

Some Reflections on the 'Earnings Credit'

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Introduction

The Australian welfare state, now nearly a century old, has grown increasingly generous, and paradoxically has trapped an increasing number of people in benefit dependency. One unmistakable indication is that, between 1986 and 1996, the proportion of working-age adults deriving most of their income from government benefits increased from 11.9% to 14.1% (Reference Group on Welfare Reform, 2000: Table 3.1). This was symptomatic of the growth of jobless households—that is, households in which no adult member was gainfully employed. In 1997-98, 16.3% of all Australian households were jobless. This represented a 3.6 percentage point increase from the 1982 figure. Even more alarming, the incidence of dependent children in these households rose from 10.2% in 1982 to 15.0% in 1997-98 (Dawkins, Gregg and Scutella, 2002: Table 1).

There is evidence that adult members in jobless households are more likely than not to lack qualifications (Dawkins, Gregg and Scutella, 2002: 20-29). Thus, one possible remedy for the growth of jobless households is to boost employment opportunities for low-skilled workers. This may be achieved, for example, by restraining the minimum wage to increase the demand for low-skilled labour (see, for example, Dawkins et al., 1998; Tsumori, 2002).

The consequent minimum wage may be too low for some workers to make ends meet and may in turn give rise to a large working-poor

population. The 'Five Economists', in an open letter to Prime Minister Howard in October 1998, proposed a temporary minimum wage freeze to tackle unemployment and at the same time a system of tax credits to help families reliant on low wages (Dawkins et al., 1998). Similar schemes operating in the United States and Britain, respectively called the Earned Income Tax Credit (EITC) and the Working Families' Tax Credit (WFTC), have succeeded, to differing degrees, in boosting employment among single mothers—a population group generally prone to a low employment rate. The EITC was first introduced in 1975, and its generosity was significantly increased in the early 1990s. The employment rate of American single mothers, meanwhile, shot up from 30% in 1992 to 45% in 1996 (Ellwood, 1999: 90). The WFTC replaced its predecessor, the Family Credit, in October 1999. The former, which offers greater generosity, is estimated to have brought 2.2% of single mothers into either full-time or part-time work (Blundell et al., 2000: 93-94).

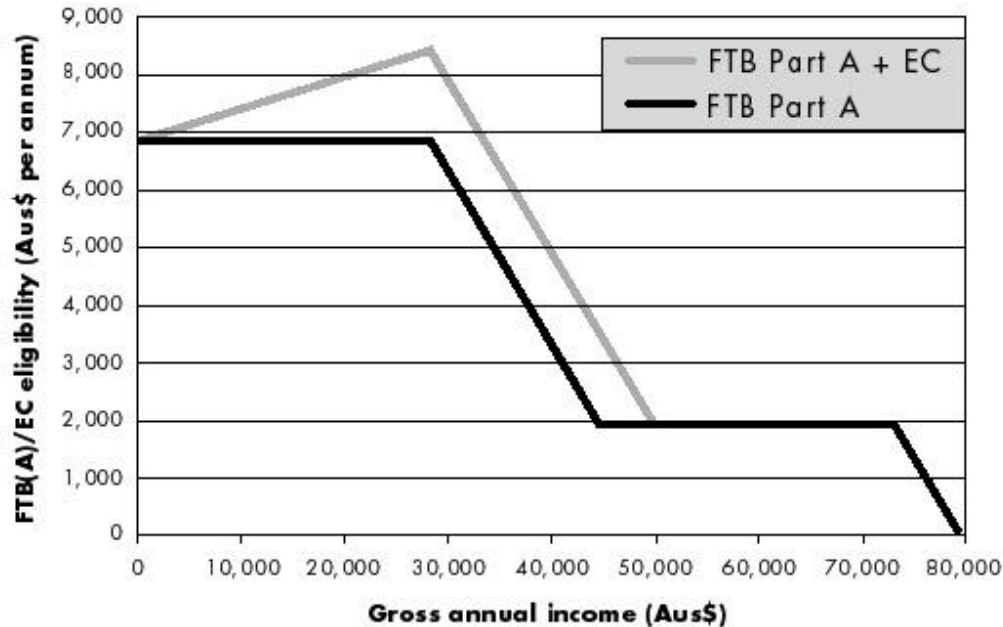
Whether such in-work benefits indeed solve the problem of benefit dependency, however, remains a question.

The proposed 'earnings credit'

The Five Economists' proposal, since its first appearance in Australia's social policy debate, has been variously elaborated. For example, a recent policy package outlined by Dawkins (2002)—one of the Five Economists—centres around the idea of an 'earnings credit' originally canvassed by Lambert (2000). In Lambert's proposal, an earnings credit of up to \$30 per week, or \$1,560 per annum, would be added on to the existing Family Tax Benefit

(FTB) Part A. Figure 1, replicated from Duncan (2002: Figure 5), illustrates how such a system would work for a couple with two children aged 8 and 13. The rates of FTB Part A are as of July 2000. This couple would be eligible for the maximum amount of FTB Part A until they attain an annual income of \$28,200. Subsequently, the payment would be withdrawn at a rate of 30% until it hits another plateau at the annual income of \$49,800. Once the couple's per annum income reaches \$73,000, FTB Part A would be phased out at a rate of 30%. The earnings credit, on the other hand, would first

Figure 1
Family Tax Payment Part A and an Earnings Credit



rise gradually at a rate of about 5.5%, and then reach the maximum amount at the same time that FTB Part A begins to taper off. Put differently, an increased work effort, under this hypothetical system, would be rewarded with a proportionate increase in the earnings credit up to a certain point. After that, the maximum earnings credit would be maintained, and thus the family in Figure 1 would still be \$30 per week better off than if out of work until the point where FTB Part A reaches the lower plateau.

Duncan (2002) simulates the effects of Lambert's proposal on employment among single parents. For the sake of simplicity, it is assumed here that, as per Lambert's original idea, there is no hours condition attached: that is, eligibility for the earnings credit would be assessed solely on the basis of the amount of money earned, as opposed to the number of hours worked. According to Duncan's findings (2002: Table 2b), the earnings credit would

raise the employment rate among single parents by 5.1%—a significant increase. The average working hours, on the other hand, increased moderately by 1.5.

The possible response to the earnings credit of other household types is yet to be examined in detail. Preliminary analysis suggests that (i) single men and women without children as well as married men would moderately increase their labour supply and that (ii) married women whose spouses are employed would slightly reduce their labour supply (Dawkins, 2002: 16).

Pros and cons of the earnings credit

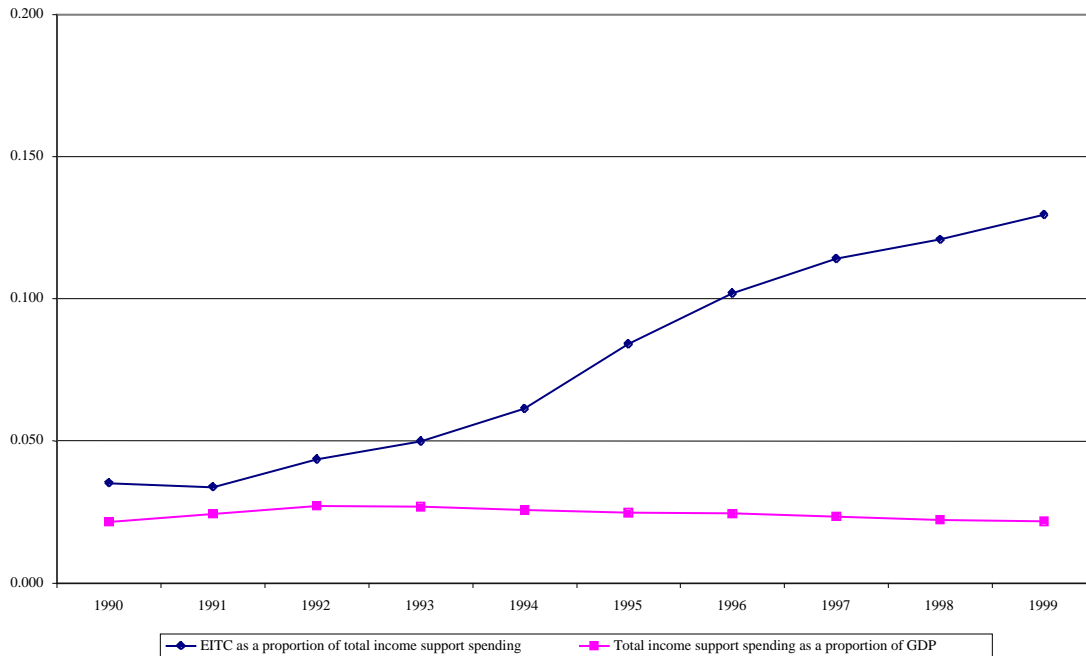
So while a temporary minimum wage freeze would help boost labour demand, the earnings credit would increase overall labour supply. As a consequence, many of those formerly jobless would escape complete benefit dependency. There would also be transgenerational effects. Joblessness, and thus benefit dependency, often ‘run in the family’: children who have grown up in jobless households tend to end up jobless themselves (see, for example, Pech and McCoull, 2000). Getting jobless parents into work, therefore, is assumed to have a considerable bearing on their children’s future in relation to benefit systems.

The US and UK experience, however, indicates that there may be a number of downsides to in-work benefits. Among other things, (i) their cost may be enormous; (ii) they may in fact act as disincentives to increase work effort; and (iii) they may not necessarily lead to lower effective marginal tax rates.

The cost of in-work benefits

The primary purpose of introducing the EITC and the WFTC was to alleviate the burden of income support programmes. Yet in the United States, total income support spending as a proportion of GDP has remained more or less constant over the decade shown in Figure 2, while EITC spending as a proportion of total income support spending has increased nearly fourfold. In other words, the EITC, at least so far, has not helped

Figure 2
The Cost of the Earned Income Tax Credit (EITC)



Note: US income support spending is defined here to include the following programmes: General retirement and disability; Federal employee retirement and disability; Unemployment compensation; Food and nutrition assistance; Supplemental Security Income; Family and Other Support Assistance; Earned Income Tax Credit; and Housing Assistance and Other.

Source: Executive Office of the President of the United States, *The Budget for Fiscal Year 2001, Historical Tables*, w3.access.gpo.gov/usbudget/fy2001/maindown.html.

reduce US income support spending. Britain's WFTC is relatively new, and so its full impact on income support spending may not be effectively measured. Yet the cost of the WFTC appears to have been high: between 1999 and 2001, spending on income tax benefit programmes jumped from £1,854 million to £5,530 million—a threefold increase (ONS, 2002: Table 5.2.4S).

Duncan (2002) has estimated the cost to the Federal Government of introducing the earnings credit in Australia. If families are assumed not to increase their labour supply as a result, the earnings credit would cost approximately \$2.5 billion, or 22% of current spending on the Family Tax Benefit programme (Duncan 2002: Table 2a). The income support expenditure with regard to single parents is expected to grow by 2.6% (Duncan 2002: Table

2c). Yet as noted above, the earnings credit does appear to have, overall, a positive effect on employment—especially that among single parents. This, in turn, might bring about a reduction in other income support spending and an increase in tax revenue. If these effects are allowed for, then the net cost to the government budget with regard to single parents would increase only by 0.2% (Duncan 2002: Table 2c). Apparently, Australia's earnings credit would not enormously increase the onus on taxpayers.

Put another way, however, the earnings credit probably will not reduce the size of income support spending in Australia. The earnings credit, although disguised as a tax credit, is still an income support programme. It might be argued that in-work benefits and out-of-work benefits differ in that those in receipt of the former are more likely to leave the programme eventually as they increase their work effort; and therefore that, in the long run, income support spending is likely to decline significantly. Yet such an argument does not seem to stand up, as seen below.

Latent work disincentives

The EITC and the WFTC, while encouraging those previously jobless to work, at the same time appear to discourage their recipients from undertaking more than the minimum amount of work. The EITC initially increases as earnings rise, then plateaus, and finally tapers off. The WFTC, on the other hand, simply tapers off after the initial, maximum level. In a word, both EITC and WFTC are sooner or later reduced by a rate proportional to the amount of work. Thus, the US and UK programmes provide good financial incentives to take minimum-wage jobs but poor incentives to move into better paid jobs

(Brewer, 2001: 56-58). The earnings credit, which is designed in a more or less similar manner to the EITC, is likely to give rise to similar work disincentives.

Moreover, there is at least one group of people that might have no work incentive at all under an in-work benefit system: married women whose spouses are in work. As noted earlier, Australia's earnings credit is estimated to reduce the labour supply of this group. This is broadly consistent with findings with regard to the EITC and the WFTC. In the United States, the employment rate of all married mothers, regardless of their earning ability, used to rise in tandem. As the EITC increased in generosity, however, the employment rate of low-wage married mothers stabilised (Ellwood, 1999: 91). Simulations with regard to Britain similarly predicted that the WFTC would decrease labour supply among married women with employed spouses by approximately 0.6% (Blundell et al., 2000: 95). This is thought to occur largely because, if these women worked, their household incomes would increase and their entitlements to the EITC or WFTC would be reduced accordingly.

Lingering high effective marginal tax rates

The interactions of in-work benefits with the rest of the tax/transfer systems mean that effective marginal tax rates for low-wage earners may remain high. In both the United States and Britain, for instance, subsidies for childcare and housing, which are means-tested, can considerably reduce returns from additional work effort (Brewer 2001: 61-62). The British case is worse. The WFTC is counted as part of income assessable for the means-testing of other payments, whereas the EITC is not. Thus, a family increasing its earnings and thereby its WFTC entitlement could at once lose a substantial portion of its

Housing Benefit entitlement, for example. In this respect, the WFTC undermines, rather than improves, work incentives. As Frank Field, the former Minister for Welfare Reform under the Blair government, comments:

Tax credits make it impossible for a growing army of individuals to improve their families' income and well-being by working harder or longer or gaining additional qualifications (Field 2002: 5).

The earnings credit proposed for Australia, assessed after all other benefits have been paid, would avoid this problem (Duncan 2002: 20). Means-testing for other benefits, however, would remain, and thus much of benefit entitlement could be lost as earnings from work increase—the same problem that exists in the absence of the earnings credit. There would be very little financial incentive for further education and training, because a pay rise as a result would in effect be penalised (Duncan 2002: 7). This indicates that, in introducing an in-work benefit programme, it would be imperative to reconsider the transfer system in its entirety.

Concluding remarks

The earnings credit might initially encourage those otherwise dependent on benefits to do some paid work, and as a consequence, reduce the incidence of jobless households. Yet it would not necessarily provide incentives to work longer hours or to move into better paid jobs. This is because an increase in earnings would, after all, lead to a reduction in benefits other than the earnings credit. By the same token, married women with employed spouses might opt out of the labour market.

The earnings credit, on the face of it, appears to be a practical solution to the entrenching problems of joblessness and benefit dependency. It will.

however, give rise to a 'low-income trap': there may emerge a large group of low-income earners who do no more than the bare minimum of work in order to avoid benefit reductions. Existing benefit dependency may be merely replaced by just another form of benefit dependency. The earnings credit does not move people into full independence—like most other benefit systems that have existed in Australia. Making work more attractive than welfare would be without doubt a step in the right direction. Yet the earnings credit in its proposed form will not achieve that goal.

The problem of benefit dependency in Australia calls for a holistic approach. The solution lies not only in welfare reform but in tax and labour market reform. On the one hand, the tax-free threshold, currently set at \$6,000, is too low. There is a good case for raising it so as to boost low-wage earners' take-home pay (Saunders, 2003). The labour market, on the other, needs to be overhauled so as to improve employment opportunities for low-skilled workers. A minimum wage freeze, the centrepiece of the Five Economists' plan, is in fact only the tip of the iceberg. There are numerous other factors that are deterring employers from taking up more workers—excessive employment protection, to name just one—and they need to be addressed once and for all. An in-work benefit system alone will not do the trick.

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