

## O P I N I O N

## Demand-Side Incentives: New Opportunities in the Low-Wage Sector



Labor market opportunities in the low-wage sector have declined worldwide. While countries with flexible labor markets are experiencing falling wages, European welfare states are witnessing a substantial and persistent unemployment increase in this market segment. The need for reform is becoming ever more evident. For reforms to be effective, however, they must go beyond breaking up rigid labor market structures. They must also focus on deregulating and vitalizing product and service markets, which create new jobs and income in this area. Only then will adequate wages no longer conflict with job security. Supporting measures to develop markets and to gain time for improved solutions have been debated in Germany for quite some time.

The debate about feasible concepts breaks down into two approaches. The first approach bases on the assumption that the current tax and transfer system creates disincentives to accept jobs in the low-wage sector, thus effectively destroying income opportuni-

ties. Financial incentives for employees in this sector are supposed to encourage employment and create a more performance-oriented tax and transfer scheme. The second approach assumes that global competition, improved production technologies, trade, and collective bargaining have rendered low-skilled work redundant or too expensive. As businesses are downsizing, they offer fewer jobs in the low-wage bracket.

Both approaches do not fundamentally oppose each other. It seems plausible that changes in the wake of globalization forced an adjustment in relative wages, on which labor markets were unable to react due to institutional rigidities imposed by the welfare state and the collective bargaining system. The question is whether to address these problems from the supply or the demand side. Is the job shortage due to the fact that businesses have no demand for labor, or is it because a non-existent labor supply keeps them from offering jobs? There are currently two million unemployed in the German low-wage sector. Given this enormous scope, any remedial policy program will only have a limited impact. It is therefore necessary to analyze the employment effects as well as the costs of a policy that aims at both the supply and the demand side. In Germany, these considerations primarily center around the subsidization of social security contributions in the low-wage sector.

Studies show that such programs bring about radical changes on the labor market. On the supply side, more people are willing to work. But there are also those among the already employed workers who want to switch to the subsidized low-wage sector. In the end, part-time work will be encouraged, but the total number of hours worked will actually decline. This kind of policy is extremely costly because it supports several different groups: newly employed workers, households that are already active in the low-wage sector, and

those who cut their working hours in order to qualify for subsidies. The latter group will be responsible for a further drop in tax revenues and social security contributions. On the demand side, the subsidization leads to a significant increase in the demand for hours worked and for additional employees in the low-wage bracket. This effect is partly offset by a falling demand in the non-subsidized areas. Given the currently rather strong demand for high-paid workers, however, this drop in demand will have only minor consequences. Since the financial burden on the demand side remains reasonable, a demand-side oriented policy seems to be a promising approach.

If the job shortage is the key problem, subsidizing only the employer side could yield a lasting effect. The subsidy would be worth the cost if it succeeds in getting unemployed workers and welfare recipients into work. This desired effect could be reinforced through stricter requirements for these target groups to accept a job. Subsidizing older and low-skilled workers for a limited time could also be worthwhile. If disadvantaged labor market groups were provided with reintegration support at an early stage, long-term unemployment could in many cases be prevented.

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