

# Is there an Emerging Consensus in Making Work Pay Policies?

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## 1 Introduction

International developments in tax and welfare policy over the last decade indicate an increasingly proactive approach on the part of governments to welfare reform. In an age of globalisation, governments are able to draw lessons from international experience in the development of domestic policy. This paper looks at patterns of welfare reform across the developed world, with specific reference to the development and adaptation of so-called “Making Work Pay” (MWP) or employment-conditional payments in Denmark, France, the United Kingdom & the United States. We argue that a degree of consensus is forming on the design, structure and administration of tax and welfare systems. However, we also argue that the transfer of MWP policies across national domains is very definitely adaptive, and strongly influenced by existing features of the incumbent income support programs, and by weaknesses in existing MWP programs of income support. Policy transfer is also driven by a political imperative to be seen to be engaged in proactive policy reform.

Tax and transfer systems were, in the past, often designed solely with distributional objectives (and fiscal constraints) in mind. More recently, the burgeoning evaluation evidence on the potential effects of employment subsidies on labour supply has led policymakers to consider the effects of tax credit and in-work benefit programmes on work incentives. Consequently, in-work benefits and employment credits, once rare, have become widespread. A growing number of countries (Canada, Denmark, France, New Zealand, the United Kingdom and the United States) have adopted a policy of subsidising low-paid workers’ wages as a way of improving work incentives. Still more countries (Australia) are actively engaged in debates on the possible use of employment-conditional payments as a way of improving work incentives among low-income and workless households.

We proceed in Section 2 with a brief overview of the major themes and motivations behind many welfare policy initiatives around the developed world. Section 3 presents a brief review of income support delivered to low-income households in the United Kingdom (culminating in the current Working Tax Credit programme, WTC), the United States (via the Earned Income Tax Credit, EITC), Denmark (up to the current Danish EITC initiative) and France (culminating in the introduction of “la prime pour l’emploi”). Section 4 focuses on the use national governments make of international experiences of welfare systems when framing domestic policy, while Section 5 extracts a series of key

ideas that appear in many recent MWP programs around the world, and which might inform future developments in Australian tax and welfare policy. Section 6 draws the threads of this discussion together, & concludes with a view of the future direction of MWP programs.

## **2 Three pillars of welfare reform**

It is instructive to view the evolution of “Making Work Pay” programmes in a wider context, by looking at the broader motivations which lie behind tax and welfare policy initiatives in developed economies around the world. Three themes have been repeated in policy statements in the United States, the United Kingdom, Australia and in many other OECD countries. The emphasis may be different, but the majority of broad statements of welfare reform highlight three over-riding objectives:

- To provide support for low-income families
- To alleviate child poverty
- To promote employment

Some policy statements can be a little unguarded. The second objective, for example, has prompted Tony Blair to commit to the “eradication of child poverty within 20 years”. In Australia, Bob Hawke was even more ambitious:

*“By the year 1990, no Australian child will be living in poverty”*

Bob Hawke, 1987.

Nevertheless, party manifestos abound with commitments to a more equal welfare system, distributing income towards families & children, promoting employment through minimum wages, wage subsidies, employment contingent benefits.

It is fair to say that the emergence of MWP policies in welfare programs around the developed world been driven in part by a changing emphasis in governments’ pursuit of these three welfare policy objectives. Although the timing may be different between countries, there appears to have been a pretty systematic shift from distributional priorities, towards a need for efficiency and the creation of employment incentives, a move away from dependency and towards self-sufficiency.

For example, at the 1997 election, the incoming UK Labour government set a number of specific policy objectives for its programme of welfare reform. These were:

*“to support families, to make work pay, and to tackle child poverty”.*

To deliver on these objectives, the UK 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.<sup>1</sup> The WFTC was an innovative programme in the context of the United Kingdom’s tax and welfare system, in the sense that it was delivered as a tax credit, and included generous additional support for working families who purchase formal childcare. Subsequent reforms to the system of tax credits<sup>2</sup> further separate the WFTC into an integrated Child Tax Credit (CTC) available to all low-income families with children, and the Working Tax Credit (WTC), paid to low-income households where at least one member works 16 hours per week or more. These new proposals are designed, in part, to improve the coherency and targeting of the UK system of welfare payments, and to create a separation of policy instruments with which to deliver on specific policy objectives<sup>3</sup>.

This paper concentrates on the evolution of welfare policy instruments with which to deliver on the third of the three stated objectives of policy reform; the promotion of employment. We look principally at some of the more important policy developments in the United Kingdom and the United States.<sup>4</sup> However, we also draw selectively on developments in Australia, Belgium, Canada, Finland, France, Ireland and the Netherlands to support the idea of a limited policy consensus. That said, we also indicate how the transfer of policy ideas across institutions is partial, adaptive both to domestic circumstances and policy structures, and to the perceived problems and faults inherent in existing MWP programs.

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<sup>1</sup> Specifically, New Deal programmes for the unemployed, and for lone parents, both of which had their roots in broadly similar active labour market policies in the US.

<sup>2</sup> which come into effect in April 2003

<sup>3</sup> The Working Tax Credit now becomes the policy instrument specifically designed to promote employment, and is available to *all* low-income working families, and not just those families with children (as was the case for the Working Families’ Tax Credit).

<sup>4</sup> This is not meant to suggest a superiority in welfare policy among the highlighted countries relative to others. It merely reflects the authors’ relative familiarity with the tax systems in these countries.

### **3 A short history of “Making Work Pay” policies**

#### ***3.1 “Making Work Pay” programs in the United States***

Low-income families in the United States receive support from three main programmes: Food Stamps, Temporary Assistance for Needy Families (TANF) and the Earned Income Tax Credit (EITC). TANF — which supports low-income families in and out of work — replaced the old Aid to Families with Dependent Children (AFDC) programme in 1996. States now receive a block grant from the Federal government and have considerable freedom to set the eligibility, generosity, work requirements and other TANF rules. The resulting variability makes it difficult to characterise the system facing a typical low-income family across the United States.<sup>5</sup> Nonetheless, most states provide a maximum credit to low-income families, subject to resource limits, time limits and work or job-search requirements. The credit is then tapered away as income rises, perhaps after an initial disregard. In addition, there are a number of means-tested programs providing subsidised healthcare, housing and childcare.

#### **The political birth of the Earned Income Tax Credit (EITC)**

The EITC was actually a pretty hard-won component of the current income support program in the United States. The earliest notion of an earned income tax credit arose out of the rejection by Senate of the Family Assistance Plan (FAP) introduced in 1969 during the Nixon administration. The FAP was essentially a negative income tax designed to replace AFDC. In the debates that led up to this rejection, the FAP fell in the crossfire of accusations by liberals that it was insufficiently generous, and by conservatives that it was overly expensive, and generated little in the way of employment incentives.

Sen. Russell Long<sup>6</sup> opposed the FAP, and proposed an alternative “work-bonus” scheme set at 10 percent of wages (subject to Social Security taxation) for those in work. For three years after the defeat of FAP, a number of politicians pressed forward with the idea of an employment-related bonus. In addition to Sen. Long’s work bonus scheme, Rep. Marsha Griffiths presented the Tax Credits and Allowances Act to the House of

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<sup>5</sup> Committee on Ways and Means (1998) describes the rules that the federal government imposes on states. Gallagher et al (1998) provides a comprehensive description of the TANF rules in all states as of October 1997. The Welfare Rules database at the Urban Institute is an online database of the key parameters in states’ TANF programmes.

<sup>6</sup> Chair of the Senate Finance Committee in 1972.

Representatives in 1974. Although both were defeated, a momentum for an earned income tax credit of some form was building. This momentum was aided by payroll tax rate increases in the early 1970's that impacted heavily on low-income families in work, and by the US recession of 1974. Sen. Long saw a variant of his work bonus scheme, called the Earned Income Credit (EIC), passed by the legislature in 1975 on a temporary, 18-month basis. The provision added a 10 percent supplement to wages up to \$4,000 (\$12,387 in 1999 dollars) for taxpayers with children and it phased out at a 10 percent rate over the \$4,000 to \$8,000 income range.

Eventually, the earned income credit became permanent in 1978. Relabelled as the Earned Income Tax Credit (EITC), the credit was extended by adding a flat range to the phase-in and phase-out ranges of the original EIC.

### **The current structure of the EITC**

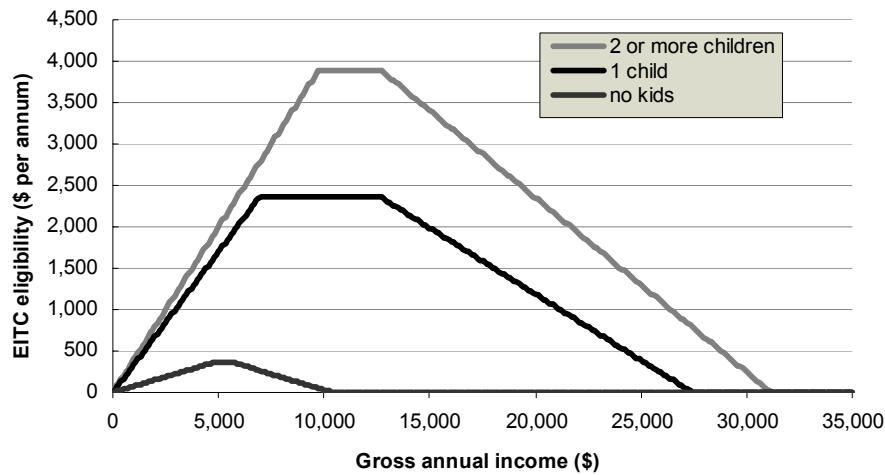
EITC is a refundable tax credit, typically paid annually in arrears and administered by the US tax authority, the Internal Revenue Service (IRS).<sup>7</sup> Families apply for it when they file their annual tax returns. Eligibility depends upon having some earned income in a year and on the number of qualifying children (children can be up to age 23 if in full-time education). The amount of credit depends on earnings, other sources of income (from investment *etc.*) and the number of qualifying children. A much smaller EITC is available for people without children. Married couples are assessed jointly. There are three regions in the credit schedule. In the phase-in region, the credit is equal to a percentage of income until the credit equals the maximum amount. There is then a flat region across which the maximum credit is received. In the phase-out region, the credit is tapered away to zero.<sup>8</sup>

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<sup>7</sup> "Refundable" in the sense that the tax credit is paid to non-taxpayers. Legislation included in the 1978 Tax Reduction and Simplification Act also introduced an 'advance payment' option for EITC eligibles so that workers could choose to receive the credit incrementally throughout the year, as an alternative to annual receipt. However, very few EITC recipients opt for advance payment. Hotz and Scholz (2002) is a recent and comprehensive review of the operation and impact of the EITC.

<sup>8</sup> In 2000, for example, a family with two or more children received a maximum credit of \$3,888 in EITC, phased in at a rate of 40 per cent. The maximum credit was reached at \$9,720, and was held until incomes passed \$12,690. Beyond this maximum, a taper of 21.06 per cent was applied to the level of EITC. At these rates, the EITC was withdrawn completely when income reached \$31,152.

*Figure 1. The Earned Income Tax Credit in 2000*



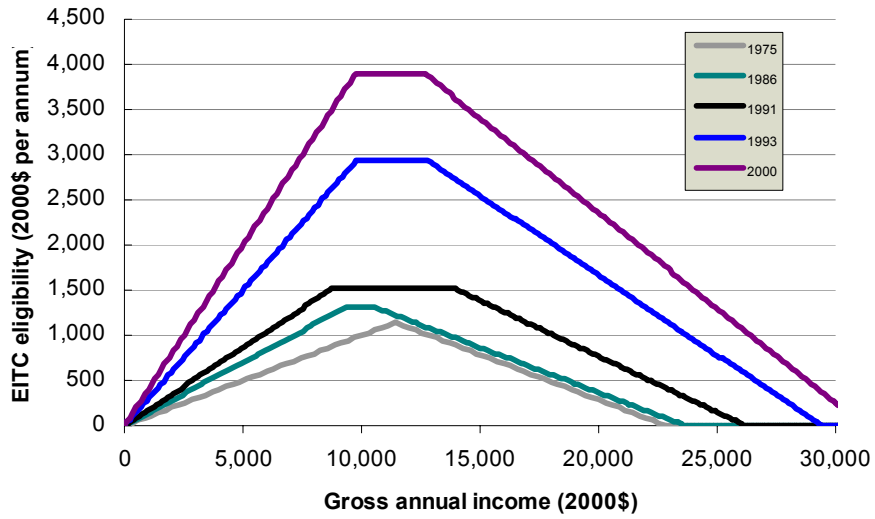
The level of support delivered through EITC was initially relatively modest, and remained so throughout the first half of the 1980s. Between 1978 and the 1986 Tax Reform Act (TRA86), the value of the EITC fell in real terms through a lack of indexation. TRA86, as part of its provisions to eliminate income taxes on families with incomes below the poverty line, increased the EITC to the point where the maximum credit in 1987 equalled the real value of the credit in 1975, and ensured that the credit would subsequently be indexed for inflation.

The generosity of the EITC increased significantly in the following decade. As part of the 1990 Omnibus Reconciliation Act, the rate for adults with two or more children was increased relative to that for families with a single child. In 1993 and again in 1996, the rate for households with two children was systematically increased relative to single child households (Figure 2). In addition, a smaller EITC was made available to childless households.

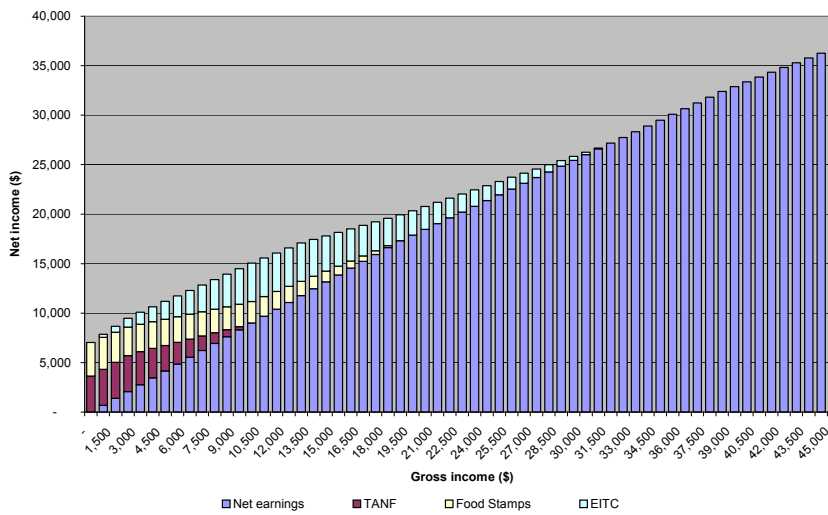
The EITC has now become an important plank in the federal Government's anti-poverty strategy. Following major expansions in the tax acts of 1986, 1990 and 1993 (taking effect in 1987, 1991 and 1994-6 respectively), the EITC now costs almost as much as Food Stamps and TANF combined.<sup>9</sup>

<sup>9</sup> In 1999, EITC spending was \$31.9bn, compared to \$16.7bn on TANF and \$19.0bn on Food Stamps (cited in Hotz and Scholz, 2001).

**Figure 2.** The development of the Earned Income Tax Credit from 1975 to 2000



**Figure 3.** US budget constraint by income source (Florida TANF structure)



Source: Brewer (2000).

### 3.2 “Making Work Pay” programs in the United Kingdom

The UK welfare system was founded on the principles laid down under the 1945-50 Labour Government, and informed by the proposals set out in Sir William Beveridge’s 1942 report. A system of contributory National Insurance benefits plus means-tested National Assistance was introduced in the 1940s, together with family allowances for all families with two or more children. Families with children received “child dependency additions” to the basic national assistance and National Insurance benefits, and child tax allowances to reduce their tax burden when working.

The original Beveridge report actually made very limited reference to the use of the benefit system to promote employment incentives. As Dilnot, Kay and Morris (1984) point out,

*“The Beveridge Report barely discusses the problem of poverty among working households. In this, it is very much a product of the particular time at which it was written[...]. For Beveridge it was axiomatic that anyone in employment had resources sufficient to support a wife and one child”,*

Dilnot, Kay and Morris (1984, p.23).

#### Family Income Supplement (FIS)

Family Income Supplement (FIS) was the first benefit in the UK aimed explicitly at low-earning families with children. Introduced in 1971 by the Conservative government under Edward Heath, FIS was regarded as a temporary measure designed to overcome some of the negative incentive effects of Supplementary Benefit, a means-tested minimum income guarantee in place at that time. Two-parent families were eligible for FIS if one of them worked 30 hours a week or more: lone parents needed only to work 24 hours a week. FIS entitlement was 50 per cent of the difference between a ‘prescribed amount’ (which varied according to the number of children in the family) and the family’s *gross* income.<sup>10</sup>

The plan was for FIS to remain in place until the government has completed a more fundamental review of the tax and social security systems. To that end, the conservative government published a Green Paper in October 1972, containing proposals for a *tax*

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<sup>10</sup> This had an unfortunate effect: an increase in gross income could actually reduce net income. Both FIS and Housing Benefit were simultaneously withdrawn as gross income increased. When combined with the increase in income tax and National Insurance liabilities, the effective marginal tax rate could exceed 100 per cent.

*credit* system. The aim of the tax credit system was twofold: first, to replace FIS and other family allowances. And second, to integrate the personal taxation and social security systems.

### **Early plans for tax credits**

The planned tax credit had three separate adult rates of support (for single adults, married couples and single parents), and child credits for each child in a family, irrespective of age. Although not primarily designed to eradicate poverty, the conservative government viewed the proposed tax credits as a more efficient means of targetting specific groups, and of streamlining the delivery of support to needy groups through the taxation system. In the end, the 1972 tax credit proposal never came into being. The conservative government under Edward Heath was defeated by Labour, under Harold Wilson, in the election of 1974, and FIS survived well into the next decade.<sup>11</sup>

### **Family Credit (FC)**

The next major series of reforms to the UK welfare system took place during the Thatcher administration that came into power in 1979. Sir Norman Fowler, the Secretary of State for Social Services, instigated a series of reviews of social security provision between 1984 and 1986. His concern centred primarily on the perceived disincentives associated with the tax and welfare system in place at that time. Overlapping tapers on taxes and means-tested income support programs led to punishingly high marginal effective tax rates, sometimes in excess of 100%, for many welfare recipients in work.

The review process led to a number of reforms (the so-called “Fowler reforms”) introduced through the 1986 Social Security Act. Among the main element in the 1986 Act were the following: Supplementary Benefit was restructured into a revised income guarantee (Income Support); a number of tapers on Housing Benefit and other means-tested benefits were aligned to overcome some of the problems of “stacking”. And Family Income Supplement was replaced in 1988 by a new in-work benefit, called Family Credit. The principal aims of these reforms were; first, to target low-income households with children; and second, to improve work incentives, not least by eliminating effective

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<sup>11</sup> One aspect of the tax credit proposals which did survive was the merger in 1977 of family and child tax allowances merged into a single non-means tested Child Benefit. Child Benefit delivered non-means

marginal tax rates of over 100 per cent. The transformation of FIS into Family Credit (FC) was central to this second objective. As indicated in the 1985 White Paper on social security reform:

*"By basing entitlement on income after tax and national insurance contributions, and assessing Housing Benefit on the same basis, Family Credit will end the present position where a reduction in benefit as earnings rise can mean an actual fall in net income after housing costs are taken into account. Similarly, by creating closer alignment between the benefits available to those families in work and those out of work, it will help to ensure that families will generally be significantly better off in work than when unemployed."*

HM Government White Paper, December 1985.

FC was available to low-income working households with children. The maximum entitlement to FC depended on the number of adults and children in the household. A family qualified for FC if at least one member worked for at least 16 hours per week. FC was withdrawn at a rate of 70 per cent as *net* income increased beyond a prescribed amount (or "applicable" amount) compared with 50 per cent of *gross* income under FIS, thereby eliminating effective marginal tax rates in excess of 100%.

In a move to integrate the social security and tax systems in the UK, and with strong resonance in the context of the current situation in the UK, the 1985 White Paper further proposed that Family Credit should be paid through the tax code as a tax credit. However, this aspect of the Family Credit proposal was defeated in the House of Lords (the upper legislative chamber in the UK) following concerns about the effects of transferring support from (in general) the mother to the wage earner. In the end, Family Credit was paid as a cash benefit (to the mother, typically) by bank payment or order book. According to David Willets MP,

*"It [the proposed tax credit payment option for Family Credit] was defeated in the House of Lords by an alliance of two groups. The small business lobby complained that employers were going to be asked to carry out much more complicated calculations to deliver PAYE than they had in the past. It was feared it would be an unfair burden on business. There was also a campaign ... about 'wallet versus purse'. The critics wanted a family benefit to go to the purse of the mother who might well not be working rather than in the wallet of the working father."*

David Willets MP. New Statesman, 13 June 1997

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tested cash help to all families with children, helping those in particular whose income was too low to take advantage of tax allowances.

The UK Government introduced a further series of reforms throughout the 1990's.<sup>12</sup> In 1992 the minimum hours of work for receipt of Family Credit was reduced from 24 to 16 hours per week for families with children. This made the benefit available to many low-paid, part-time workers previously excluded from financial support.<sup>13</sup> In 1995, the government added a £10 per week payment for families with at least one adult working 30 hours or more, in order to make full-time work relatively more attractive to low-income families. A childcare earnings disregard was added for low-income families purchasing formal (registered) childcare. This allowed expenditure of up to £60 per week on childcare to be disregarded from the Family Credit means test.

At this time, entitlement to Family Credit in the UK was restricted to working families with children. That is not to say that similar developments were not considered in the United Kingdom. In 1995, the then Conservative UK government released a Green Paper (Department for Social Security, 1995) that proposed the introduction of the *Earnings Top-Up* (ETU). This was an in-work benefit very much in the mould of the Family Credit, but designed specifically for people (singles and couples) without dependent children. And in the following year, the *Taxation of Benefits under Pilot Schemes (Earnings Top-Up) Order* made provision for a pilot study of the effects of the ETU on employment incentives. Although the scheme was never introduced<sup>14</sup>, this initiative nevertheless illustrates a continued pattern of close association between reforms to the US EITC scheme and proposals for reform to in-work benefits in the UK.

Table 1 summarises the main events in the history of in-work support in the United Kingdom.

### **The Working Families' Tax Credit (WFTC)**

Following its election in 1997, the Labour government has introduced a range of reforms to the United Kingdom's welfare and active labour market policies. One of the major elements was the introduction of the Working Families' Tax Credit (WFTC) as the main system of financial support for low-income working families with children, replacing Family Credit in October 1999.

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<sup>12</sup> These are covered in more detail in Duncan (2000).

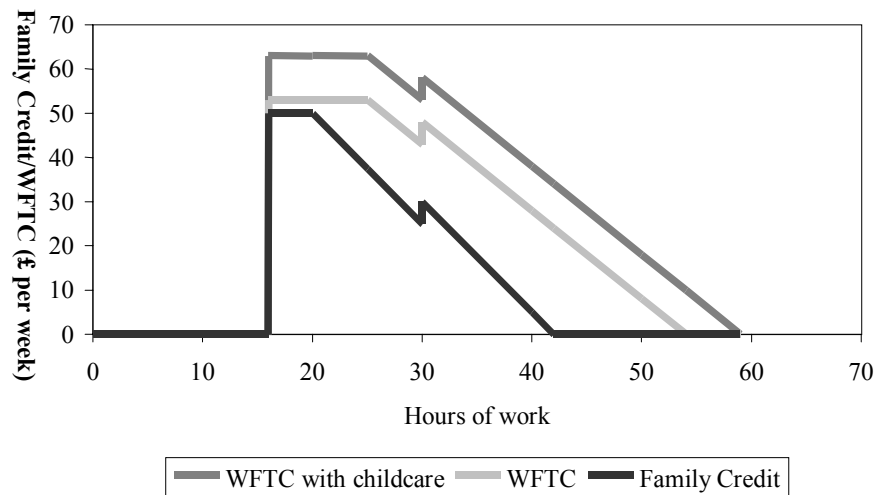
<sup>13</sup> Dilnot and Duncan (1992) discuss this particular reform in detail.

<sup>14</sup> The election of a Labour government in 1997 prevented the ETU from passing into national legislation.

The structure of the Working Families' Tax Credit (WFTC) was similar to the earlier Family Credit regime, but substantially more generous. Relative to Family Credit, the WFTC provided for; increases in the adult and child credits; an increase in the threshold before the payment is withdrawn; a reduction in the withdrawal rate from 70 per cent to 55 per cent, and; a new and potentially generous credit to cover childcare costs. The government expected a near doubling of the number of recipients compared with FC to around 1.5 million, at an additional cost of around £3bn under WFTC.

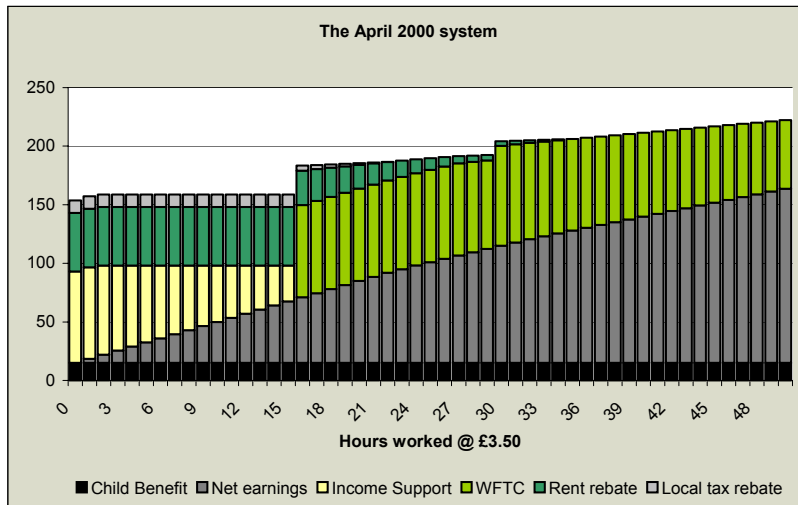
A stylised comparison of WFTC and FC is shown in Figure 4. The figure shows the value of the two credits at various hours of work.

**Figure 4: Family Credit and WFTC**

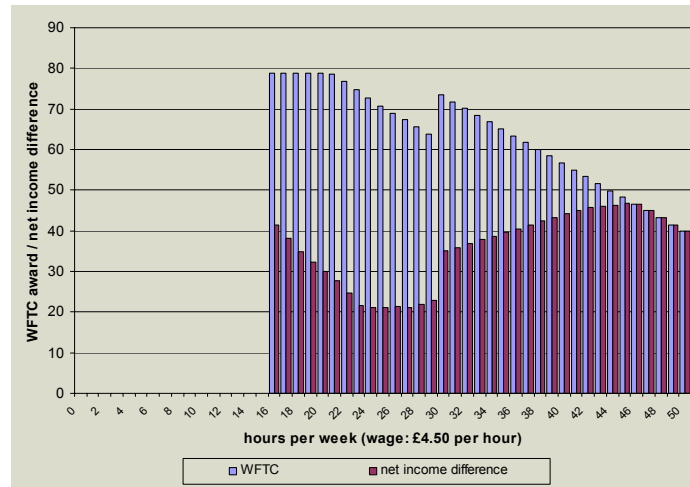


Households who are eligible for FC and WFTC are often also entitled to Housing Benefit and Council Tax Benefit. These last benefits interact with the in-work credits, meaning that disposable income increase by less than the value of the FC/WFTC payment. Figures 5a and 5b indicates the degree to which the increased generosity of WFTC is negated by interactions with other benefits. Nevertheless, the intention behind the WFTC is clear.

**Figure 5a.** UK budget constraint by income source, single parent, 2000



**Figure 5b.** WFTC award and net income difference, single parent, 2000



The WFTC was innovative to a degree in the context of the UK tax and welfare system, in the sense that it was delivered as a tax credit, and included generous additional support for working families who purchase formal childcare. However, it was also a compromise, in the sense that it replicated 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 was targeted at working families *with children*, with no specific parallel

MWP program for childless families. As a result, the WFTC was a *partial* instrument with which specifically to deliver employment incentives, in that it could only be used to promote employment among households with children. The WFTC was intrinsically bound up with objectives additional to that of “making work pay”. In terms of the “three pillars” of welfare reform, the WFTC was also used to target the first and the third pillars (“*supporting families with children*”, and “*alleviating child poverty*”). Pam Meadows saw this early on in the tax credit debate in the UK:

*"The debate tends to be muddled because it is not clear whether the objective is to reward work or to improve the well-being of families. The two objectives, while not incompatible, produce different policy recommendations, depending on the relative importance of each."*

Ms Pamela Meadows of the Policy Studies Institute  
In the UK SSSC Interim Report, October 1998.

As a design idea, it seemed more logical and coherent to identify *separate* policy instruments with which to deliver on specific objectives.

### **The Working Tax Credit (WTC)**

This has motivated a series of policy reforms in the United Kingdom, scheduled to come into force in April 2003. The Working Families’ Tax Credit (WFTC) is to be replaced by two new credits; the *Working Tax Credit* (WTC) and the *Child Tax Credit* (CTC).<sup>15</sup> The aim is to streamline and simplify the existing system. The Child Tax Credit (CTC) combines: the Children’s Tax Credit<sup>16</sup>, the per-child elements of the WFTC; the childcare support element of the WFTC; and the per-child elements of the Income Support system and income-related Jobseekers Allowance<sup>17</sup>. The Working Tax Credit (WTC) combines the adult component of the WFTC for families with children with an entirely new system of support for low-income working families without children.

Extending MWP programs to childless families in this way, whilst innovative in the UK tax and social security system, is something that has been in place for some time in the United States.<sup>18</sup> The WTC for childless single people and couples will not be as generous

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<sup>15</sup> Brewer and Clark (2001) discuss these proposals extensively.

<sup>16</sup> introduced in April 2001 and reduces the income tax bills of around 5 million income-tax-paying families with children under 16.

<sup>17</sup> CTC will only replace these elements of IS and JSA in April 2004, one year later than the rest of the reforms

<sup>18</sup> As part of the Omnibus Reconciliation Act of 1993, the EITC was extended to provide a (relatively small) credit for workers without children

as for families with children, and the eligibility conditions are tougher; only people over 25 are eligible, and they have to be working 30 hours or more per week to qualify.

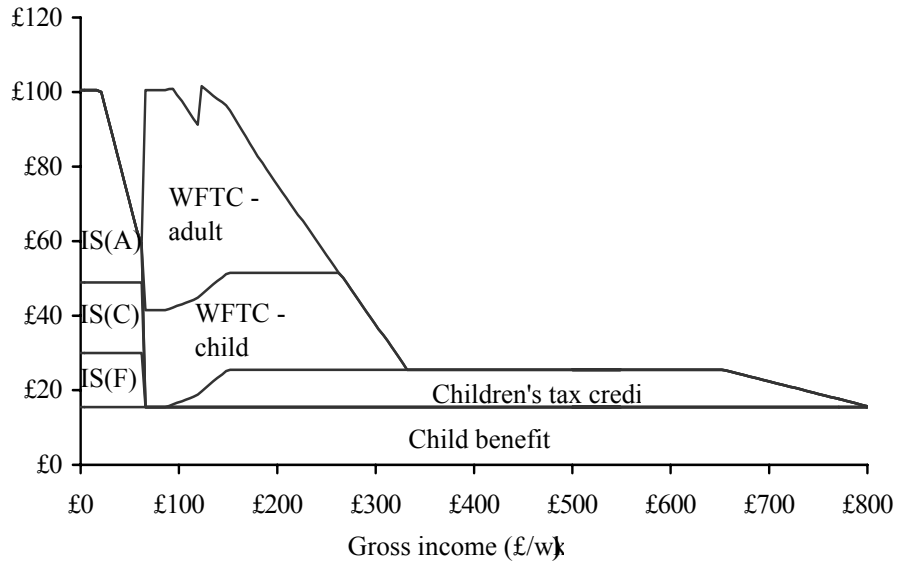
There are also differences in the assessment and delivery of the new tax credits. The WTC and CTC will be based on gross annual income, jointly assessed for a couple. By contrast, the WFTC was assessed on net income. Couples choose who will receive the CTC, whereas the WTC must always be paid to an earner in the family. The new tax credits will respond to changes in families' employment circumstances over the tax year. Once the credits have been fully phased in (by 2004/5), most families will apply for or renew an award in the summer, at which point an award will be made based on annual income in the previous tax year. However, payments may change if circumstances change during the year and they will be reconciled at year-end if the interim award proves inaccurate. People who apply in mid-year or whose income changes significantly will receive an award based on their estimate of current-year income. Again, payments will be reconciled at year-end if the estimate proves to be inaccurate. This is a significant change from WFTC, where awards were based on a snapshot of income every six months.

Figures 6 and 7 illustrate the essence of this restructuring of MWP and income support. The first shows the situation in 2001-02, with four sources of child support:

- universal child benefit;
- premiums for children in means-tested benefits for people out of work (income support and job-seekers' allowance);
- credits for low-paid parents in work (the Working Families' Tax Credit); and
- the children's income tax credit.

The second chart shows how the last three have been unified into a single Child Tax Credit, and a Working Tax Credit available to all low-wage working families who satisfy income- and hours-related conditions of eligibility. This makes the logic of the system easier to understand: child support will be paid directly to the caring parent while the Working Tax Credit will be paid by employers to the wage earner. It should therefore be easier to target each of the three stated policy objectives of the UK government (supporting families, alleviating child poverty, and promoting employment) through the separate policy instruments now available. In other words, the proposed reforms should improve the *coherence* of the UK tax and transfer system.

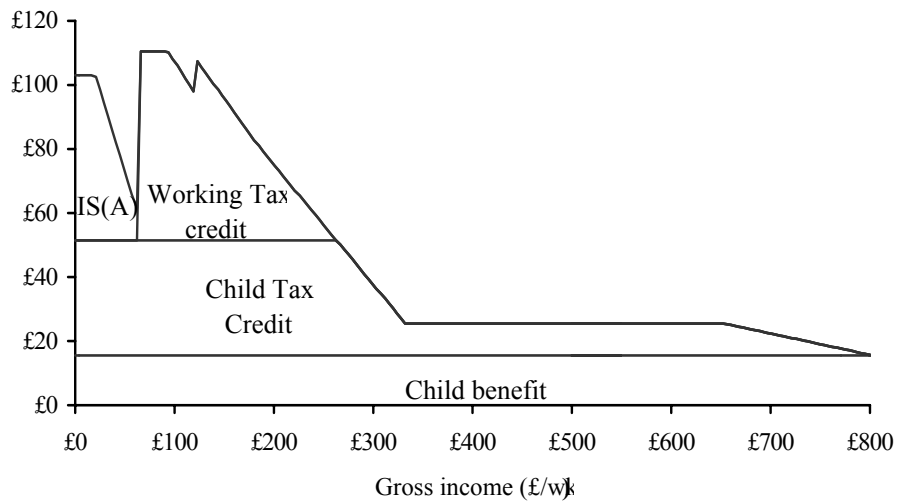
**Figure 6.** MWP and income support for families with children in the UK, Pre-April 2003



*Note:* Assumes family qualifies for WFTC at a weekly wage of £65.60, corresponding to 16 hours of work at the minimum wage. IS(A): adult income support; IS(F): family premium in income support; IS(C): child additions in income support

*Source:* Brewer, Clark and Myck (2002)

**Figure 7.** MWP and income support for families with children in the UK, Post-April 2003



*Note:* Assumes new tax credits equalise support for families with children on low incomes; that the family qualifies for employment tax credit (at weekly wage of £65.60, i.e., 16 hours of work at the minimum wage)

*Source:* Brewer, Clark and Myck (2002)



**Table 1.** A history of “Making Work Pay” programs in the UK and US

<b>Year</b>	<b>United Kingdom</b>	<b>United States</b>
1969-72	<p>1970 Family Income Supplements Act: Family Income Supplement (FIS) introduced in 1971 as a means-tested in-work benefit</p> <p>1972 Proposals for a new tax credit released in a gov’t Green Paper. (<i>never realised</i>)</p>	<p>1969: The Family Assistance Plan (FAP) proposed by the Nixon Administration. FAP was to provide a guaranteed income for all families with children who satisfied work test requirements.</p> <p>1972: FAP received approval in the House of Representatives, but was defeated in the Senate.</p> <p>1972 Sen Russell Long proposes a tax credit for working poor (a “work bonus”). Defeated</p>
1973-75	<p>1973 Social Security Act. Established basic scheme of social security contributions</p> <p>1975 Child Benefit Act. Family Allowances replaced by the new benefit of child benefit.</p> <p>1975 Social Security Pensions Act. State Earnings Related Pension Scheme (SERPS) to be introduced, providing for earnings-related retirement pension.</p>	<p>1974: Rep. Martha Griffiths introduced the Tax Credits and Allowances Act. Defeated.</p> <p>1975 Tax Reduction Act. Established a tax credit (a variant of the Long scheme) for low-income working families with children. Known as the Earned Income Credit (EIC).</p> <p>1975 Revenue Adjustment Act. Extended EIC into the Earned Income Tax Credit (EITC)</p>
1976-78	<p>1977 Family and child tax allowances merged into a single non-means tested Child Benefit</p>	<p>1976 Tax Reform Act: EITC entitlement extended.</p> <p>1978 Tax Reduction and Simplification Act. Introduced an ‘advance payment’ option for EITC eligibles as an alternative to annual receipt.</p>
1979-83	<p>1983: House of Commons Treasury Committee inquiry into the structure of personal income taxation and Income Support.</p>	<p>1979 Technical Corrections Act: required EITC income to be assessable for AFDC entitlement.</p> <p>1981 Omnibus Reconciliation Act: required joint EITC–AFDC recipients to receive EITC as a monthly advance payment (in line with AFDC). Cut AFDC generosity.</p>
1984-88	<p>1986 Social Security Act: Housing Benefit reformed. FIS replaced (in 1988) by Family Credit. Alignment of benefit tapers to eliminate high METRs.</p> <p>1988 FIS replaced by Family Credit (FC) (increased generosity, lower overall METR). Hours condition on eligibility (24 hours per week)</p>	<p>1984 Defecit Reduction Act: reversed the 1979 TCA, requiring only confirmed EITC receipt to be used in assessment for AFDC. Also increased the generosity of EITC.</p> <p>1986 Tax Reform Act: Reversed the erosion of EITC generosity, returning EITC entitlement to 1976 levels.</p>
1989-92	<p>1989 Social Security Act: more stringent activity test introduced for Unemployment Benefit.</p> <p>1992 Hours condition on eligibility for FC reduced (from 24 to 16 hours per week)</p>	<p>1990 Omnibus Reconciliation Act: EITC generosity increased. Separate rates for 2+ children. EITC excluded from means tests in other welfare programs.</p>

**Table 1 (cont.).** A history of “Making Work Pay” programs in the UK and US

<b>Year</b>	<b>United Kingdom</b>	<b>United States</b>
1993		1993 Omnibus Reconciliation Act: EITC generosity increased for families with 2+ children. EITC extended to include workers without children.
1994/5	1995 Additional credit of £10 in FC for those working 30 hours per week.  1995 Childcare expenditure disregards in FC introduced	
1996	1996 Jobseekers Act. Unemployment benefit was abolished and replaced by Jobseeker's Allowance, a two-tier contribution-based and income-related benefit for the unemployed.	1996 Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) introduced. AFDC replaced by <i>Temporary Assistance for Needy Families</i> (TANF)
1997	1997 Labour Government elected in UK. Chancellor announces intention to introduce new tax credit	1997 Taxpayers Relief Act: included provision to disqualify false EITC claimants from future receipt.  1997 Balanced Budget Act: provided additional funds to IRS for EITC compliance activities.
1998	SSSC visits US to examine EITC implementation issues. Chancellor pre-announces WFTC reform  A range of active labour market programs introduced for lone parents, young unemployed, older workers and the disabled (the <i>New Deal</i> )	
1999	WFTC replaces FC (increased generosity, reduced taper, generous support for childcare costs)	
2000	Increase in generosity. WFTC paid through the tax code	
2003	WFTC and child-related income support components restructured into the Child Tax Credit (paid to carers) and the Working Tax Credit (paid to wage earners)  WTC extended to workers without children.	

**Sources:** Brewer (2000); Dolowitz (2000); Eissa and Liebman (1996); Hotz and Scholz (2002); Ventry (2000)

## 4 Welfare reform: where do ideas come from?

### 4.1 *globalisation and welfare policy*

With increasing globalisation of economic activity, there are increased opportunities to 'learn' from policy experiences and interventions elsewhere. Although it continues to be the case that the public and social policy decision making process is fashioned largely by national priorities, it is nonetheless also the case that more than ever before national policy decisions are being informed by international experiences and policy structures. A number of factors have contributed to this. First, as a result of globalisation and technological development, policy ideas and initiatives are more easily communicated in the international arena.<sup>19</sup> Second, the surge in regionalism in the last decade or so of the twentieth century has stimulated more active dialogue on comparative policy. Third, many OECD governments claim to pursue programmes of 'evidence based' policy. Fourth, international agencies like the World Bank and IMF actively facilitate or implement the transfer of policy.

The spectrum of policy domains across which policy transfer seems to be occurring is a broad one and it is not the purpose of this lecture to provide a survey. It is instructive, nevertheless, to use the concept of policy transfer to provide focus for the current debate on welfare policy among developed countries around the world.

### 4.2 *policy co-ordination and policy transfer*

In many senses, policy transfer, or the communication of policy ideas across institutions, is a natural consequence of the globalisation, or internationalisation, of economic activity. It is well known that globalisation increases interdependence between economies. With increased openness, shocks that originate in one economy are more likely to impact on another. However, this is also true of policy *innovation*. In a closed economy there is no scope for policy-induced spillovers. In an open economy there is, and the more open the economies concerned, the greater the potential for *policy co-ordination* and *policy transfer*.

Policy transfer may be defined as the process of adopting or adapting policies from elsewhere that are deemed to be more efficacious than current practice. Dolowitz and Marsh (2000) view policy transfer as a process where

*"... knowledge about policies' administrative arrangements and ideas in one political setting is used in the development of policies' administrative arrangements, institutions and ideas in another setting."*

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<sup>19</sup> See Stone (2000) for a discussion of the role of policy institutes and think tanks in the transfer of policy ideas.

There are two important characteristics of policy transfer that should be noted. First, it is predicated on the belief that policy intervention will be welfare enhancing; second, it is evidence based. The public choice view of policy formulation views a given set of policies as the outcome of a process of interaction between competing interest groups and political lobbies. Policy transfer, on the other hand, is a process whereby governments adopt what they see as best practice, or better practice, by reference to experience with those policies elsewhere. Of course, there is still scope for lobbying from domestic pressure groups to establish national objectives and priorities. Nevertheless, the globalisation of public policy allows governments (or to be more accurate their advisers) to gain access to a wider information set and evidence on what works, or does not work, elsewhere in the global economy.

So, is there evidence to support the idea of a global convergence of MWP policy? Is the apparent convergence in public policy merely coincidental? There is firm evidence to the contrary. This can be seen most recently in the context of tax and welfare policy. Consider the evolution of MWP programs as a means of subsidising low-wage employment in the United Kingdom, from Family Credit in 1995 to the Working Families' Tax Credit (WFTC) in 1999, and now to the Working Tax Credit (WTC) and child tax credit (CTC) in April 2003. As is apparent from Table 2, there are comparable or parallel patterns of welfare reform in the United States and the United Kingdom, extending over a period stretching as far back as the early 1970's, and certainly pre-dating the most recent development of tax credits in the UK.

#### ***4.3 employment tax credits: a case study in US-UK policy transfer***

In preparation for the introduction of the Working Families' Tax Credit (WFTC) in 1999, the UK Government initiated a wide-ranging consultation exercise which gathered evidence from a range of sources on the effectiveness of work-related support in promoting employment incentives and supporting families on low incomes. It is certainly true that the WFTC reform in the UK was informed to a large degree by the US experience of the Earned Income Tax Credit<sup>20</sup>. The issue was initially raised by the current UK Chancellor of the Exchequer, Gordon Brown, in his 1997 budget speech:

*"...I have therefore also asked Martin Taylor to consider at an early stage the advantages of introducing a new in-work tax credit for low-paid workers. It would draw upon the successful experience of the American earned income tax credit, which helps reduce in-work poverty, and now helps 19 million lower-paid workers in America. [...] Conclusions that emerge from this tax benefit review will inform the judgments in my next Budget..."*

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<sup>20</sup> See Eissa and Liebman (1996)

Rt Hon Gordon Brown MP (Chancellor), Budget Speech, 2<sup>nd</sup> July 1997.

Shortly after its election, the UK government commissioned the Social Security Select Committee (SSSC) to visit the United States to learn about the structures, implementation and practical experience of American welfare systems. Following their visit, Martin Taylor released two reports on the possibility of a tax credit system for the United Kingdom (HM Treasury 1998a, 1998b) to coincide with the Budget of March 1998. And during that budget, the UK Chancellor confirmed that an employment-contingent tax credit, the Working Families' Tax Credit, was to be introduced in the following year.

#### ***4.4 adaptation and lesson-drawing in the transfer of welfare policy***

In the parliamentary debates that followed the 1998 Budget proposal, we see very clear evidence of lesson-drawing and partial policy transfer. In response to a parliamentary question in 1998 put by Mr Jim Cousins (MP for Newcastle Central), Mr David Davis MP flagged up the close relationship between the WFTC and the US system of Earned Income Tax Credit:

*"Working Families' Tax Credit is based on the American EITC. [...] In America, the EITC is known for its administrative complexity, its weakness as an incentive provider and its proneness to fraud [...] It would be a tragedy if, on top of its other problems, that problem were to afflict the WFTC as well."*

Mr David Davis (MP for Haltemprice and Howden), 23<sup>rd</sup> March 1998.

Quoted in the First Interim report on tax and benefit reform released by the UK Social Security Select Committee in 1998, Mr Chris Kelly, Head of Policy for the UK Department of Social Security put the point succinctly:

*"You cannot simply pick up the US system and transplant it over here. [...] The US earned income tax credit system forms part of a system which is different in a number of very different respects from the system that we operate over here both in terms of the number of people who have annual tax returns, the fact that people are used to having repayments of tax at the end of the year whereas with our system it tends not to happen for the majority and the fact that we have a very extensive system of other benefits whereas the US does not apart from food stamps."*

Chris Kelly, Head of Policy for the UK Department of Social Security, 1998.

And in a later parliamentary debate (in this case following the introduction of the WFTC), the same Member of Parliament again drew attention to the lessons drawn from the US experience of EITC, and the partial and adaptive nature of the transfer of US welfare policy to the UK:

*“In addition, we have the experience of the earned income tax credit in the United States, on which the Working Families’ Tax Credit is based. [...] The United Kingdom proposals were developed to be aligned with the pre-existing in-work benefit system rather than the tax credit system in the United States. For example, eligibility for the EITC was originally checked retrospectively, in line with the policy on tax measures. The IRS now verifies eligibility before payment. Such a process is built into the UK proposals because they are based on existing structures for in-work benefits.”*

Mr David Davis (MP for Haltemprice and Howden), 16<sup>th</sup> February 2000

What is interesting here is not merely the fact that lesson-drawing from US experience is integrated into the formulation of UK welfare policy, but that lesson-drawing flags up limitations in the wholesale transfer of a particular welfare policy from one domain to another. In this example, the complexities of administration and the prevalence of fraud in EITC claims are highlighted as potential dangers that ought to be accounted for in the design of the UK tax credit system.

Let’s move to Australia, to see how international experiences (both positive and negative) are forming part of the ongoing debate on the role of MWP policies in the Australian income support system.

In October 1998, a group of five economists wrote an open letter to the Prime Minister of Australia with a range of policy ideas with which to target unemployment and promote work incentives. One of the ideas in this letter was the introduction of an Employment Tax Credit (ETC) with which to supplement the wages of low-income working households. Much of the motivation behind the proposed ETC draws on experience elsewhere (principally the United Kingdom and the United States) on the use and effectiveness of employment-conditional subsidies and tax credits.

The idea was considered by the Reference Group on Welfare Reform. The McClure Interim report, commenting on the pros and cons of employment conditional benefits, said the following:

*“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

[ASD...] *a bit more stuff here*

#### **4.5 a global laboratory**

It is easy to find evidence in support of policy transfer as an active concept in the international debate on welfare policy. In its simplest form, policy transfer represents the collection of international experiences on welfare policy, as an input into the process of domestic policy formation. However, there is evidence that the process of policy transfer has evolved beyond a simple one-way process, into a more general environment of mutual learning and lesson-drawing. The point is most elegantly put by Walker and Wiseman (2001) in the context of the dialogue between the United States and the United Kingdom. They visualise the communication of welfare policy ideas in terms of a ‘*transatlantic policy transfer loop*’, where ideas in one institution are adapted in another institutional setting, with the effects of those modifications in turn being monitored by the donor institution. We have seen evidence in the 1980’s and 1990’s of UK welfare policy taking a lead from US experience of the EITC system. However, the effects of introducing the WFTC in the United Kingdom are in turn being monitored closely by other countries, including the United States. In other words, the UK experiences of employment credits are being communicated back to the United States, and may form an input into future policy developments in America.

The point is best illustrated in a recent statement from Jeffrey Liebman, a prominent US academic and policy commentator on welfare policy:

*“The Working Families Tax Credit combines the best features of the UK’s Family Credit and the US’s Earned Income Tax Credit. [...] The most impressive feature of this plan is that it achieves the advantages of paying benefits through the tax system without losing the many desirable features of Family Credit, and without sacrificing the simplicity of the UK tax system [...] Initial indications are that the Labour government has taken a good programme and made it better”.*

Prof Jeffrey Liebman (Harvard), *Financial Times*, 17<sup>th</sup> March 1998.

Of course, it would be arrogant to suggest that the UK-US axis represents the only important line of communication in the welfare policy debate. Welfare reforms and pilot studies around the world form the subject of a plethora of evaluation studies, each looking in detail at the impact of reform on behaviour, on distribution and on cost. With such a surfeit of information, it is relatively easy for governments around the world to learn of new policy, and draw lessons from their implementation, as an input in their own welfare reform agenda. In some sense, governments have access to a global laboratory in which welfare policy experiments are being conducted, the effects evaluated, and the results communicated to those who shape policy.

## 5 Some key ideas in welfare policy reform

We've talked about policy transfer, about drawing lessons (both positive and negative) from international experiences, of adapting policies to suit domestic social and economic conditions. So, what lessons can we draw from the patterns of welfare reform in UK, US and in other OECD countries? What ideas are generally considered effective? Which ideas are being transferred effectively? Do we see a consensus emerging in the objectives, structure and administration of MWP programs?

The following feature strongly among the key ideas being pursued in welfare reform around the developed world:

### 5.1 *active labour market programs*

In the United Kingdom, financial assistance for the unemployed was delivered through Income Support until 1996, before being replaced by the new Jobseekers Allowance (JSA). Recipients of JSA were required to enter into a "Jobseekers agreement", and to demonstrate their active participation in job search. One of the key initiatives of the UK government was the introduction in 1998 of a range of "New Deal" programmes for lone parents, the young unemployed, for older workers, and for the disabled. Participants in each of these programmes are assigned a Personal Advisor, who provide assistance with job search & job application (see Table 2). Although generally mandatory, participation in New Deal programmes for some groups (lone parents in particular) is voluntary.

The active labour market policies introduced in the UK were by no means innovative or unprecedented. Similar schemes had existed for some time in various guises in the United States and Australia. American programs stretch as far back as the 1969 Family Assistance Plan proposed (but never completed) by the Nixon administration. And the Australian *Working Nation* white paper of 1994 makes specific provision for active labour market programs (the *Job Compact*, *JobSkills*, *SkillShare*) to assist in labour market re-entry.

For an even earlier Australian precedent, one can go back further. The New Deal for Lone Parents scheme in the UK bears striking comparison with the Jobs, Education and Training (JET) scheme, which was initiated in Australia in 1989 under the Hawke administration at the same time as the Child Support Scheme (CSS). The JET scheme is a voluntary labour market programme which puts lone parents in receipt of Sole Parent Pension in contact with a JET adviser. According to the Australian Department for Family and Community Services (FaCS), JET

“..provides structured assistance that includes a return to work plan; information, advice and referrals to government and community services including assistance with finding childcare; training; job network referral and [...] job subsidies for customers seeking work”

DSS Annual Report 1997-8, Section 4.5.2.

It can be difficult to evaluate active labour market programmes, given that much of the help offered under such programmes is non-pecuniary in nature and relatively difficult to quantify. Official statistics argue that the New Deal programmes in the United Kingdom have been successful in promoting employment. In a written answer in July 2002, the UK Minister for Work and Pensions, Mr Nick Brown MP, presented figures showing that more than 50 per cent of participants exiting the New Deal for Lone Parents moved into unsubsidised employment (see Table 3). However, it can be difficult to assign these employment transitions directly to the New Deal programme, since those exiting the New Deal to take up paid work may have done so anyway.

Table 2. *Description of UK New Deal programmes*

<i>New Deal for Lone Parents (NDLP)</i>	<i>New Deal for Young People (NDYP)</i>	<i>New Deal for 25+ (ND25+)</i>
<b>Programme description</b>		
<p>NDLP is a <i>voluntary</i> programme. Lone parents on Income Support and with a youngest child aged 3+ are invited to an interview. Those with younger children may also choose to join.</p> <p>NDLP personal advisers deliver a comprehensive package of advice and support tailored to meet the needs of the individual lone parents (including advice on sources of support for childcare costs)</p> <p>All lone parents on IS with a youngest child of school age are required to attend a Personal Adviser meeting.</p>	<p>NDYP is a <i>mandatory</i> programme for those aged 18-24 who have been unemployed for six months.</p> <p>NDYP has 3 phases:</p> <ul style="list-style-type: none"> <li>• a <i>Gateway</i> period of intensive tailored advice and guidance for up to four months with additional specialist provision as required.</li> <li>• Those not finding work during Gateway are offered one of four options each including an element of education or training: a subsidised job with an employer; full-time education or training; work on the Environment Task Force or with the voluntary sector.</li> <li>• Follow-through provides extra adviser support to ensure that as many as possible move on into jobs.</li> </ul>	<p>ND25+ is a <i>mandatory</i> programme for those unemployed more than two years. It involved a series of advisory interviews followed by <i>voluntary</i> participation in subsidised employment, education or training.</p> <p>ND25+ has 3 phases:</p> <ul style="list-style-type: none"> <li>• a <i>Gateway</i> period of up to 4 months;</li> <li>• a period of full-time intensive activity (IAP), including periods of project-based work experience, work placements with an employer and subsidised employment. IAP lasts 13 weeks (but may be extended to 26). It is mandatory for those aged 25-49. The over 50s may access IAP provision on a voluntary basis.</li> <li>• a follow-through period, usually of 6 weeks, of supported job search</li> </ul>

Source: Centre for Economic and Social Inclusion (CESI) brief.

Table 3. *Destination of participants exiting New Deal programmes (April 2001–March 2002)*

<i>Programme</i>	<i>per cent of leavers</i>		<i>per cent of</i>	<i>Per cent of</i>	<i>per cent of leavers</i>
	<i>Total Leavers</i>	<i>moving into unsubsidised work</i>	<i>leavers moving on to other benefits</i>	<i>leavers moving for other known reason<sup>(1)</sup></i>	<i>moving to unknown destinations<sup>(2)</sup></i>
New Deal for Young People	178,500	37.2	11.6	19.7	31.5
New Deal 25 plus	63,600	29.7	21.2	29.7	19.4
New Deal for Lone Parents	90,720	57.4	1.1	34.0	7.5

*Source: Parliamentary answer by Mr Nick Brown, Minister for Work and Pensions, to a written question. 19<sup>th</sup> July 2002.*

Participation in the UK's New Deal programme is voluntary for lone parents. It is therefore likely that those lone parents who move from the New Deal to paid employment are more motivated, or positively disposed to finding work, and would therefore have been more likely to find employment in any event. There have been a number of independent evaluation studies of New Deal policies in the UK, with most concluding that the effect of New Deal programmes on labour market outcomes have been positive but modest. One such study maintains that around 20 per cent of jobs gained following participation in the New Deal for Young People programme were additional to those that would have been gained anyway, at an estimated cost of around £20,000 (US\$30,000) per job.<sup>21</sup>

Studies in the United States have found active labour market policies to be relatively costly and ineffective. For example, Freeman and Gottschalk (2000) suggest that *Enterprise Zones*, an initiative to move jobs into areas of high unemployment, cost as much as Aus\$100,000 (US\$60,000) per job.<sup>22</sup> They found that more traditional policies generated more consistent, albeit modest, benefits. Wage subsidies were found to have increased employment among qualifying workers, and active labour market programmes offering public employment to participants were found to have increased the number of workers from targeted groups working during the program. Similar studies elsewhere in the US and continental Europe generate broadly equivalent conclusions, that active labour market

<sup>21</sup>Van Reenan (2001), "No More Skinny Schemes? Active Labour Market Policies and the British New Deal for the Young Unemployed in Context", Institute for Fiscal Studies

<sup>22</sup> See Freeman and Gottschalk (eds.) (2000) *Generating Jobs: How to Increase Demand for Less-Skilled Workers*, New York: Russell Sage Foundation.

policies of the “New Deal” persuasion contribute to only modest improvements in employment at relatively high cost.<sup>23,24,25,26</sup>

It is hard to find equivalent evaluations of the JET programme in Australia. According to the 1997-8 Annual Report 1997-8 of the (then) Department for Social Security in Australia, an evaluation study showed JET to have been “instrumental in assisting workforce entry for a substantial proportion of JET customers”.

## **5.2 mutual obligation and conditionality of welfare support**

As a relative newcomer to the Australian system of welfare support, it strikes me that the concept of ‘mutual obligation’, in its various guises, remains a dominant point of controversy, arousing more passion than pretty much any other aspect of the policy debate.

Mutual obligation is by no means a recent concept. I was pleased to learn that the United Kingdom was at the forefront of the development of obligation as early as the 16<sup>th</sup> Century. Apparently, following concern at the number of beneficiaries of religious charities after the closure of the monasteries, the death penalty was introduced for those who were able to work, but refused to do so.<sup>27</sup>

More recent incarnations of mutual obligation are, fortunately, less severe. However, one can trace the development of programs which require active participation by welfare recipients in job search and job skill enhancement throughout the later part of the 20<sup>th</sup> Century. The emphasis has, inevitably, changed over time and across political administration. In the United Kingdom, the Thatcher administration adopted a strong line on welfare receipt, with an emphasis on individual responsibility for finding employment. The role of the state was to provide a strong economic environment in which the benefits of wealth creation would “trickle down” to generate employment opportunities. A famous (some might say, notorious) quote by Sir Norman Tebbit recounted how his unemployed father “got on his bike” to find work, with the implication that welfare recipients should (metaphorically) do the same.

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<sup>23</sup> Brodaty and Fougère (2002), *Do Long-Term Unemployed Workers Benefit from Active Labour Market Programs? Evidence from France 1986-1998*, paper presented at the 2002 Econometric Society European Meetings.

<sup>24</sup> Calmfors, Forslund and Hemstrom (2002), *Does Active Labour Market Policy Work? Lessons from the Swedish Experiences*, IFAU Working Paper No. 2002:4

<sup>25</sup> Kluge, Lehmann and Schmitt (2002), *Disentangling Treatment Effects of Polish Active Labour Market Policies: Evidence from Matched Samples*, CEPR Discussion Paper No 3298.

<sup>26</sup> Sianesi (2002), *Swedish active labour market programmes in the 1990s: overall effectiveness and differential performance*, Institute for Fiscal Studies Working Paper 02/03.

<sup>27</sup> Thanks go to Rosanna Scutella for this valuable insight.

The Blair administration has adopted an arguably more compassionate tone, stressing the responsibility of government to provide opportunities for employment, and assistance in job search and skill enhancement. However, the concept of mutual obligation permeates the policy discourse and the language of welfare reform in the United Kingdom. Tony Blair has emphasised the “rights and responsibilities” of welfare recipients; the New Labour manifesto introduced the idea of a “social contract” between welfare recipients and government. Indeed, the very language of welfare reform reinforces the need for activity, with Unemployment Benefit being replaced by Jobseekers’ Allowance, with receipt conditional (for many groups) on mandatory participation in “New Deal” programs of assistance with job placement and job skill development.

The language of welfare reform in the US is even more stark in its emphasis on mutual obligation, reflecting a tightening in the conditions for welfare support. Aid for Families with Dependent Children (AFDC) was replaced in 1996 by *Temporary* Assistance for Needy Families (TANF, my italics), with mandatory job search requirements and time limitations on receipt.

Although elements of mutual obligation are present in most modern welfare systems in the developed world, the degree to which individual obligations bind or constrain behaviour varies across nations. In the US, TANF has demonstrably been effective in reducing welfare rolls. For example, receipt of TANF by sole parent households has fallen by around 50 per cent. But at what cost? It has been argued that the most recent US welfare reforms are unacceptably stringent, offering few exemptions to even the most needy or disadvantaged groups in society. Some social commentators in the US argue that the current brand of mutual obligation represents an infringement of individual freedoms and citizenship, impinging on the rights of families to care for their children, and unemployed seekers to choose appropriate or rewarding labour market roles.

Despite this, the concept of mutual obligation seems, to me, to be an important and pragmatic element in modern welfare policy. The challenge to policy formers is to frame the system in a sympathetic and flexible manner, consistent with the nation’s social values and priorities. There is clearly a need for appropriate exemptions for vulnerable groups in society, and for effective job creation and training programmes to uphold the government’s side of the mutual obligation bargain.

### **5.3 *promoting employment through MWP policies***

The preoccupation with MWP programs in welfare policy discussions around the world indicates a perception by many governments that policies of this form can be effective in promoting work incentives among low-income households. Of course, the particular design features of such

programs are important, and we identify later a number of problems and concerns that have emerged from international experiences in the design and implementation of MWP policies.

Countries as diverse as Belgium, Canada, Finland, Italy, New Zealand, the United Kingdom and the United States have now adopted a policy of subsidising low-paid workers' wages as a way of improving work incentives. Many other countries (including Australia and Denmark) are actively considering whether to adopt MWP policies as part of their respective programmes of welfare reform. It is therefore important to consider the degree to which such programs can generate positive employment effects, and the specific design features of an MWP policy that either help or hinder in that regard.

Much of the evidence on the employment and labour supply effects of MWP programs centres on the experience of the UK and US. This is natural, given the long history of MWP programs in these two countries compared with others in the OECD. Before citing empirical evidence, it is therefore worth emphasising how much the behavioural effects of MWP policies are conditioned by the design features specific to the US EITC and the UK WFTC. In both cases, the tax credit is assessed on family incomes. The UK tax credit system combines with an individual-based tax system, while the US EITC operates within a family-based tax system. Both tax credits have increased substantially over the last two decades. This provides an opportunity both for *ex-ante* and *ex-post* evaluation. Most programs implemented or proposed elsewhere in the OECD are relatively recent innovations, and can therefore only be assessed on an *ex-ante* basis.

There is evidence that the Earned Income Tax Credit (EITC) in the United States, which subsidises those workers who accept employment but who have low family incomes, promotes employment (Hotz and Scholz, 2000). Meyer and Rosenbaum (1999) calculate that 63% of the increase in labour force participation rates of lone-parent families (the main group of beneficiaries) between 1984 and 1996 was due to the EITC. Eissa and Liebman (1998) believe that the 1986 expansion of the EITC increased labour force participation of lone parents by 2.8 percentage points, rising to 6 percentage points for those lone-parents who had the lowest level of education. Ellwood (2002) believes that welfare reform accounts for half of the increase in employment of female-headed households over recent years, the EITC another 30%, with the remainder being due to improved labour market conditions.

Fewer empirical studies exist on the impact of EITC on the labour market behaviour of two-adult households. Those that do report ambiguous employment and labour supply responses. For example, Eissa and Hoynes (2000) analyse the combined effects of the 1993 and 1996 expansions in

EITC entitlement on patterns of employment among married couples. They find a modest increase in participation among males in two-adult households with children (of around 0.2 percentage points), but a *decrease* in employment among women of up to 1.2 percentage points. The reasons for this apparently counter-intuitive result are actually relatively intuitive. Because the EITC is assessed on family income, a reduction in labour supply among secondary earners in two-adult households (usually women) increases the family's EITC entitlement. Women may therefore withdraw from the labour market without too much of a reduction in overall household income.

Similar effects have been uncovered in the United Kingdom. Empirical studies of the effects of the move from Family Credit to the WFTC in the late 1990s estimated a net increase in employment ranging from between 10,000 to 100,000 people (Blundell, Duncan, McCrae and Meghir, 2000). However, this net figure combines an increase of around 2.2 percentage points in the employment rate among single-headed households with a *reduction* of around 0.5 percentage points in the employment rate among women in couples.

Canada has been experimenting with earnings supplements (the Earnings Supplement Programme and the Self-Sufficiency Project). The final report on the project shows that the SSP increased both employment significantly -- one year after the project started, 'program group members were twice as likely as control group members to be working full time' (Michalopoulos *et al.* 2002). Because employment went up, aggregate earnings also went up - by as much as 20 per cent on average. This is a significant effect, although not so substantial as to make the programme pay for itself (through reduced benefit payments and increased tax revenues), at least in the short run.

#### **5.4 *cost-effectiveness of MWP policies***

Some care is required in assessing the cost-effectiveness of MWP policies. The aim of an MWP program is to shift the balance between incomes in and out of work. Tax and transfer systems were, in the past, often designed solely with distributional objectives in mind. MWP policies, once rare, have now become widespread. Most in-work transfers around the world perform 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. The cost-effectiveness of MWP programs should therefore be judged relative to the weight governments attach to these objectives. Much of the cost of a MWP program may come from providing additional financial gain to families already in work. These costs may be interpreted narrowly as "deadweight" if the sole intention of the policy is

to promote employment. However, if the MWP program is also intended to serve a distributive purpose, then to interpret the cost as deadweight is too harsh.

### **5.5 *simplification and coherency***

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.

It is easy to see how complexity and inconsistency can emerge in the development of tax and welfare programmes. Inertia, administrative complexity, political stagnation are all conditions under which governments might engage in piecemeal tax reform, fitting 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 effects of *incrementalism* in tax policy reform on the coherency of the system as a whole can be significant.

#### **the WTC and CTC reforms in the United Kingdom: a move towards coherency?**

The policy reforms in the United Kingdom, scheduled to come into force in April 2003, were motivated in part by a desire to move towards a more coherent structure of income support. As discussed earlier, the Working Families' Tax Credit (WFTC) is being replaced by two new credits; the *Working Tax Credit* (WTC) and the *Child Tax Credit* (CTC).<sup>28</sup> The aim is to streamline and simplify the existing system. The Child Tax Credit combines three sources of support for families with children into a single instrument paid directly to the caring parent. And the Working Tax Credit will be available to all low-income working households, not just those in families with children.<sup>29</sup> This makes the logic of the system easier to understand: child support will be paid directly to the caring parent while the employment credit will be paid with wages by employers. It should therefore be easier to target each of the three stated policy objectives of the UK government (supporting families, alleviating child poverty, and promoting employment) through the separate policy instruments which will become available following these most recently announced reforms. In other words, the proposed reforms will improve the *coherence* of the UK tax and transfer system.

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<sup>28</sup> Brewer and Clark (2001) discuss these proposals extensively.

<sup>29</sup> See Figures 5 and 6 for a comparison of the current system of support in the UK, and the proposed system to be introduced in 2003.

### **the ANTS reform in Australia: a move towards coherency?**

These same concerns, of simplicity and coherency of welfare instruments and policy objectives, run as a parallel theme in the recent policy debate in Australia. Much of the motivation behind the introduction in July 2000 of *ANTS (a new tax system)* centred on the need for simplification of a system which had, through a process of incremental reform over the previous decade or more, grown overly complex and unwieldy. The Australian Treasurer's 1998 report, which laid out the detail of the new tax system, included an explicit recognition of the damaging effects of incrementalism and piecemeal reform. The report counted *twelve* forms of family assistance payments, many of which targeted equivalent policy objectives: The same report went on to identify simplification and transparency as central objectives of reform:

*"There is a need to simplify the structure and delivery of assistance for families. The number of programmes could be reduced substantially with only one payment dealing with each target group and their delivery being made through one agency."*

"Tax Reform: not a new tax, a new tax system". August 1998, p.43.

In addition to the introduction of GST, the July 2000 reforms in Australia simplified considerably the pre-existing structure of support for families and children:

- ❑ Family Allowance, Family Tax Payment Part A and Family Tax Allowance Part A were integrated into a single payment, called *Family Tax Benefit Part A*.
- ❑ Basic Parenting Payment, Guardian Allowance, Family Tax Payment Part B, Dependent Spouse Rebate, Sole Parent Rebate and Family Tax Assistance Part B were integrated into a single payment, called *Family Tax Benefit Part B*.
- ❑ Childcare Cash Rebate and Childcare Assistance were integrated into a single payment, called *Child Care Benefit*.

These reforms move the post-ANTS system of income support in Australia much closer to a coherent structure, with separate policy instruments to target each of the stated objectives of the Australian government.

## **6 An Emerging Consensus in MWP Programs?**

In charting the development of MWP policies, first in the bilateral dialogue between US and UK, and latterly through the spread of MWP programs across other countries in Australia, New Zealand and Europe, it is interesting to consider whether or not a consensus is emerging in the design of programs of support for working households. Established MWP programs have clearly evolved, in a

fashion which has arguably brought design features closer together. And newer MWP programs (in Belgium, France, Finland) have mirrored the structure of their established forerunners in a number of respects.

Nevertheless, it is apparent that the lessons that have been drawn from the experiences and implementation of WFTC and EITC have informed the design of new programs. Among the major issues of interest to those countries framing new MWP policy

➤ The employment effects of MWP policies

- Much of the evaluation evidence on employment effects of MWP policies suggests an uneven impact across demographic groups, something that has been of major concern to those (eg. Denmark, France, and a number of other European countries). considering the introduction of new MWP programs. Result from evaluations of MWP programs in the UK and US persistently show that second earners in two-worker households typically have a reduced incentive to work, principally when MWP payments are assessed on family income. The response to these lessons are unclear. Moving to a system of individual assessment raises distributional concerns regarding the family income of those receiving tax credit support. Moving to a system of joint taxation raises similar concerns regarding the incentives such a system creates for single- relative to two-earner households.

➤ Cost-effectiveness of MWP policies

- When judged narrowly in terms of their effectiveness in promoting employment, most evidence suggests that MWP policies are relatively expensive. This would raise obvious concern if this were the sole criterion by which to judge such programs. However, MWP programs also serve a distributional purpose; to provide financial support to specific groups of low-income working families (perhaps those with young children, as was the case in the UK under WFTC, and as is the case under the differentiated rate structure of EITC in the US). The extent to which the provision of income support to families already in work is regarded as “deadweight”, rather as redistribution, is therefore a question that can only be answered in the context of the objectives that have informed the structure of the MWP policy.
- One response to concerns about cost-effectiveness, a num has been to led to the systematic emergence of so-called “mutual obligation” and conditionality of support,

either restricting eligibility to certain classes of individual, or (more broadly) by adding time-limitation to entitlement (TANF) or introducing two-tiered entitlement (Job Seekers Allowance)

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## 7 Appendix: Design Issues for MWP policies

Design features of in-work transfer programmes vary somewhat from one country to another. Relatively innocuous design choices can generate significant, unanticipated and potentially adverse work incentives.

### 7.1 *Structural conditions of entitlement*

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

- 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 Working 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.<sup>30</sup> 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 hours 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 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

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<sup>30</sup> This is certainly the case in the three countries (Australia, the United Kingdom and the United States). studied specifically in this paper.

of entitlement.<sup>31</sup> 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.<sup>32</sup>

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 UK system improves the targeting of the benefit towards working households, and may therefore be more effective in promoting employment incentives. 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 hours 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.<sup>33</sup>

## ***7.2 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.<sup>34</sup> 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.

## ***7.3 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.<sup>35</sup> However, the choice of the unit of assessment is not

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<sup>31</sup> 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.

<sup>32</sup> 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.

<sup>33</sup> Holtzblatt and Liebman (1998) present a useful comparison of the structure, administration and incentive implication of EITC and WFTC. Whitehouse (1996) presents a more international viewpoint.

<sup>34</sup> Walker (2000) provides a clear exposition of this effect in the UK context.

<sup>35</sup> 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.

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. 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.<sup>36</sup> 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 welfare payment. In the UK, Family Credit was paid to the caring parent (usually the mother). The Working Families' Tax Credit, on the other hand, is more likely to be paid to the taxpayer in the household (potentially the father). Depending on the extent of income-sharing within the household, this largely administrative change in structure can have substantial welfare 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.

#### **7.4 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. For example, the apparent increase in the generosity of WFTC in the UK are not realised by those families who also qualify for Housing Benefit. This is because WFTC forms part of the assessable income used in the Housing Benefit means test. This interaction compromises the effectiveness of WFTC both as a redistributive tool and as a vehicle for improving work incentives.<sup>37</sup>

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<sup>36</sup> Duncan and Giles (1998b) 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.

<sup>37</sup> 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.

### **7.5 *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.<sup>38</sup>

### **7.6 *Tax credits versus income/expenditure disregards***

Systems of in-work financial support sometimes compensate household expenditures necessary for entering employment. In the United Kingdom, both Family Credit and the current Working Families' Tax Credit have provided additional financial support for households that purchase formal childcare. Under Family Credit, childcare expenditure up to a ceiling could be disregarded in the means test. Disregards extend entitlement to a means-tested benefit, but do not necessarily increase the level of the benefit. For those already on the maximum entitlement to Family Credit, the childcare expenditure disregard offered no additional financial support. Any effects on employment incentives are limited to those already in part-time employment, perhaps at an earnings level beyond the Family Credit taper. The childcare credit component of the Working Families' Tax Credit, on the other hand, increases the maximum payment for those already on maximum WFTC entitlement who purchase formal care. This is likely to generate a greater incentive among currently non-working households to take up paid employment, but will also be more expensive than the FC disregard, with a greater deadweight cost.

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<sup>38</sup> 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 (1999); Dickert, Houser and Scholtz (1995); Hoynes (1996); Keane and Moffitt (1997); Moffitt (1990).