized welfare agencies is not available in many cases.

¹⁵ Irrespective of a 10% or 30% cut, the calculation base for a sanction is the base payment of unemployment benefit II. Since welfare recipients have little to no savings, sanctions are substantial.