The Brookings Institution

POLICY BRIEF

July 2002

Policy Brief #104

Earnings Insurance for Germany

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For more than a decade, Germany has suffered high rates of unemployment and very slow employment growth. Workers who have lost their jobs face unusually long spells of unemployment, in part because the adverse incentives of the German unemployment compensation system provide strong impetus for unemployed workers to remain jobless.

An unemployed German worker protests in Berlin. The barrel reads: "low wages, unemployment, social welfare, rising profits."

For both social and economic reasons, it is essential to minimize the economic damage and personal disruptions that job loss imposes on laid-off workers. It is equally important, however, to offer displaced workers positive incentives to become re-employed as quickly as possible, which can be accomplished by our proposed system of earnings insurance for displaced workers.

German unemployment remains stubbornly high, and has increased dramatically compared with unemployment in the United States. During the long economic expansion of the late 1990s, the annual German unemployment rate never fell below 7.9 percent. Unemployment in the eastern part of the country is particularly severe, but even in the more prosperous West, the unemployment rate remains high. Germany continues to enjoy relatively low joblessness among young adults, but unemployment among older workers has soared. The unemployment rate among Germans 55-64 years old is now more than five times the rate among Americans of the same age. The high unemployment rate of older Germans occurs in spite of the fact that older Germans now have a much lower participation rate in the workplace than Americans past the age of 55.

Except during recessions, high German unemployment is not caused by an exceptionally high layoff rate, but rather is the result of a low exit rate out of unemployment, especially among older unemployed workers and workers who have been unemployed for six months or more. Compared with other industrialized countries, Germany has a relatively low rate of entry into unemployment, but the low re-employment rate is the result of demand- and supply-side factors that

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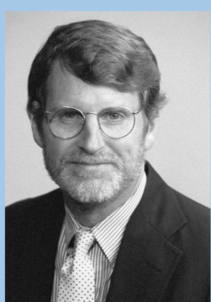

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reduce the availability of jobs that are attractive to the unemployed.

For a variety of reasons, German employers are slow to create new jobs, even when the economy is expanding. Equally important is the fact that many jobless workers are reluctant to search energetically for new jobs. The unemployed are often unwilling to accept new job openings when vacancies become available, because the wages on these jobs seem low compared with the social protection benefits they can receive as unemployed workers. Social protection for the German unemployed rests on three pillars (see box at right): standard unemployment insurance, means-tested unemployment assistance, and means-tested social assistance. The generosity of German unemployment benefits, especially for the long-term unemployed, helps explain some of the distinctive characteristics of German joblessness. Because an unemployment insurance payment replaces a large percentage of the earnings workers lose as a result of unemployment, it reduces pressure on workers to look diligently for a new job.

Generous social protection and high levels of unemployment are a costly burden for active workers and employers. The combined contribution rate for unemployment benefits and labor services to the unemployed is 6.5 percent of wages below a taxable wage ceiling. In 2000, benefit payments under Germany's unemployment programs amounted to 2.8 percent of the total wage and salary income paid to German wage earners. As a result of unification and rising unemployment in the West, this percentage is substantially higher than

Three Pillars of Income Support for Germany's Unemployed

Unemployed Germans receive income protection under one of three main programs:

Unemployment Insurance

Replaces wages lost as a result of job loss. Provided to workers who become unemployed after paying into the program for at least twelve months during the three years before registering as unemployed. To qualify, an unemployed worker must be under 65, registered as unemployed, actively seeking work. Monthly payments equal 60 percent of a claimant's past net earnings (no child dependents) or 67 percent of past net earnings (at least one child dependent). Potential duration of insurance is linked to length of a worker's past unemployment contributions and to worker's age. For workers older than 44, benefits can last 18 to 32 months.

Unemployment Assistance

Replaces wages lost as a result of job loss. Unlike unemployment insurance, program is means-tested. Eligible recipients must exhaust unemployment insurance benefits, be registered as unemployed, meet the needs test, be under 65, and continue to seek work. Monthly payments equal 53 percent of a claimant's past net earnings (no child dependents) or 57 of past net earnings (at least one child dependent). Recipients can collect payments for an indefinite period (up to age 65) if they meet all eligibility requirements. Eligibility reassessed annually.

Social Assistance

Means-tested minimum income program available to low-income Germans, including working poor and pensioners. Unemployed workers with very low income and few assets may qualify even if they are ineligible for either of the other two programs.

Table 1. Displaced German Workers and Wage Losses, 1998-2000

Category of displaced worker	Thousands of workers	Euros	Dollars
Workers who left job between January 1999 and May 2000	7,008		
Of whom:			
—Workers who left job involuntarily	3,050		
—Involuntary job losers who found a new job	1,513		
—Re-employed job losers who experienced wage loss	370		
—Re-employed job losers with valid record of wage loss	114		
Average monthly earnings loss of eligible workers with loss		€1,014	$963
Workers who left job involuntarily between January 1998 and May 1999, found a new job by May 2000 and experienced earnings loss	168		
Of whom:			
—Re-employed job losers with valid record of wage loss	48		
Average monthly earnings loss of eligible workers with loss		€928	$882
Displaced workers eligible for wage insurance (total)	538		
Average monthly earnings loss		€988	$939

Source: Authors' calculations using the May 1999 and May 2000 German Socio-Economic Panel Survey (GSOEP): €1.00 = $0.95.

the comparable rate during the 1980s. In 2000, American spending on unemployment benefits was just 0.4 percent of U.S. wage and salary income.

HOW EARNINGS INSURANCE WOULD WORK

Earnings insurance would help replace some of the earnings that are lost when workers are forced out of their jobs by economic change. It is an idea that has been proposed by Brookings economists to deal with wage losses of American workers who are displaced as a result of trade, and it has been adopted by the U.S. Senate in a newly passed bill that gives the president authority to negotiate new trade agreements. We think the plan can also help displaced workers in Germany. We define a displaced worker as one who has held a permanent job for at least two to three years and who is dismissed from that job as a result of a plant closing or a large-scale reduction in company payrolls. Unlike unemployment insurance, which replaces part of workers' lost wages when they are unemployed after a layoff, earnings insurance will replace part of workers' earnings loss after they find new but lower-paying jobs. If an earnings insurance program replaces 50 percent of lost weekly wages, for example, workers who earned €3,000 a month on their old jobs and who find new jobs that pay €2,000 per month would receive an earnings insurance payment of €500 per month, or one-half of the workers' €1,000 per month wage loss. No earnings insurance payments would be made until an unemployed worker found a new job, and to keep the system affordable, the duration of earnings insurance payments would be limited and the maximum weekly payment capped.

Compared with long-term unemployment benefits, earnings insurance offers two important advantages. First, it provides compensation to many workers who receive little help under traditional unemployment insurance. Research on economic losses caused by displacement shows that some displaced workers lose more income as a result of pay cuts they accept in new jobs than they do as result of unemployment. Workers who quickly find a new job, but at a lower wage, do not qualify for unemployment benefits, even though they can experience large earnings losses as a result of displacement. Earnings insurance would help reduce these losses for a limited period, such as during the first two years after workers lose their jobs.

Unemployed German workers who are between 52 and 56 years old qualify for 26 months of unemployment insurance. Research suggests that these unemployment benefits contribute to lengthy unemployment spells. If some of the money that is now spent on unemployment insurance were used instead to provide earnings insurance to displaced workers between the ages of 52 and 56, the typical displaced worker would find jobs faster than under the existing system.

To qualify for the proposed earnings insurance payments, laid-off workers would only need to document that they have been "displaced" under criteria that would be determined when the program is established.

The earnings insurance payment would replace a fixed percentage of the worker's earnings loss, up to a monthly or annual ceiling. The fraction of lost earnings that is replaced could vary by a worker's age and length of service in his previous job. Workers who become re-employed in jobs that pay a higher wage or in jobs with the same pay earned in their old jobs would not receive income supplements under the program. Nor should wage insurance be provided to workers who accept part-time jobs.

ADMINISTERING THE PROGRAM

Qualified workers who are dismissed from their jobs would be informed by the local labor office of their eligibility for earnings insurance when they register for unemployment insurance benefits. The wage level that is "replaced" by earnings insurance would be the same wage used to determine a worker's unemployment insurance benefit. This means that workers would not receive earnings insurance for wages above the wage ceiling that is used to assess unemployment insurance taxes. Eligible workers who become re-employed within two years of losing their jobs would receive monthly or quarterly income supplements equal to a fixed percentage of their wage loss, and this percentage would be determined at the time displaced workers register as unemployed. The monthly or quarterly earnings insurance payment would be subject to a ceiling, which would need to be calibrated to ensure the program is affordable and equitable.

Table 1 provides estimates of the number of German displaced workers who would have qualified for wage insurance benefits under our proposed program in 2000. The estimates are derived from interview responses on the May 1999 and May 2000 German Socio-Economic Panel Survey (GSOEP), a German household

Table 2: Displaced Worker Earnings Insurance Program Annual Cost Estimates (2000), in millions of euros/dollars

Ceiling on annual benefit payments	Replacement rate for lost earnings		
	30%	**50%**	**70%**
Not capped	€ 1,912 / $1,816	€ 3,187 / $3,028	€ 4,462 / $4,239
Capped at €20,000 per year	€ 1,787 / $1,698	€ 2,978 / $2,829	€ 4,169 / $3,961
Capped at €10,000 per year	€ 1,142 / $1,085	€ 1,903 / $1,808	€ 2,665 / $2,532

Source: Authors' calculations using the May 1999 and May 2000 German Socio-Economic Panel (GSOEP): €1.00 = $0.95.

survey, and reflect unemployment experiences between January 1998 and May 2000. Because of the limited size of the sample, there are only a relatively small number of workers who lost their jobs and then became re-employed during the period analyzed. Our estimates of average earnings loss must therefore be considered imprecise.

Wage insurance payments would begin as soon as practicable after a worker becomes re-employed and would cease two years after his dismissal from the pre-displacement job. Payments would be administered through the labor agency responsible for administering the current unemployment insurance program, which has both the wage data and expertise to calculate insurance payments. To prevent job churning, workers would be limited to receiving the income supplement just once during any five-year period, so that no worker could receive wage insurance for more than two years out of every five years worked.

The table shows that roughly 3 million German workers suffered involuntary job loss between January 1999 and May 2000. Of this number, 1.5 million became re-employed by the time of the May 2000 interview. One-quarter of the re-employed workers, or 370,000 people, accepted a new job for which the wage was lower than the wage of their pre-displacement job. The other three-quarters of re-employed workers earned wages that were approximately equal to or greater than the wages they earned before they were laid off. For roughly one-third of the workers who suffered a wage loss, the GSOEP contains enough information to estimate the size of workers' wage loss. For an average worker who experienced a loss of earnings on the new job, the wage loss was slightly more than €1,000 (or $950) per month.

If wage insurance were provided to workers for up to two years, some workers who lost their jobs in 1998 and then became re-employed would have been eligible for wage insurance payments in May 2000. The GSOEP survey implies that an additional 168,000 German workers lost their jobs in 1998, became re-employed before the May 2000 interview, and experienced a loss of earnings on their new jobs. Thus, a total of approximately 538,000 Germans lost their jobs in 1998 and 1999, became re-employed, and obtained a lower wage on their new job than they earned in the jobs they lost.

"If the availability of earnings insurance payments reduces the duration of insured unemployment spells, the impact on public budgets is likely to be quite favorable."

Table 2 shows the estimated cost of compensating the displaced workers described in Table 1. Assuming a 50 percent replacement and subsidy rate, the table indicates that a wage insurance program would have cost about €3.2 (or $3.0) billion in 2000, when the German unemployment rate averaged 7.9 percent. For purposes of comparison, this is less than 15 percent of the cost of unemployment insurance benefit payments in the same year. If annual earnings insurance payments were capped at €10,000 ($9,500), the annual cost of the program would have been €1.9 ($1.8) billion per year, or 40 percent less than the cost of an uncapped program.

The cost estimates in Table 2 rest on the assumption that re-employment patterns would remain unchanged after an earnings insurance program is implemented. If workers become re-employed more quickly or if more workers accept jobs that result in a wage cut, the cost of the program would rise. It seems likely, however, that this development would reduce rather than increase the cost of social protection for the unemployed, even though it would increase the cost of earnings insurance. If the availability of earnings insurance payments reduces the duration of insured unemployment spells, the impact on public budgets is likely to be quite favorable.

FINANCING WAGE INSURANCE

Paying for wage insurance benefits requires real resources. If the job-finding success of unemployed workers does not change, an earnings insurance program that replaces one-half of earnings losses would have cost approximately €3.2 billion ($3.0 billion) in 2000. To raise these revenues, it seems sensible to trim some other components of social protection now provided to the unemployed. One possibility is to restrict the availability of long-term benefits under the unemployment insurance and unemployment assistance programs.

If unemployment insurance payments were limited to one year, as they were before 1985, older workers who now qualify for unemployment insurance during their second and third year of joblessness would be required to apply for unemployment assistance benefits. The cost saving from limiting unemployment insurance benefits to one year is difficult to estimate with the limited information published by German statistical agencies. Based on a crude estimate of the cost savings from restricting unemployment insurance eligibility to twelve months, it seems plausible that budgetary savings might be large enough to pay for an earnings insurance program that replaces 50 percent of lost earnings, if annual wage insurance payments are capped at €10,000 ($9,500) per year.

To make the earnings insurance payments more generous while maintaining the affordability of the program, benefits could be restricted to workers who are considered particularly vulnerable to economic change. Because the wage insurance payments are being financed through reductions in unemployment insurance benefits to workers who are 45 years of age and older, it is natural to limit earnings insurance payments to older workers. Alternatively, benefit payments could be made more generous for older workers, either through an increase in the earnings replacement rate or by an extension in the duration of potential benefits. Workers 45 or older could be provided with wage insurance that replaces 70 percent of lost wages, for example, or they could be offered wage insurance that lasts up to three years after a worker's layoff. The greater generosity of the program for older workers seems justified, since many studies show that older workers typically suffer larger and more permanent earnings losses as a result of displacement than younger workers.

HOW EARNINGS INSURANCE CAN HELP DISPLACED WORKERS

Compared with long-term unemployment benefits, earnings insurance has two important advantages. First, it provides compensation to many workers who receive little help under traditional unemployment insurance. Recent research on the economic losses caused by displacement shows that many displaced workers lose more income as a result of the wage cut on their new jobs than they do as result of unemployment. Workers who quickly find a new job, but at a lower wage, do not qualify for unemployment benefits, even though they can experience large earnings losses as a result of their displacement. Earnings insurance would reduce these losses for the first two years of unemployment.

Second, earnings insurance provides workers with better incentives than the long-term unemployment benefits that would be partially replaced by earnings insurance. One incentive provided by earnings insurance is a larger financial payment to workers who become re-employed soon after they lose their jobs. In contrast, long-term unemployment compensation provides the biggest benefits to workers who delay their acceptance of new jobs.

One important issue is the level of wages available to unemployed workers in Germany. It should be obvious that workers who earn low wages before displacement cannot anticipate much benefit from an earnings insurance program. The workers who would derive the largest benefit from earnings insurance are those who earn average and above-average wages in their pre-displacement jobs.

How likely is it that a worker earning average or above-average wages will be forced to accept a large pay cut when he finds a new job? In the United States and other countries with wide pay disparities, this risk is quite high, especially for displaced workers over 40 (see Brookings Policy Brief #73, "A Prescription to Relieve Worker Anxiety," Lori G. Kletzer and Robert E. Litan). Our tabulations of the GSOEP show that large wage losses upon re-employment are less common in Germany. One reason is that wage differentials are smaller in Germany than they are in the United States. Only one-quarter of re-employed displaced workers in the GSOEP sample reported that their re-employment salary was below their pre-displacement salary. Because German wages fall in a fairly narrow range, most workers who become re-employed can expect to earn similar wages in their old and new jobs.

Germany's narrow wage differentials provide one explanation for the small pay losses that unemployed German workers suffer when they become re-employed. A

The authors gratefully acknowledge helpful comments and suggestions from Dr. Stefan Eisel of the Konrad-Adenauer-Stiftung and Robert Litan of Brookings and the invaluable research assistance of Sandip Sukhtankar of Brookings. They also thank the Konrad Adenauer Foundation and the German Marshall Fund of the United States for generous financial support.

Brookings gratefully acknowledges the generosity of the Virginia Wellington Cabot Foundation for its support of the Policy Brief series.

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second explanation is that unemployed German workers are reluctant to accept jobs where they must accept a pay cut. In a recent study, roughly 40 percent of re-employed American workers said they suffered a pay cut upon re-employment (Kletzer and Litan). However, displaced U.S. workers find jobs much faster than displaced workers in Germany, in part because more of them are willing to accept pay cuts.

CONCLUSION

Earnings insurance is not by itself a panacea for high German unemployment (nor would it solve the unemployment problem in the United States or any other industrialized country). Although wage insurance can help improve incentives for workers who earn average and above-average wages before they are displaced, a different approach is needed to improve work incentives for displaced workers who earned low wages.

Earnings insurance, along with unemployment insurance reform, can change the financial incentives facing the unemployed, and wage insurance can provide indirect incentives for employers to create job opportunities at lower wages. If employers received job applications from many more workers eager to accept jobs—and willing to accept jobs that pay below-average wages—some employers might create such jobs when it became profitable to do so.

By encouraging unemployed workers to look energetically for jobs, even jobs that pay below-average wages, earnings insurance has the potential to spur renewed job creation in both east and west Germany.

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