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Welfare to Work in the United Kingdom

Wolfgang Ochel*

In most OECD countries unemployment of low skilled workers is high. This is due to the form of technical progress, competition by low-wage countries and the traditional social security system. The traditional social security system follows a wage replacement policy. It pushes the reservation wage up and thus destroys part of the employment opportunities that otherwise would have been available. The alternative to the policy of wage replacement is a policy of wage supplement. Benefits are not given on condition of staying away from formal employment but on condition of participating in it but still not earning enough. A number of mainly Anglo-Saxon countries have moved from a wage replacing to a work complementing welfare system. One of those countries is the United Kingdom. Its welfare-to-work programme consists essentially of a "working families' tax credit" (now: "working tax credit").

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Table 1
Unemployment rates by education for population 25 to 64 years of age, 2001

	Below upper secondary education		All levels of education	
	Men	Women	Men	Women
Austria[a)]	6,9	5.9	3,2	3.6
Belgium[a)]	7.7	13.5	4,8	7.4
Denmark	4.0	6.2	3,1	4.1
Finland	10.5	12.7	7,2	8.1
France	9.7	14.4	6.2	9.8
Germany	15.6	11.5	7.7	8.1
Greece	4.9	12.3	5.3	12.5
Ireland	5.5	5.1	3.3	2.9
Italy	6.9	14.0	5.8	10.7
Netherlands[a)]	3.0	5.0	2.0	3.4
Norway[a)]	2.3	2.2	2.6	2.0
Portugal	2.7	4.6	2.7	4.3
Spain	7.3	16.1	6.2	13.3
Sweden	5.6	6.4	4.5	3.8
UK	9.4	5.7	4.1	3.4
Australia	8.1	7.0	5.2	5.1
Canada	10.2	10.2	6.2	5.8
US	7.5	8.9	3.7	3.3

[a)] 2000.

Source: OECD, Education at a Glance, OECD Indicators 2002, Paris 2002, p. 118.

Unemployment of low skilled workers and replacement policy

Most OECD countries have high rates of unemployment for the less skilled, as a rule considerably exceeding the general unemployment rates. Table 1 shows the unemployment rate for employable persons between ages 25 and 64 with a qualification below upper secondary education. It shows that in 2001, the general unemployment rates exceeded 10 percent only in Greece (women), Italy (women) and Spain (women). For the less skilled such rates prevail in Belgium (women), Finland, France (women), Germany, Greece (women), Italy (women), Spain (women) and Canada. The unweighted average unemployment rate of workers with a "below upper-secondary education" is roughly 50 percent higher than the general unemployment rate of the countries examined in Table 1.

The high unemployment rates of low-skilled workers are due to technical progress, competition by low-wage countries and the traditional social security system. This system grants benefits on the condition of not working. These benefits operate like a wage paid for idleness, which the market wage has to exceed. Since no one is willing to work at a market wage below the social benefit attainable without working, this benefit is a lower bound on market wages. Between the "replacement income" and the net wage, however, there can be a certain gap. In any case, an increase in the entire wage structure is linked with an increase in "replacement income" (Figure 1).

However, in a market economy, an upper bound on an individual's market wage is given by his (or her) productivity, i.e. the value added he or she is capable of creating. Thus there is a fundamental problem with people whose productivity is below the benefit that the welfare state is willing to provide. These people, in principle, cannot find a job in a market economy under traditional policies. The wage has to be above their benefit to make them offer their labour, and the wage has to be below productivity to make firms demand this labour. The two conditions are mutually exclusive. The wage replacement policy turns out to be a policy of increasing the reservation wage – the wage below which a worker will refuse a job – and of preventing the creation of jobs that otherwise would have been available.

Figure 1

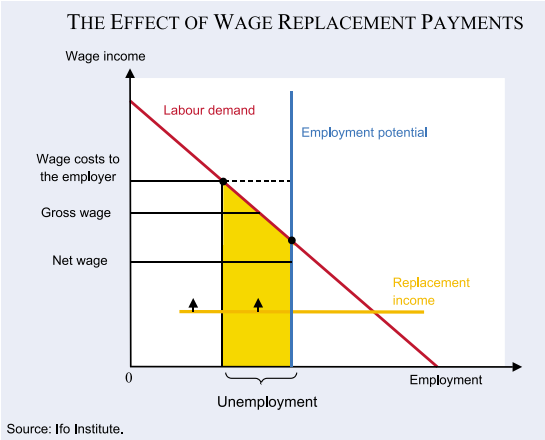
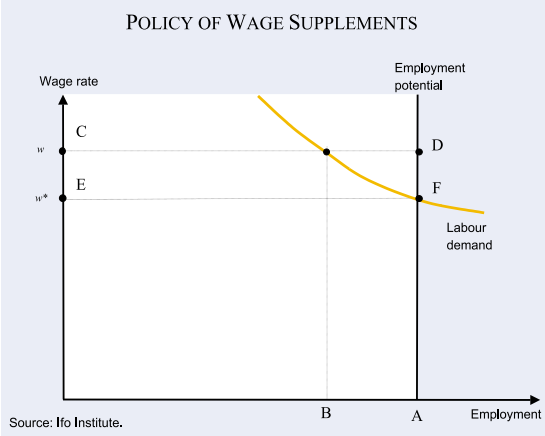


Figure 2



This problem used to be minor when benefits were low relative to average incomes. However, the gradual expansion of the welfare state has increased the number of people who are affected and has therefore increased the number of unemployed, in particular among the less educated, whose productivity is low relative to the minimum income that the state provides them.

The policy of providing social and unemployment assistance by replacing labour income has not only destroyed jobs by increasing reservation wages, it has also worked as a policy of subsidising black market activities. It is true, of course, that this was not intended, but as informal labour is the natural alternative to formal labour and as the payment of benefits stops when formal labour income is obtained, it is clear how the incentives have worked (EEAG 2002, Ch. 6).

Welfare policy of wage supplementation

The alternative to a policy of wage replacement is a policy of wage supplementation. Benefits are not given on condition of staying away from formal employment but on condition of participating in it and nevertheless not earning enough. Figure 2 illustrates the underlying mechanism. There is a well-defined demand curve for labour of relatively low productivity as a function of its (net) cost to the employer and an inelastic supply of labour. The market-clearing wage cost to the employer would be w^*. It is assumed that the corresponding net wage is below the socially acceptable minimum wage.

A wage replacement policy offering a public benefit payment of the minimum socially acceptable income places a floor under the market wage (resulting in wage costs to the employer of w) and causes unemployment of A – B. Under the alternative policy of supplementing low earnings from public resources there is no floor to the market wage. The wage will fall to a level where the corresponding wage cost to the employer is w^*. Unemployment disappears. The income of low skilled workers is brought up to the socially acceptable level by an employment subsidy corresponding to w-w^*, costing the government an amount represented by the area CDFE.

Benefits supplementing wages (that is to say tax credits in the UK) do not only affect the decision of the unemployed whether or not to participate in the labour market but affect also those who are already in employment. Their market wage will be depressed by the new wage supplement policy. In addition, the volume of the labour services they are prepared to supply will be affected. This can be illustrated by the typical pattern of a tax credit for employees.

Figure 3

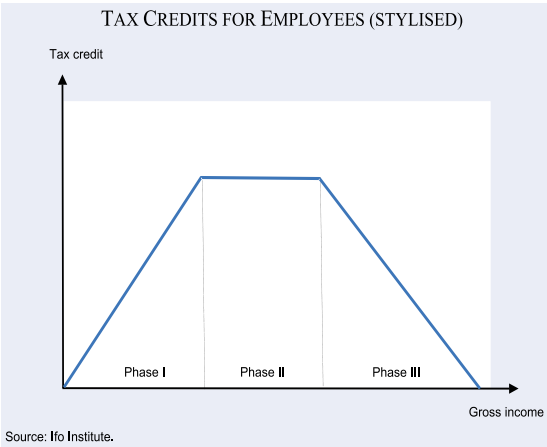


Table 2
Incentives for additional labour supply by granting employees a tax credit

	Phase I	Phase II	Phase III
Substitution effect	positive (tax advantage for additional hours worked)	none	negative (implicit tax on additional hours worked)
Income effect	negative	negative	negative
Total effect	?	negative	negative
Source: Ifo Institute.			

In Figure 3 the amount of the tax credit is a function of gross income. Three phases can be distinguished: at first the tax credit increases as income increases (phase I), in a second phase it remains constant, and beyond a certain level of income it decreases (phase III). The effect of the tax credit on total hours worked is different in the three phases.

Two effects must be distinguished: the income and the substitution effect. By increasing the net income of employees the subsidies make it possible for the beneficiaries to enjoy more leisure and reduce working time (income effect). At the same time, the subsidies change the relative prices of work and leisure, which leads to substitution effects, whose strength varies according to the tax credit phase (see figure 3). For a worker in the initial phase, the tax credit creates incentives to work more and to reduce time away from work. In phase II substitution effects no longer take place. And finally, in phase III the individual worker no longer has any incentive to work more; by withdrawing the tax credit additional income is effectively taxed which creates a disincentive for the supply of additional working hours. The sum of income and substitution effect is in phase II and III negative and in phase I indeterminate. Only empirical studies can tell us how the supply of labour will in fact respond (see Table 2) (Ochel 2001).

The Working Families' Tax Credit in Great Britain

In-work benefits have a long tradition in Great Britain. As early as 1971 the Family Income Supplement was introduced; in 1988 this was replaced by the Family Credit (FC) and in 1999 its place was taken by the Working Families' Tax Credit (WFTC). The WFTC was subsumed within the Child Tax Credit (CTC) and the Working Tax Credit (WTC) in April 2003.

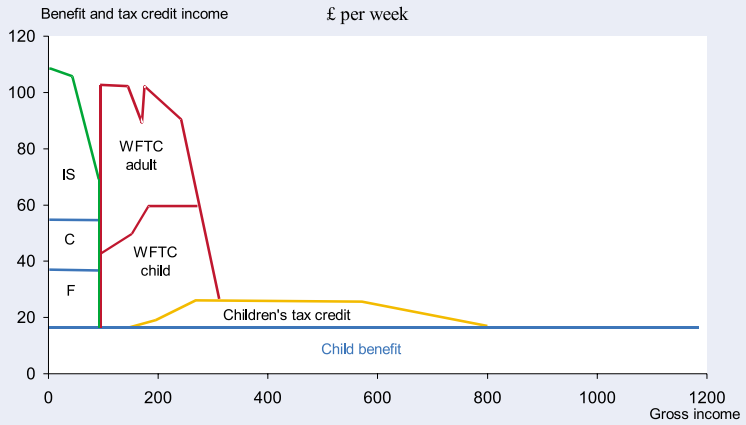
The WFTC aimed to increase the net income of low wage earners. An incentive was created to accept work with low pay. Families with at least one dependent child were entitled to the WFTC if one adult worked at least 16 hours a week. Families with net assets exceeding £ 8,000 were excluded. The tax office had got the operative responsibility. The basic amount for an adult was £ 59.00 per week in 2001; children's credits ranged between £ 26.00 and £ 26.75. If more than 30 hours were worked per week the credit increased by £ 11.45. Cost of child care were added to the WFTC in the proportion 70 percent of eligible child care costs up to an upper limit of £ 94.54 weekly (for families with two or more children £ 140). Single parents could claim this entitlement if she or he worked more than 16 hours a week; for couples with a child or children both had to work more than 16 hours. In taking into account the household's net income, an exemption of £ 92.90 per week was allowed. For

Table 3
Parameters of the Working Families' Tax Credit in Great Britain, 2001

Basic tax credits (£ per week)	
Adult	59.00
Children	
between 0 – 10 years of age	26.00
between 11 – 15 years of age	
between 16 – 17 years of age	26.75
18 years old	
Treatment of child care costs	Child's tax credit increased by 70% of child care costs up to £ 140 a week.
Withdrawal rate (per cent)	55
Income threshold (£ per week)	92.90
Upper limit to assets allowed (£)	8,000
Minimum work week (hours)	16
Additional credit if work week exceeds 30 hours (£)	11.45
Responsible authority	Tax office
Source: Inland Revenue 2001.	

Figure 4

FINANCIAL SUPPORT FOR A FAMILY WITH ONE CHILD UNDER THE WFTC



Notes: IS is adult allowance, F is the familiy premium and C is the child allowance in income support or income-related JSA. The graph does not show the childcare tax credit, housing benefit or council tax benefit.

Source: Brewer 2003, p. 6.

net income exceeding £ 92.90, a withdrawal rate of 55 percent was applied (see Table 3).

In order to determine the incentive effect of the WFTC it is necessary to compare the in-work benefits with the out-of-work benefits. People in employment with a dependent child or children in the low-wage brackets who worked at least 16 hours a week received the WFTC as well as a generous allowance for the expenses of child care (child tax credit). For the unemployed or for those with a weekly working time of less than 16 hours there was the Job Seeker Allowance (JSA) or the Income Support (IS).[1,2] In addition, a Child Benefit independent of income was paid (see Figure 4).

The WFTC reduced the net replacement rate considerably. Without WFTC, in 2001 the net replacement rate for a couple with one dependent child was 143 percent in the case of part-time employment, or 92 percent with a full-time job. WFTC resulted in the disposable income of the unemployed being only 76 percent of that of part-time employed or 60 percent of that of full-time employed (assuming the employed were paid the minimum wage). The WFTC had a similar effect on the income position of single parents (see Table 4[3]).

Giving the unemployed strong incentives to work was, however, accompanied by high withdrawal rates when the WFTC entered phase III. Although the withdrawal rate had been lowered from the FCs 70 percent to 55 percent, nevertheless, the marginal tax burden (including the effects of the income tax) remained high. Amongst the 1.1 million families benefiting from WFTC in 2000, 950,000 were in phase III and were subject to a marginal rate of income loss of 60 percent or more, and 210,000 of these were losing benefits and paying taxes to the amount of 80 pence or more on every additional pound earned. This extremely high marginal tax burden cannot fail to have a negative effect on the hours employees are willing to work.

The WFTC and the child tax credit exerted a strong incentive to take up gainful employment. According to estimates by the experts of the Institute for Fiscal Studies, if these in-work benefits had not been in place, a considerably smaller number of unemployed would have found work. As mentioned above, in 2000 1.1 million families – out of 27 million employed – fulfilled the eligibili-

Table 4

Net replacement rate (with employment at minimum wage) in Great Britain 2001 (in %)

	Single parent, 1 child		Couple, 1 child	
	Part-time employment	Full-time employment	Part-time employment	Full-time employment
A Without WFTC	110	70	143	92
B With WFTC	58	46	76	60

A Net replacement rate = disposable income without work/disposable income with work. The disposable income includes: gross wages, income support, child benefit minus employee's contributions to social security and income tax. Assumptions: minimum wage = £ 3.70 an hour; 4.3 weeks = 1 month; child care costs not included.

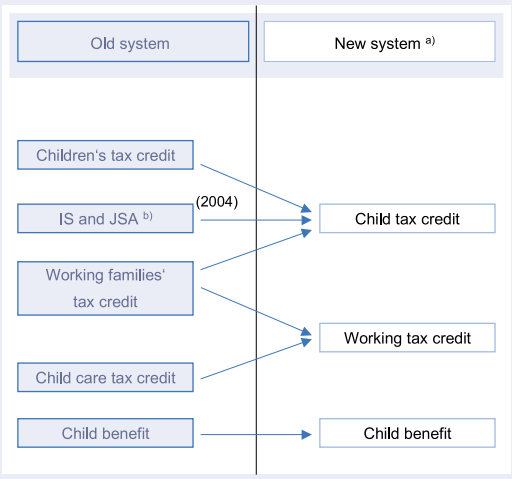
B As in A, but WFTC.

Source: M. Brewer 2000, pp. 55, 56 and 58.

[1] The last named applies only to couples with dependants who are ill or disabled and to single parents.
[2] Furthermore, households with low income could receive Housing Benefits and an exemption from local taxes (Council Tax Benefit).
[3] But if one takes into account the Housing Benefit and the Council Tax Benefit, which was much more important for the unemployed or for those with very low incomes, then the net replacement rate was much higher. On the other hand, it was decreased by the generous Child Care Tax Credit, which is not taken into account in the calculations of Table 4.

Figure 5

FROM THE OLD TO THE NEW TAX CREDIT SYSTEM



a) as of April 2003.
b) Child allowances and the family premium in income support (IS) or income related jobseeker's allowance (JSA).

Source: Brewer (2003), p. 2.

ty criteria of WFTC (Brewer 2000, p. 48). (Of course, not all of those benefiting from WFTC were necessarily formerly unemployed.) Simulations carried out by Gregg, Johnson and Reed (1999) and by Blundell et al. (2000) indicate that the strongest incentive to work was exerted by WFTC on single mothers, but also married men and women (without a partner with a job) felt a strong incentive to work as a result of WFTC. On the other hand, WFTC exerted a negative incentive on married women whose husbands were in work. The rapid increase in employment of single parents (Brewer and Gregg 2001, p. 23) was in all likelihood due to the fact that since the introduction of the Child Tax Credit 70 percent of child care costs had been taken over by the state; this arrangement removed an important obstacle to women's participation in the labour market.

Table 5
Parameters of the Working Tax Credit in Great Britain, 2003-04

Single people without children (£ per week)	29.30
Couples with and without children and lone parents (£ per week)	58.15
Extra amount for disabled adults (£ per week)[a]	39.15
Child care element (£ per week)	
• Maximum eligible cost for 1 child	135.00
• Maximum eligible cost for 2 or more children	200.00
• Percent of eligible costs covered	70
Withdrawal rate (percent)	37
Income threshold (£ per week)	97.30
Upper limit to assets allowed (£)	8,000
Minimum work week (hours)	
• with children	16
• without children	30
Additional credit if work week exceeds 30 hours (£ per week)	11.90
Responsible authority	Tax office

[a] There is an extra amount for people over 50 returning to work as well.

Sources: HM Treasury, Inland Revenue (2002), p. 32; Brewer (2003), p. 5.

WFTC strongly promoted taking on employment by those previously unemployed. It did not, however, offer any incentives for those already in work to work more hours. Despite the reduction of the withdrawal rate to 55 percent in phase III, the WFTC still led to a high marginal effective tax rate. Hence there was a tendency to limit the total time worked weekly, instead of increasing it. As a result, the proportion of part-time workers with a working week of 16 hours (and more) was high (Blundell 2000, p. 42).

The new tax credits

In April 2003 the British Government introduced two new tax credits: the Child Tax Credit and the Working Tax Credit. The CTC now represents the major source of government financial support for children. It is designed to simplify the system of financial support for parents. Entitlement to the CTC does not depend on whether an adult in the family is working. The WTC is designed to make work more financially attractive. It supports adults with and without children in low-paid work. It represents the first substantial policy in the UK to help those without children when they are working.

Figure 5 shows how the new tax credits combined the different parts of the old system. The children's tax credit, child allowances and the family premium in income support or jobseeker allowance and part of the WFTC were subsumed within the CTC. The main part of the WFTC and the childcare tax credit (which was part of the WFTC) were subsumed within the WTC. The child benefit, a universal, non-means-tested payment remained unaffected by the reform.

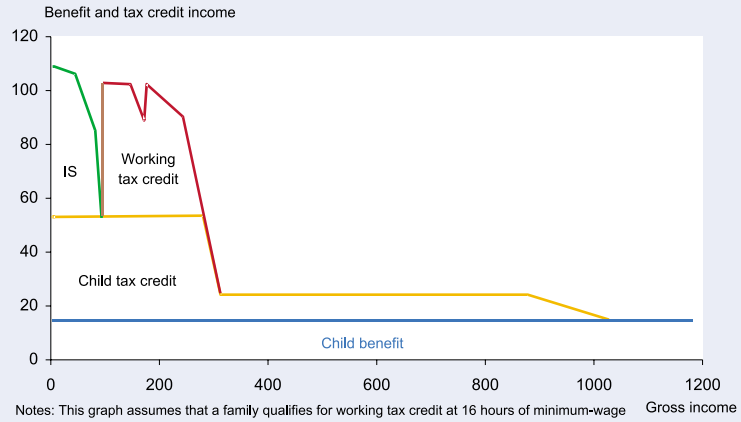
In 2003-04 the WTC consists of the following:

– Single people without children are entitled to a credit of £ 29.30 a week.

Figure 6

FINANCIAL SUPPORT FOR A FAMILY WITH ONE CHILD UNDER THE WTC

£ per week



Notes: This graph assumes that a family qualifies for working tax credit at 16 hours of minimum-wage work (£ 67.20 p. w.) and for the 30-hour premium at £ 126 p. w. It does not show the childcare tax credit, housing benefit or council tax benefit.

Source: Brewer 2003, p. 6.

– Couples with or without children and single parents are entitled to a credit of £58.15 a week.
– Families with children with both adults working can receive help with approved childcare costs.
– Families with children must work 16 or more hours a week to be entitled, and those without children must work 30 or more hours a week.
– There is a bonus of £ 11.90 a week for those working 30 or more hours a week.
– Families with annual incomes below £ 97.30 a week are entitled to the full amount. Incomes above this level reduce entitlement at the rate of 37 p per pound (before deducting income tax and National Insurance)[4] (Brewer 2003, p. 5; Table 5).

The structures of the new tax credits are illustrated in Figures 6 and 7.

It is too early to say how the WTC affects employment. Experts of the Institute of Fiscal Studies, however, have made some predictions. Comparing the WTC with the WFTC, they have come to the conclusion that the WTC will improve the financial reward for primary earners moving into work in two-person households and worsen it for second earners. This is very similar to the impact of introducing the WFTC.

But how will the WTC affect work incentives of single people? Research results indicate that there is no evidence that individuals without children are deterred from working by inadequate financial incentives.[5] If there is an incentive effect at all, it relates to taking on a job. On first examination, this seems to have been encouraged. However, WTC probably did not motivate those with jobs to increase their weekly working hours. The contrary is more likely, since a high percentage of single, low-wage earners were faced with an increase in the effective marginal tax rate (Brewer 2003, p. 12).

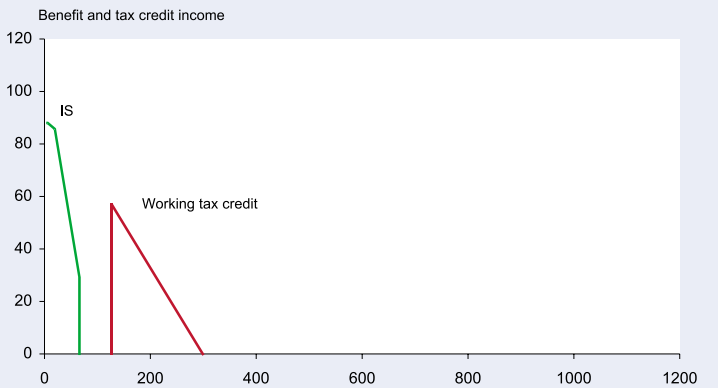
Conclusion

A wage replacement welfare policy prevents the creation of jobs for low skilled workers. The alternative is a policy of wage supplementation as pursued in the UK with its WFTC and since 2003 its WTC. These tax credits strongly promote taking on employment (with a minimum of 16 hours per week) by those previously unemployed. They do not, however, offer any incentives for those already in work to work more hours.

Figure 7

FINANCIAL SUPPORT FOR A COUPLE WITHOUT CHILDREN UNDER WTC

£ per week



Notes: This graph assumes that a family loses entitlement to income support at 16 hours of minimum-wage work (£ 67.20 p. w.) and qualifies for working tax credit at 30 hours of minimum-wage work (£ 126 p. w.) It does not show housing benefit or council tax benefit.

Source: Brewer 2003, p. 7.

[4] WFTC awards used to be reduced by 55 p for every pound of income in excess of some threshold after deducting income tax and National Insurance.

[5] This contrasts strongly to the research findings for those with children that supported the introduction of the WFTC for families with children (HM Treasury 1998).

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