

In-work benefits: literature review

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Introduction

The current paper gives an overview of in-work benefits (IWB) in some of the OECD countries. The main underlying aim is to establish whether IWB programs could serve as examples for Central and Eastern European countries, in particular for the EU8, i.e. the new Member States of the European Union.

In-work benefits (also called employment-conditional benefits) are a central element in 'Making Work Pay' strategies, which can be seen as efforts to tailor employment-friendly social policies with aims of simultaneously alleviating family poverty and boosting employment. As the name of in-work and employment-conditional benefits suggests, these benefits are paid only to persons who have taken up a full-time or part-time job.

The IWB programs are established primarily with a view to reduce benefit dependency and increase employment (OECD 1998). IWBs are designed to increase the net income from work and the difference between in-work income and out-of-work benefits, thereby increasing employment incentives, which in turn is expected to increase labor supply (Wu 2000).

Further aims which may be associated with these programs include:

- redistributing income towards low and middle income families, thereby reducing poverty of families with children;
- tackling high unemployment among less skilled workers;

Nevertheless, even if redistribution is one of the explicit or implicit aims of IWB programs, these schemes do not aim at guaranteeing a particular minimum standard of living (CESifo 2000).

In this paper, the following programs are reviewed*:

United Kingdom: Working Tax Credit and Child Tax Credit;

Ireland: Family Income Supplement, Back-to-Work-Allowance and Continued Child Payment;

Netherlands: Employed Persons' Tax Credit;

France: 'Prime Pour l'Emploi'

Common characteristics and diversity of in-work benefits

Programs that come under the heading of 'in-work benefits' may nevertheless have quite different types, designs and target groups.

* I am grateful to Marre Karu from PRAXIS Center for Policy Studies for her assistance in collecting information.

One of the target groups of IWBs is recipients of unemployment benefits or of social assistance who may have little incentive to seek or accept employment due to the small difference between the net income obtained from unemployment or social assistance benefits and the level of disposable income if employed with a minimum wage (or low wage). Another factor leading to a poverty trap may relate to benefit calculation rules, if any improvements in gross income would be offset in whole (or in large part) by a reduction in benefits (Ochel 2001). Put in other words, beneficiaries may face disincentives to break out of the unemployment and poverty trap if the net replacement rate of their benefits is high or if the transfer reduction rate, to which additional earnings are subject, is high. To solve these problems, the replacement rate or the transfer reduction rate shall be lowered.

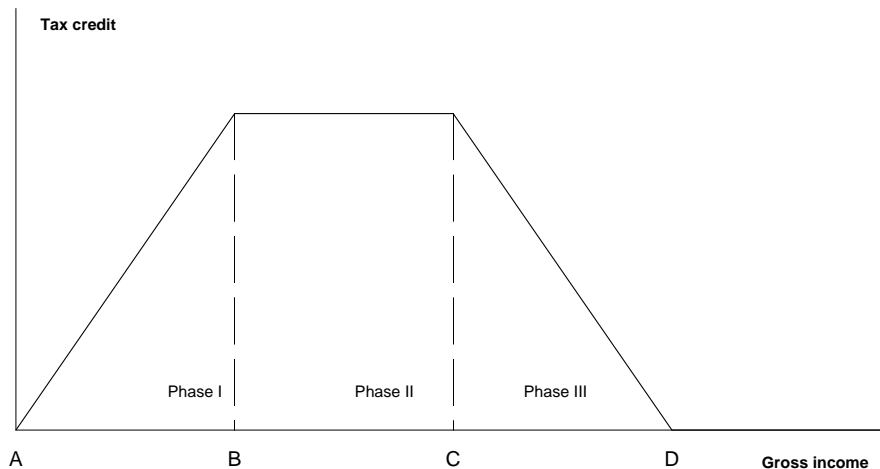
Another common target group of IWBs is low-wage earners, in particular families with children. In this case, the aim is not only keeping parents in employment, but also giving incentives to increase disposable income by prolonging working hours.

IWBs may take the form of tax credits, wage-related transfers or lump-sum payments. The choice of the program type largely depends on the target group.

Tax credits are directed to low income working families, aim at improving the net income of these families and thus contribute to reducing poverty, while at the same time creating work incentives. Wage-related transfers and lump-sum payments are aimed at those currently not in work, seeking to ease the transition from long-term unemployment to work.

Normally, tax credit schemes have no time limit, while wage-related transfers are time-limited.

In tax credits schemes, the amount of tax credit is typically a function of gross income with phase-in and phase-out elements (Chart 1). The typical pattern of tax credits includes three phases (Ochel 2001): at first the tax credit increases as gross income increases, in a second phase it remains constant, while beyond a certain income level the amount of tax credit starts to decrease and eventually stops when gross incomes reach a certain maximum.



Source: Ochel 2001

Chart 1. Tax credit as a function of gross income (stylized).

When analyzing the programs of the UK, Ireland, the Netherlands and France, the focus is on the following issues: what is the evidence about impacts of IWB programs on reduction of poverty and increasing employment; what are the administrative issues related to introduction of such programs; what is the interaction of IWB programs with other policy measures.

United Kingdom

In the UK, in-work benefits have a long tradition albeit the system has evolved over a series of reforms. In 1971, a Family Income Supplement (FIS) was introduced to assist working parents with low income. In 1988 the FIS was replaced by a Family Credit (FC) – a top-up cash payment for couples with children and low household incomes. A major reform was implemented in 1999, when the FC was replaced by a tax credit program – Working Families' Tax Credit (WFTC), which almost doubled the generosity of the program, compared to FC. In 2003, WFTC was replaced by two separate tax credit programs – Working Tax Credit (WTC) and Child Tax Credit (CTC). The latest reform separated the support for working families from support for children.

At the time of reform, the declared aims of the tax credits were seen as (HM Treasury 2002):

- supporting families with children, recognizing the responsibilities that come with parenthood;
- tackling child poverty, by offering the greatest help to those most in need, such as low-income families;
- helping to make sure that work pays more than welfare and that people have incentives to move up the earnings ladder.

Working Tax Credit (WTC)

The WTC is a tax credit program, which tops up the earnings of persons working on low or moderate incomes. To be eligible, the person shall work at least 16 hours per week. For couples at least one partner must work 16 hours per week. Working persons can claim tax credit if they: (a) are responsible for at least one child (up to the 31 August after their 16th birthdays) or qualifying young person (in full-time non-advanced education until their 19th birthday); (b) have a disability which puts them at a disadvantage in getting a job or (c) in the first year of work, having returned to work aged at least 50 after a period of at least six months receiving out-of-work benefits. Other adults (e.g. those without dependent children and disability) qualify if they are aged at least 25 and work for at least 30 hours a week (HM Revenue and Customs 2006a).

WTC is made up of different elements. In 2006-07, the basic element of WTC amounts to £1,665 per year. Further elements depend on particular circumstances of the claimant and his/her family, and include second adult and lone parent element (£1,640), disability element (£2,225), 30 hour element (£680), 50+ element (£1,140 or 1,705 depending on working hours). Furthermore, the WTC program includes a specific element designed to subsidize childcare costs for working families, covering to eligible persons up to 80 per cent of their childcare costs, up to a maximum limit of £175 per week for one child and £300 for two or more children (HM Revenue and Customs 2006b).

If the employment income of the claimant is equal to or less than the taper start point – in 2006-07 this is £5,220 per year – the full amount of tax credit entitlement is due for the entitlement period. Above this threshold, the maximum amount of tax credit is reduced at the taper rate of 37% (i.e. in case of income above the threshold, the maximum award is reduced by 37p for every pound of income above the threshold).

The amount of tax credit is assessed on annual income, but calculated on a daily bases.

The initial award of tax credit is normally based on the previous tax year's income. During the year, claimants are required to report to the Her Majesty's Revenue and Customs (HMRC) service some changes of circumstances (such as a partner joining or leaving the household, or a significant fall in the amount spent on formal childcare) and are encouraged to report others (changes in the number of dependent children; changes in family income; changes in weekly hours). If a change in circumstances justifies a higher award, then the payment to the family is increased for the rest of the year, and HMRC makes a one-off payment to cover the underpayment in the year to date. If a change in circumstances justifies a lower award, then an overpayment has arisen and the monthly payment to the family is then reduced or stopped for the rest of the year, so that the total amount of tax credits paid in the tax year is equal to the total entitlement for the tax year (Brewer 2006).

It is notable that workers' participation in a so-called 'salary sacrifice scheme' (the worker agrees to accept a reduced wage from the employer in return for a non-cash benefit) may actually increase a worker's entitlement to the WTC as the income on which

they are assessed for WTC purposes is reduced, resulting in a higher tax credit (Low Pay Commission 2006).

Child Tax Credit (CTC)

Child Tax Credit is a payment to support families with children. CTC consists of two components:

- a family element of £545 per year, doubled in the year of a child's birth;
- an amount per dependent child of £1,445 per year (higher for disabled children).

In 2006-07 families with annual gross incomes below £14,155 are entitled to the full amount. Above this threshold, the tax credit is reduced using the same taper reduction rate as for the WTC – 37% (i.e. the maximum award is reduced by 37p for every pound of income above the threshold). The family element of the child tax credit is retained until income exceeds a second threshold of £50,000 a year, at which point the family element is tapered away at a rate of £1 for every £15 (i.e. 6.67%) in excess of £50,000

The CTC is paid to the main caretaker, irrespective of employment status. In fact, CTC is not an in-work benefit as the caretaker does not have to work to claim the CTC. CTC is paid in addition to Child Benefit and any Working Tax Credit.

Tax credits can be claimed by individuals or jointly by couples. Initial tax credit awards are provisional as these are based on a proxy for current-year income. Awards only become final when families confirm to HMRC service what their income was over the preceding tax year. Tax credit payments are made weekly or monthly (depending on the choice of the applicant) by HMRC into bank or post office accounts of recipients.

Other in-work-benefits

Besides the tax credits, the UK has also other IWBs, notably some lump-sum cash benefits for persons who take up jobs and leave the benefit program:

- Back to work bonus: a one-off payment of up to £1,000 if certain benefits stop because of work.
- Child Maintenance Bonus: a one-off payment of up to £1,000 for people who receive child maintenance and leave benefit to start work
- Job Grant: a one-off payment of up to £100 for persons aged 25 and over who were previously receiving a benefit (jobseekers' allowance, income support, incapacity benefit or severe disablement allowance) continuously for 52 weeks, and take up work at least 16 hours a week while the employment is expected to last at least 5 weeks.

Evaluation

As of December 2005, the WTC provided in-work support to around 1.8 million families (single persons or couples), of them about 1.5 million families with children and 320 thousand families without children (Brewer 2006).

At the same time (2005 end year), 5 million families with children were receiving the CTC and further 600,000 families with children were receiving the equivalent level of support through out-of-work benefits. The total number of families receiving child benefit was around 7.4 million, so around 1.8 million families with children were receiving Child Benefit but not the CTC nor extra help for their children through out-of-work benefits, either because they did not claim or because they were too rich to be eligible. In the majority of cases (73%), entitlement to tax credits exceeded families' liabilities to income tax (Brewer 2006).

In 2004–05 financial year total expenditures on tax credits was £15.8 billion or about 1.3% of GDP.

Brewer (2005) has shown that the CTC is more effective in reducing poverty than the WTC, while the WTC has stronger work incentives. He concludes that no single measure can affordably cut poverty without reducing work incentives, thereby underlining the trade-off inherent in the double aim of tax credit programs.

As the former WTFC was divided into separate programs of WTC and CTC quite recently (in 2003), there is still only limited evaluation on the effectiveness of the new schemes. However, the earlier WFTC program has been extensively evaluated.

Several authors (Blundell et al 2000, Ochel 2001, Brewer et al 2005) have found that the WTFC exerted a strong incentive to take up gainful employment compared to the pre-reform situation *inter alia* by effectively lowering net replacement rates of benefits for persons taking up employment at minimum wage (either full-time or part-time).

Bell (2005) indicates that between 2002-03 and 2003-04 fiscal years child poverty fell by 100,000 and attributes this largely to the WFTC program. Brewer (2006) also notes that the program reduced the number of families in poverty.

St Martin and Whiteford (2003) refer to estimations that the WFTC program produced about 100 000 new jobs, while the cost was about 1% of GDP.

Simulations by Blundell et al (2000) indicated that the WFTC had strongest incentives to work for single mothers. This result is confirmed also by a number of other researchers. Francesconi and Van Der Klaauw (2004) calculated that the WFTC increased the employment rate of lone mothers by about 7 percentage points. In particular, the fact that the program has covered a part (earlier 70%, from 2006 under WTC up to 80%) of child care costs has been seen behind the rapid increase in employment of single parents (Brewer and Gregg 2001) by reconciliation of work and family responsibilities for single parents. However, at the same time the WFTC has also been attributed significant reductions in single mothers' subsequent fertility and in the rate at which they married (Francesconi and Van Der Klaauw 2004).

On the other hand, WFTC was shown to exert a negative incentive on married women whose husbands worked. However, according to calculations of Brewer et al (2005) the

negative effects have been quite modest. They observed that the WFTC reduced labor supply of mothers in couples by 0.6 percentage points.

The 2003 reform addressed some of the observed weaknesses of the former WFTC scheme. While WFTC had strong incentives to take up employment for those previously unemployed, there were no incentives to work more hours for those already in employment. Vice versa, in the phase-out income bracket workers faced a high marginal effective tax rate, which gave an incentive to limit weekly working hours instead of increasing it (Ochel 2001). This led to a high proportion of part-time workers with a working week of 16 or more hours (Blundell 2000). This element was improved in the WTC scheme, which now takes into account the weekly working hours in calculation of the amount of tax credit, encouraging move to full-time work.

Brewer et al (2005) show that the number of recipients of in-work benefits increased markedly upon the introduction of WFTC and continued to rise thereafter. This was to be expected due to higher generosity and broader personal scope of the program compared to the FC. Concerning interaction of the WFTC with other (out-of-work) benefit schemes, Brewer et al (2005) point out that the caseload of lone parents on Income Support (means-tested social assistance) had declined slowly but steadily already from 1996 with no discernable change around 1999/2000.

At the same time it has been observed that the take-up ratios of in-work benefits have been lower than for out-of-work social assistance payments. In 2002-2003 the take-up ratio of Income Support and Housing Benefit among lone parents was 96-97%, while for the WFTC it was ten percentage points lower. Among couples, the difference was even larger, 85-92% for out-of-work social assistance against 62% for WFTC.

The WTC and CTC programs are administrated by the HM Revenue and Customs office (formerly Inland Revenue). Until 2006 employers were responsible for paying tax credits through the payroll, along the regular wage payments. This placed a crucial role in management of the program on employers. Studies of employers' experiences found that employers using computerized payroll systems managed with administration of tax credits relatively easily as the provision for this was programmed into payroll software. At the same time, employers using manual payroll systems, mainly small firms, often tackled difficulties in setting up and handling tax credit payments (Athayde et al 2003; Coleman et al 2003). Employers deducted the amounts paid to employees as tax credits from income tax and national insurance contribution obligations and could apply to the Inland Revenue for additional funding where these were insufficient to cover the amount paid out in tax credits. To assist employers in day-to-day management of payments, the Inland Revenue set up advice services: website, telephone helpline, employers' reference manual, seminars and courses. Payment through the wage packet underlined the pro-work message of tax credits, yet employers (in particular in small enterprises) found the program too onerous to operate in spite of measures undertaken to assist them. From April 2006, tax credit payments are made directly by the HMRC.

The administrative side of tax credit programs has also been criticized for extensive overpayments, as the system is not able to respond quickly to changes in family circumstances, resulting in high levels of repayments, penalties (up to £300 for not reporting changes in family situation) and consequent hardship amongst people on low incomes. In 2004-05 overpayments concerned nearly one third of all tax credit awards, while the total value of overpayments amounted to about £2 billion or over 12% of the total expenditure on tax credits (Brewer 2006).

The experience of tax credits in the UK has shown that it is very difficult to find a suitable compromise between the administrative simplicity on one hand and a proper incentive structure of the program on the other hand. This trade-off has led to a number of parametric and administrative changes in the UK tax credit programs over a relatively short period, and further changes are currently debated.

Ireland

Ireland, similar to the UK, has several programs of in-work benefits to assist low-income workers.

The IWB programs in Ireland include:

- the Family Income Supplement (FIS)
- the Continued Child Dependent Payment (CCDP)
- the Back to Work Allowance (BTWA)
- the Part Time Job Incentive (PTJI)

However, the main IWB program in the UK – WTC – is a tax credit scheme, while the FIS program in Ireland is a cash transfer.

Family Income Supplement (FIS)

Family Income Supplement (FIS) in Ireland paid to low-paid working families with dependent children (under age 18 or 22 if in full-time education). People in paid full-time employment (19 hours per week or 38 per every fortnight) which is expected to last for at least 3 months are eligible. Self-employment does not qualify as employment in this context. A couple (married or unmarried) can cumulate their working hours to fulfil the 19 hour requirement.

FIS payment is 60% of the difference between families' average weekly net income and the income limit that varies according to the family size (in 2006 from €465 for one child to €905 for 8 or more children). The minimum benefit is €20, paid to all families whose family income is less than €20 below the income limit.

Assessable family income includes applicants' and his/her spouses' or partners':

- income from work or self-employment (including extras, overtime bonuses);
- income from occupational pensions;

- any other income including social welfare or Health Service Executive payments.

Unearned income, income from a charitable organization and certain benefits (e.g. Child Benefit, Carer's Allowance, Orphan's Allowance or Pension, Supplementary Welfare Allowance) are not included. People receiving Unemployment Benefits or Assistance, Retirement Pension or Pre-Retirement Allowance are not eligible for FIS.

The amount of the benefit is fixed for a year (52 weeks) as long as applicant continues to meet the FIS qualification conditions. A review of the entitlement can be carried out at any stage after the claim is put into forward if there is a doubt concerning person's eligibility for FIS. Also, random spot-check can be carried out.

The increase or decrease in the salary during the entitlement period does not affect the eligibility or amount of the benefit. The only change which can increase the amount of benefit is an additional child in the household.

Back to Work Allowance (BTWA)

Under the BTWA scheme, unemployed persons who take on jobs can keep part of their previous unemployment compensation for a limited period of time. To qualify, the person must be age 23 or over, have been previously unemployed for 5 years, having entitlement to unemployment allowance amounting to at least €50 (single person) or €78 (couples) per week. There is a further condition that by hiring these persons the employer's total number of jobs must have increased. The amount of BTWA is 75% of the former unemployment allowance during the first year on the job, 50% in the second year and 25% in the third year.

There is no wage limit to apply for BTWA. Beneficiaries also can receive "secondary benefits" (e.g. Back to School Clothing and Footwear Allowance, Diet Supplement, Rent and Mortgage Interest Supplement) for 3 years as long as the household income is less than €17.43 gross per week.

Employers are eligible to take part of the scheme if they offer job that does not replace another employee, is at least 20 hours work per week and will last for at least 12 months.

Continued Child Payment (CCP)

The Continued Child Payment (CCP) is a lump-sum cash benefit program for long-term unemployed people (over 12 months) entering full-time employment or self-employment which is expected to last for at least 4 weeks. CCP provides for long-term unemployed and for participants in public employment programmes continuation of child support for 13 weeks, provided that they accept full-time employment (www.welfare.ie).

All Irish IWB programs are administrated by the Department of Social and Family Affairs, benefits are paid to the bank account of recipients.

Evaluation

According to Ochel (2001) the in-work benefits in Ireland have been successful in improving the income of low-paid working families.

In 2000, the BWTA was claimed by 34,506 persons. As the total number of long-term unemployed was 95,000, the program is considered to have considerable impact on reducing the long-term unemployment. In a survey, 73 per cent of recipients of BWTA stated that without the continued payment of unemployment benefits they would not have accepted work. 60 per cent of the BTWA recipients reported that they had been unemployed for more than two years (34% for more than 3 years), while 50 per cent had been actively seeking work in the previous 6 months.

The impacts of BWTA have appeared to be long-lasting and not temporary, as nearly two-thirds of former recipients stayed at work after three years of transition from unemployment to employment. At the same time, BWTA makes it possible for the employer to lower gross wages and there was evidence that nearly half of them have taken advantage of this possibility (Ochel 2001).

The BTWA program was reformed in 2001, when the program was targeted to very long-term unemployed – the duration of previous unemployment as a condition for eligibility was increased from 12 months to 5 years, to exclude persons who would probably have found a job even without the program.

Total expenditures on social welfare in Ireland amounted to €1.3 billion in 2004, representing 7.7 per cent of GDP. Of this €238.1 million (2.1 per cent of total social welfare expenditure or less than 0.2 per cent of GDP) was spent on various employment supports – FIS, BTWA, PTJI, Back to Work Enterprise Allowance, Back to Education Allowance, Farm Assist (Department of Social and Family Affairs 2004).

The expenditure on FIS was €55.8 million in 2004 (23 per cent increase compared to 2003). At the same time, expenditures on BTWA have declined, following modifications in the program conditions. In 2004, expenditures on BTWA amounted €5.7 million – a 33 per cent decrease compared to 2003 (Department of Social and Family Affairs 2004).

The FIS was received by 14,727 families (44,718 beneficiaries) in 2004. More than half of the recipients of FIS are lone parents and families with one or two children who receive considerable amount of benefit per week. 43% of families receiving FIS had one child, 28% two children; 62% were lone parent families. In 2004, most of the families received € 251-400 per week (Department of Social and Family Affairs 2004). FIS increases the net income to the level which is higher than unemployment benefits and thereby creates strong incentives to work (Ochel 2001).

At the same time, parameters of the FIS scheme create a situation where after a certain level of gross earnings there is no practical incentive to increase working hours in order

to increase family's net income, similar to the situation with the UK's WTFC program prior to 2003 reform.

Another problem, observed initially in respect of the FIS program, was the low take-up ratio. According to estimations, only 30% of potential beneficiaries in earlier years actually applied for FIS (Stephens 2005). Research by the Economic and Social Research Institute (ESRI) suggested that in 2004 the take-up ratio in expenditure terms was 35% - 38% of potential expenditure, while more likely to apply for a benefit were families with a higher entitlement (Brennan 2006). At the same time, the low take-up rate diminished the impact of FIS on poverty and employment.

In order to broaden the scope of eligible people and increase take-up, several changes were subsequently made (Missoc 2001):

- the earlier requirement of working 30 hours per week was changed to 38 hours per fortnight;
- program was made available to job-sharers;
- qualifying period in employment has been reduced from six months to three;
- income limits have been increased on a regular basis;
- net income instead of gross income is used to calculate the eligibility and amount of benefit.

Shifting to net incomes made more families eligible to FIS, in particular among middle income families (Combat Poverty Agency 1997).

Change in the requirements of working time has been necessary to adjust to the increasing variety in labour market and to provide sufficient income to people in non-traditional work. Providing FIS for people in non-traditional work (short working hours, job-sharing, short contracts) is significant for encouraging of female labour market participation since 35% of women were working part-time in 2004 in Ireland (OECD 2005).

Nevertheless, marginal earners with very small part-time jobs are not eligible for FIS. People working part-time are eligible for unemployment benefits and there is also the Part Time Job Incentive (PTJI) that provides for payments to long-term unemployed who accept part-time employment. Instead of their unemployed benefits they receive a weekly flat rate payment. (Department of Social and Family Affairs 2006)

Besides changing the program parameters, the Government has undertaken several campaigns to address the earlier problems of low take-up. In 1993, there was a campaign aiming at raising awareness of the employment incentive aspect of the scheme (Missoc 2001). Another extensive awareness campaign together with a free helpline to answer questions was carried out in 2005 (Brennan 2006).

In addition to low awareness about the program in earlier years, complicated and time-consuming application procedure and delay in receiving benefits were attributed to the low take-up rate (van Oorschot 1995).

The effectiveness of the CCP program and the net overall effect of all Irish IWB programs have not been studied.

Netherlands

Employed Person's Tax Credit (EPTC)

The EPTC is a tax credit for employed or self-employed people whose income from the current work is below €8,132. The amount of the tax credit depends on the income from employment (wages, profits from business activities, income from self-employment) and the age of a person. For persons up to the age of 57 the maximum amount of tax credit in 2006 is €1,357, increasing to €2,095 for persons aged 62-64 and declining then to €998 for persons aged 65 and over (http://www.belastingdienst.nl/variabel/buitenland/en/buitenland_en-20.html). The parameters of the tax credit program thus include additional incentives to encourage employment of older workers, aged 57-64.

Entitled to the maximum amount of EPTC are persons with income from employment greater than €17,729 per year (in 2005). For persons with income €17,729 or less, the amount of EPTC is reduced.

In contrast to tax credits in the UK, which are in essence top-up payments to eligible persons, the EPTC and other tax credits in the Netherlands are credits against income tax and national insurance contributions, reducing the amounts the person owes in tax and contributions. Various tax credits, including the EPTC, come in addition to the general tax credit (non-taxable allowance), which amounts to €1,990 in 2006. The maximum size of all tax credits can not exceed the total income levy, which is the total amount of taxes and national insurance contributions owed by the person.

The general tax credit and employed person's tax credit are taken into account by the employer or the benefit agency and reduce the amount of payroll tax the persons has to pay on wages or benefits.

The Dutch system of tax credits also includes a Child Tax Credit, which amounts to €802 (for persons aged under 65), provided the aggregate income of the household does not exceed €28,521. Above this threshold, a taper reduction rate of 5.7% is applied and above the income threshold of €44,034 the child tax credit is no longer payable. Single parents are entitled to an additional tax credit of €1,401.

As a general rule, partners are taxed individually in the Netherlands and also tax credits (including the EPTC) are applied individually. However, for entitlement to the Child Tax Credit, the total income of the household is assessed.

Tax credits are administrated by the Tax and Customs Administration. EPTC payments are made annually as tax returns after submitting the tax declaration.

Evaluation

Employment-related tax credits came into discussion in Netherlands in late 1990s due to the relatively high structural unemployment rate among low skilled workers, which was twice as high as among skilled workers in 1997. One explanation for this was a high replacement rate for low wage employees. This depressed the motivation of low skilled to search and accept a job. The rationale of employment tax credit was seen in decreasing the replacement rate for low skilled and low wage employees (Van Oers et al 2000).

If the EITC in US aims at reducing poverty, then the main purpose of EPTC in Netherlands is to tackle the problem of unemployment among the low skilled. For this reason, eligibility is individual and not based on household (Van Oers et al 2000).

Prior to introduction of the program, the potential effects of employment-related tax credits on the Dutch labor market were analyzed using the general equilibrium model MIMIC (Van Oers et al 2000). The model showed that the EPTC increases the income in all skill levels and thus, decreases the replacement rate. The credit has a biggest effect on the replacement rate of unskilled. In particular, people who did not participate on the labor market before an EPTC was introduced, may be encouraged to start working as the average tax burden drops.

Study by Nellissen et al (2005) showed that the EPTC increased participation by 12,000 persons in 2000. EPTC also influenced the working hours of people – the gains in terms of full-time employment are even larger (14,000). Low-educated persons have the largest advantage of the EITC, married men and high-educated persons the lowest. The costs of creating one full-time job were rather high in 2000. An extra full-time job created by EPTC cost €64,000. Nellissen et al (2005) also suggest that the EPTC has a more stable impact on job creation, compared to other policy measures like labor cost reduction, which in their view appear to be more effective in economically bad times.

Van Oers et al (2000) argue that in circumstances where there is a very high share of part-time employment, as is the case of Netherlands, the EPTC should be based on hourly and not yearly income, because as the target group of the EPTC is low paid and low skilled people, EPTC based on yearly income causes ill-targeting. Also Bovenmberg et al (1998) argue that linking EPTC to hourly wages instead of annual incomes would help to mitigate the trade-off between the goals of raising labor supply (measured in working hours) and fighting unemployment. They argue that EPTC based on hourly wages would be more effective in cutting unskilled unemployment, because within the same total budget, more tax benefits can be provided to full-time workers with low hourly wages.

Bovenmberg et al (1998) point out the trade-off between increasing the participation rate of partners (secondary earners) and reducing the rate of unskilled unemployment. In their view, EPTC based on hourly wage would be more effective in reducing the unemployment of low skilled people, but it is less effective in raising the labor force participation for women.

France

Prime Pour l'Emploi (PPE)

The French tax credit program, “La Prime Pour l’Emploi” (PPE), was launched by the Jospin government in spring 2001, against the background of a relatively high number of working poor and unemployment traps in the minimum guaranteed income program (RMI). In 2000, there were 1.3 million persons working for a monthly payment less than 533 Euros. At the same time an employee working for a monthly payment of 442 Euros or 50 per cent of the minimum wage (SMIC) lost entitlement to RMI. Considering also, that beneficiaries of RMI have access to certain in kind benefits (in particular for children), the advantage in getting a new job was very low, if not negative (Mandin and Palier 2002).

The PPE program introduced in 2001 aims at increasing income from work for the low-paid, with the twin objectives of redistributing income to the less-skilled and increasing the incentives to work for those with low potential earnings (Stancanelli 2005).

The PPE is a tax credit for low-income households where at least one person holds a job and where the declared taxable income is below a ceiling of 1.4 times the minimum wage SMIC for a single person or 2.1 SMIC for a couple. In 2005, the relevant income thresholds were respectively €12,606 for single persons and €25,211 for a married couple, while each child increased the income limit by €3,483. Thus, for example, for a couple with two children, the income threshold for entitlement to the PPE was €32,177.

The amount of PPE is calculated on the basis of a working time, family status, number of children and taxable income (Ribeiro and Ruivo 2005).

The PPE is made up of a variable component and a lump-sum component. The variable component is calculated on a graduated scale, increasing with the working hours (from 30% to 100% of minimum wage) and on a graduated decreasing scale according to the wage (from 100% to 140% of minimum wage). The lump-sum component of PPE takes into account the family status, with increases for inactive spouse and children (Ribeiro and Ruivo 2005).

PPE is paid to an individual (not the household), in spite of the fact that the means-test is based on total household income. However, the amount of the tax credit is low relative to similar programs in the UK and the US. Also, the child additions are very low and therefore the redistributive scope of the measure is considered rather limited (Stancanelli 2005).

Previously, the tax credit was allocated to the income tax and the difference was disbursed only in the subsequent year. From 2004 an advance is possible if some illegible requirements are met (see Ribeiro and Ruivo 2005).

Evaluation

Most of the available studies, which are based on simulation exercises using pre-reform survey and tax declaration data, conclude that the effects of the PPE on employment are limited (see Stancanelli 2005). Laroque and Salanié (2002) claimed the program to have small positive employment effects on French women's labor supply, which would amount to about 3000 new jobs. Choné (2002), looking at couples' labor market supply, estimated that the program would increase female employment by roughly 0.4%.

Stancanelli (2005) was first to use actual PPE program data to evaluate the employment effects and concluded that the tax credit increases incentives to work for non-employed persons. However, the program decreases incentives to work for married women with a working partner entitled to the tax credit, because of means-testing on total household income. It also reduces working hours for those recipients with earnings between 1 and 1.4 the minimum wage, who would receive higher tax credit payments if they were earning less.

At the same time Stancanelli (2005) notes that the announcement of the PPE policy measure may in itself have had an impact on individual behavior in spite of the relative small amounts of money paid by the program. On the other hand, individual work incentives are reduced by the time delay of tax credit payment.

In 2005, the total number of recipients of the PPE amounted to 8.8 million persons (over 14% of the total population), while total expenditures of the program amounted to €2.7 billion (about 0.2% of GDP). The average amount of PPE in 2005 exceeded €500. Against the magnitude of the program, its efficiency has been often regarded as low (AP 2006).

Lessons for the Central and Eastern European countries

The evidence from experience of the OECD countries with IWB programs indicates that tax credits appear to be effective in encouraging lone-parent families and households where no-one works to go to work. However, in some cases the tax credit has been reported to have actually lowered the employment rate of married women with working spouses. As benefits are income-tested, they raise marginal tax rates on families above a modest income level. The effect is concentrated on second earners, who can face these high marginal tax rates as soon as they enter the workforce, increasing the incentive to have just one bread winner and less gross earnings so as not to lose the credit (see St Martin and Whiteford 2003).

St Martin and Whiteford (2003) also argue that employment-conditional benefits work best when they are restricted to bringing in individuals who have little incentive to work otherwise.

Obviously, IWBs are not the only factor determining whether it pays to work. The economic equation includes many more elements, including the minimum wage, income tax and social security contribution rates, level of social assistance benefits etc. These and other context factors influence also the potential role of IWB programs in the whole policy package. In particular, the relevance of work incentives provided by IWBs depends on how the level of minimum wage compares with the rates of out-of-work social benefits.

Concerning the countries analyzed in this review, in France and the Netherlands, the minimum wage is relatively high, around 60 per cent of the median earnings of full-time workers (OECD 1998). On the other hand, the UK and Ireland are countries with relatively lower minimum wages.

One common argument holds that IWBs have relatively more importance in countries with low minimum wage to top-up the incomes of families with low incomes. Sometimes, IWBs have been even regarded as a policy measure complementary to a low minimum wage (OECD 1998; St Martin and Whiteford 2003). At the same time, it has been argued that compared to the minimum wage, the IWB are better targeted to deal with in-work poverty among families. Another positive feature attributed to IWBs is that they may act as a temporary earnings 'insurance' (OECD 1998).

Nevertheless, success of certain policies in some countries does not imply that the same would work in other societies. There is therefore no straightforward answer whether in-work benefits should be taken to the policy menu of decision makers in Central and Eastern Europe, and if yes, what is the scope for policy transfer from Western to Eastern Europe.

The choice of strategies, which work best to encourage work and reduce poverty at the lower end of the wage scale, is largely a matter of context.

As indicated above, IWBs appear to have relatively more importance for countries, which have a relatively high distribution of earnings, low minimum wage and where means-tested social assistance programs have created poverty traps. In many of the CEECs the earnings dispersion is relatively high, and the minimum wage rather low compared to average wage. This would indicate that the IWB programs could be considered among policy alternatives. Another alternative could be reducing the net replacement rate of social assistance benefits by increasing the minimum wage more than social assistance benefit rates. However, in some of the CEECs the Government does not enforce the minimum wage, but has delegated the issue to be negotiated between trade unions and employers' organization.

It shall be considered also that due to very high economic growth rates in almost entire region of Central and Eastern Europe, demand for labor force is currently high and real wages (including minimum wage) increase steadily. IWB programs in Western Europe were mostly introduced at times when these countries faced stagnation of job growth. Therefore the emphasis of these schemes was on encouraging supply side of the labor market.

Given the current context in Central and Eastern Europe, it could be argued that perhaps here the emphasis of possible IWB programs could be more on social cohesion aspects and redistribution in favor of families with low earnings (including single parents). Nevertheless, there is probably still some also room for encouraging employment. Albeit employment rates have been increasing and unemployment reducing, the share of long-term unemployment in total unemployment remains high.

Needless to say, IWBs are not without criticism. Critics have indicated that IWBs may undermine the wage floor as employers may be tempted to keep wages low, knowing that the government will make up the difference. However, the practical evidence in this respect is limited.

Qualitative studies of employers' experiences with tax credits from the UK have indicated also another adverse effect. In businesses where variable working hours are common, employers have found that because of tax credits, staff is increasingly unwilling to work flexibly and prefer stable hours so that their tax credit entitlement remains constant. In turn, employers are tempted to avoid recruiting potential tax credit recipients because of the inflexibility of recipients towards their working hours (Athayde et al 2003).

The IWB programs are designed to give incentives, but obviously, the behavioral response to these incentives varies both inside and across countries with such programs. This is *inter alia* influenced by interplay with other tax and benefit schemes, but also cultural factors (e.g. stigmatization, work morale etc.) may be relevant.

Obviously, there is also a potential interplay with labor market policies aiming at activation of unemployed persons. IWBs shall not be regarded as an alternative but rather

as complementary to active labor market policies. While some IWBs, like back-to-work-allowances, could be considered simultaneously as a part of the labor market policy package, the latter measures often do not relate to persons who already are in long-term employment. Therefore, the target groups of IWBs and active labour market policies do not always coincide (see also Blundell and Meghir 2002).

Bargain and Orsini (2006) have simulated the potential effects of the UK's WFTC scheme, if this were transferred to three other EU member states: Finland, France and Germany. Their simulations indicated that while effects on income distribution were considerable, the interaction of the new instrument with the structural characteristics of the economy and the population could lead to counterproductive secondary effects, like potential disincentives on employment of women in couples. In their view, the implementation of the reform could then only be justified if the social inclusion (i.e. transition into activity) of some specific household types (singles and single mothers) is valued more than a rise in the employment per se. Bargain and Orsini (2006) further argue that at least in Continental Europe and in Scandinavia attention should be shifted from policy transfer of IWBs towards demand side policies given the level of structural involuntary unemployment, and active labor market policies that aim at permanently increasing the productivity of less skilled workers. In other words, they again point out the limits of supply-side measures in promoting employment.

There are also political economy considerations related to possible policy transfer. In-work benefits, in particular tax credits, have emerged as the politically most acceptable instruments in tax-benefit reforms of many Anglo-Saxon countries (Bargain and Orsini 2006). This is against the background of relatively sophisticated income tax schemes with progressive tax rates and different tax breaks. At the same time, tax reforms in several CEECs (Estonia, Latvia, Lithuania, Slovak Republic) have introduced flat rate income taxes with simple structures and administrative procedures and very few extra deductions.

In Estonia, the non-taxable allowance currently amounts to two-thirds of the minimum wage. Families with two or more children have further tax deductions (currently amounting to two-thirds of the minimum wage for the second and each following child). As a result, the effective income tax rate for lower wage families with two or more children is often very low. Against political aims to reduce income tax rate from the current 24% to 20% by 2009 while increasing the non-taxable allowance so that there would be no income tax on minimum wage, introduction of tax credits based on weekly working hours would clearly sophisticate tax administration and does not look politically attractive.

Nevertheless, other types of in-work benefits, e.g. some context-tailored analogues of the British and Irish Back-to-Work-Allowances could be considered, in particular having regard to the relatively high share of long-term unemployed. Obviously, as the Central and Eastern European countries are not a homogenous group of countries, tax credits could still be analyzed as one of the policy alternatives for some states.

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IWB programs in the UK, Ireland, the Netherlands and France

| | UK | | Ireland | | Netherlands | France |
|------------------------------|--|------------------------|--------------------------------------|--|-----------------------------------|---|
| | WTC | CTC | BTWA | FIS | EITC | PPE |
| Program type | Tax credit | Tax credit | Cash benefit | Cash benefit | Tax credit | Tax credit |
| Responsible authority | Tax office | | Social welfare office | | Tax Office | Tax Office |
| Covered situation | Employed or self-employed persons | Families with children | Long-term unemployed taking up a job | Employed persons with children and net household earnings less than €165-905 (depending on the number of children) | Employed or self-employed persons | Employed persons with earnings less than 1.4 times minimum wage |
| Min working hours (per week) | 16 | - | - | 19 | No | No |
| Time limit | No limit | No limit | 3 years | 52 weeks (extension possible) | No limit | No limit |
| Mode of payment | Weekly or monthly through the bank account or post | | Weekly through the bank account | | Monthly through employers | Annually through tax office |

Source: Ifo; HM Revenues and Customs; compilation by author