Getting Jobs into Jobless Households:

Tax Credits, Welfare Reform and Wage Setting

by

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EXECUTIVE SUMMARY

I.   Introduction and Policy Objectives

This paper is concerned with designing and analysing a policy package with the main aims of reducing the unemployment rate, reducing the incidence of jobless households (especially jobless families with children), and reducing the proportion of the working aged population who are heavily dependent upon welfare.

This policy package would bring together:

- the wage-tax trade-off idea of the "Five Economists"; and
- the rationalisation of the income-support system and improvement of work incentives, consistent with the recommendations of the McClure Report.

An important feature of the proposed policy package is the establishment of an *employment credit*(to be used in the "wage-tax trade-off"),to be paid as tax credit The paper therefore pays particular attention to the idea of tax credits and argues that such a *employment credit* can be well integrated into a rationalised and coherent, modular income support system of the kind recommended in the McClure Report. The proposed *employment credit* would be carefully linked with the existing Family Tax Benefit Part A.

The paper also canvasses the idea that a *chid credit* could also be instituted as an extension of the existing Family Tax Benefit, as part of the modular income support system,

II.   Jobless Households

One of the three objectives listed above is to reduce the incidence of jobless households in Australia. This is a major explicit objective of welfare reform in Australia, as proposed by the McClure Report. This target may be an even more important focus than reducing the traditional unemployment rate, especially where children are present in the jobless households.

While employment levels in Australia have improved from the low levels experienced in the early 1980s, joblessness has become increasingly concentrated into jobless households. By 1997/98, over 16 per cent of working age households had no adult member in paid work, while nearly 1 in 6 children lived in such households. Indeed the incidence of jobless households with children is one of the highest in the OECD.

Part of the explanation for the growth in jobless households, lies in the changing structure of households. In particular there has been a shift towards single person households. Of at least equal importance, however, has been the polarisation of employment into either multiple job households or jobless households.

Of jobless households with children, lone parent households represent about sixty per cent, while about half of the children in jobless households are in lone parent households. One of the main causes of the particularly high incidence of jobless households with children by international standards, therefore, is probably a relatively high incidence of joblessness in lone parent households.

However, there has also been a considerable growth in jobless couple households and about half of the children in jobless households are in couple households. Further, couple households with children are the main household type that has experienced the process of polarisation of employment between "all work" and "no work" households.

III. Towards a Policy Package

In the face of the inter-related problems of an unemployment rate that remains stubbornly above six per cent, the sixteen per cent rate of jobless households, (in which about one in six children reside) and the related high incidence of households that depend heavily on income support, there is a strong argument that the major economic and social policy priority in Australia, is to increase both the supply of and the demand for labour, especially, from jobless households.

The Supply of Labour

The major thrust of welfare reform is to increase the supply of labour from jobless households (and households with very little employment – perhaps a few hours a week).

This requires a combination of improved work incentives, increased administrative requirements on income support recipients who have a capacity for work, and individualised service delivery to job seekers. Some progress has been made since the McClure Report in each area, but there is a strong case now, for a major push on work incentives.

Of the options available, an *employment credit* looks to be the most promising. Its effect on labour supply would be significantly positive and are discussed further in section IV below.

The Demand for Labour

While an increase in the supply of labour from jobless households can lead to a significant reduction in jobless households, there is also a very strong case for policies aimed at boosting the demand for labour, especially low skilled labour, which tends to be prevalent amongst the unemployed and in jobless households. This is the key to achieving a stronger growth in employment for a given rate of economic growth.

Sustained strong economic growth is one desired ingredient of an economy, to produce a growth in the demand for labour. However the employment content of growth has been disappointing in the 1990s, despite sustained strong output growth. It has become increasingly clear that economic growth alone will not solve the problem of unemployment and joblessness in Australia.

The other major determinant of labour demand is real-labour costs, which are driven primarily by what happens to wages. If the rate of growth of wages can be slowed, along with sustaining strong economic growth, then the demand for labour will grow more strongly.

It is this principle that led the so called "Five Economists" to propose (for a period of time), the provision of an *employment credit* for low-wage earners in low income families, in place of award wage increases; a kind of wage-tax trade-off.

The Wage-Tax Trade-Off of the "Five Economists"

At the last Safety Net Wage Case, the Australian Industrial Relations Commission (AIRC) awarded an $18 a week wage rise to award wage earners. It is very clear that many low-wage earners gained very little from this decision.

Take a family with two adults and two children, with one adult receiving the national minimum wage for a full-time job – that is $413.40 before the decision. If the partner is not working they also receive a parenting payment (partnered). They got the $18 a week increase in the gross earnings from the wage decision. But after changes to their taxes and

transfers, they were only just over $3 a week better off. This resulted primarily from the means test on parenting payment, plus income tax paid.

The award wage increase also raised the hurdle facing unemployed jobseekers, who are mostly low skilled. The effect of the wage decision on the national wage bill could be expected to reduce the number of jobs that would otherwise exist, by around 60,000 to 70,000 about 0.75 per cent.

If a wage tax trade-off could prevent similar decisions over the next four years, it is reasonable to expect that this would add around 3 per cent to the employment rate and take about 1.5 per cent off the unemployment rate. Low-wage earners in low-income households would also become better off, because they would gain more from the proposed *employment credit* than they would from award wage increases.

It is pleasing that the AIRC, in its Safety Net decision, indicated that it would take into account changes in taxes and transfers in future decisions.

Whether the government should rely on the AIRC in implementing a wage tax trade-off over a number of years, under its current terms of reference, however, is an important policy issue. There is a case for amending their terms of reference to increase the importance of the incomes of low wage earners in low-income households, and reduce the importance of preserving relativities between award wages and enterprise bargains.

The case could also be made, in the longer term, for minimum wages being set by Parliament having considered the recommendations of a group of experts on both the wages safety net and the income support system and on the inter-relationship between the two.

Towards a Modular Income Support System Incorporating an Employment Credit and a Child Credit

The McClure Report recommended a rationalisation of the income support system, to become simpler and more integrated. For example rather than operating completely separate income support payments for lone parents, disability support pensioners, and unemployed job seekers from other types of households, a modular system was proposed. This would include a base payment for everyone receiving income support, plus add-ons for such things as: the costs of living alone, the presence of children and the costs of disability.

There are good reasons to proceed with this type of reform, as part of the broad "welfare to work" strategy. There is also a strong case for one of the modules in this system to be a work incentive module that could be implemented as an *employment credit*. It is also a good idea to explore the idea of a *child credit* as the module to help families with children.

IV. The Use of Tax Credits

An Employment Credit

The "Five Economists" have proposed a particular form for an *employment credit*, to fit well into the current tax-transfer system. This would be attached to the current Family Tax Benefit Part A, in a manner that is illustrated in a diagram on page 13. This avoids the problem of "overlapping tapers", which could otherwise have led to serious disincentives to work for some households, as the tax credit is withdrawn. Just like the current Family Tax Benefit, in principle the employment credit could be administered though the benefit

system, rather than the tax system, although it is argued that there is a stronger case for it being paid through the tax system than for the child credit.

Modelling suggests that this *employment credit* would have a large positive impact on the labour supply of lone parents, a small positive impact on the labour supply of single males and females without children and on married males, and a small negative effect on partnered women's labour supply (with male partners working). A more developed paper on this topic, jointly with Professor Alan Duncan from the UK, will follow in the next few months.

A Child Credit

The idea that a tax credit could also be the mechanism for delivery of that component of the modular income support system that is for children is also explored, and design issues discussed. In principle this could consolidate into one payment the following existing payments: Family Tax Benefit Part A; Family Tax Benefit Part B; Child Care Benefit; and payments for newly born babies including Maternity Allowance and the new Baby Bonus. It could also, in principle incorporate that part of Parenting Payment (Single) that is due to the presence of a child and that part of Parenting Payment (Partnered) that is due to the presence of a child, although that is a less obvious proposal.

A more developed paper on this topic, jointly with Professor Alan Duncan from the UK, will follow in the next few months. That paper will examine the design, costing and likely behavioural effects of such a policy.

V. The Policy Package and Its Effects

Overview

The proposed policy package has a number of ingredients.

1. An *employment credit*, which will increase the supply of labour from jobless households. This credit will be the "work incentive module" in the new modular income support system (see 3 below).
2. This *employment credit* would be traded off against award wage increases allowing the real cost of labour, especially low skilled labour to be reduced significantly over the next three to four years, thus increasing the demand for labour, especially low skilled labour which is prevalent in jobless households.
3. Movement towards a more integrated, modular income support system This would include a base payment for everyone receiving income support, plus add-ons for such things as: the costs of living alone; the presence of children; the costs of disability; and work incentives.
4. In addition to the work incentive payment, it is possible that the component relating to the presence of children could also be in the form of a "*child credit*". This would build upon the current Family Tax Benefit.

Effect on Employment, Unemployment and Jobless Households

The main ingredient of this policy package that will lead to a boost in employment is the downward pressure on labour costs (especially the costs of employing low-skilled workers) from the restraint on minimum award wages. Over a three or four year period this is estimated to boost employment by about three per cent.

This, in turn, would reduce the unemployment rate by an estimated one and a half per cent, so that a five per cent unemployment rate should be achievable without raising inflationary pressure.

The increased work incentives, mainly due to the *employment credit*, is a complimentary policy that will help to ensure that a substantial proportion of the new jobs are taken by people from jobless households (or households with only a few hours of work) who are currently heavily reliant on welfare.

The *employment credit* would have a large positive impact on labour supply of lone parents, a small positive impact on the labour supply of single males and females without children and on married males, and a small negative effect on married women's labour supply (with husbands working). The large positive impact on lone parents will significantly reduce the incidence of jobless households. The smaller positive effect on single males and females without children, and on married males, would also have a negative impact on the incidence of jobless households. The only negative effect on labour supply (but a small one) would be on women in couples where the male is also employed. As the male is also employed this would not have any effect on the incidence of jobless households.

Effect on the Governments Budget

The Gross Cost of the Employment Credit

The cost of the *employment credit* for the government depends critically on its design and magnitude. The gross cost of the particular "Five Economist proposal" in Dawkins et al (2000), as costed by Lambert (2000) would be of the order of $1 billion in year 1, $2 billion in year 2 (as the tax credit is doubled) and $3 billion in year three. This would further increase if the policy was extended to a fourth year. Later estimates by Duncan (2002), suggest a cost about 17 per cent lower than this.

There is a case for examining ways of reducing the gross cost. One question that needs to be addressed is whether the *employment credit* needs to be as large as that proposed in Dawkins et al (2000). Given that the value of the tax credit to low-wage earners in low-income families, would be much higher than the value of an award wage increase that they would otherwise get, it may be possible to design an employment tax credit in the proposed wage tax trade-off with a gross cost of say $0.75 billion in year 1, $1.5 billion in year 2, and $2.25 billion in year 3, and $3 billion in year 4.

Savings from the "Fiscal Dividend" of the Policy

The policy package is designed to boost employment and to reduce unemployment, reduce the incidence of jobless families, and reduce the numbers relying heavily on income support.

First, for example, the anti-inflationary wage restraint would enable monetary policy to be more expansionary, than it otherwise would be, producing stronger growth in GDP, and higher tax revenue, lower unemployment benefits etc.

Second the effect on real labour costs would also lead to a boost in labour demand, higher employment and a stronger government budget as a result.

Third the improved work incentives will lead to greater movements from welfare to work, than have occurred in comparable periods of employment growth in the past.

Modelling of the wage tax trade-off by Richardson (1999) and Dixon and Rimmer (2001, 2002), suggest that in the long run, the policy will result in a net positive impact on the annual budget, because of the effect on output and employment. Dixon and Rimmer's modelling suggests that this could be within about five years. Richardson's modelling suggests that it might take a while longer.

It is reasonable to believe that the fiscal dividend from the policy package being discussed here, could be larger than that estimated by the modelling of the kind undertaken by Richardson (1999) and Dixon and Rimmer (2001, 2002), because of the welfare to work effects of the improved work incentives. That is greater movements from welfare to work, than have occurred in comparable periods of employment growth in the past. For example, analysis by Duncan (2002), presented in this paper, suggests that the up-front cost of the employment tax credits that go to lone parents, will largely be recouped due to the labour supply response.

It is also possible that by substantially reducing the unemployment rate and incidence of jobless families and heavy reliance on welfare, that there could be other savings to federal and state government budget that may not have been included.

More research on budgetary impact of the policy package is needed. However, if required, it seems quite possible that a policy package of this kind, that would substantially reduce the unemployment rate and the number of jobless households, could be designed to budget neutral within five or six years, and have a positive effect on the budget thereafter.

Given the broader economic and social benefit of the policy package, it is arguable that aiming for it to be budget neutral over a five or six-year period, is too stringent a test. If the government and the society are willing for the budget still to be incurring some costs, after that time, the confidence with which the government can proceed with the policy package would be further enhanced.

The Cost of the Possible Child Credit

If a *child credit* is implemented in the new modular income support system, the effect of this on the budget depends, of course, on the design of that tax credit. This will be examined in a future paper, with Professor Alan Duncan from the UK.

Offsetting Savings in the Proposed Modular Income Support System

In the whole reform package, there are other savings that could be offset against the cost of the tax credit. These could include the following.

- Indexing income support payments to the CPI, (currently some are indexed to the CPI (e.g Newstart) and others are indexed to average earnings e.g. (Parenting Payment (Single)).
- There may be savings associated with other aspects of the simplification and integration of the income support system, in relation to new entrants to the system, who may not receive the level of income support that they might have received had the system not been reformed (e.g. some lone parents).

In the first three years of the reform package, these savings though significant, can only be expected to be relatively modest offsets to the cost of the *employment credit*. After five or six years, however, these savings would become larger and could make a very significant contribution to the medium to long run fiscal effectiveness of the policy package.

VI. Conclusions

With unemployment remaining stubbornly above 6 per cent, a jobless household rate of 16 per cent, and with about one in six children living in such households, the development of a policy package to confront these problems should be Australia's major economic and social policy priority.

This paper provides an outline of such a policy package that would bring together the wage-tax trade-off idea of the "Five Economists" and the rationalisation of the income-support system and improvement of work incentives, consistent with the recommendations of the McClure Report on welfare reform. An *employment credit* is an important part of the proposed package, to be provided in place of wages safety net increases for three or four years. This should enable the unemployment rate to be reduced to around 5 per cent and the incidence of jobless households to be cut significantly.

While there would be substantial up-front costs to the government's budget, it should be within the scope for a budget that is benefiting from strong economic growth. Further the economic impact of the policy would generate substantial benefits for the budget in the medium to long-term. As well as achieving its employment objectives, the policy could be paying for itself in not much more than five years.

In simplifying and integrating the income support system, in addition to an *employment credit*, there is a case for considering the idea of a *child credit*, building on the existing Family Tax Benefit. The author will be undertaking further research on this and its economic implications, with UK expert, Alan Duncan.

1. Introduction and Policy Objectives

1.1. Introduction

This paper is concerned with designing and analysing a policy package with the main aims of reducing the unemployment rate, reducing the incidence of jobless households (especially jobless families with children), and reducing the proportion of the working aged population who are heavily dependent upon welfare.

This policy package would bring together:

- the wage-tax trade-off idea of the "Five Economists"; and
- the rationalisation of the income-support system and improvement of work incentives, consistent with the recommendations of the McClure Report.

An important feature of the proposed policy package is the establishment of an *employment credit* (to be used in the wage tax trade-off). to be paid as a tax credit.[2] The paper therefore pays particular attention to the idea of tax credits and argues that tax credits can be well integrated into a rationalised and coherent, modular income support system of the kind recommended in the McClure Report. The proposed *employment credit* would be carefully linked with the existing Family Tax Benefit Part A.

The paper also canvasses the idea that a *chid credit* could also be instituted as an extension of the existing Family Tax Benefit, as part of the modular income support system.[3]

The author of the current paper is one of the so called "Five Economists"[4], (see Dawkins 2002) and was also one of the members of the Reference Group that produced the McClure Report that recommended a simplified income support system as well as improved work incentives (Reference Group on Welfare Reform 2000).[5] In this paper, therefore, I seek to provide an outline how to put together a policy package that takes the broader approach to reducing unemployment and joblessness of the "Five Economists", and at the same time produces a simplified income support system and improved work incentives along the lines proposed in the McClure Report.

It is such an integrated package that is needed in Australia to reduce the unemployment rate, reduce the jobless household rate, and reduce the proportion of the working age population who rely heavily on income support.

1.2. The Policy Objectives

Despite the strong performance of the Australian Economy over the last decade, employment has not grown strongly enough to bring the unemployment down to an acceptable level. Reducing the unemployment rate down to a significantly lower number, perhaps 5 per cent, should be one of the objectives of policy.

A second objective, which is arguably becoming more important however, is to reduce the number of jobless households, particularly jobless households with children. Despite some growth in the proportion of the working age population that are employed, over the last

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[2] In principle, this could be paid as employment conditional benefit through Centrelink, rather than as a tax credit, although the author favours a tax credit for reasons outlined in section 4.3.

[3] However, in the case of the child credit there is a stronger case for implementing it through the benefit system., (see section 4.3)

[4] The other four are John Freebairn, Ross Garnaut, Michael Keating and Chris Richardson

[5] The McClure Report also noted the importance of the inter-relationship of the welfare system and the wages system, even though it consider that it was beyond its terms of reference to make specific recommendations about improving this relationship.

twenty years, there has also been a growth in the proportion of households (which contain working age people) that are jobless. In Australia there is a particularly alarming problem of the number of children living in jobless households. This stands at around one in six. Figure 1, shows that the jobless household rate with children in Australia is one of the highest in the OECD.[6]

Figure 1: Jobless Household Rate by Country for Households with Children (OECD 1996)
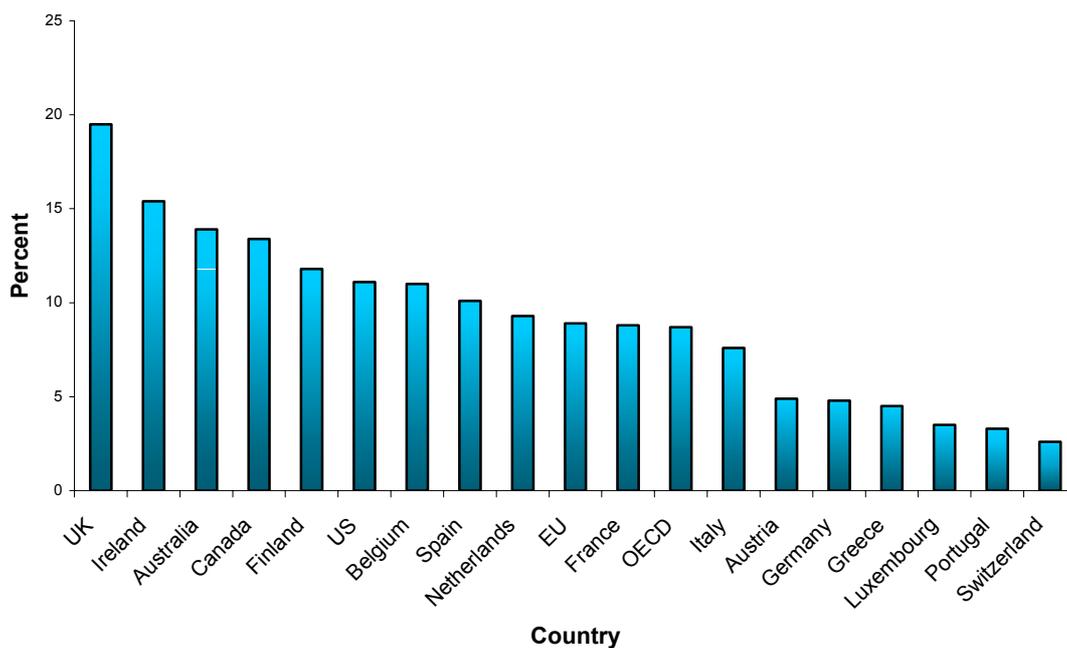
Source: OECD (1998)

The problem of reducing the number of jobless households is a major and explicit priority of the Commonwealth Government's welfare reform process, as recommended by the McClure Report (Reference Group on Welfare Reform 2000b). It is jobless households that have the highest dependency on welfare and the growth in welfare dependence over the last twenty years to a large extent mirrors this growth in jobless households. Another major objective of welfare reform as recommended by the McClure Report was to substantially reduce the proportion of the working age population who are heavily reliant on income support. The major priority of welfare reform is to move people, as far as possible, from welfare to work.

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[6] The jobless household rate with children, increased a little after 1996 but has probably reduced a little in the last two years, and may be slightly lower now than it was in 1996. However, it has not changed very much and is still probably one of the highest in the OECD.

2. The Growth and Incidence of Jobless Households[7]

While employment levels in Australia have improved from the low levels experience in the early 1980's, joblessness has become increasingly concentrated into households or jobless households, (Dawkins, Gregg and Scutella 2002a, 2002b). By 1997/98, over 16 per cent of working age households had no adult member in paid work.

Table 1 (taken from Dawkins, Gregg and Scutella 2002a), shows the aggregate employment rate (the individual non-employment or jobless rate is then calculated as one hundred minus the employment rate) and the overall incidence of jobless households from 1982 to 1997/98. Aggregate employment recovered between 1982 and 1990 after the early 80s recession and has since been broadly unchanged. By contrast, there has been a near continuous growth in the overall incidence of jobless households, from 12.7 per cent in 1982 to 16.3 per cent by 1997/98. This rise in jobless households mirrors the increasing number of households where a member is claiming one of the three major income support payments (unemployment, disability and lone parenthood).

Table 1: Comparison of employment rates and jobless household rates, 1982 to 1997/98

	Employment rate	Recipient rate of major Income Support Payments	Jobless households		Working age adults in jobless households		Dependent children in jobless households	
	%	%	N	%	N	%	n	%
1982	70.43	15.40	558,343	12.67	801,352	9.45	432,274	10.11
1986	71.90	14.88	641,127	14.88	925,112	10.76	496,474	11.52
1990	74.22	15.82	649,466	14.20	948,166	10.49	511,367	11.42
1994/95	73.06	20.44	751,886	15.48	1,112,880	11.79	616,341	14.20
1995/96	74.30	20.91	754,398	15.11	1,068,740	11.18	565,060	12.92
1996/97	72.79	22.92	821,939	16.77	1,161,142	12.27	686,529	15.58
1997/98	73.69	21.26	819,442	16.28	1,165,596	12.11	660,242	15.00

Source: Dawkins, Gregg and Scutella (2002a, p139)

As Dawkins, Gregg and Scutella (2002a) pointed out just as the incidence of jobless households has risen, so has the proportion of income units that depend heavily on government cash payments for their income.

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[7] This section of the paper is based upon on Dawkins, Gregg and Scutella (2002a, 2002b)

"The Reference Group on Welfare Reform (2000a) noted that between 1986 and 1996 the proportion of workforce-age income units with at least 90% of their income from government cash payments rose from 11.9 to 14.1% (Technical and other appendices, Table 3.1, p28). Again this was a period over which employment rose. So the rise in jobless households is mirrored in terms of rising welfare dependency". Dawkins, Gregg and Scutella (2002a p137).

Table 2 also shows the proportions of working age adults and the proportion of children in jobless households. Both of these have also risen over the period, with the proportion of dependent children in jobless households rising at a notably faster rate.

"The proportion of children in jobless household having risen by 5 percentage points to 15 percent. Labour force data published by the Australian Bureau of Statistics (1999) suggests that the upward trend in the number of children living in jobless families has continued over recent years with about 860,000 (17.4 per cent) of dependent children living in jobless households in June 1999." Dawkins, Gregg and Scutella (2002a, p137)

Thus about 1 in 6 children live jobless households. Indeed, as we have seen, in Figure 1, the incidence of jobless households with children is one of the highest in the OECD.

Part of the explanation for the growth in jobless households, lies in the changing structure of households. In particular there has been a shift towards single person households. Of at least equal importance, however, has been the polarisation of employment into either multiple job households or jobless households, (Dawkins, Gregg and Scutella, 2002b).

Table 2 shows that of jobless households with children, lone parent households represent about 56 per cent and this has grown from about 45 per cent on the early 1980s A major cause, therefore, of the high incidence of jobless households with children, by international standards, is probably a high incidence of joblessness in lone parent households.[8]

However, while about 56 per cent of jobless households with children are lone parent households, Table 3 shows that this accounts for a lower proportion of the children in jobless households, about 51 per cent. The remaining 49 per cent are in couple households. Table 4 shows that the jobless household rate is especially high and growing in large families with four or more dependent children, albeit a relatively small group in the population.

Just as about half of children in jobless households live with both parents, it should be noted that couple households *with children* are the main household type that have experienced the polarisation of employment between "all work" and "no work" households, (Dawkins, Gregg and Scutella 2002b). Shifts in employment away from less educated men towards prime aged better educated women, explains about 40 per cent of the adverse shift against couples with children.

Hence there is a large shift in patterns of employment in households with children, way from a dominant single male earner toward a more dual earner and no earner (couple and single) households with children.

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[8] The factors underpinning international differences in the incidence of jobless households is the subject of a current study at the Melbourne Institute

Table 2: Jobless households with children – by Sole Parent and Couple Households (percentage)

	1982	1986	1990	1994/95	1995/96	1996/97	1997/98
Sole parent households	45.09	53.39	55.15	49.63	55.28	58.78	56.06
Couple households	54.91	46.61	44.85	50.37	44.72	41.22	43.94

Source: This table is an extension of the analysis in Dawkins, Gregg and Scutella (2002a)

Table 3: Children in Jobless households – by Sole Parent and Couple Households (percentage)

	1982	1986	1990	1994/95	1995/96	1996/97	1997/98
Sole parent households	42.39	49.99	50.64	46.98	54.53	55.84	51.03
Couple households	57.61	50.01	49.36	53.02	45.07	44.16	48.97

Source: This table is an extension of the analysis in Dawkins, Gregg and Scutella (2002a)

Table 4: Jobless household rate by number of children, 1982 to 1997/98

	1982	1986	1990	1994/95	1995/96	1996/97	1997/98
One dependent	10.39	11.27	12.98	14.8	14.06	16.14	15.74
Two dependents	8.25	9.93	9.84	10.8	12.82	11.96	12.00
Three dependents	9.57	12.29	10.92	15.82	9.98	15.68	14.56
Four or more dependents	16.58	15.42	15.58	21.84	17.83	26.56	25.00

Source: Dawkins, Gregg and Scutella (2002a p.140)

3. Towards a Policy Package

3.1. Introduction

In order to achieve all the objectives outlined in section 1, it will be necessary to implement policies that will significantly increase both the supply of and the demand for labour, especially from jobless households.

On the supply side, we need to increase the labour force participation rate (and in some case increase hours of work from just a few hours a week), by engaging people into the labour market especially out of jobless households (e.g. lone parents, disability support

pensioners) as well as increasing the incentives for the single unemployed and the unemployed in jobless couples to search for and accept jobs when offered them.

On the demand side, we need to increase the demand for labour, especially low skilled labour in jobless households (and households with very few hours of paid employment).

Labour supply policies are discussed in section 3.2. and especially the role that an *employment credit* can play in providing incentives for people to move form welfare to work. Labour demand policies are discussed in section 3.3.

In section 3.4., the wage tax trade-off proposed by the Five Economists, is discussed, and how it would increase both the supply of and demand for labour.

In section 3.5. the case for a more integrated modular income support system is discussed. This will lead on, in the subsequent section 4, to a discussion of the potential role of tax credits in such a rationalised income support system.

3.2. Labour Supply Policies

3.2.1. "Sticks", "carrots" and services

The major thrust of welfare reform is to increase the supply of labour from jobless households (and households with very little employment – perhaps a few hours a week).

This requires a combination of improved work incentives, increased administrative requirements on income support recipients who have a capacity for work, and individualised service delivery to job seekers. Some progress has been made since the McClure Report in each area[9], but there is a strong case now, for a major push on work incentives.

3.2.2. Work Incentives, Replacement Rates and Effective Marginal Tax Rates

The interaction of tax rates and means tested social security benefits lead to high effective marginal tax rates for many low-income families. Increased targeting of welfare payments in the 1980's along with an increasing generosity in payments may be one of the contributing factors that led to the rising occurrence of the jobless household (Dawkins, Gregg and Scutella 2002a).

Figure 2 presents evidence on the growth in the "replacement rate" for households of different types since the early 1980s, and gives a priori evidence that growing work disincentives may have contributed to the growth in the incidence of jobless households. These replacement rates represent the proportion of the income that could be obtained by the household if it held one full-time minimum wage job, relative to that which could still be obtained if the household had no job and relied exclusively on income support payments. Replacement rates for low paid part-time jobs can be even higher. Furthermore these illustrative figures do not include the withdrawal of Rent Assistance for the large proportion of those renting privately who live in jobless households.

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[9] The first policy package following the McClure Report was called *Australians Working Together*. This provided for an upgrading of the individualised service delivery to Centrelink customers and introduced some new obligations in benefit recipients, especially lone parents. A 'working credit' was introduced to reduce the loss of earnings experienced by benefit recipients who take temporary employment, which results from benefits being calculated on the basis of each fortnightly level of earnings.

Figure 2: Net Replacement Rates of income support versus minimum age, various non-renter income unit types
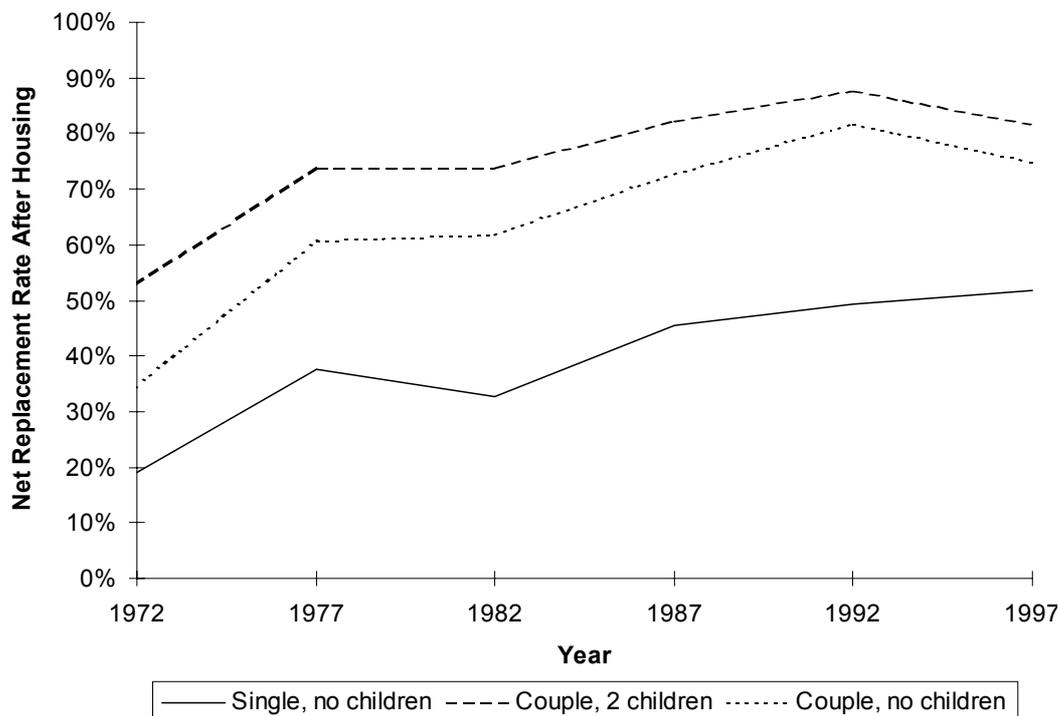
Source: Reference Group on Welfare Reform (2000b), Appendix 4, p.50

To give an idea of the work incentives that a jobless couple currently faces, Dawkins Gregg and Scutella (2002a) presented the following two examples, one with two children and one with no children. They assumed that the couple is on allowances with rent assistance.

"For a couple without children an increase in wage income from $0 to $500, (which might result from the couple taking one full-time job at a wage a little higher than the minimum possible, would result in an increase in net income of just $73.66. For the couple with two children net income would increase by $141.52. When you consider the costs of job search, travel to work etc., this make the decision to take such a job look barely economic. If both partners obtained jobs worth $500 each the effect on net income is more than twice as great ($412.00 with no children and $344.90 with two children)[10].

For families without children (and even for those with children prior to the recent reforms) there are substantial extra disincentives to take full-time work at or just above the minimum wage. For example, a single adult without children with a $400 a week income receives $171 more than being on welfare without rent allowance but $130 with. In contrast the returns to being a second earner are very large. An additional $400 a week second income on top of a first income at the minimum wage produces a net household gain of $255 (or $217 with Rent Assistance).[11]"

Dawkins, Gregg and Scutella (2002a p.151)

For some families effective marginal tax rates can exceed 100%. This happens for example, for some families who have a Youth Allowance child as well as children who attract the

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[10] Prior to the reforms to the generosity of family payments and taper rates (introduced with the new tax system), these figures would look even less attractive for families with children.
[11] Reference Group on Welfare Reform (2000b), Technical and other appendices, Table 4.1, pp46-47.

Family Tax Benefit. This is due to the overlap between the Means Test for FTB (A) and the Youth Allowance Parental Income Test.

3.2.3. *Reforming the Income support system to improve work incentives*

The McClure Report noted that the Australian social security system is tightly targeted to people in need, which could be viewed as a strength in terms of the cost to taxpayers and providing limited assistance to those who can look after themselves. However, it went on to argue that this tight targeting can significantly reduce work incentives as social security payments are withdrawn at relatively high rates and income tax is payable.

In addition, means tests for different benefits sometimes overlap, so that individuals or families may face two or more tapers on different benefits at any one time (Keating and Lambert 1998a, 1998b). This problem of high effective marginal tax rates means that people sometimes receive little or no increase in disposable income from extra work and the resultant earnings.

It noted that the most severe effective marginal tax rates related to couples, as outlined in 3.2.2. above.

There are, broadly speaking, two possible approaches to ensuring adequate incentives for people to take up and to stay in paid work. One is to reduce the level of benefits paid to people when they are not working. The other is to increase the amount of income received when a person is working. This can be done by increasing people's earnings (for example, by increasing the minimum wage), by cutting taxes (thus increasing people's take-home pay) or through in-work benefits that offer additional assistance to low-paid workers in low-income families. Increasing minimum wages as not favoured as the approach because it would cut across the objective of increasing employment opportunities for disadvantaged people.

On using income tax cuts it was argued that

"while general reductions in income tax would not be expected to have an adverse effect on low-wage employment, it would also be relatively ineffective in targeting the most disadvantaged families, as much of the benefit of tax cuts would flow to people in middle to higher income households."

(Reference Group on Welfare Reform, 2000b p26)

The terms of reference of the Reference Group precluded the cutting of anyone benefits. And as a general principle they were against cutting an persons benefits. They therefore concluded that "in-work benefits" was the preferred approach.

(Reference Group on Welfare Reform, 2000b p26).

3.2.4. *"In- Work Benefits"*

In-work benefits, i.e. income support payments received while also receiving wage income, can be of two kinds: supplementing earnings through basic income support payments; or employment conditional benefits.

One idea canvassed was whether to reduce the withdrawal rate on Newstart and other allowance payments, thus moving this income test towards the income test applying for pensions. However, there is major problem with this idea. That is that too large a reduction in the withdrawal rate would, reduce the incentive for some people to take-up full-time work, unless some form of benefit matched it for people in full-time work. It is important that improved incentives for part-time work should not unduly compromise incentives for full-time work.

One radical method of increasing the incentive to work full-time would be to enable full time employees to become eligible for Newstart allowance or the proposed participation support payments discussed above, could be extended to full-time workers. However, this would be a costly approach and unlikely to be cost effective.

The other option, which looks more promising, is to introduce an employment conditional benefit, i.e. a benefit that is paid only to people who have income from employment or who have a certain minimum level of employment.

This can, in principle, be implemented either through the benefit system or through the tax system. Overseas examples include the Working Families Tax Credit in Britain and the Earned Income Tax Credit (EITC) in the United States.

The McClure Interim report, commented on the pros and cons of such employment conditional benefits

"There is considerable research available on the potential impact of schemes such as the EITC. Firstly, they can make a significant difference in encouraging income support recipients into work. This is especially the case for lone parents in the United States. Their impact on couples with children is less positive. Although they induce some people to move from income support to work, they also reduce workforce participation by some second earners in a family as assistance is withdrawn at higher income levels. In the Australian context, it would be critical to integrate any such tax credit with the new Family Tax Benefit to ensure that the expected positive work incentive effects flowing from the ANTS package were not compromised."

(Reference Group on Welfare Reform 2000a p44)

Subsequent research at the Melbourne Institute (Dawkins et al 2000), in association with Simon Lambert, then at NATSEM (Lambert 2000), has resulted in a proposal, linked with the Five Economists Plan, which would enable an *employment credit* to be well integrated with the ANTS tax system. This involves attaching the *employment credit* to Family Tax Benefit Party A. This proposal, its costs and its likely effects on labour supply, is outlined in section 4.2 below.

3.3. Labour Demand Policies

While an increase in the supply of labour from jobless households can lead to a significant increase in employment, there is also a very strong case for policies aimed at boosting the demand for labour, especially low skilled labour that tends to be prevalent amongst the unemployed and in jobless households.

Sustained strong economic growth is one desired ingredient of an economy, to produce a growth in the demand for labour. However, as can be seen in Table 5 the employment content of growth has been disappointing in the 1990s, despite sustained strong output growth. It has become increasingly clear that economic growth alone will not solve the problem of unemployment and joblessness in Australia.

Table 5. Economic and Employment Growth in the 1980s and 1990s (Average annual rates of change)

	1978-79 to 1989-90 per cent	1989-90 to 1999-00 per cent
GDP per capita	1.8	2.1
Employment	2.4	1.3
Productivity (GDP per hour)	1.0	2.1
Real wages	0.1	1.7

Source: Dawkins and Keating (2002)

The other major determinant of labour demand is real-labour costs, which are driven primarily by what happens to wages. If the rate of growth of wages can be slowed, along with sustaining strong economic growth, then the demand for labour will grow more strongly.

It is this principle that led the so called "Five Economists" to propose (for a period of time), the provision of a tax credit for low-wage earners in low income families, in place of ward wage increases; a kind of wage-tax trade-off.

3.4. A Wage Tax Trade-Off: "The Five Economists' Plan"

At the last Safety Net Wage Case, the Australian Industrial Relations Commission (AIRC) awarded an 18-a-week wage rise to award wage earners. It is very clear that many low-wage earners gained very little from this decision.

Take a family with two adults and two children, with one adult receiving the national minimum wage for a full-time job – that is $413.40 before the decision. If the partner is not working they also receive a parenting payment (partnered). They got the $18 a week increase in the gross earnings from the wage decision. But after changes to their taxes this resulted primarily from the means test on parenting payment, plus income tax paid.

The award wage increase also raised the hurdle facing unemployed jobseekers, who are mostly low skilled. Estimates from the Five Economists suggest that the effect of the wage decision on the national wage bill could be expected to reduce the number of jobs that would otherwise exist by around 60,000 to 70,000 about 0.75 per cent.

If a wage tax trade-off could prevent similar decisions over the next four years, this could add about 3 per cent to the employment rate and take about 1.5 per cent off the unemployment rate. Low wage earners in low income households would also become better off, because they would gain more from the proposed employment credit than they do from award wage increases.

A more detailed outline of the five economists plan, and its likely effect on employment and the distribution of income, is provided in Appendix 1.

It is pleasing that the AIRC, in its Safety Net decision, indicated that it might take into account changes in taxes and transfers in future decisions.

Whether the government should rely on the AIRC in implementing a wage tax trade-off over a number of years, under its current terms of reference, however, is an important

policy issue. There is a case for amending their terms of reference to increase the importance of the incomes of low wage earners in low-income households, and reduce the importance of preserving relativities between award wages and enterprise bargains.

The case could also be made, in the longer term, for minimum wages being set by Parliament on the recommendation of a group of experts on both the wages safety net and the income support system and on their inter-relationship.

3.5. Towards the Modular Income Support System Proposed by McClure[12]

The McClure Report recommended a rationalisation of the income support system, to become simpler and more integrated. For example rather than operating completely separate income support payments for lone parents, disability support pensioners, and unemployed job seekers from other types of households, a modular system was proposed. This would include a base payment for everyone receiving income support, plus add-ons for such things as: the costs of living alone, the presence of children and the costs of disability.

There are a number of arguments against having a system as complex as the current system, with its array of benefits and associate means tests and taper rates, many of which overlap. The first is that people do not understand the way that it operates and are uncertain about the effects on their net incomes from changes in their private incomes due to extra paid work. If people are risk averse this can make the disincentive to work greater than it would be in a less complex system. This argument, therefore, is part of the thrust for stronger incentives to work. Further, the complexity of the system is such that reforms aimed at a particular objective can have unintended consequences.

A related point is that much of the interaction between clients and Centrelink is concerned with dealing with the complex payment system. If the system was simpler the relationship between clients and Centrelink could be more focussed on helping to raise the chances of economic and social participation of those on benefits.

Another set of arguments relates to the categorical structure of the income support system. There is a division of recipients into rigid categories of one type of pension or allowance and it's associated payments and means tests and any associated mutual obligations and associated employment assistance services. These rigid categories imply that there is a large variation between categories and little variation within categories and that people circumstances do not change much. The Reference Group considered that these were false assumptions that need to be remedied. (Reference Group on Welfare Reform 2000a, p.34.)

On the simplified payment structure the McClure Report outlined a framework for developing a more streamlined system. It was argued that a simpler approach than the current pension / allowance divide would be to adopt "a modular construction of the income support payment rate". This could include a standard base rate of payment plus add-on modules to address various additional needs such as the costs of children; the extra cost of living as the only adult in a household; any additional costs of lone parenthood; additional costs of childcare; housing costs above some specified level; costs of disability; and remote area costs. (Reference Group on Welfare Reform 2000b p.23)

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[12] Section 3.5. is based on the authors discussion of he case for welfare reform as proposed by the McClure Report, in a Policy Forum on Welfare Reform in the *Australian Economic Review,* (Dawkins 2001)

4. Tax Credits

4.1. Tax Credits

As outlined under 3.5 above, there are good reasons to proceed with this type of rationalisation of the income support system, as part of the broad "welfare to work" strategy. There is also a strong case for one of the modules in this system to be a work incentive module that could be implemented as an *employment credit* implemented through the tax system. In a modular system there is a powerful argument that one of the modules should be designed to promote work incentives. The basic effect of all the other modules is to deter work, because they are received whether a person is working or not. This deterrence effect can be ameliorated by linking the payments with activity requirements, and by allowing some proportion of the benefit to be retained when a person is receiving a limited level of earnings. But neither of these kind of policies are as fundamental in their approach to encouraging work as an "*employment credit*".

It is also a good idea to explore the idea of a separate child tax credit as the module to help families with children. Experience with tax credits in the UK has led the UK government to look at reforming their tax credit system to achieve such separation, (see Appendix 2).

Thus it would be clear in the modular system, which module to use for which purpose. If the aim is to increase work incentives, then the *employment credit* is the instrument. If it is to provide extra support for children in jobless households, then the *child credit* would be the instrument.

4.2. Increasing work incentives through an employment credit[13]

4.2.1. Introduction

As noted in section 3.5. above the McClure Report was concerned about the problem of integrating an employment conditional tax credit with Family Tax Benefit to ensure that the expected positive work incentive effects flowing from the ANTS package were not compromised.

Dawkins et al (2000) have outlined a particular form for an *employment credit,* to fit well with the ANTS package and to be suitable for using in a wage tax trade-off along the lines of the five economists plan. It was developed by Simon Lambert in consultation with Dawkins and was a further development of the idea first developed by Keating and Lambert (1998a, 1998b). This would be attached to the current Family Tax Benefit Part A, in a manner that is illustrated in Figure 3 in which EC is short for the *Employment Credit*.[14] This avoids the problem of "overlapping tapers", which could otherwise of led to serious disincentives to work for some households, as the employment tax credit is withdrawn for higher income households.

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[13] The material in this section which reports the effect of the tax credit on the labour supply of lone parents is taken from Duncan (2002) which is being further developed by the author of the current paper with Duncan into a forthcoming joint paper.

[14] The case illustrated in Figure 3 corresponds to a family with two children aged 8 and 13 as at July 2000.

Figure 3: Family Tax Benefit Part A plus an Employment Credit (EC)
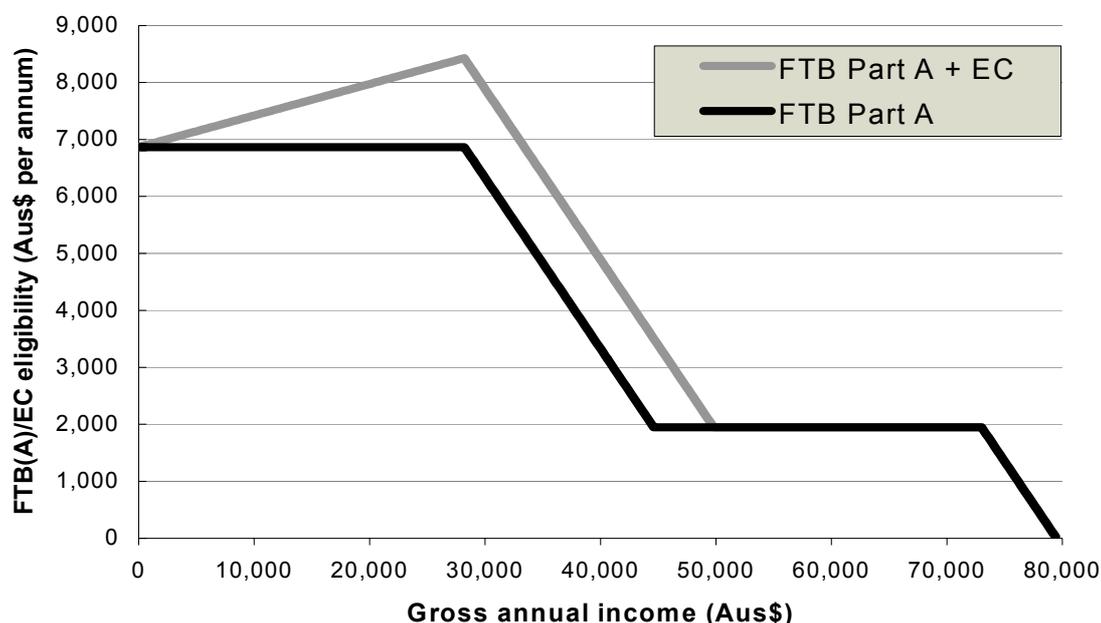
Source: Duncan (2002 p.19)

The basic *employment credit* (EC) proposal of Lambert (2000) would be to provide a maximum credit of $30 per week to the recipient. This would be introduced over a three year period, in roughly equal amounts, as an alternative to award wage increases in the Wages Safety Net Cases.

There were no specific hours conditions for EC eligibility in the Lambert (2000) proposal. For the series of simulations presented Duncan (2002), he experimented with the structure of the EC, both by varying the level of the maximum EC, and by introducing specific hours conditions for entitlement, of the form that currently limit entitlement in the UK WFTC system. Specifically, he examines a range of variants to the EC that restrict entitlement to lone parents who choose to work 10, 20 and 30 hours. And he considers the effects of increasing the maximum entitlement to EC to $40 per week.

Table 6 summarises the overall costs of these EC variants (expressed in Aus$ millions), using the Melbourne Institute Tax and Transfer Simulator (as described in Creedy, Duncan, Harris and Scutella, 2002). It is important to note that these simulated costs are *static*, in the sense that they *do not* include any adjustments for changes in labour market behaviour following the introduction of the EC. The Lambert (2000) proposal (to be introduced over a three year period) is modelled by Duncan to cost around Aus$2.5billion[15], or around 22% of the overall cost of FTB payments. By introducing hour's conditions for entitlement, these (static) costs are reduced to a degree. For example, if entitlement were restricted to those working 20 hours or more, then the overall cost of the credit reduces to around Aus$2.3billion.

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[15] This estimate is lower than that of Lambert (2000). This needs further examination.

Table 6: The simulated cost of the Lambert (2000) Employment Credit and variants (in Aus$millions, and as a proportion of the cost of FTB payments)

	Value of *Employment Credit* (Aus $ per week)			
	30		40	
Hours condition	Δ cost	Δ %	Δ cost	Δ %
no limit	+2482	*+22%*	+3518	*+31%*
Hours>10	+2460	*+21%*	+3488	*+30%*
Hours>20	+2310	*+20%*	+3281	*+28%*
Hours>30	+2088	*+18%*	+2969	*+26%*

Source: Duncan (2002, p28)

These cost savings are relatively modest, since many households will lose much or all of their entitlement to *employment credit* before reaching the hours condition for eligibility. The cost of the basic Lambert (2000) credit increases significantly, from Aus$2.5billion to Aus$3.5billion if the maximum credit is increased to $40 per week. Not only does the *employment credit* increase for those previously eligible for the $30 credit, but there will be some previously non-eligible workers who are entitled to the more generous credit.

4.2.2. The Effect on Lone Parents

Table 7 reports the results of a series of simulations by Duncan (2002) of the labour supply responses of lone parents to different variants of the Lambert (2000) proposals.[16]

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[16] The model of labour supply used to simulate the employment effects of the *employment tax credit* for lone parent households in Australia is described fully in Duncan and Harris (2002). For a discussion of how econometric models of this form are used in simulation routines in general, and in the Melbourne Institute Tax and Transfer Simulator in particular, see Creedy, Duncan, Harris and Scutella (2002). The model allows for quite flexible preferences over hours of work and net incomes, and accounts for fixed costs (including childcare costs) that affect the likelihood of employment. These costs differ by the age and number of children. An important feature of the models we use is that they allow preference heterogeneity across household types. That is, preferences and costs are allowed to vary with observable factors such as age and demographic composition. Moreover, they are also allowed to depend on unobservable characteristics. We use the model to generate a *probability* that a person with a certain set of observed characteristics will participate or work a certain number of hours. This probability should be interpreted as the proportion of people in the population with these characteristics that carry out the action being evaluated (e.g. participation in the labour market). Simulating the effects of the reform involves estimating the changes in these probabilities (proportions) as a result of the policy being introduced.

Table 7: Employment effects of the Employment Credit among lone parents (proportional increase in employment, and average hours change)

	Value of *Employment Credit* (Aus $ per week)			
	30		40	
Hours condition	Δ emp (%)	Δ hours	Δ emp (%)	Δ hours
no limit	+5.1%	+1.5	+6.4%	+1.8
Hours>10	+4.7%	+1.5	+6.3%	+1.9
Hours>20	+4.1%	+1.5	+5.9%	+2.0
Hours>30	+2.6%	+1.3	+3.6%	+1.7

Source: Duncan (2002) p.29

The basic $30 per week *employment credit*, linked to FTB Part A, is modelled to increase employment rates among lone parent households by around **5.1 per cent,** with average hours increasing by around 1.5. So, the main effect of the *employment credit* is on participation, a feature common to many equivalent simulations of the effects of *employment credits* on lone parents' employment incentives in the US (for example, in Eissa and Liebman, 1996) and the UK (see Blundell, Duncan, McCrae and Meghir, 2000). As hour's conditions are introduced to the $30 credit, we see a reduction in the simulated employment response, for reasons explained earlier in the paper. Restricting eligibility to those who choose to work 20 hours is modelled to result in a **4.1 per cent** increase in employment among lone parents.

One can see how hours conditions and increases in the level of entitlement can be combined to improve the efficiency of the *employment credit* in promoting employment. If, for example, entitlement to the *employment credit* were limited to those lone parents who choose to work for 20 hours or more, then the employment gain reduces from 5.1 per cent to 4.1 per cent. However, if the maximum *employment credit* is then increased from $30 to $40 per week, the simulated increase in employment rises to **5.9 per cent** among lone parent households.

Finally, Table 8 compares the costs of the *employment credit* among lone parent households when one ignores behavioural responses to those that take full account of the simulated increases in employment. As lone parent households move into employment to take advantage of an *employment credit*, their entitlement to other allowances, and the amount of tax they pay, will adjust also. If one measures the change in the overall net cost to the Australian government of an *employment credit* (as a proportion of the net cost of payments minus taxes paid), the basic Lambert (2000) plan ($30 per week, no hours condition) would increase net costs in respect of lone parents by around **2.6 per cent** when behavioural responses are ignored. However, if one factors the likely increases in employment into this assessment, the *adjusted* net cost is only **0.2 per cent**.[17]

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[17] It is unlikely that such flowbacks would be repeated for other demographic groups, whose employment responses are likely to be more modest.

Table 8: The adjusted net cost of the Employment Credit among lone parents

| | Value of Employment Tax Credit (Aus $ per week) | | | |
| | 30 | | 40 | |
Hours condition	Static (%)	Adjusted (%)	Static (%)	Adjusted (%)
no limit	+2.6%	+0.2%	+3.6%	+0.4%
Hours>10	+2.6%	+0.0%	+3.5%	+0.3%
Hours>20	+2.6%	-0.6%	+3.2%	-0.5%
Hours>30	+1.8%	-1.2%	+2.4%	-1.5%

Source: Duncan (2002), p.30

4.2.3. The Effect on other Household Types

Preliminary modelling suggests that a relatively small positive impact on the labour supply of single males and females without children and on married males, and a small negative effect on married women's labour supply (with husbands working). This will be further developed and reported in a forthcoming paper with Alan Duncan.

4.2.4. Designing an Employment Credit for a Wage-Tax Trade-Off

When a tax credit is to be used in a wage tax-trade-off, consideration must be given to the design features that are appropriate for this purpose. One consideration here is what the Australian Industrial Relations Commission (AIRC) would see as equal or superior to an award wage increase. We have noted that award wage increases are of very little value to many low wage earners in low-income families and the kind of tax credit proposed by the five economists would be of considerably higher value to most low wage earners in low-income families. To the extent that the AIRC sees its safety net adjustment as a policy aimed at low-wage earners in low-income families, this should make a compelling case.

As some low-wage earners in low-income families only work a few hours a week, there is an argument that, in this context, a minimum hours requirement may not be appropriate. It was for this reason that the Lambert (2000) proposal outlined in Dawkins et al (2000), is for a tax credit to be from the first hour of work. However, this is an issue that might require further discussion.

Further, if the case for a safety net adjustment is strongest for supporting families with children (in-keeping with the early tradition of the arbitration system in the form of the famous Harvester Decision), there might be a case for a more generous credit to families with children than to couples without children or to singles. If this is thought to be to the case, then it is arguable that an adjustment of the family tax benefit or a new child tax credit might even be the appropriate instrument. This requires further discussion.

If the AIRC is more concerned about those people relying on the award system per se, as opposed to enterprise bargains, regardless of their family income, this will make the policy implementation harder. There are a substantial number of minimum award wage earners in middle and high-income families who would not benefit from a tax credit for low-income families.

It does seem inappropriate in the more decentralized wage setting system for a safety net decision to focus on the needs of high-income families. So it is to be hope that this problem would not arise. Having said that there are arguments for a national minimum wage, which would apply to workers regardless of their household income. This is to avoid the potential use of monopsony power in the labour market to exploit low-wage workers. There is even the possibility where monopsony power exists, that at a very low minimum wage, an increase could lead to an increase in employment (Metcalf 1999). However, international evidence presented in Metcalf (1999) – see Appendix 1 – shows that Australia's national minimum wage is high by comparison with other countries. Thus it is very unlikely that the kind of pause in award wage increases proposed by the "Five Economists", would not lead to national minimum wage that would be below the optimal level. Even after three or four years of holding award wages where they are Australia would still probably have a national minimum wage as a proportion of median earnings that was still above the norm for the OECD. This is something that the AIRC could monitor.

4. Should the Employment Credit be administered through the tax system or the benefit system?

In proposing a wage-tax trade-off, the "Five Economists" proposed that the employment conditional benefit should be a tax credit. Implementing such a benefit through the tax system is the approach that has been adopted in the UK and the US.

The same work incentive payment could, in principle, be administered through the benefit payments system. This is primarily an administrative issue, and the complexities of administering the payment through the tax or transfer system will not be discussed in detail here. However, in Appendix 2, a discussion by Duncan (2002) of some of the design issues for "in-work" employment conditional benefits is reproduced.

Duncan notes that in the UK, the choice of the tax system may be partly because of the possible stigma associated with receiving it through the benefit system.

"It has been argued that households endure a degree of *stigma* when receiving financial assistance through a Benefits Agency or Social Security office. Stigma might be sufficient to discourage claim for a transfer payment altogether. Tax credits such as the US EITC, and now the WFTC in the UK, deliver financial support through the tax code where possible, rather than through the Benefits Agency. The argument for the UK's shift of delivery method from benefits agency (under FC) to the Inland Revenue (for WFTC) is that it eases application and receipt compared with a benefit payment, and might reduce the stigma of a claim for support from the state. It is therefore possible that the shift from benefit payment to tax credit as a means of delivery of financial support for low-income workers might affect the level and pattern of take-up." (Duncan 2002 p.8)

A related idea is that receiving the benefit through the "wage packet" may have stronger incentive effects that receiving it as a payment from Centrelink.

Another administrative point in favour of the tax system, is that wage-earners in general, have a relationship with the tax office, and this is a benefit for wage earners. If the benefit was administered through Centrelink, this might require many people who currently do not relate to Centrelink to make a claim to that orgnaisation.

If the benefit was confined to families with children this might not be such a big problem as if it is extended to people without children. If it is part of a trade-off involving the foregoing of award wage increases it is unlikely that it would be confined to families with children.

For these reasons, this author currently favour the idea of paying these credits through the tax system. At present Family Tax Benefit can be paid through either the tax system or the

benefit system. This principle should be extended to the *employment credit*. For Family Tax Benefit, however, the benefit is typically taken by the primary carer within the benefit system. It might be wise to have the *employment credit* paid through the tax system and the child credit through the benefit system, so that the distinction between the two and their purposes are transparent.

One of the other issues that has to be confronted in implementing an *employment credit* is the period of assessment and payment. A related issue is how to deal with fluctuations in family income. This has proved to be a controversial problem of Family Tax Benefit.

4.4. The case for an integrated child tax credit

The proposed modular income support system for children would include one or more modules for the presence of children.

The current tax-transfer system is somewhat complicated in the way that it provides for children. It includes the following main components.

- Family Tax Benefit Part A. This is benefit that is means tested on family income. There is a payment for each child in the family, which varies according to the age of each child. The maximum payment is reduced as family income increases above a certain level (currently about $30,000 per year). When income reaches a certain level, (which varies depending upon the number and age of the children), e.g. currently about $40,000 where there is just one child and that child is aged between 13 and 15, then the family continues to receive the base rate of payment for each child, until it reaches a considerably higher level of family income (currently about $77,000 where there is one Family Tax Benefit child). Thereafter it is withdrawn as 30 cents on the dollar and ceases (at about $81,000 for a family with one child and that child is 17 or under, or more where there are more children).

- Family Tax Benefit Part B. This is benefit for couples where the secondary earner must have income below a certain amount. It is worth about $2,750 a year, currently, if the youngest child is under 5 and about $1,900 a year if the youngest child is 5 or over. The primary earner is not subject to an income test. The secondary earner can earn up to about $1,700 at present before the benefit is affected. Thereafter it is withdrawn at 30 cents in the dollar and disappears at about $11,000 a year if the youngest child is under 5 years and at about $8,100 a year if the youngest child is between 5 and 18 years of age.

- Child-care subsidies. Child-care subsidies are paid on an hourly rate (up to about $22 per week for a non school child and about $19-70 for a school child) and are normally paid to the providers of child-care to reduce the fees charged. There is a maximum rate payable to families with incomes under about $30,000 (who also receive the maximum rate of Family Tax Benefit Part A). Thereafter it is tapered out until it becomes a minimum rate is payable above a certain income level (about $85,000 per year for one child in care, $93,000 for two children) and progressively higher incomes for more children in care.

- Other payments relating to children also include a Maternity Allowance and Baby Bonus for certain parents with newborn babies.

In principle the idea that parenting payments could be incorporated into the child credit could also be considered, although arguably, the origin of lone parent pensions is due to more than just the presence of a child. However, for completeness the idea should be explored. Parenting payments are of two kinds: -

- Parenting Payment (Single). This is pension for sole parents, up to about $10,900 per year, at present, means tested against their income. There is a free area, followed by a withdrawal rate of 40 cents in the dollar. To the extent that this payment is higher than Newstart Allowance for a single person, this can be seen as a payment for the presence of a child.

- Parenting Payment (Partnered). This is payment for a partnered parent, up to about $8,700 per year. While the maximum entitlement is the same as for Newstart, the means test is slightly different, which can result in a higher payment at some levels of income. This is means tested against both the customer's income and the partner income. The partner may earn up to about $14,500 before there is any effect. Thereafter it is withdrawn at 70 cents in the dollar. The customer can earn up to $1,600 per year their income has any effect. It is withdrawn first at 50 cents in the dollar after that, and after a higher income, 70 cents on the dollar. To the extent that this can, in some circumstance be slightly higher than Newstart Allowance that the customer would receive without children, this can be seen as a payment for the presence of a child.

It can be seen that some of these payments tend to go to parents who are not working or work to a very limited extent. These would include Family Tax Benefit Part B, a large proportion of Parenting Payments (Single and Partnered) – which are progressively withdrawn as the receiving parents work, plus maternity allowance and the baby bonus.

On the other hand other benefits go to many working parents. These include child-care subsidies, which tend to go mainly to working parents who need the childcare to facilitate work. Family Tax Benefit Part A is also paid to working parents (although this depends on the amount of paid work and associate income). Working parents also receive Parenting Payments, albeit at reduced rate if they have earnings above a certain amount, and none at all above a certain income level.

In a simplified income support system of the kind proposed in the McClure Report, there would be a case for integrating these payments into as simple a system as possible. One-way to do this would be to reform Family Tax Benefit, to incorporate all forms of payment that relate to children. This could then be called *child credit*.

If this Child Tax Credit were to incorporate child-care subsidies, (which tend to go to working parents), and the current Family Tax Benefit Part B (a kind of child care subsidy for non working parents), which goes largely to parents without jobs, the following question arises. Should the way that we subsidise families with children differentiate between whether the parent is working or not. One possible model is to have one *child credit*, which could be built upon the current Family Tax Benefit Part A, which provides for children in a consolidated fashion, leaving the parents to decide whether to use the funds to purchase child care provision, or whether to support a parent who chooses to do the child care themselves. It may still be appropriate to have two or more components of the *child credit*.

How easily such a consolidated tax credit can be designed, and what the effect would be on the various family types is a topic to be covered in a subsequent paper with Professor Alan Duncan from the UK. That paper will also explore the labour supply effect of such a reform. If it is introduced alongside an *employment credit*, it would also be wise to model their joint effects on family incomes and labour supply behaviour.

4.4. Coherency of the tax-transfer system and keeping the employment tax credit and the child tax credit separate.

As mentioned in section 4.1. for the "coherency" of the tax transfer system, there are strong arguments in keeping with the idea of a modular income support system for keeping the *employment tax credit* and *child tax credit* separate. In this regard it is instructive to learn form the UK experience.

Duncan (2002) has written the following about the UK experience with tax credits.

"Tax and transfer systems around the developed world are typically products of *incremental* changes or additions. It is much rarer to find that a country's tax and transfer system has been designed as a coherent and integrated entity. Nevertheless, it can be useful to consider the range of objectives on which a government's tax and welfare policy is based, and to reflect on whether the incumbent system of taxes, subsidies and transfer payments is either effective or efficient in delivering on those objectives. This is particularly true in periods in which fundamental reforms are being considered.

It is easy to see how difficulties can emerge when public policies are introduced or amended in order to deliver on stated objectives. Whether through inertia, or because of administrative complexity, there is a natural tendency to compromise on structural public policy reforms in order to fit easily into an existing policy framework. And of course, the motivation for fundamental reform is tempered by political considerations, most obviously the desire to limit the number of 'losers'. It would be naïve not to recognise that these are real and powerful pressures. However, the consequences of such practical considerations on the coherency of a tax and transfer system can be significant.

To develop the concept of *coherency*, it is instructive to examine recent proposals, which have been put forward to overhaul the current system of family payments in the United Kingdom. Following its election in October 1997, the incoming UK government set a number of specific objectives. These were:

"to support families, to make work pay, and to tackle child poverty"

To deliver on these objectives, the government introduced a series of labour market reforms during their first period of office, most notably the Working Families' Tax Credit (WFTC), together with a range of active labour market policies. The WFTC is innovative to a degree in the context of the UK tax and welfare system, in the sense that it is delivered as a tax credit, and includes generous additional support for working families who purchase formal childcare. However, it is also a compromise, in the sense that it replicates many of the eligibility criteria for Family Credit, the previous in-work benefit aimed at low-income working households with children. Most crucially, the credit is targeted at working families *with children*. As a result, the WFTC is both a *partial* and an *inefficient* instrument with which specifically to deliver employment incentives. Firstly, the WFTC can only promote employment among households with children. And secondly, the WFTC is intrinsically bound up with the first and the third objective ("*supporting families with children*", and "*alleviating child poverty*"). Hence, there is an inevitable overlap between the WFTC and other instruments in the government's portfolio designed to target families with children. As a design idea, it seems more logical and coherent to identify *separate* policy instruments with which to deliver on specific objectives.

The UK will introduce two major reforms of the tax and benefit system in 2003: the integrated child credit and the employment credit. While some important features of the system have yet to be announced, a consultation paper sets out the basic structure (Inland Revenue, 2001). The aim is to streamline and simplify the existing system. For example, the integrated child credit will combine three sources of support for families with children into a single instrument paid directly to the caring parent." Duncan (2002 p. 22-23)

5. The Whole Policy Package: a summary

5.1. The Policy Package: A Summary

The proposed policy package has a number of ingredients.

1. An *employment credit*, which will increase the supply of labour from jobless households. This tax credit will be the "work incentive module" in the new modular income support system (see 3 below).
2. This tax credit would be traded off against award wage increases allowing the real cost of labour, especially low skilled labour, to be reduced significantly over the next three to four years, thus increasing the demand for labour, especially low skilled labour which is prevalent in jobless households.
3. Movement towards a more integrated, modular income support system. This would include a base payment for everyone receiving income support, plus add-ons for such things as: the costs of living alone; the presence of children and costs of childcare; the costs of disability; and work incentives.
4. In addition to the work incentive payment being an *employment credit*, it is possible that the component relating to the presence of children could also be in the form of a *child credit* building upon the current Family Tax Benefit.

5.2. Effect on Employment, Unemployment and Jobless Households

The main ingredient of this policy package that will lead to a boost in employment is the downward pressure on labour costs (especially the costs of employing low skilled workers) from the restraint on minimum award wages. Over a three or four year period this is estimated to boost employment by about three per cent.

This, in turn, would reduce the unemployment rate by an estimated one and a half per cent, so that a five per cent unemployment rate should be achievable without raising inflationary pressure.

The increased work incentives, mainly due to the *employment credit*, is a complimentary policy that will help to ensure that a substantial proportion of the new jobs are taken by people from jobless households (or households with only a few hours of work) who are currently heavily reliant on welfare).

The *employment credit* would have a large positive impact on labour supply of lone parents, a small positive impact on the labour supply of single males and females without children and on married males, and a small negative effect on married women's labour supply (with husbands working). The large positive impact on lone parents will significantly reduce the incidence of jobless households. The smaller positive effect on single males and females without children, and on married males, would also have a negative impact on the incidence of jobless households. The only negative effect on labour supply (but a small one) would be on women in couples where the male is also employed. As the male is also employed this would not have any effect on the incidence of jobless households.

5.3. Effect on the Governments Budget

5.3.1. *The Gross Cost of the Employment Credit*

The cost of the *employment credit* for the government depends critically on its design and magnitude. The gross cost of the particular "Five Economist proposal" in Dawkins et al (2000), would be of the order of $1billion in year 1, $2 billion in year 2 (as the tax credit is doubled) and $3 billion in year three.

There is a case for examining ways of reducing the gross cost. One question that needs to be addressed is whether the *employment credit* needs to be as large as that proposed in Dawkins et al (2000). Given that the value of the tax credit to low wage earners in low income families, would be much higher than the value of an award wage increase that they would otherwise get, it may be possible to design an *employment credit* in the proposed wage tax trade-off with a gross cost of say $0.75billion in year 1, $1.5billion in year 2, and $2.25 billion in year 3.

5.3.2. Savings from the "Fiscal Dividend" of the Policy

The policy package is designed to boost employment and to reduce unemployment, the incidence of jobless families and the numbers relying heavily on income support.

First, for example, the anti-inflationary wage restraint, should enable monetary policy to be more expansionary, than it otherwise would be, producing stronger growth in GDP, and higher tax revenue, lower unemployment benefits etc.

Second the effect on real labour costs, will also lead to a boost in labour demand, higher employment and a stronger government budget as a result.

Third the improved work incentives will lead to greater movements from welfare to work, than have occurred in comparable periods of employment growth in the past.

Modelling of the wage tax trade-off by Richardson (1999) and Dixon and Rimmer (2001a 2001b), suggest that in the long run, the policy will result in a net positive impact on the annual budget, because of the effect on output and employment. Dixon and Rimmer's modelling suggests that this could be within five years. Richardson suggests that it might take a while longer.

It is reasonable to believe that the fiscal dividend from the policy package being discussed here, could be larger than that estimated by the modelling of the kind undertaken by Richardson (1999) and Dixon and Rimmer (2001a, 2001b), because of the welfare to work effects of the improved work incentives. That is greater movements from welfare to work, than have occurred in comparable periods of employment growth in the past. For example, analysis by Duncan (2002), presented in this paper, suggests that the up-front cost of the *employment credit* that go to lone parents, will largely be recouped due to the labour supply response.

It is also possible that by substantially reducing the unemployment rate and incidence of jobless families and heavy reliance on welfare, that there could be other savings to federal and state government budget that may not have been included.

More research on budgetary impact of the policy package is needed. However, if required, it seems quite possible that a policy package of this kind, that would substantially reduce the unemployment rate and the number of jobless households, could be designed to budget neutral within five or six years, and have a positive effect on the budget thereafter.

Given the broader economic and social benefit of the policy package, it is arguable that aiming for it to be budget neutral over a five or six-year period, is too stringent a test. If the government and the society are willing for the budget still to be incurring some costs, after that time, the confidence with which the government can proceed with the policy package would be further enhanced.

5.3.3. The Cost of the Possible Child Credit

If a child credit is implemented in the new modular income support system, the effect of this on the budget depends, of course, on the design of that tax credit. This will be examined in a future paper, with Professor Alan Duncan from the UK.

5.3.4.Offsetting Savings in the Proposed Modular Income Support System

In the whole reform package, there are other savings that could be offset against the cost of the employment credit. These could include the following.

- Indexing income support payments to the CPI, (currently some are indexed to the CPI (e.g. Newstart) and others are indexed to average earnings e.g. (Parenting Payment Single).[18]
- There may be savings associated with other aspects of the simplification and integration of the income support system, in relation to new entrants to the system, who may not receive the level of income support that they might have received had the system not been reformed (e.g. lone parents)[19]

In the first three years of the reform package, these savings though significant, can only be expected to be relatively modest offsets to the cost of the *employment credit*. After five or six years, however, these savings would become larger and could make a very significant contribution to the medium to long run fiscal effectiveness of the policy package.

1. Conclusions

With unemployment remaining stubbornly above 6 per cent, a jobless household rate of 16 per cent, and with about one in six children living in such households, the development of a policy package to confront these problems should be Australia's major economic and social policy priority.

This paper provides an outline of such a policy package that would bring together the wage-tax trade-off idea of the "Five Economists" and the rationalisation of the income-support system and improvement of work incentives, consistent with the recommendations of the McClure Report on welfare reform. An *employment credit* is an important part of the proposed package, to be provided in place of wages safety net increases for three or four years. This should enable the unemployment rate to be reduced to around 5 per cent and the incidence of jobless households to be cut significantly.

While there would be substantial up-front costs to the government's budget, it should be within the scope for a budget that is benefiting from strong economic growth. Further the economic impact of the policy would generate substantial benefits for the budget in the medium to long-term. As well as achieving its employment objectives, the policy could be paying for itself in not much more than five years.

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[18] In a more integrated system, it would seem appropriate to index payments to lone parents in the same way as those receiving unemployment benefits.

[19] For example, while existing lone parents might have their benefits maintained, it is hard to see how, in a more integrated system, a lone parent entering the system would be as favourably treated relative to unemployment benefit recipients as in the current system. Both would receive a base payment with an add on (perhaps the child credit) for children , and lone parents might also get a living alone add on, as would a single beneficiary without children, who was living alone. Of course many lone parents would benefit from the reforms because of the employment credit. Also the precise effect on lone parents, with children of different ages, would depend upon the way in which child payments were reformed.

In simplifying and integrating the income support system, in addition to an *employment credit*, this paper has also considered the idea of a *child credit,* building on the existing Family Tax Benefit. The author will be undertaking further research on this and its economic implications, with UK expert, Alan Duncan.

APPENDIX 1

The Five Economists Plan and The Wage Tax Trade-Off

The following text is an edited extract from Dawkins (2002), to be published in the June issue of the *Australian Journal of Labour Economics*

1. The five points in the "Five Economists' Plan"

The "five economists'" letter to the Prime Minister in October 1998, can be summarised as containing five main points about the kind of policy package that could bring unemployment down to around 5 per cent.

1. Steady fiscal policy and monetary policy and continued microeconomic reform aimed at a continued strong and stable growth path.

2. Replacing Wages Safety Net adjustments, for the time being, with tax credits for low wage earners in low-income families, (to be done in a way that reduces effective marginal tax rates for low income families).

3. A long-term commitment to further reduce effective marginal tax rates, especially for low to middle income families.

4. A systematic approach to labour market programs.

5. Up-grading the education and training systems over the longer-term.

Previous papers (Dawkins 1999, Keating 2001[20]), have discussed all five features of the plan.

Point 2, the wage tax-trade-off, is the one that we emphasised most in our letter as a major innovation that could have substantial employment creating effects over the first few years of the plan. This appendix therefore concentrates on that part of the plan.

2. The wage tax-trade-off

2.1. An overview

We proposed that for a period of time, say four years, tax credits should be used as a way of increasing the incomes of low-wage earners in low-income families, rather than increases in the award wages safety net.

This approach had a number of advantages in our minds.

(i) Award wage increases are not a good way of increasing the incomes of low wage earners in low-income families.

(ii) Tax credits would be a much better way of increasing the incomes of low-wage earners in low-income families.

(iii) Suspending award wage increases for say four years, would have a very beneficial effect on employment, because it would significantly reduce the growth of average real wages.

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[20] These papers also discussed the causes of high unemployment, which provided useful back ground for the choice of the five features of the plan.

(iv)   It would be especially helpful to the employment of low skilled labour because the wage of low skilled labour, relative to high skilled labour would be reduced.

These four points are elaborated in sections 3.2. to 3.5.

2.2. The Effect of Award Wage Increases on Low Wage Earners in Low-Income Families

Research by Sue Richardson and Ann Harding (1998) highlighted how those people receiving low wage rates are well spread throughout the distribution of family incomes. This makes award wages safety net adjustments, sometimes called "Living Wage" increases, a very blunt equity device.

Figure A1 taken from Richardson and Harding (1998) shows their estimates of the proportion of adult minimum wage earners in each decile of the distribution of annual equivalent disposable family income, in 1994.[21] The bold broken line in the figure shows the distribution across all adults in the population 1994. The dotted line shows the distribution across all those in the labour force. If minimum wage earners were equally distributed across the distribution of family incomes 10 per cent of them would be found in each decile.

Figure A1: Proportion of Adult Minimum Wage Earners in Deciles of Annual Equivalent Disposable Family Income, in 1994 and 1986
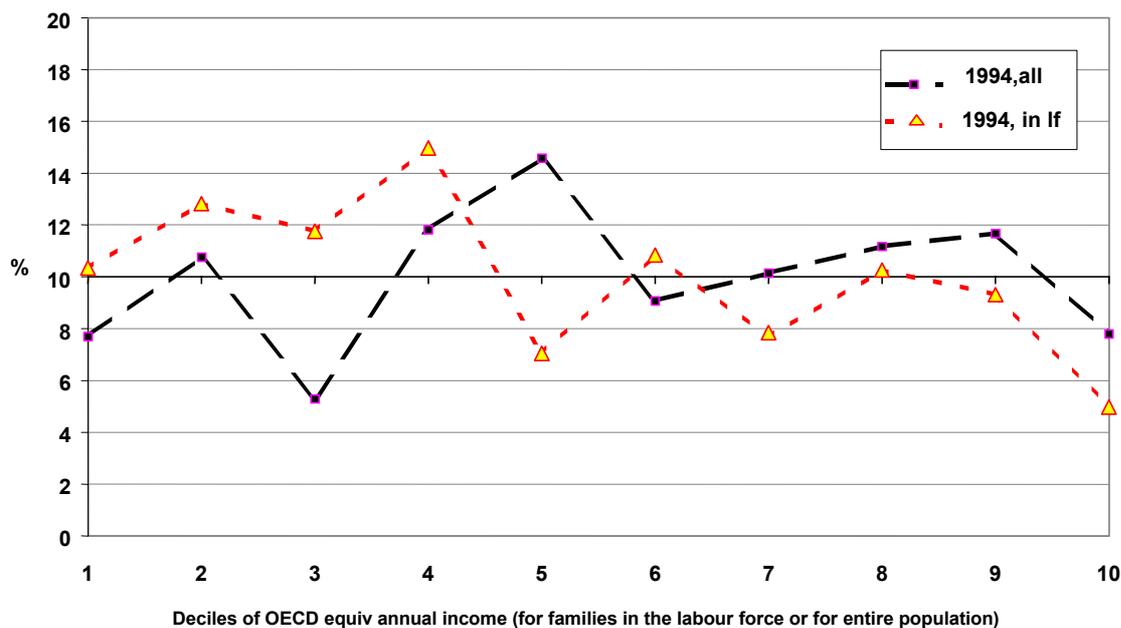
Source: Richardson, S. and Harding, A. (1998) "Low Wages and the Distribution of Family Income in Australia", Paper for Conference of the International Association for Research on Income and Wealth.

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[21] Richardson and Harding also examine the distribution of low wage earners (with a higher cut-off than the national minimum wage), and find similar results. They also look at the effect on the distribution of income without equivalising income. This does not change the basic conclusion that low wage and minimum wage workers are well spread around the income distribution.

If we focus on the whole population of adults, the lowest incidence of minimum wage earners is found in the third decile (about 5 per cent) and the highest in the fifth decile (about 15 per cent). There is also a disproportionately high incidence of minimum wage earners in the seventh, eighth and ninth decile and even about 8 per cent in the top decile. In contrast they are disproportionately under-represented in the bottom and third deciles. The latter finding is partly because there is a disproportionate over-representation of people with no work at all in the lowest deciles.

If we focus on those in the labour force, as would be expected there is a slightly higher representation of minimum wage earners in the bottom four deciles, but they are still very well spread around the whole distribution, with about half in the fifth decile or above.

2.3. The Tax Credit Proposal and its Effects on Low Income Families and on Income Distribution

One of the five economists, Michael Keating, developed a specific tax credit proposal (Keating and Lambert (1998a, 1998b). Under this proposal a tax-free tax credit of the order of 2 per cent would be paid as a supplement to the wage of low wage earners in low-income families, as an alternative to a Living Wage increase, in each year of the policy. After a certain level of income is reached the tax credit would be tapered out, but in combination with the tapering of other family payments in such a way as to avoid as far as possible, increasing effective marginal tax rates.

As an example, Keating pointed out that this would amount to an increase in disposable income of a little over $10 per week tax-free for a low paid employee earning two thirds of average male ordinary time earnings. To produce an equivalent increase in income for someone in the withdrawal range for family payment in the tax/transfer system that applied at the time would have required a wage increase of as much as $70 per week. This was nearly three times the $27 per week that the ACTU requested in its Living Wage claim in 1999.

Subsequent to the Keating-Lambert proposal, the Coalition Government reformed the tax system with the "ANTS" package. The Keating Lambert proposal was subsequently modified by Lambert (2000), to be well integrated with the new tax system.

Lambert's tax credit has been modelled on STINMOD as part of a modelling of the wage tax trade off implemented over a three year period. The tax credit was assigned a maximum value of $30 per week in 2003/04, at the end of the three years period. (i.e. Maximum of $1,560 per annum). This credit grew from the first dollar of a families wage and salary income, accumulating at a 5 per cent rate, to the maximum at $31,150 (the projected threshold of the lower income test for FTB Part A).

> "While accumulated on an individual basis the tax credit was income tested on an income unit basis – consistent with the income testing of family assistance. In some cases the income test was extended to include other single income units considered to be dependent on the parental income unit (young students and the young unemployed). This extension was designed to be consistent with the current dependency rules for youth allowance.
>
> Eligibility for the tax credit was based solely on the receipt of wage and salary income by an individual. There was no link between award status and eligibility for the tax credit. Therefore someone who received the wage increase for those not on awards would be eligible for a tax credit and, subject to the income test, might receive an entitlement. On the other side of the coin, a person who did not receive a wage increase would be eligible for an earnings credit but might not receive any entitlement because of the operation of the income test. This might reflect that person's own income (not all on awards are on low wages), a partner's or parental income.

The linking of the tax credit to FTB Part A means that it is more tightly tested (on an income unit basis) for those without dependent children who are not eligible for family assistance. There is therefore an element of horizontal equity in this approach."

(Lambert 2000, pp 31-32)

The design of the tax credit and how it would fit in with Family Tax Benefit part is outlined in and appendix to Dawkins (2002). Lambert (2000) has also simulated the effects of the policy (including the trade-off with wages) on the distribution of income across Australian income units (roughly households), using the STINMOD model. His analysis suggests that the policy is likely to cause a redistribution of income away from the top part of the income distribution and towards the lower part boosting the incomes of low to middle income families.

Table A1 is one of the tables from Lambert's analysis. Columns 1 and 2 involve a wage tax trade-off, (column 2 having a higher average wage increase for those not relying on awards than column 1). The remaining columns do not have the award wage freeze or tax credits and represent a range of assumptions about the rates at which awards and other wages might increase over a three-year period. The analysis is done in such a way that a good way of examining the effect of the policy is to compare column 1 with column 3 and column 2 with column 4, although other comparisons may also be made. The important point to note is that the winners from the policy, in terms of their share of disposable income) (in columns 1 and 2) are in income deciles 2 to 7, and the losers are in deciles 8, 9 and 10.

It should be stressed that the simulations were restricted to the first round effects of the policy and do not incorporate the effects of the employment increase of the kind found by Dixon and Rimmer (2000) and others. Since these involve a significant reduction in unemployment they would further reinforce the positive distributional impacts of the policy.

Table A1: Share of disposable income by decile of weekly disposable income.

Decile of weekly income unit disposable income	Sub-scenario									
	1	2	3	4	5	6	7	8	9	10
	Share of total weekly disposable income %									
1	0.91	0.90	0.91	0.90	0.91	0.89	0.91	0.90	0.91	0.89
2	3.55	3.51	3.54	3.50	3.53	3.50	3.54	3.50	3.53	3.50
3	4.59	4.55	4.55	4.52	4.55	4.51	4.55	4.52	4.55	4.52
4	6.08	6.04	6.04	5.99	6.04	5.99	6.04	5.99	6.04	5.99
5	7.34	7.32	7.19	7.17	7.20	7.18	7.19	7.17	7.20	7.17
6	8.83	8.81	8.72	8.71	8.71	8.71	8.71	8.72	8.71	8.71
7	10.55	10.55	10.52	10.53	10.52	10.53	10.52	10.52	10.52	10.53
8	13.15	13.18	13.19	13.21	13.21	13.22	13.19	13.22	13.20	13.21
9	16.98	17.02	17.13	17.20	17.16	17.20	17.14	17.19	17.15	17.20
10	28.02	28.12	28.22	28.27	28.19	28.26	28.21	28.28	28.19	28.27
All	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: STINMOD

Source: Lambert (2000)

2.4. The Effect on Employment

If minimum award wages were frozen for four years, then inflation would effectively reduce the real wages (real before tax) of those who depend upon award wages safety net adjustments. The reduction would be a bit over 10 per cent (if the Reserve Bank is successful in achieving its inflation target). Assuming that award wage earners would otherwise receive real wage increases, the policy would reduce real wages of award wage earners relative to what they would otherwise receive, by greater than 10 per cent. If the effect of wages safety net adjustments would be to increase real award wages by about 1 per cent per year (increases in nominal wages of about 3.5 per cent per year), then the overall effect of the policy would be to dampen the growth of real award wages by around 14 to 15 per cent.

About 25 per cent of employees would be directly affected and about 20 per cent of the national wage bill.[22] As a result, average real wages would be reduced by about 2.5 to 3 per cent relative to what they would otherwise have been (assuming no flow-on effects to other workers, and without any worker who relies on the safety net moving onto enterprise bargains).

In our letter to the Prime Minister, the five economists quote the findings Debelle and Vickery (1998). In their estimate of the elasticity of labour demand, Debelle and Vickery (1998) found an elasticity of –1.0. Thus they concluded that a two per cent cut in average real wages would increase employment by about two per cent (and reduce the unemployment rate by one percent). On this basis the policy proposal could be expected to produce an increase in employment of the order of 2.5 to 3 per cent and reduce the unemployment rate by around 1.25 to 1.5 per cent below what it would otherwise have been.

A more recent estimate of the aggregate wage elasticity of labour demand (Lewis and MacDonald 2002) suggests that total hours worked has an elasticity of –0.9, and the aggregate elasticity of demand for workers was –0.8. On this basis our estimate of a reduction in the unemployment rate of around 1.25 to 1.5 per cent might be a little high. A reduction by about 1 to 1.25 per cent would be implied by the Lewis and MacDonald (2002) estimates.

There are a number of caveats to the above estimates. First, since those who rely on the wages safety net have below average wages, and are of below average skill, the responsiveness of the demand for their labour to changes in their wages is likely to be above average. This suggests that the employment effect would be larger than estimates based on the average worker. Further, if the effect of the pause were to flow on to other wages, then the effect could be further enhanced.

On the other hand there is the possibility that freezing award wages would lead to some workers (who currently rely on wages safety net adjustments), receiving over-award pay or moving to enterprise bargains, thereby reducing the wage effect and dampening the employment effect. On the other hand if the demand for award wage workers increases, this could increase the number of workers on awards. (We will return to the issue of flow on effects and movements off awards later).

Meanwhile let us return to the point that less skilled workers have a higher elasticity of labour demand than higher skilled workers

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[22] More details of the coverage of award wages are provided in Dawkins et al (2000) and Dawkins and Loundes (2000).

2.5. The Effect on the Employment of Unskilled Workers.

Hamermesh (2000) who is acknowledged as a leading world authority on labour demand, (see for example Hamermesh, 1993), has made the following observation

> "the preponderance of evidence suggests that labour demand elasticities are substantially higher i.e. employment demands are more responsive, for a given cut in wages for low skilled workers, than for high wage workers. The evidence I think is quite clear on that.
>
> That being the case, real wage growth cuts for low-wage workers will have a much bigger effect on total unemployment reduction than will an across-the- board slow down in real wages"

(Hamermesh 2000, p.23)

Hamermesh was basing this statement on a range of studies in various countries. While there have been few studies of the elasticity of labour demand for low skilled workers in Australia such evidence that exists suggests that Australia is not an exception to this principle (e.g. Lewis 1985).

3. The employment effect of the wage-tax trade-off: other estimates that have been produced

3.1. Borland

In his discussion of the five economists plan, Borland (1999) wrote that his best guess of the effect of the proposal on the unemployment rate was that it would reduce it by 1 percentage point after a total of four years. In arriving at this best guess, he provided upper and lower bound estimates. His upper bound estimate was of a reduction in unemployment by 2.1 percentage points, resulting from a 7.2 percentage increase in employment. His lower bound estimate was of a 0.3 percentage point reduction in unemployment, resulting from a 2.1 percentage increase in employment.

These estimates were based on upper and lower bound estimates of the effect on average real wages and upper and lower bound estimates of the elasticity of labour demand for low skilled workers.

3.2. Richardson

Richardson (1999) modelled a revised version of the plan on the Access Model of the Australian economy, in a study for the Business Council of Australia. In this plan the award wage pause was for just three years. In this analysis an extra 169,000 jobs are created after a total of ten years, and the unemployment rate reduced by 1 percentage point. Two thirds of the employment effect was achieved after six years. As explained more fully in section 5.10., the policy was also found to pay for itself in the long run because of increased tax revenue and less expenditure on unemployment benefits.

3.3. Dixon and Rimmer

3.3.1. Introduction

It was noted in section 3 above that if the award wage pause were to flow on to other wages, then the effect could be enhanced. On the other hand there is the possibility that freezing award wages would lead to some workers (who currently rely on wages safety net adjustments), receiving over-award pay or moving to enterprise bargains, thereby reducing the wage effect and dampening the employment effect.

To understand these interactive effects it is necessary to use an integrated model of the economy. Dixon and Rimmer (2001a, 2001b) have modelled these interconnections using the MONASH Model. That model has two advantages over the alternatives:

(i)   it disaggregates the labour market into a larger number of occupations than other similar models. This allows us to use information we have on the number of workers in different occupational groups who depend upon the wages safety net; and

(ii)   the extent of flow-on effects to workers, and the extent to which people might cease to become dependent on the wages safety net, is made endogenous.

Dixon and Rimmer (2001a) constructed two distinct scenarios to evaluate using the model.

Under the first, the reduction in real wages discussed above is assumed to be permanent in its effect. The wage-tax trade-off is accepted under the system as a long run change with the tax credit seen as the appropriate compensating policy. There is thus no need for any catch-up adjustments after the three-year period of the freeze.

Under the alternative scenario, the wage shock is taken to be temporary. In other words, at the end of the three-year period there is a readjustment during which previous relative wages are re-established.

3.3.2. Scenario 1

Under Scenario 1, the policy leads to strong and sustained employment growth. After 3 years, employment is more than 2 percentage points higher than it would have been without the policy. After 6 years, it is over 3 percentage points higher, and after 10 years it is almost 4 percentage points higher than it would otherwise have been.

Compared with what they would otherwise have been, real before-tax wages are lower for all groups. However, the downward effect on real after-tax wages is significantly smaller: after ten years, on average they are about 1 to 2 per cent lower than they would otherwise have been.

There are significant gains in both national income and employment. Real GDP gets a big boost. It is about 2 per cent higher after 5 years, and over 3 per cent higher after 10 years. Total employment is almost 4 percentage points higher. The largest growth in employment is amongst those who rely on wages safety net adjustments for wage increases. The size of this group increases by about 10 per cent in three years.

This makes the policy look very attractive and, as Dixon and Rimmer point out, the tax credit is a small price to pay, for the very large benefits.

The only people who appear to be significant losers in this policy are those workers who both currently depend upon award wage increases and who are in relatively high-income families. Since the credit is means tested on family income, they do not qualify for the tax credit.

3.3.3. Scenario 2

Under Scenario 2, while there are similar short-run gains in employment these are not sustained. Short-run gains in GDP are also made, but again these are reduced in time, although they do remain positive after 10 years.

Thus the main effect of the policy under this Scenario 2 is to bring forward in time employment and output growth and to defer some of the growth in wages that would otherwise have occurred. This could still be a very worthwhile policy particularly if it was

considered that there is more likely to be under-utilised labour in the short run than in the long run. It may be a useful strategy to address the problems of the group of long-term unemployed carried over from the early nineties.

3.3.4. Which scenario should we believe?

A good way of thinking about these simulations is that they provide upper and lower bound estimates of the effect of the policy. The most realistic scenario probably lies somewhere between the two.

Good reasons why there would be a good chance that permanent effects would ensue have been outlined in Dawkins et al (2000). A central point here is that, by using the tax credits as compensation and causing a more equitable distribution of income, any social pressures for catch up in the wages safety net, are weakened.

Further, because of the unusual nature of the wages safety net in Australia, with minimum wages being much higher relative to median wages than in most other countries, it seems very unlikely that market forces would greatly offset the effects of the policy. The falls in real wages seem likely to be effective.

3.3.5. Flow-On Effect and the Effect on the Number of Workers Relying on Awards

In the Dixon and Rimmer (2001a) analysis, the flow on effect to the wages of other workers (whose wages are not solely reliant on wages safety net adjustment) are made endogenous. As are the number of workers relying on awards. They find significant flow on effects because the restraint of award wage earners affects the ability of other to secure wage increases, and the number of workers relying on award wages increases. This is because the effect of the increased demand for award wage earners outweighs the supply side effect of workers wanting to move off awards onto higher wage setting processes such as enterprise bargains.

3.3.6.Comparing the Policy with a Cut in Payroll Tax

One idea that is sometimes put forward as an alternative way of reducing wage costs in order to achieve a stronger growth in employment is to cut payroll taxes.

Dixon and Rimmer (in Dawkins et al (2000) find that the employment effects of such a policy would be very small compared with the effects of the wage tax trade-off. Even if cuts in payroll tax were possible without increases in other taxes, the effects would be quite small. This occurs because the cuts only cause very small effects on effective labour supply compared with the wage tax trade-off.

3.3.7.Further analysis by Dixon and Rimmer

In a subsequent paper, Dixon and Rimmer (2001b) enrich their analysis by introducing a more disaggregated analysis of labour supply behaviour, and the differential tendency of the short-run and long-run unemployed to make effective offers to the labour market compared with the employed. The results suggest that an outcome somewhere between the two scenarios in their first paper, and also that the biggest impact is on the long-term unemployed. This is because the major determinant of the size of the stock of long-term unemployment is the flow of the short-term unemployed into long-term unemployment. Their modelling concludes that it is this flow that the policy has a major impact on.

4. Minimum Wages in Australia and Other OECD Countries: An Addendum

It is sometimes argued that international evidence on the effects of minimum wages, especially from the US, suggest that increases in minimum wages do not affect employment much and therefore increases in minimum award wages in Australia should not affect employment much.

Leading international authority on the economic of labour demand, Professor Dan Hamermesh's commented on this is the following way at a conference in 1999 BCA (2000) are a good summary.

> "Changes to the minimum wage have two avenues of effect on labour demand. First there is the demand elasticity, but more important is how many people are affected by it."

He went on to argue that in the UU increases in the minimum wage are

> " not going to make any difference whatsoever because there is nobody or hardly anybody, down there in the US at that level. In the US, minimum wage cuts affect many fewer people, relatively than do minimum award wages in Australia. A large number of empirical studies for the US, Britain, Germany look at wage elasticities by skill category. The preponderance of them suggest the evidence I indicated, namely that these elasticities are larger at the lower end of the skill distribution. I do not think that minimum wage studies are relevant for this".

(BCA 2000, p.24)

In the US the minimum wage is indeed, much lower relative to median earnings than in Australia, and many fewer workers are paid the minimum wage. Table A2 presents evidence from Metcalf (1999) on the real value of the national minimum wage in each of nine countries, (including the UK and Australia) and its value relative to full-time median earnings. This shows that Australia, is at the high end of the distribution as far as minimum wages are concerned.

Table A2: Summary of Minimum Wage Systems in selected OECD Countries with a National Minimum

Country (year of introduction)	End-1997 NMW[1] in $US using PPP's[2]	Mid-1997 NMW as % of full-time median earnings
Australia (1996, same form since 1907)	6.65	54
Belgium (1975)	6.40	50
Canada Women (1918-30); Men (1930-59)	5.33	40
France (1950, 1970 in current form)	5.56	57
Japan (1959, 1968 in current form)	3.38	31
Netherlands (1968)	6.00	49
Spain (1963, 1976 in current form)	2.94	32
United States (1938)	5.15	38
United Kingdom (1999)	5.44	44

[1]National minimum wage, [2]Purchasing power parity
Source: Reproduced from Metcalf (1999)

When it is added that the federal minimum wage is only the bottom rung of a whole structure of minimum wages in Australia, this provides further reason to become nervous about the effect of raising them significantly, especially armed with the knowledge that

international evidence suggests that the elasticity of demand for low skilled labour tends to be higher than for others.

Metcalf was a member of the Low Pay Commission in the UK which was asked by the Blair government to recommend the level at which the UK minimum wage should be set. The Commission undertook extensive research as well as consultation. They concluded that " the National Minimum Wage should be introduced at a rate which offers real benefits to the low paid, while avoiding unnecessary risks to businesses and jobs", and advised that the appropriate rate for the National Minimum Wage should be 3 pounds 70 pence per hour in June 2000 along with an initial Development Rate of 3 pounds 20 per hour (for 18 to 20 year olds) and accredited trainees over 21 for a limited period of time. (Low Pay Commission, 1998 p.5).

The Low Pay Commission were very keen to avoid setting the minimum wage too high, in order to avoid serious adverse employment effects. David Metcalf (1999), in the article referred to above, of the London School of Economics, one of the Low Pay Commissioners, has subsequently written a journal article on the subject of minimum wage setting. Metcalf (1999) pointed out that his reading of the international research evidence is that modest increases in minimum wages, when they are at very low levels, do not tend to have adverse effects on employment, (and may sometimes have positive effects). However, at higher levels increases in minimum wages can be expected to have significant adverse effects on employment.

It is particularly noticeable, that all of the studies of minimum wages in France (the only country in Table A2 with the minimum wage higher than in Australia), reviewed in the Joint Government's submission to the Safety Net Review (2000-2001), a significant negative relationship between minimum wages and employment was found.

If minimum award wages were held where they are for four years in Australia, then the national minimum wage could be expected to be getting down towards the UK level as a percentage of median earnings.

APPENDIX 2– DISCUSSION OF THE DESIGN FEATURES OF IN-WORK BENEFITS

The following text is an extract from Duncan (2002, pp2-8)

Introduction

Most in-work transfers around the world have been designed with two main objectives in mind: (i) to redistribute financial resources to low-income families; and (ii) to promote employment incentives. For some in-work transfer payments, there may be additional criteria, perhaps to redistribute towards families with children or to target more specifically low-wage rather than low-income households. So how do in-work transfer programmes achieve these twin objectives of (possibly targeted) redistribution of income and improved employment incentives?

The UK system of support for low-income working households is unusual in that it includes an explicit hours-of-work condition as well as an earnings-related 'means-test' when assessing the level of entitlement.[23] Most in-work transfers base entitlement on earnings alone, as is the case for the Earned Income Tax Credit (EITC) system in the United States.[24]

The desirability of an explicit hours condition is the subject of some debate. On the positive side, it can be argued that the hours-related eligibility condition in the WFTC improves the targeting of the benefit towards working households, and may therefore be more effective in promoting employment incentives. There may also be a higher deadweight cost to the EITC, since the tapers are relatively low compared with WFTC and extend higher up the earnings distribution. On the negative side, higher withdrawal rates are typically needed to pay for the greater generosity of hours-conditioned transfers. This might lead to labour market 'inertia': people have an incentive to work at or near the hour's threshold, but little or no incentive to work much beyond. In contrast, EITC recipients can adjust their labour-market behaviour with a potentially smaller loss of entitlement. Indeed, they might ultimately find it less burdensome to float off receipt entirely as they acquire skills and labour market experience.

Below is listed a series of design considerations that are relevant when constructing a system of financial support for low-income working families. Relatively innocuous design choices can generate significant, unanticipated and potentially adverse work incentives. In the categorisation that follows we highlight where this might be so.

Structural conditions of entitlement

There are, in general, three ways in which entitlement to an in-work benefit might be established:

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[23] The Canadian Self-Sufficiency project (SSP) is perhaps the only comparable transfer programme, which includes an explicit hours condition among the rules of entitlement See Card, Michalopoulos and Robins (2000) for a detailed analysis of the Canadian SSP pilot.

[24] The EITC includes three regions; a 'phase-in' region for which entitlement increases as earnings increases, a plateau where maximum entitlement is maintained, and a 'phase-out' region where the credit is withdrawn until exhausted. So, EITC entitlement depends on hours of work, but does not include a specific hours-related condition.

- First, limits to eligible family types. Under the current Working Families' Tax Credit (WFTC) in the United Kingdom — as with its two predecessor benefits, Family Income Supplement and Family Credit — eligibility is restricted to families with children. However, the new Employment Tax Credit (with which the United Kingdom government plans to replace part of WFTC from 2003) might extend in-work support to people without children.[25] In the United States, the generosity of the Earned Income Tax Credit (EITC) is differentiated according to the presence and the number of children.

- Second, an hours-of-work condition. Compared with an earnings condition alone, this can target people working a 'desirable' number of hours at potentially lower cost to the public purse (for a given level of entitlement). However, this introduces another potential hazard: that the hour's condition is exploited by employees and employers (either independently or collusively). When targeted on part-time employment, the in-work benefit can reduce incentives for full-time workers as well as increase incentives for those not currently in work.

- Thirdly, an income condition targets financial help on low-income households. It is possible, as under the EITC in the United States, to structure the income condition to provide positive employment incentives with a 'phase-in' range. However, the in-work benefit is, by definition, however, less targeted on employment *per se*, with no discrimination between high-hours/low-wage and low-hours/high-wage combinations.

The period of assessment and payment

Benefit structures that are, on the surface, very similar can produce markedly different incentives if they have different payment and assessment periods. For the WFTC, "the assessment period is between 7 weeks and 4 months depending on the frequency of wage payments", according to Brewer (2000). Payments are then fixed for the following 26 weeks, regardless of any change in employment status. Such rules open the door to adjustments in labour market behaviour between assessments and, in the extreme, to abuse of the system. By the same token, it is difficult to see how a tax credit that is delivered annually and in arrears would have the same incentive effect as a structurally and monetarily equivalent benefit delivered more frequently throughout the year.

The unit of assessment and payment

Most in-work benefit systems around the world are assessed on household rather than individual income. This contrasts with the personal tax system, which typically operates at the level of the individual rather than the family unit.[26] However, the choice of the unit of assessment is not innocuous. Consider a household where the man is in low-wage employment and in receipt of in-work financial support. When benefits are assessed at the level of the household, any increase in labour supply by the woman will reduce the benefit payment to the household, thus acting as a disincentive to the secondary earner (in this case, the woman). On the other hand, if benefits are assessed at the level of the individual, then the positive employment incentive to the secondary earner is preserved.

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[25] This is certainly the case in the three countries (Australia, the United Kingdom and the United States). studied specifically in this paper.

[26] This choice of the household as the unit of assessment introduced some complexity to the administration of the new WFTC program, given that the calculation of UK income tax liability hitherto took no account of the income of the partner.

In general, choosing the household as the unit of assessment tends to favour single-earner households, whereas individual assessment is relatively beneficial for the incentives of two-earner households.[27] Of course, individual assessment is much less effective at targeting financial help towards low-income households, and is therefore likely to be less desirable on equity grounds.

It can also be important to know who actually receives the benefit payment. Under Family Credit, the caring parent generally received the benefit (usually the mother). The Working Families' Tax Credit, on the other hand, is more likely to be paid to the taxpayer in the household. For two-adult households, this is more likely to be the man. Depending on the extent of income sharing within the household, this largely administrative change in the structure of in-work financial support could have some significant behavioural consequences. *In extremis*, if there existed no income sharing within the household, then the move from FC to WFTC could represent a significant transfer of resources away from the mother.

Assessable income, and interaction with the tax system

The distributional and employment effects of tax and benefit reform can only be examined within the context of the whole tax and transfer system. A reform can appear relatively generous when looked at in isolation, but less so once interactions with other elements of the tax and benefit system are taken into account. This is usually because income from one transfer scheme is included in assessable income for another transfer programme. In the move to the WFTC, for example, the increases in the level of adult and child credits imply significant gains for households on maximum entitlement. But these gains are not realised the many families who also qualify for Housing Benefit, since WFTC forms part of the assessable income used in the Housing Benefit means test. This interaction compromises the effectiveness of WFTC both as a re-distributive tool and as a vehicle for improving work incentives.[28]

Early in-work benefits in the United Kingdom were plagued with problems of high effective marginal tax rates (EMTRs) over significant ranges of earned income because of the structure of the means test. Under Family Income Supplement (FIS), the level of in-work benefit was withdrawn at a rate of 50 per cent of *gross* income. With income tax and National Insurance contributions alone (at the then rates of 30 per cent and nine per cent respectively), this took overall EMTRs to 89 per cent for households in receipt of FIS. If Housing Benefit was also being paid, the EMTR could rise to levels above 100 per cent. Under Family Credit, the level of in-work financial support was withdrawn at a rate of 70 per cent of *net* income. This relatively simple reform reduced EMTRs to 79.6 per cent under FC for households paying tax and National Insurance alone and to 92.9 per cent for households also receiving Housing Benefit.

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[27] Duncan and Giles (1998) experiment with alternative units of assessment for Family Credit, and find empirical support for this conclusion. Duncan and Reed (2000) look at the simulated employment effects among two-adult households when current levels of WFTC are increased. They find that an increase of 25 per cent in the maximum level of WFTC, when assessed on household income, will increase the proportion of single-earner households by 3½ per cent and lower the proportion of two-earner households by around 2 per cent.

[28] One can reduce taper rates to WFTC to an extent which would give some entitlement to those working beyond the end of the Housing Benefit taper, but this is an expensive solution which does not address the underlying structural problem.

Nevertheless, EMTRs remained high for people receiving in-work financial support, not least because of the interaction between FC and other elements of the tax and transfer system (especially Housing Benefit). Any income from FC is included in the means test for Housing Benefit. This lowers considerably the level of Housing Benefit for those in receipt of Family Credit and hence reduces the potential incentive effects of the Family-Credit system. Figure 2 demonstrates this problem: note how much less is the gain in overall net income at 16 hours per week than the level of Family Credit.

The structure of an in-work benefit can also influence wage progression. When withdrawal tapers are high, the lion's share of any income gain through wage progression will be lost through reduced benefit entitlement. So the incentive for employees to develop human capital through participation in education and training programmes is much reduced, since they will see little financial gain to doing so. Duncan (2000) has also made the point that it is also possible for employers to exploit a generous in-work benefit to subsidise wages. It should be added however, that in an economy with very high minimum wages, as in Australia, employment tax credits can be used as proposed by the "Five Economists" as an alternative to raising minimum wages, in a deliberate attempt to reduce labour costs.

Method of delivery of financial support

It has been argued that households endure a degree of *stigma* when receiving financial assistance through a Benefits Agency or Social Security office. Stigma might be sufficient to discourage claim for a transfer payment altogether. Tax credits such as the US EITC, and now the WFTC in the UK, deliver financial support through the tax code where possible, rather than through the Benefits Agency. The argument for the UK's shift of delivery method from benefits agency (under FC) to the Inland Revenue (for WFTC) is that it eases application and receipt compared with a benefit payment, and might reduce the stigma of a claim for support from the state. It is therefore possible that the shift from benefit payment to tax credit as a means of delivery of financial support for low-income workers might affect the level and pattern of take-up.[29]

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[29] The choice to participate in a welfare programme forms part of an ongoing literature in the United States, Canada and the United Kingdom. See *inter alia* Blundell, Duncan, McCrae and Meghir (2000); Dickert, Houser and Scholtz (1995); Hoynes (1996); Keane and Moffitt (1998).

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