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## Unemployment Benefit and Wages: The Impact of the Labor Market Reform in Germany on (Reservation) Wages

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## Unemployment Benefit and Wages: The Impact of the Labor Market Reform in Germany on (Reservation) Wages

### Abstract

In this paper, we contribute to the literature on the impact of the unemployment benefit on (reservation) wages. We use the German BA-Employment Panel (2008) to identify the effect of a reduced unemployment benefit due to the labor market reform of 2005 in Germany. Using this unique experiment, we find strong evidence that a lower unemployment benefit has an adverse effect on wages.

JEL Code: J64, J65.

Keywords: Unemployment benefit, reservation wages, wages.

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## 1 Motivation

Theory predicts that a lower unemployment benefit (UB) decreases the (reservation) wages [see Rodgeron et al. (2005)]. Empirical literature supports this prediction. There are two ways to examine this UB effect. The first is to measure the impact of UB on reservation wages using survey data [see Feldstein and Poterba (1984) or Addison et al. (2009)]. The second is to measure the impact of UB on wages [see Topel (1984) or McCall and Chi (2008)]. Theory allows conclusions to be drawn about the impact of UB on wages and the impact of UB on reservation wages. We contribute to the literature on the effect of UB on wages. To do so, we use the natural experiment of the labor market reform of 2005 in Germany.

The empirical measurement of this effect demands an exogenous variation of the UB. A good approach is a natural experiment in which the UB varies. The labor market reform of 2005 in Germany satisfies this condition. While other concerns exist, the three main issues of this reform are the following: (1) the flexibility of the labor market (e.g., temporary employment), (2) the introduction of top-up benefits and (3) the substantial decrease in long-term UB [see Jacobi and Kluve (2006)].<sup>1</sup> Before the 2005 reform, the UB was a fraction of the individual's earnings. Since 2005, however, the long-term UB is fixed and non-income-related. We use the German BA-Employment Panel (2008) to show a negative effect of a reduced long-term UB on wages. We argue that this negative effect is driven by a decrease in the reservation wage.

The remainder of this paper is organized as follows: Section 2 introduces the data. Section 3 describes the theoretic foundation and our empirical strategy. Section 4 presents our results. Section 5 concludes this study.

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<sup>1</sup> The top-up benefit should ease the re-employment of long-term unemployed via wage subsidy.

## 2 Dataset

We use the BA-Employment Panel (2008), which consists of 2 percent of all employees with social security in Germany. This dataset contains quarterly individual information (e.g., sex, age, wage, employment status, education, type of employment) and firm-specific information (e.g., firm size, proportion of old (>55) and young (<20) employees, economic sector) between the first quarter 1998 and the last quarter 2007. To ensure a balanced panel, we use the BA-Employment Panel (2008) from the year 2000 forward.<sup>2</sup> We focus on full-time employees. Because of structural differences in the labor market, we divide the dataset into east and west Germany [see Kronthaler (2003) or Smolny (2009)]. We truncate the wages at one euro below the maximum level up to which contributions to the social insurance that have to be paid as incomes above this level are only reported voluntarily. We also truncate wages at a lower bound to exclude workers who receive top-up benefits.<sup>3</sup> We truncate at the level of 650 euro because this is the average need of a long-term unemployed person in 2008 [Federal Statistical Office Germany (2010a)]. To use more control variables, we extended the BA-Employment Panel (2008) with the industrial-specific gross value added (real annual value, base year: 2000) [Federal Statistical Office Germany (2010b)]. The empirical test of a search model implies the need for additional information with respect to labor market conditions. Therefore, for different industries, we calculate the share of workers who become unemployed (lay-off risk). We seasonally adjust the lay-off risk.<sup>4</sup> Additionally, we calculate the job tenure as a proxy for the working experience. To avoid a time trend of the dependent variable, we calculated the real wages using inflation data of the Federal Statistical Office

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<sup>2</sup> Before the year 2000, it is not possible to follow people through unemployment quarters.

<sup>3</sup> Top-up benefits are paid additionally to low incomes.

<sup>4</sup> We also calculate the probabilities of getting a job (out of unemployment and employment). Those rates are strongly correlated with the lay-off risk in our sample. Therefore, only one rate can be used as an exogenous variable.

(2011). The real wages between 2000 and 2007 were stationary.<sup>5</sup> We then divided our dataset into different industries according to the European national accounts system [see Federal Statistical Office Germany (2007)].<sup>6</sup>

### 3 Methodology

Following Burdett and Mortensen (1998), the UB has a positive impact on the reservation wage and, therefore, an indirect, positive impact on the wage. To identify this impact, we use a search model with exogenous job destruction and job matching. Workers are rational, utility maximizing and risk averse. Firms maximize their profits. The wage equation of such a framework can be written as [see Rodgerson et al. (2005)]:

$$w = (1 - \theta)w_R + \theta(y - \pi_R). \quad (1)$$

The wage depends on the reservation wage  $w_R$ , the firms' marginal revenues of an occupied post  $y$  and the revenue of a vacancy  $\pi_R$ . The bargaining power of employees is given by  $\theta \in (0,1)$ . Equation (1) shows the direct link between the wage and the reservation wage. The general reservation wage is as follows:

$$w_R = UB + (\alpha_0 - \alpha_1) \int_{\omega_R}^{\infty} \left[ \frac{1-F(w)}{r + \lambda + \alpha_1[1-F(w)]} \right] dw. \quad (2)$$

The reservation wage is determined by the UB, the rate of finding a job out of unemployment is  $\alpha_0$  and employment  $\alpha_1$ , the lay-off risk is  $\lambda$ , the discount factor is  $r$  and the wage distribution in the economy is  $F(w)$ . Combining equations (1) and (2) delivers:

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<sup>5</sup>Because we observe a fixed number of time periods, we applied the Harris-Tzavalis test for stationarity on every subgroup [Harris and Tzavalis (1999)]. The non-stationarity hypothesis is only not discarded for low- and high-skilled women in East and West Germany in the Construction Industry. These two groups are too small to derive reliable test results.

<sup>6</sup> We exclude inter-industrial mobility of workers because theory and empirics [e.g., Neal (1995)] argue that this mobility is not that important for employees.

$$w = (1 - \theta)UB + G(\alpha_0, \alpha_1, \lambda, \theta, \gamma, \pi_R, F(w), r). \quad (3)$$

The real wage depends positively *ceteris paribus* on the UB. The function  $G$  includes the other relevant parameters. The effect of UB on wage is positive. From equation (3), it is easy to derive an empirical model, as follows:

$$w_{it} = \beta_0 + \beta_1 UB_t + \text{controls} + u_{it}. \quad (4)$$

The real wage  $w$  of each individual  $i$  in period  $t$  is estimated via a constant, the UB, the controls and an error term. To measure the effect of a reduction of the UB, we use a dummy variable that becomes unity from 2005 forward. This dummy covers the substantial decline of the outside option (long-term UB) for the worker. The parameter  $\beta_2$  describes the impact of a lower long-term UB on wages from 2005 forward as a consequence of the labor market reform. To isolate the effect of the UB reduction, we use common control variables. These are age, professional status, firm-size, firm's age structure, industrial-specific gross value added per worker, individual job tenure, industrial specific lay-off-risk and quarter dummies to control for seasonal effects. We run individual fixed effect regressions for three skill levels, for males and for females.<sup>7</sup> An individual without vocational training is classified as low skilled. For a medium skill level, a completed vocational training is necessary and a higher academic degree is the criterion for high skilled. We do so for six different industries (building, manufacturing, retail, real estate, renting and business activities, transport, storage and communication, financial) in east and west Germany. To draw a detailed picture while preserving the quality of the data, only industries with a share of more than 4 percent of all employees are considered.<sup>8</sup>

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<sup>7</sup> The Hausman-test suggests using fixed effect estimations. Testing the independent variables for pairwise correlations shows that collinearity is not a problem.

<sup>8</sup> A regression for the whole economy with dummies for the different industries produces similar results. Industry-specific fixed effect regressions allow us to draw a more detailed picture.

#### **4 Evidence for Germany**

As mentioned in the previous section, we measure the impact of a lower long-term UB on wages by using a dummy variable, which becomes unity from 2005 and on. By using a number of appropriate control variables, the UB variable describes the pure impact of the structural break due to the labor market reform of 2005. Theoretically, the UB dummy covers all three effects of the labor market reform (flexibility, top-up benefit and lower long-term UB). Our methodology and dataset ensure that we measure the pure effect of the lower UB. The effect of the top-up benefits is excluded through dropping observations under the low income bound (650 euros). The effect of the increasing flexibility is covered by the industry-specific lay-off risk. Table 1 indicates the coefficient of the UB variable in the wage estimation for several industries in west Germany.

**Table 1: Regression results for West Germany**

	<b>Construction Industry</b>	<b>Manufacturing Industry</b>	<b>Wholesale and Retail Trade</b>	<b>Real Estate, Renting and Business Activities</b>	<b>Transport, Storage and Communication</b>	<b>Financial intermediation</b>
Male						
<b>Low</b>	-46.95*** (-8.67)	-39.36*** (-21.73)	-53.90*** (-10.41)	-53.73*** (-8.77)	-61.45*** (-15.81)	-88.62*** (-6.28)
R <sup>2</sup>	0.0133	0.2089	0.1093	0.4114	0.0593	0.0272
Obs.	27648	210797	39538	16341	31008	3960
<b>Medium</b>	-56.69*** (-28.6)	-54.61*** (-57.82)	-84.12*** (-42.74)	-75.97*** (-33.81)	-57.38*** (-31.00)	-133.36*** (-48.18)
R <sup>2</sup>	0.1829	0.3048	0.1837	0.1473	0.1678	0.1246
Obs.	261912	1138386	436050	173572	190281	101814
<b>High</b>	-149.79*** (-13.17)	-131.87*** (-57.89)	-283.34*** (-38.73)	-134.91*** (-40.77)	-169.44*** (-13.80)	-198.76*** (-44.79)
R <sup>2</sup>	0.1638	0.0727	0.0733	0.0637	0.0120	0.0899
Obs.	11955	173326	31899	91812	7543	24191
Female						
<b>Low</b>	-2.88 (-0.10)	-31.72*** (-12.45)	-50.06*** (-8.42)	-77.20*** (-8.47)	-50.22*** (-4.32)	-49.98*** (-4.59)
R <sup>2</sup>	0.0812	0.0349	0.0374	0.2619	0.0016	0.0039
Obs.	1383	82984	22475	7844	4395	5705
<b>Medium</b>	-18.13** (-2.31)	-39.21*** (-17.11)	-53.49*** (-19.98)	-44.63*** (-14.18)	-45.56*** (-11.30)	-71.94*** (-20.99)
R <sup>2</sup>	0.0057	0.0369	0.0648	0.0245	0.0132	0.0529
Obs.	22759	194598	212809	105419	43205	71788
<b>High</b>	-46.93 (-0.87)	-85.47*** (-8.27)	-136.13*** (-7.58)	-93.57*** (-9.25)	-17.61 (-0.84)	-147.09*** (-10.21)
R <sup>2</sup>	0.1482	0.0760	0.0103	0.0359	0.0662	0.0746
Obs.	1453	16595	9541	16745	2405	6294

Controls: Age, Professional Status, Firm-size, Firm's Age Structure, Industrial Specific Gross Value Added per Worker, Lay-off Risk, Job Tenure, Quarter dummies

Source: authors' calculation. Significance-level: 0.01(\*\*\*), 0.05(\*\*) and 0.1(\*). T-values are reported in parentheses below the coefficients.

In every industry for nearly all skill levels and for both genders, we find highly significant negative coefficients. The coefficient increases according to the number of employees with a higher skill level. The lowering of the outside option has a greater effect on the highly skilled,



as evidenced in the table.<sup>9</sup> The negative coefficient does not imply that real wages decrease after the reform. The labor market reform (lower UB) has a lowering effect on wages, *ceteris paribus*. This finding is also valid for east Germany [see Table 2].

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<sup>9</sup> The increasing of the effect with a higher skill level is also a result of a level effect, because the wages also increase with a higher skill level.

**Table 2: Regression results for East Germany**

	<b>Construction Industry</b>	<b>Manufacturing Industry</b>	<b>Wholesale and Retail Trade</b>	<b>Real Estate, Renting and Business Activities</b>	<b>Transport, Storage and Communication</b>	<b>Financial intermediation</b>
Male						
<b>Low</b>	1.25 (0.07)	-33.21*** (-3.05)	16.22 (1.51)	-43.90*** (-3.04)	-64.83*** (-6.70)	-140.05*** (-3.16)
R <sup>2</sup>	0.0065	0.0321	0.0735	0.2326	0.0978	0.7107
Obs.	1870	6442	2370	1364	2828	202
<b>Medium</b>	-22.67*** (-8.43)	-28.85*** (-13.69)	-24.33*** (-10.23)	-49.38*** (-13.96)	-48.81*** (-21.18)	-111.22*** (-11.22)
R <sup>2</sup>	0.0747	0.2113	0.1915	0.4083	0.1137	0.0357
Obs.	88248	146080	77060	32682	58710	6256
<b>High</b>	-45.55*** (-2.56)	-97.53*** (-13.25)	-55.13*** (-4.44)	-77.92*** (-10.67)	-79.25*** (-5.25)	-72.28*** (-5.06)
R <sup>2</sup>	0.2161	0.0253	0.0123	0.0416	0.0276	0.0048
Obs.	3917	19676	4402	13826	2150	2111
Female						
<b>Low</b>	10.96 (0.26)	-43.58*** (-3.59)	-29.76** (-2.55)	-85.11*** (-6.05)	-141.72*** (-5.21)	-56.39* (-1.71)
R <sup>2</sup>	0.3216	0.0054	0.0909	0.0075	0.0002	0.0448
Obs.	167	4099	1549	943	719	341
<b>Medium</b>	0.57 (0.06)	-23.09*** (-5.92)	-20.81*** (-7.74)	-52.24*** (-13.66)	-40.12** (-9.00)	-39.27*** (-6.15)
R <sup>2</sup>	0.0000	0.0609	0.1629	0.1392	0.0098	0.0019
Obs.	7401	44711	50750	29457	18414	13072
<b>High</b>	-104.99** (-2.86)	-81.13*** (-6.26)	-59.83*** (-4.58)	-8.97 (-0.78)	-76.25** (-3.35)	-53.58*** (-3.14)
R <sup>2</sup>	0.0148	0.0591	0.0000	0.0884	0.0457	0.0012
Obs.	1200	6395	3209	7215	1032	2262

Controls: Age, Professional Status, Firm-size, Firm's Age Structure, Industrial Specific Gross Value Added per Worker, Lay-off Risk, Job Tenure, Quarter-dummies

Source: authors' calculation. Significance-level: 0.01(\*\*\*), 0.05(\*\*) and 0.1(\*). T-values are reported in parentheses below the coefficient.

In east Germany, the effect is smaller than in west Germany. This may be due to the lower average wage level in east Germany.

Our results contribute to the literature by identifying the negative effect of a lower UB in the natural experiment of the 2005 labor market reform in Germany. A lower UB results in a decrease in wages.

## **5 Conclusions**

The lower long-term UB due to the labor market reform of 2005 in Germany lowers wages, *ceteris paribus*. This does not imply that the average wage necessarily decreases, as other effects may superimpose on the impact of the reform. The degree of the effect depends on the industry, the skill level and the gender. The lower long-term UB appears to contribute to the weaker development for wages. Following the theory, the depressing effect of the lower UB on wages decreases the reservation wage because of the lower outside option. Along with Addison et al. (2009), we find indications for a declining reservation wage due to a lower UB in Germany.

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## Appendix

**Table 3: Regressions results for the Manufacturing Industry in West Germany**

	Low Skilled Male	Medium Skilled Male	High Skilled Male	Low Skilled Female	Medium Skilled Female	High Skilled Female
Age	7.91*** (10.38)	18.52*** (48.84)	99.12*** (113.02)	10.08*** (9.03)	33.45*** (34.88)	89.69*** (22.16)
Worker	-262.89*** (-26.07)	-284.00*** (-104.58)	-308.07*** (-19.92)	-13.73 (-1.22)	-122.72*** (-15.24)	-722.93*** (-12.13)
Technician	-187.54*** (-17.59)	-254.94*** (-108.01)	-205.02*** (-20.14)	25.61* (1.71)	-86.95*** (-10.28)	-399.65*** (-4.81)
Foreman	146.50*** (5.26)	22.50*** (5.61)	-8.18 (-0.55)	607.41*** (6.19)	98.73*** (3.66)	(omitted)
Small Company	-67.45*** (-18.44)	-81.69*** (-49.91)	-74.00*** (-16.79)	-29.17*** (-5.86)	-64.04*** (-16.78)	-170.33*** (-8.67)
Large Company	65.33*** (23.13)	73.76*** (51.10)	46.13*** (14.60)	40.15*** (10.86)	62.64*** (18.73)	60.52*** (4.39)
Under 20	36.05 (1.44)	-34.69*** (-3.82)	-302.27*** (-7.68)	41.83 (1.27)	-31.95 (-1.48)	52.37 (0.30)
Over 55	-70.83*** (-5.58)	-172.58*** (-29.80)	-139.17*** (-8.13)	-215.82*** (-12.27)	-236.85*** (-19.26)	-147.56* (-1.93)
Lay-off risk	-5333.02*** (-9.48)	-3014.02*** (-12.76)	18792.92*** (34.18)	-1626.30* (-1.77)	4060.32*** (5.83)	15393.26*** (5.48)
Gross Value Added	-0.11 (-0.57)	-0.23** (-2.25)	-7.59*** (-30.84)	-0.88*** (-3.03)	-2.14*** (-8.43)	-6.47*** (-5.73)
Job tenure	2.65*** (21.19)	4.19*** (69.18)	3.41*** (27.60)	2.40*** (13.19)	1.60*** (10.39)	0.48 (0.83)
<b>Lower UB</b>	-39.36*** (-21.73)	-54.62*** (-57.82)	-131.87*** (-57.89)	-31.73*** (-12.45)	-39.22*** (-17.11)	-85.47*** (-8.27)
Constant	2461.23*** (7.91)	2467.41*** (18.52)	894.28*** (99.12)	1725.18*** (10.08)	1464.14*** (33.45)	943.46*** (89.69)

Source: authors' calculation. Significance-level: 0.01(\*\*\*), 0.05(\*\*) and 0.1(\*). T-values are reported in parentheses below the coefficients. The models were all estimated with quarter dummy variables. In order to ensure a clear representation these variables were omitted from the table.

**Table 4: Regressions results for the Manufacturing Industry in East Germany**

	Low Skilled Male	Medium Skilled Male	High Skilled Male	Low Skilled Female	Medium Skilled Female	High Skilled Female
Age	21.37*** (3.92)	9.28*** (9.21)	40.80*** (11.70)	3.01 (0.50)	20.08*** (10.69)	40.24*** (6.46)
Worker	-226.68*** (-5.89)	-278.43*** (-43.40)	-196.18*** (-4.75)	-34.94 (-0.61)	-118.88*** (-9.63)	-244.43*** (-4.35)
Technician	-160.65*** (-3.79)	-256.00*** (-46.43)	-181.06*** (-9.12)	185.52*** (2.76)	-100.08*** (-8.99)	-238.77*** (-4.93)
Foreman	(omitted)	46.43*** (5.11)	-95.79*** (-3.78)	(omitted)	-79.66** (-2.41)	-42.83 (-0.42)
Small Company	-20.72 (-1.43)	-62.63*** (-24.07)	-77.56*** (-8.51)	-24.92 (-1.51)	-51.65*** (-9.77)	-32.85** (-1.99)
Large Company	-17.39 (-1.07)	91.07*** (30.41)	81.38*** (8.46)	67.37*** (2.87)	67.39*** (12.22)	78.61*** (4.74)
Under 20	293.79** (2.34)	78.17*** (5.08)	-257.63*** (-3.55)	712.72*** (4.48)	-83.39*** (-2.59)	425.21*** (2.86)
Over 55	27.12 (0.42)	-87.75*** (-9.30)	-239.17*** (-7.56)	-363.70*** (-5.00)	-147.87*** (-9.21)	71.48 (1.37)
Lay-off risk	5288.26*** (2.73)	-2449.78*** (-12.24)	2063.48*** (2.63)	3994.70** (2.26)	2711.68*** (5.10)	3108.29* (1.75)
Gross Value Added	1.92** (2.21)	-0.30* (-1.82)	0.97* (1.71)	1.72* (1.82)	-0.20 (-0.65)	0.28 (0.28)
Job tenure	-3.95*** (-4.60)	3.77*** (31.25)	5.18*** (13.76)	2.68*** (3.21)	0.09 (0.38)	3.28*** (4.33)
<b>Lower UB</b>	-33.22*** (-3.05)	-28.85*** (-13.69)	-97.54*** (-13.25)	-43.58*** (-3.59)	-23.09*** (-5.92)	-81.13*** (-6.26)
Constant	1199.83***	1863.24***	1140.78***	1583.01***	993.26***	780.53***



(21.37)

(9.28)

(40.80)

(3.01)

(20.08)

(40.24)

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Source: authors' calculation. Significance-level: 0.01(\*\*\*) , 0.05(\*\*) and 0.1(\*). T-values are reported in parentheses below the coefficients. The models were all estimated with quarter dummy variables. In order to ensure a clear representation these variables were omitted from the table.

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