

IMPROVING WORK INCENTIVES

**Tim Callan  
Brian Nolan**

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## 1. Introduction

Concern about the impact of the tax and welfare systems on work incentives, and the consequences for employment and unemployment, has been a recurrent theme in ongoing debate about tax and welfare reform. The background to this situation has already been described in the preceding paper (Ruane, 1996), which identified some of the underlying forces at work. In this paper, we review the evidence on the pattern of incentives generated by the current system, noting relevant international comparisons, particularly with respect to the UK. We then go on to consider some of the alternative proposals for reform of tax and welfare aimed at improving work incentives.

In recent years, budget changes have seen real increases in social welfare, or tax cuts in real terms, costing in the region of £200m per annum on a full-year basis. The Report of the Expert Working Group on the Integration of the Tax and Social Welfare Systems (Tax and Welfare Group or TWG) noted that, on reasonable assumptions regarding economic growth and the growth in other public expenditure, similar resources might be available in future years for improvements in the tax/transfer systems. A key concern expressed by the TWG was that best use be made of such resources, with year-to-year budgetary choices being made in the context of a coherent medium-term strategy.<sup>1</sup>

A coherent strategy will have to take into account trade-offs between the government's income support objectives and the efficiency losses associated with high effective tax rates (including withdrawal of welfare benefits). It will also have to take into account

- differences in responsiveness to effective tax rates across the population, *and*
- the existing distribution of effective tax rates/replacement rates

If the employment-increasing effects of reforms to tax and social welfare are to be maximised, it will be necessary to target effective tax rate reductions particularly towards groups where the potential response is greatest. This can depend in part on the distribution of effective tax rates or replacement rates: it seems reasonable that a cut in replacement rates from, say, 90% to 60% will be more likely to affect a work/non-work decision than a cut from 40% to 10%.<sup>2</sup>

There has been a great deal of research internationally, which helps to identify the relative responsiveness of different groups to financial incentives to work. While results can be sensitive to small changes in the specification of the model or the construction of the dataset used for estimation, (see, for example, Mroz 1987) results in the international literature are often taken as suggesting that

- Married women's participation tends to be more responsive to economic incentives than that of married men or most single people
- Greater than average responsiveness may also be found among lone parents (with child care costs being an important element of the financial calculations) and the pre-retirement age groups

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<sup>1</sup> For this reason, the TWG considered a "resource envelope" of about £1,000m over a five-year period, in assessing alternative packages designed to improve work incentives.

<sup>2</sup> It is sometimes argued that the importance of high tax rates is underestimated because individuals alter their behaviour so that they do not face such high tax rates. While it is important to be aware of this possibility, the focus here on work/non-work decisions means that the high effective tax rate will be observed.

- Most of the potential response in total labour supply arises from decisions over whether or not to take a job, rather than changes in hours of work<sup>3</sup>

How relevant are these findings to the Irish context? A number of studies<sup>4</sup> illustrate the importance of economic variables for married women's labour force participation in Ireland, and confirm that married women's labour supply is more responsive to the net reward from employment than that of married men. The labour supply of lone parents and the retirement decision are certainly deserving of further investigation in Ireland. But another factor may also be of particular importance in the Irish context: migration. The supply of labour to the Irish labour market may be particularly influenced by the decisions of potential emigrants and potential return migrants. This includes many young, single people. For those who are legitimately claiming benefits and seeking work, there are a range of mechanisms through which the tax/transfer system can affect individual behaviour and market outcomes (as discussed in *Integrating Tax and Welfare*). For example, high benefit rates may raise reservation wages, lead to increased duration of unemployment, skill loss and crowding out of low-wage employment.

The recent CSO study of the Live Register/Labour Force Survey points to the possible importance of another form of behaviour - working and claiming benefits - which *may*, in part, represent a response to poor work incentives.<sup>5</sup> The CSO estimates suggest 11 per cent of those claiming benefit may be engaged in full-time work; but the difficulties in tracing addresses for many of those on the Live Register (even allowing for some "inertia") suggest that this phenomenon may be even more extensive. Further analysis of the unique CSO dataset would be needed to establish the characteristics of those who are working and claiming. It may be that some, at least, are faced with a system in which signing off the Live Register and taking up a job may yield little financial reward, and respond by continuing to claim benefits while working full-time.

The potential response to improvements in work incentives therefore includes increased tax and welfare compliance, as well as labour supply responses such as increased participation of married women in the paid labour market, or reduced duration/incidence of unemployment. But for both forms of response, two key features should be noted:

- It is measurement of incentives in the legitimate system which is of interest, and this is what is undertaken here.
- The relevant incentive is not the "marginal tax rate" on a pound of extra earnings, but a comparison of potential disposable income when in work with disposable income when not in work.

It is to such comparisons that we now turn.

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<sup>3</sup> For example, a recent survey (Blundell, 1992) notes that "it is usually felt that the response to tax reductions in terms of working hours by prime-aged men is small and possibly negative, with working hours probably determined in some collective manner".

<sup>4</sup> Callan and Farrell (1991), Murphy and Walsh (1996), Callan and van Soest (1996).

<sup>5</sup> There will, in any tax/transfer system - even quite radical basic income schemes - be some gains to be made by breaking the rules - evading taxes, or fraudulently claiming benefits. Correspondingly, there is a need for controls and penalties on such behaviour.

## 2. Measuring Work Incentives

Until the development of the ESRI tax-benefit model (Callan, O'Donoghue and O'Neill, 1996) assessment of the evolution of financial incentives to work, and evaluation of the impact of policy changes on such incentives, relied heavily on calculations for a small number of hypothetical households or families. While such calculations can be useful in teasing out the implications of alternative proposals, it has severe limitations. This approach cannot deal with the underlying diversity of families with respect to a range of characteristics - family composition, the labour force status and earnings of husband and wife, housing tenure - which affect social welfare entitlements and income tax liabilities.

### **Measures of Work Incentives**

The measures used here are based on those defined for an OECD cross-country study (see Pearson and Whitehouse, 1996, for details). The replacement rate (RR), which is commonly used to summarise the balance between incomes in and out of work, is defined simply as

$$RR = \frac{\text{Family net income when working}}{\text{Family net income when not working}}$$

For those who are unemployed, this calculation requires an "employment counterfactual", taken to be a full-time job at an hourly wage rate predicted from their education level and previous labour market experience (see Callan, O'Donoghue and O'Neill, 1994, for details). An alternative used in the OECD study, and in Callan and Nolan (1996), is to consider counterfactual jobs at some fixed earnings level. The OECD project used median earnings, and a low-earnings figure which represented the cut-off for the bottom 10 per cent of full-time male employees (the 10th decile of full-time male earnings). It is results of this type which are used in comparisons with the UK.

For those who are employed, the "unemployment counterfactual" is the receipt of Unemployment Assistance (at the long-term rate). In the case of a married couple, replacement rates are estimated for *both* husband and wife, with the labour force status and gross earnings of the partner held constant: net earnings and benefit receipt of partners will, in general, be affected, and this is taken into account in the calculations.

The average tax rate (ATR) is defined in a similar fashion:

$$ATR = 100 * \left( 1 - \frac{\text{Family net income when working} - \text{Family net income when not working}}{\text{Gross individual earnings when working} + \text{Employer social insurance contribution}} \right)$$

The inclusion of employer social insurance contributions in this expression means that it can be seen as a measure of the proportion of the gross labour costs for a person moving from unemployment to employment which go to the government in terms of increased tax revenue, increased social insurance contributions (by both employer and employee) and reduced transfer payments.

In what follows, we present measures of the financial incentive to work derived from *SWITCH*, the ESRI tax-benefit model. The model is, at present, based on data from the ESRI's 1987 Survey, uprated with respect to a number of key characteristics including earnings growth, the fall in the number of large families, and

the rise in registered unemployment. (A model based on 1994 data is currently under construction and will be completed next year). The model focuses on cash benefits and cash incomes. It does not include rent and mortgage supplements under the Supplementary Welfare Allowance scheme, or non-cash benefits such as medical cards or rent reductions under the differential rent scheme.

Two measures of the financial incentive to take up a job or remain in employment are used (as described in the box). One is the familiar *replacement rate* (essentially, the ratio of net income when employed to that when unemployed or not at work). An alternative perspective on the balance between income when in work to income out of work is provided by the *average tax rate*, which abstracts from the level of income enjoyed when out of work, and focuses on the extent to which the gross labour cost of a job (including employer social insurance contributions) is retained by the employee taking up a job.

Table 1 shows the distribution of replacement rates for those who are currently in jobs, those who are unemployed (and receiving benefit), and those who describe themselves as being in home duties (a category dominated by married women, but including some lone parents).

Table 1: *Estimated Distribution of Replacement Rates by Economic Status, 1994*

<i>Replacement rate category</i>	<i>Employees</i>	<i>Unemployed</i>	<i>"Home duties"</i>
		%	
<50	61	30	8
50-60	13	15	13
60-70	10	21	28
70-80	9	20	31
80-90	4	9	17
90-100	2	4	2
Over 100	1	1	1
All	100	100	100

About 1 in 6 of those currently in employment faces a replacement rate higher than 70 per cent. This proportion rises to about 1 in 3 of those who are unemployed and claiming benefit. But the group with the greatest proportion facing high replacement rates is those who are in home duties. Over half of this group face replacement rates of higher than 70 per cent. This group includes many married women, with husbands in full-time employment. A number of factors contribute to high replacement rates for this group, including

- The size of the husband's net earnings
- Low potential earnings, because of time spent out of the labour market while rearing children
- Income-splitting provisions in the income tax code, which mean that the wife faces the same tax rate on initial earnings (after exhausting the PAYE/PRSI allowances) as the tax on the last pound of the husband's earnings

Table 2 provides an alternative perspective, focusing on the average tax rate (ATR) facing each group. This can be seen as providing a more appropriate measure of the influence of the tax and benefits systems on the financial incentives facing the

different groups - it is not influenced by the existence of other income, such as the earnings of a husband. Employer's social insurance contributions (usually at 12.2% in 1994/5) are now included.

Table 2: *Estimated Distribution of Average Tax Rates by Economic Status, 1994*

<i>Replacement rate category</i>	<i>Employees</i>	<i>Unemployed</i>	<i>"Home duties"</i>
		%	
<50	48	9	48
50-60	27	15	24
60-70	14	27	12
70-80	7	33	11
80-90	3	11	4
90-100	1	4	1
Over 100	1	1	0
All	100	100	100

The picture using ATRs suggests that the financial incentive to work is worst for those who are currently unemployed and in receipt of benefit. About half of those who are unemployed face an ATR in excess of 70 per cent. This compares with about 12 per cent of employees, and 16 per cent of those who are engaged in home duties. The fact that ATRs for those in home duties are higher than for employees reflects the influence of the tax treatment of married couples noted earlier.

Table 3: *Estimated Distribution of Replacement Rates for Unemployment Payment Recipients Classified by Family Type, 1994*

<i>Replacement rate category</i>	<i>Single</i>	<i>Married</i>	<i>Married with children</i>
		%	
<50	54	17	2
50-60	20	36	7
60-70	18	21	24
70-80	7	17	38
80-90	2	3	19
90-100	0	5	8
Over 100	0	0	2
All	100	100	100

Table 3 focuses on the unemployed, and highlights the impact of family status on the distribution of replacement rates. For single people, less than 1 in 10 face a replacement rate above 70 per cent; but about 1 in 4 of those who are married, without dependent children, face such a rate. For those who are married and have dependent children, the proportion rises to about two-thirds.

How does Ireland compare with other countries in terms of the financial incentive to work? Some insights from this can be gained from an OECD project currently nearing completion<sup>6</sup>, and from some recent Irish-UK comparisons (Callan

<sup>6</sup> Selected results are contained in Pearson and Whitehouse (1996), while more extensive results will be reported in a forthcoming OECD study.

and Sutherland, 1996; Duncan and Giles, 1996; Callan and Nolan, 1996). Measured against average wages in each country, basic income support rates have increased in Ireland (by about 10 percentage points) while they have fallen (by at least 10 percentage points) in the UK. This difference is now reflected in the distribution of replacement rates for the unemployed in the two countries.<sup>7</sup> On the assumption that the unemployed could obtain a job at median earnings, almost 30% of the Irish unemployed faced replacement rates above 60 per cent, compared with only 10% of the UK unemployed. With an alternative low wage assumption (see box), almost three-quarters of the Irish unemployed faced replacement rates above 60 per cent, as against half of the UK unemployed - but the incidence of very high replacement rates (above 80 per cent) was much closer (12% in Ireland and 10% in the UK).

In broader comparisons (Callan and Sutherland, 1996; Pearson and Whitehouse, 1996) Irish and UK income support rates, relative to average net earnings, appear to be lower than in many other EU countries. Correspondingly, replacement rates calculated by the OECD for some European countries appear to be well above Irish rates. Irish rates are higher relative to the average for the unemployed with children, and for very long-term unemployment (the OECD calculates entitlements after 5 years of unemployment).

### **3. Approaches to Improving Work Incentives**

If some of the unemployed face little or no financial incentive to take up work, what can be done to improve those incentives? We now outline the various ways in which this can be approached, sketching out some relevant findings for Ireland as we do so.

#### *Cutting Benefits*

If the financial return from working relative to income support and secondary benefits when unemployed is inadequate, this ratio could clearly be improved by cutting benefits. To do so at a stroke would require a cut in unemployment compensation in nominal terms. General reductions in nominal benefit levels have been rare in OECD countries. However, targeted reductions or benefit ceilings have been implemented in Ireland and elsewhere. As far back as 1976 a provision was introduced in the operation of Pay-Related Benefit (PRB) payable with Unemployment Benefit (UB) whereby total cash support for an unemployed person could not exceed 85% of their previous wage. More recently, PRB has been steadily reduced and finally phased out altogether, significantly reducing the level of income support available to a substantial proportion of UB recipients.

Over time, if take-home pay is increasing in real terms the ratio of employment income to benefits could be improved without a cut in nominal benefits by allowing take-home pay to increase more rapidly - for example, by indexing benefits to prices rather than net earnings. This has effectively been the policy implemented in the UK for a number of years. In the Irish case, from the late 1970s to 1990 the support provided to a single man by Unemployment Assistance (long-term) rose from about 20% to about 30% of average male take-home pay. Flat-rate UB, by contrast, rose only up to 1983 and then declined, falling below UA from the late

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<sup>7</sup> The comparisons are undertaken on the basis of income before housing costs and before housing benefits. The inclusion of housing-related assistance would tend to increase replacement rates in each country, but the net effect on the comparison is unclear.

1980s. Since 1990 UA has been rather stable as a proportion of average take-home pay while UB has risen - by 1994 they were each paying the same rate. Since 1994 take-home pay has risen relatively rapidly while both UA and UB have been increased only in line with prices.

#### *Altering the Balance between Insurance and Means-testing*

A number of OECD countries have reduced entitlements to insurance-based unemployment compensation, with the result that the unemployed fall back on means-tested support more quickly. While this may in some cases reduce the level of income support payable and thus replacement rates for the individual concerned, it may also have major side-effects in increasing effective marginal tax rates on the earnings of spouses or other household members and impact on their incentive to stay in work. In the Irish case, the duration for which insurance is payable and contribution conditions have been maintained (though PRB has been phased out as we have seen). The 1994 Programme for Government contained a commitment to "the maintenance and development of the social insurance system" - a Green Paper on the topic is expected shortly.

#### *Improving In-Work Benefits*

A direct approach to improving the ratio of income in work to income when unemployed is to provide income support not only to the unemployed but also to a targeted sub-set of those in employment. Because out-of-work support is usually higher for those with child dependants, they are most often the target group for in-work benefits. The UK Family Credit and US Earned Income Tax Credit (EITC) are prototypical examples of two distinct variants on this approach. Family Credit is a cash benefit payable weekly to those in low-paid employment with child dependants, while EITC in practice is almost always received as an annual tax refund. The Irish Family Income Supplement is of the former kind, being closely modelled on the UK predecessor to Family Credit. For those who take it up, this type of in-work benefit can certainly be effective in raising quite significantly the return from working versus unemployment. However the twin problems which it faces are low take-up and, for those who do receive the benefit, a high withdrawal-plus-marginal tax rate producing poverty traps.

The take-up of FIS in the 1987 ESRI survey was estimated to have been no higher than about 25% of eligible families, or perhaps 40% of potential expenditure/benefit. Since then considerable efforts have been made to improve the take-up rate, including an extensive information campaign, the introduction of a minimum £5 per week payment, and the exclusion of FIS payments from the medical card means test. At the same time, there have been substantial changes in the scheme and the level of payments, with the income limits rising, the number of hours work required to qualify falling, and the withdrawal rate increasing to 60%. The number of claimants and total expenditure on FIS have indeed grown quite rapidly, the former going from about 5,500 in 1987 to 11,400 in 1995 and the latter from £4.4 million to over £21 million. However, analysis of numbers now eligible for FIS, using the ESRI SWITCH model based on the 1987 sample but uprated to 1994, suggests that the take-up rate has increased only slightly if at all (Callan, O'Neill and O'Donoghue 1995). Take-up rates with the EITC are very much higher, but an annual payment at the end of the tax year may not have the desired impact on perceptions among the



unemployed of the benefits of taking up work. The feasibility of using the tax system to make an automatic short-term payment is however worth exploring.

The other key problem with FIS is the poverty traps it creates for recipients, in interaction with the income tax and PRSI contribution systems. Over a significant range of income, an extra £10 in gross earnings, for example, can lead to a fall of £6 in FIS received and an increase of more than £4 in income tax and PRSI, leaving the family worse off. Over time, improvements in FIS have tended to help reduce replacement rates but at the cost of expanding the poverty trap. While the number of families actually affected by the most severe FIS-related poverty traps is not large, the distortions are inequitable and undesirable. Making FIS dependent on income after rather than before tax and PRSI contributions would help eliminate the most severe poverty trap, so that the marginal tax-cum-benefit-withdrawal rate would be no more than 75-80% at most. This could cost between £20-£50 million depending on take-up. Extending FIS to those without child dependants has also been mooted. Whatever the structure, compared with alternative strategies in-work benefits of this sort will achieve relatively low cost and effective targeting only at the cost of worsening incentives higher up the income distribution.

#### *Increasing In-Work Incomes and Incentives Via Income Tax*

Tax reductions for those on low incomes can increase net incomes in work, although if benefits when out of work are also taxed they may not necessarily reduce replacement rates. In the Irish case, income tax payable on relatively low incomes has risen sharply over time, primarily because personal allowances have not been indexed, and the marginal tax rate on many low incomes has been raised because of the operation of "marginal relief". In the 1980s exemption limits, below which one is not subject to income tax, were introduced on the basis that this was a cost-effective way of directing relief to those on low income, much less costly than a general increase in personal allowances. In 1989 substantial child additions to the exemption limits were introduced. As the gap between personal allowances and exemption limits widened, however, the problem of phasing in taxation for those whose incomes do exceed the exemption limit loomed larger. Without special provision, the marginal tax rate on an increase in income bringing one above the exemption limit would be well in excess of 100%, with tax payable at the standard rate on the full excess over one's total allowances rather than over the exemption limit. The marginal relief system operates for such taxpayers by (currently) restricting the amount of tax paid to a maximum of 40% of the excess of income over the exemption limit. However, this means that currently one in six taxpayers is taxed through this system, facing a relatively high marginal tax rate which, in combination with FIS withdrawal, can create severe particularly poverty traps.

The Integration Working Group paid considerable attention on this marginal relief, describing it as effectively a second tax system for lower incomes, and recommended that it be limited and eventually abolished over time by increasing personal allowances at a faster rate than exemption limits. Analysis of the incentive effects by the Integration Group showed that this would reduce hypothetical replacement rates for those on incomes of £10,000 and above (by 2-3 percentage points), with no change for those below that level. The cost of increasing personal allowances to the exemption limit level would be about £290 million in a full year.

### *Increasing In-Work Incomes by Reducing PRSI Contributions*

Like income tax, social security contributions on low earnings can contribute to high replacement rates: indeed they are more likely to do so since contributions are not levied on unemployment compensation whereas income tax may be. Reform of PRSI to improve work incentives has received a good deal of attention in recent Irish Budgets, with mixed results. To improve returns to low-earning work, a system of weekly allowances for employee PRSI contributions was introduced in 1995, and in 1996 the allowance was increased from £50 to £80 per week (financed by abolition of the additional income tax allowance for full-rate PRSI contributors). However, for the Employment and Training and Health Levies a threshold (currently £188) now operates below which the 2.25% levies are not payable: the result is that an increase in earnings from just below to just above the threshold faces a very high effective tax rate.<sup>8</sup>

The reform of PRSI presents a range of options from the minimal to the radical step of abolishing employee contributions entirely. The issues involved are brought out by the Integration Group, which was unable to agree on this topic: some members favoured the abolition of employee contributions but others saw this as eroding the link between contributions and benefits and giving rise to problems in the treatment of the public service. Similar positions have been debated going back to the Commission on Taxation and beyond, and little progress seems to have been made in establishing, for example, whether the contributory principle does actually affect willingness to pay. The Integration Group did recommend the phasing out of the levies, but since the cost would be close to £400 million and the improvement in replacement rates would be relatively small, did not think it appropriate that they be abolished in the short run. They recommend that the levies be more closely related to employee PRSI: at a minimum, the exemption threshold should be frozen in real terms. Such an alignment with PRSI seems inconsistent with the Group's endorsement of the Commission on Taxation's view that the levies are simply taxation and should be integrated with general taxation over time.

### *The Tax Treatment of Married Couples*

As emphasised earlier, married women's labour force participation appears to be particularly sensitive to incentives. In Ireland the tax treatment of married couples, whereby allowances/bands are fully transferable between spouses, contributes to high marginal tax rates on the second earner in a couple, usually the wife. A more individualised system of taxation could thus improve work incentives for this group. Various options have been considered in Callan and van Soest (1996), which estimated labour supply responses and incorporated them into an evaluation of the alternatives. A positive overall labour supply response was found to a revenue-neutral package which involved greater independence of taxation between husband and wife, with a slight negative impact on the labour supply of husbands being offset by a much greater increase in the labour supply of married women.

### *Basic Income*

The idea of a basic income, an unconditional tax-free payment to each person, is a simple and attractive one which has a long history but has been receiving a good deal of attention in Ireland and elsewhere in recent years. While its proponents would

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<sup>8</sup> There is a similar but more serious discontinuity in employers' contributions.

also see various other attractions (see for example Parker 1994, van Pariis 1993), a basic income would improve work incentives in that an unemployed person would retain the basic income when taking up employment, and pay tax only on their earnings: the benefit withdrawal-cum-marginal tax rate is simply the marginal tax rate itself.

In an Irish context, the costing and incentive effects of such a scheme have been investigated in Callan, O'Donoghue and O'Neill (1994) using the ESRI tax-benefit simulation model: this study was commissioned and drawn on by the Integration Group. As far as incentive effects are concerned, this showed that the incidence of very high replacement rates could indeed be greatly reduced. However, if a full-blown basic income scheme paying current levels of support had to be financed on a revenue neutral basis from within the current income tax-transfer system, the marginal tax rate on earned income would have to be over 60%, so the numbers facing replacement rates of 60-80% would rise. On this basis the Integration Group concluded that "the introduction of a full basic income would be highly problematic and the high tax rates needed to fund it would have a deleterious effect on employment" (p. 35). Various partial basic income (PBI) schemes have also been proposed. One is a basic income for children only, which we look at shortly. An alternative is to have a partial basic income for all, at a level below social welfare rates, with a means-tested top-up for those relying on the payment. The Integration Group examined a number of variants of a partial basic income, and saw some merit from an incentives point of view in one which replaces tax allowances and exemption limits. The level of PBI involved would in that case be around £20 per week for each adult, and the full structure of social welfare transfers - contributory and non-contributory - would have to continue in operation. A higher PBI of £38 would be required before Child Dependent Additions and FIS could be abolished. A more ambitious PBI, involving a basic payment of £57 and a top-up of £10 (except for the elderly who would receive a full basic income), has been proposed by CORI (1995). As with other forms of basic income, couples and families with children tend to gain at the expense of single-person households. The Integration Group Report discussed the advantages and disadvantages of this proposal at some length, but does not address the incentive effects in any detail, concluding that the tax rate of 50-55% required to finance it make the effects on employment uncertain. However the extent to which the tax rate required could be reduced by the extra resources expected to be available as a result of economic growth, or other resources which might potentially become available specifically to a basic income scheme,<sup>9</sup> merits further investigation.

#### *Child Income Support*

Disincentives for employment are not necessarily at their worst for families with children, because some countries treat such families relatively generously when in work via benefits and tax concessions. However in the Irish case these are not sufficient to offset child income support for the unemployed, so those with dependent children face the highest replacement rates and reforms to tax and social welfare targeted at this group are a priority. The notion that the different elements of child income support - currently Child Benefit, CDAs, FIS and child additions to the income tax exemption limits - could be integrated into a single payment has a long

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<sup>9</sup> Resources potentially freed up as a result of introducing some form of basic income but not with alternative reforms could include training allowances or headage payments.

pedigree. This is considered in some depth by the Integration Group, drawing on analysis using the SWITCH model (Callan, O'Donoghue and O'Neill 1994). A full Basic Income for Children paying an untaxed payment equal to the sum of current Child Benefit and CDAs would cost about £400 million per annum. It would reduce replacement rates for those not in receipt of FIS at all income levels, overcoming the non-take-up problem, but for FIS recipients at the lower income levels (below £9,000) replacement rates rise. This could be overcome by retaining a residual FIS for that group, but at the cost of high marginal tax-benefit withdrawal rates for those affected.

A less costly option would be to increase the universal child payment to the same amount but make it taxable: this would cost about £200 rather than £400 million per annum. This would again improve replacement rates for those not in receipt of FIS, but for those in receipt replacement rates are unchanged or rise. Analysis using the SWITCH model in Callan, O'Donoghue and O'Neill (1994) suggests that, compared with the current situation where take-up of FIS is low, such an "integrated Child Benefit" would reduce the percentage of unemployed facing replacement rates of over 80% very substantially. Since marginal relief taxpayers would pay tax at 40% on their child income support, their replacement rates would rise in the absence of special provision. This option therefore looks more attractive if the exemption limit/marginal relief structure is being phased out, and residual FIS might again be desirable. There would also be legal issues to be addressed in making the payment taxable in the hands of the parents.

An alternative route to targeting child income support is to means test rather than tax it. This is what the Child Benefit Supplement proposed in the 1994 Programme for Government involves: Child Benefit would be retained and an additional supplement would be paid to all those below an income limit, irrespective of whether their incomes were from employment or social welfare. Depending on the parameters of the system, such a scheme could cost over £100 million. With plausible parameters, replacement rates generally fall for those not in receipt of FIS, but for those currently in receipt they could rise at low incomes so once again a residual FIS might be necessary. The Integration Group looked in some detail at the mechanics of operating such a means test, which would cover a broad group not currently facing such testing, and concluded that it would be administratively complex and costly, needing a lead-in time of up to two years.

A much more limited interim measure proposed by the Integration Group in its interim report and introduced in the 1996 Budget was a provision whereby someone moving from long-term unemployment into employment could continue receiving CDAs for a period of 13 weeks. This was seen as an important bridge to cover the period of uncertainty while awaiting a decision on FIS entitlement, but has apparently been taken up in very few cases as yet.

#### *Reform of Secondary Benefits*

As well as basic unemployment compensation versus income when in work, incentives will be affected by extra cash or non-cash support when unemployed which is not available when in work (whether this comes about through linking these supports to particular contingencies or through means-testing them). In the Irish case the two most important additional supports are medical card cover for health care and assistance with housing costs. The contribution of medical card cover to the unemployment trap should have been eased by recent measures whereby someone moving from long term unemployment into a job retains the medical card (irrespective

of earnings) for three years, though there may be an information problem in this instance both for administrators and potential beneficiaries. The loss of cover may loom particularly large for those with children, and the Integration Group looked at extending medical card cover to all children. The cost would be about £60 million per annum, and on that basis the Group - although seeing this as equitable, transparent and easy to administer - did not recommend it.

As far as housing costs are concerned, the main supports currently provided are through Supplementary Welfare Allowance Supplements, local authority differential rents, and tax relief. Support through SWA is particularly likely to contribute to unemployment (rather than poverty) traps because it is confined to those not in full-time employment. About 80,000 households currently benefit from SWA Rent and Mortgage Supplements, and the average amount per recipient is about £12.50 per week. The most urgent need would therefore appear to be for a unified housing benefit scheme covering at least the private sector, along the lines recommended by the NESC (1990).

#### *Encouraging Part-time Work*

Efforts have been made to alter the social security system to facilitate part-time working in a number of OECD countries, including Ireland. The scope for working part of the week and claiming UB or UA for the remainder has been widened in a number of respects. It is now possible to work systematic short-time for 3 days, for example, and receive unemployment compensation for the other two, or do casual work for up to three days if signing on for three.<sup>10</sup> In addition, the Part-Time Job Incentive Scheme pays an income support to a long-term unemployed individual taking up work of less than 24 hours per week, which is not affected by wages in the part-time job.

#### *Temporary Support for Return to Work*

An extensive range of temporary payments or supports have been implemented in different countries to ease the transition from unemployment, especially long-term unemployment, into work. In the Irish case, in addition to the recent provisions for retention of CDAs and medical card cover for a time already described, the Back to Work Allowance allows a long-term unemployed person or lone parent (aged at least 23) to take up employment in certain specified sectors and retain 75% of their previous social welfare payment for a year and 50% for a further year. Secondary benefits are also retained.

#### *Assistance with Costs of Working*

Where costs are incurred when working but not when unemployed, this contributes to disincentives. The largest single cost is generally child-care, and this can be a major influence on the incentives facing lone parents and married women in particular. Various OECD countries provide universal or targeted assistance with child care, through direct provision, cash transfers or tax reliefs, in order to facilitate taking up employment. In the Irish case child minding expenses can be deducted in assessing means for purposes of Lone Parent's Allowance only, there is no generalised tax relief for such expenditure and little state provision.

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<sup>10</sup> For UA, such earnings are assessed as means but only after a deduction of the relevant daily UA rate plus £15 per day.

### *Tightening Benefit Conditionality/Encouraging Job Search*

Finally, efforts to improve the financial reward from taking up work may be accompanied by direct measures to encourage unemployed people to search more actively for jobs and/or to take up any job offers they do receive, with reducing or withdrawing unemployment compensation as the sanction. Job search requirements for benefit entitlement have been tightened in a number of OECD countries, and in the UK this is a central element in the recently-introduced Jobseekers Allowance. In Ireland the tendency in the 1990s appears to have been an easing in the policing of the condition that one should be "available for and genuinely looking for work", on the basis that enforcing job search behaviour on long-term unemployed individuals with very low escape probabilities was unreasonable or a misallocation of resources. The frequency with which one has to "sign on" has also been reduced for the same reason.

## **4. Conclusions**

There has been some improvement in work incentives, as measured by the replacement rates facing the unemployed, over the 1987-1994 period. (Callan, Nolan and O'Donoghue, 1996). But the situation in 1994, as outlined here, shows a great deal of room for improvement. Our best estimate is that close to one-third of the unemployed face cash replacement rates - which do not take account of assistance with housing or medical cards - of over 70 per cent.

There is a wide range of approaches to improving the incentive to take up work, and experience elsewhere does not suggest there is any one tried and tested "magic bullet". We do however know a good deal more than heretofore about the immediate impact various options for reforming the Irish tax and welfare system would have on incentives, as well as on the income distribution. Important lessons are that having a substantial impact on replacement rates will involve a package of reforms, that this package will not come cheap, and that of necessity a significant proportion of the benefit will go to those in the middle of the income distribution.

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