

Executive Summary

Policymakers attempt to accomplish three broad goals in designing benefit systems: support the living standards of low-income families, especially when children are present; encourage work and economic self-sufficiency; and keep costs to the taxpayer low. These goals often are in conflict with one another, so trade-offs have to be made.

This publication analyses the effects of taxes and benefits on incomes of working-age individuals and their families in 29 OECD countries¹ for the year 2005, and it describes changes since 2001. Detailed country-specific information about tax and benefit systems, and a regularly updated selection of key indicators calculated from the OECD Tax-Benefit Models are available on the Internet at www.oecd.org/els/social/workincentives. This volume focuses on comparisons across countries, and the sort of questions it answers include: what benefits do unemployed people in different countries receive and how does this compare to the net income they receive while in work? Does the amount of benefit depend on how long someone is unemployed? How much extra does the tax and benefit system give to families with children? How much does a jobless person need to earn before he or she is better off than they would be if they stayed on benefit? Apart from unemployment benefits, what other government policies impact on financial work incentives and what is their net effect?

Two special chapters provide additional analysis. Chapter 4 looks at the effect of childcare costs on family incomes, and how the tax and benefit system is adapted to help meet these costs, so changing the incentives to work for parents. Chapter 5 outlines the trends in recent reforms of benefit systems across OECD countries.

Benefit entitlements, income adequacy and poverty risks

One of the key objectives of benefit policy is to prevent people's living standards from dropping to unacceptably low levels. What level is deemed "unacceptable", of course, varies across countries and different family situations. One way of illustrating countries' views on this issue is to look at the *minimum* benefit level in the social benefit system. This minimum might be provided in the form of special minimum-income benefits, such as social assistance, or it might be embedded in earnings-related unemployment benefit systems in the form of a benefit "floor". It is important to note that – increasingly – not everyone with income below the relevant minimum might be entitled to top-up transfers from the government, even in countries operating such benefits. Eligibility can be subject to "residency tests" (has the person lived in the country for a sufficient amount of time?) or activity tests (is the benefit client actively looking for work and co-operating with other integration measures?).

For those entitled to receive minimum income benefits, the report finds that benefit levels are mostly below commonly-used relative poverty thresholds, sometimes substantially so. That said, real net incomes of social assistance recipients tended to increase between 2001 and 2005: for families with no other incomes, the gap between social-assistance benefits and the poverty threshold has narrowed by about four percentage points on average for families with children, and by one to two percentage points for childless families. This reflects the high priority attached to reducing child poverty in many OECD countries.

For short-term unemployed persons with access to unemployment benefits, existing tax-benefit systems provide very different degrees of income replacement across countries. For single people who previously earned the national average wage, *net* replacement rates (the ratio of income out of work to income in work, after taking account of taxes and benefits) are below 40% in Ireland, Australia, Greece, New Zealand and Turkey, but are 70% and above in Switzerland, Portugal and Luxembourg. In general, net replacement rates tend to be higher at lower earnings levels and higher for families with children. A synthetic index of net replacement rates which takes into account different family types and unemployment spell durations is used by the OECD to describe general trends in out-of-work benefit generosity.² On average across the 29 OECD countries, its level was 56% in 2005, 3 percentage points lower than in 2001. The report finds the highest levels of this index (above 70%) in most of the Nordic countries. With values of below 30%, the index of benefit generosity is much lower in countries where benefits for the long-term unemployed are very low or non-existent (the United States, Greece, Turkey and Italy).

Does it pay to work?

While the incomes of people unable to find work are an important determinant of poverty rates, the finding that minimum-income benefit levels are often set below the poverty threshold does, in itself, not necessarily imply that policies to reduce poverty are failing. Governments frequently seek to encourage employment and self-sufficiency with policies attempting to support transitions from unemployment or inactivity into work, especially for the poor.

One way of looking at how tax-benefit systems perform in this respect is to ask how much a person needs to earn in order to raise family income *above* the poverty threshold. The report shows that in a number of countries, even those working full-time at wages close to the national average may struggle to do so if children are present. Examples of such poverty traps can be found in Spain, Switzerland, Canada, Denmark and the United States. In those countries, a person with a non-working spouse and two children would need to earn at least 90% of the average wage to keep family income from falling below 60% of average family income.

High tax burdens for those taking up work are one of the factors that can limit the financial gains from employment. In addition, jobless people entering a new job generally lose entitlement to part or all of their out-of-work benefits; how these benefits are phased out can therefore be crucial for whether or not it pays to work. On average across OECD countries, and taking account of both in-work taxes and the loss of out-of-work benefits, an unemployment benefit recipient returning to a full-time job at average pay loses as much as 66 cents for each euro or dollar earned in the new job. Yet, work incentives are much stronger in a number of countries. In Australia, Greece, Ireland, Japan, Korea and

New Zealand, unemployed people generally get to keep more than half of their gross earnings when they take up a job. Even in these countries, there are, however, exceptions where work incentives are considerably weaker for certain family situations or at lower earnings levels.

A range of different policy instruments can be employed to ensure strong work incentives. In some countries, benefits for those without work are kept deliberately low so as to provide a strong incentive to find a paid job. However, if this strategy is not successful, there is a risk of income poverty. In other cases, a combination of low tax and contribution burdens for employees (*e.g.* most Anglophone countries, Korea, or the Slovak Republic) or in-work benefits that top up in-work earnings (*e.g.* Finland, France, New Zealand, United Kingdom, United States) are used. If successful, a combination of these policies can keep work incentives intact and at the same time prevent or reduce poverty among the jobless. They are, however, no free lunch. Measures that improve incentives to move from unemployment to work can reduce the incentive to train or to increase hours of work, or (in the case of in-work benefits) reduce the work incentives facing second earners in a family; they also involve additional public spending. Still, the alternatives are not simply “good work incentives and low benefit payments” *versus* “high benefit payments and poor work incentives”. The policy choices open to policymakers are much wider than is often recognised.

The impact of childcare

Parents with young children are typically faced with a choice between returning to employment and staying at home to care for the children. While childcare policies can help parents better reconcile care and employment, poorly-designed or implemented measures can in fact make it harder to reconcile work with family life.

This report quantifies the net costs of childcare, accounting for price differences across countries as well as a wide range of childcare support policies. It shows that childcare costs can be very substantial, even after taking account of subsidies, tax breaks and special benefits for users of non-parental childcare. Typical out-of-pocket expenses for two children in a full-time, centre-based care amount to around 12 to 14% of family net income on average across the OECD. At up to 50% of family net incomes, centre-based care is most expensive in Switzerland and the Anglophone countries (except Australia), and lowest in eastern and northern European countries (less than 10%).

The financial reward of full-time employment is reduced considerably once childcare costs are accounted for: low-wage second earners in about half the countries see more than two-thirds of their earnings consumed by childcare fees, income taxes and reduced benefits. A related finding is that, on average, relative income gains for lone parents and second earners are not too different when childcare costs are taken into account. This suggests that most countries target childcare support towards (low-wage) lone parents, as lone parents face particularly poor work incentives in most countries when childcare costs are not taken into account. Yet, targeting tends to be less important in countries where childcare is least expensive. Policies to make quality childcare affordable for all parents require a substantial commitment of resources, both financial and non financial. But, if properly designed, the money is likely to be well-spent, with better career/family choices

for parents and positive effects on maternal employment and child well-being, especially once the child is older than 1-2 years.

Benefit reforms: most recent trends

In the past, most countries focused their benefit system reforms on changes of eligibility conditions, tightening or restricting access to programmes as well as possibly reducing benefit durations. Examples of reductions of benefit rates and amounts were rare. This has changed in recent years. In a number of countries, benefit rates have been adjusted downwards, sometimes considerably. The package of measures in Germany summarised as the “Hartz reforms” restricted eligibility to payments but also reduced benefit rates, especially for the long-term unemployed. The Slovak Republic (unemployment benefit and social assistance) and Switzerland (social assistance) are other examples of countries where benefit levels have been reduced. Correspondingly, falls in net replacement rates for many family types are recorded in about one third of OECD countries, in some of them by significant amounts.

This reduction in benefit levels relative to income is a striking recent development, and is one that has passed somewhat unnoticed. It is perhaps the first time in the recent past that such a pattern of benefit cuts has been observed, as previous reductions in benefit levels have been isolated in just a handful of countries.

At the same time, a trend from the past which continues in recent years is the extension or establishment of employment-conditional benefit programmes. Measures ensuring a more gradual phase-out of existing benefits when taking up work can pursue similar objectives, namely to make work pay. Experiences with these types of in-work benefits are mixed. Evidence shows that they can be an effective policy tool. By providing extra resources to low-wage workers, they improve work incentives, redistribute resources to low-income groups and tend to reduce in-work poverty. But the success of in-work benefits very much depends on the resources devoted to them and their particular design (for instance, while facilitating a limited degree of work attachment for recipients of out-of-work benefits, a gradual phase-out of benefits can actually lock people into benefit dependency). Implementation of such programmes also presents considerable challenges – often they are based on outdated income information so are not responsive to changes in current behaviour; they have proven vulnerable to fraud and misuse; administrative costs have sometimes been high and errors in payment substantial. Where in-work benefits have been most successful, those problems have been overcome. If other countries want to share in this success, they, too, must get the administration right.

Notes

1. Mexico does not have an extensive system of working-age benefits and so is not included in this analysis.
2. This indicator takes into account housing benefits but not childcare costs.