

## V. MAKING WORK PAY

There has recently been increased interest in policies that subsidise work at low pay in order to “make work pay”.<sup>1</sup> Such policies operate either by reducing employers’ cost of employing low-wage labour or by raising the disposable incomes of workers with low earnings. Making work pay policies address three problems afflicting persons with low earnings potential: exclusion from the labour market, high risk of unemployment and low earnings if in work. The long-term solution to these problems is to increase the earnings capacity of individuals, notably through higher educational attainment as well as better on-the-job training. However, in the short and medium term, making work pay policies can help to increase employment and the income of low productivity workers. Moreover, they reduce the risk of an underclass becoming alienated from society. This chapter briefly reviews the difficulties that low productivity workers face, how the various making work pay policies might alleviate such difficulties, and the extent to which such policies are effective and efficient in solving these problems.

*Making work pay policies aim at reducing problems faced by persons with low earnings potential and their dependants*

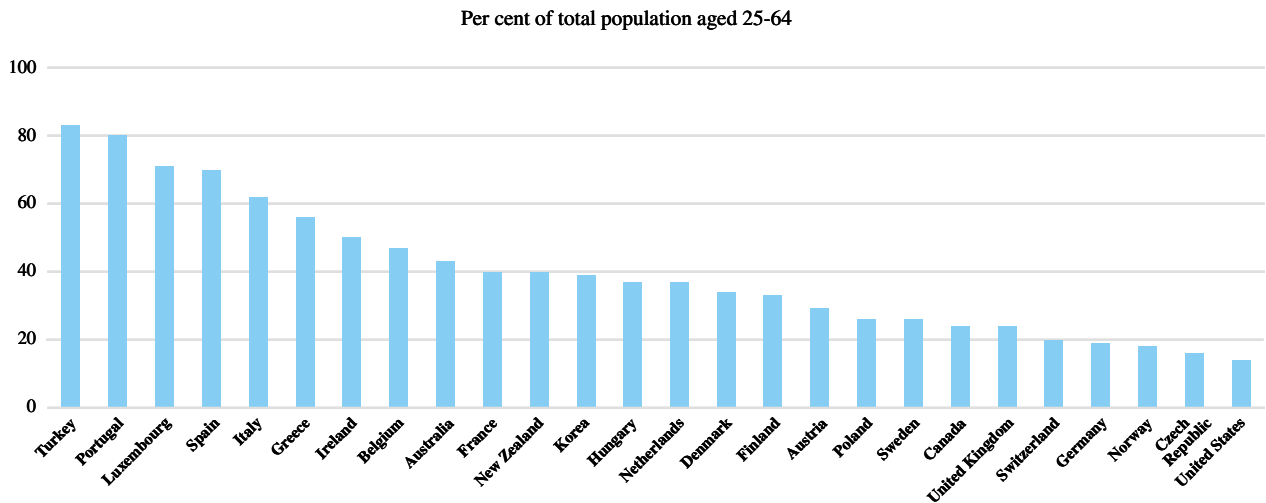
The review presented in the chapter suggests that making work pay policies have achieved some success in stimulating employment of people with low earnings capacity. Moreover, they have often proved to be effective in redistributing income towards those with low pay. However, these policies have also weakened work incentives for those already in work, though in the countries already pursuing such policies these negative effects have not been so strong as to offset the positive employment effects. To maximise their effectiveness, making work pay policies need to be tailored to specific framework conditions in each country, and the introduction or expansion of such policies may have to be accompanied by changes in other areas of labour market and social policies.

### The economic situation of persons with low skills

Low earnings capacity is generally associated with low educational qualification and lack of work experience. Across OECD Member countries, the proportion of the population aged 25 to 64 that has attained only lower secondary education or less varied considerably in the mid-1990s (Figure V.1). As women have often received less education than men in the past, females are over-represented in the lowest educational group in many countries.<sup>2</sup> Moreover, their job-related skills are often adversely affected by breaks in careers related to family responsibilities, and this may strongly affect the earnings capacity of even relatively educated single mothers. Although young people tend to have relatively high educational qualifications, inexperienced youth that leave school early do not have enough skills to command high earnings capacity. Lack of recent job experience also makes the long-term unemployed less attractive in the eyes of employers.

*Persons with low educational attainment and lack of work experience suffer from various problems:*

1. This chapter draws heavily on papers presented at an OECD workshop on Making Work Pay held in September 1999. These papers will be published in *OECD Economic Studies No. 31* (forthcoming). Further background material for the chapter comes from OECD, *Implementing the OECD Jobs Strategy – Assessing Performance and Policy*, Paris, 1999; and OECD, *Making Work Pay*, Paris, 1997.
2. See Table A1.2b in OECD, *Education at a Glance 1998*, Paris, 1998.

Figure V.1. **Individuals aged 25-64 with lower secondary education or less, 1996**

Source: OECD, *Education at a Glance – OECD Indicators*, 1998.

### ... low labour force participation...

Labour force participation of groups with only basic educational attainment is low in most OECD countries (Figure V.2, upper panel). The labour force participation rate of the adult population with at most lower secondary education is often 20 percentage points lower than for those who left the education system after completing an upper secondary education and the gap is much larger still compared with those with tertiary education.

### ... high unemployment rate...

Less educated workers account for a high proportion of total unemployment in most OECD countries. Their unemployment rate is generally above the average (Figure V.2, middle panel), by a factor of as much as two in the United States and the Czech Republic.<sup>3</sup> Serious low-skilled unemployment problems in many countries appear to be related to relatively high floors on labour costs, related to high minimum wages and/or high payroll taxes imposed on low wages, that prevent workers with (perceived) low productivity from being hired. For example, comparatively high floors on labour costs in some European countries in the past (such as in France and in Belgium) may have acted as a barrier for employment for the lower skilled, for inexperienced youth, as well as for the long-term unemployed.

### ... and/or low pay

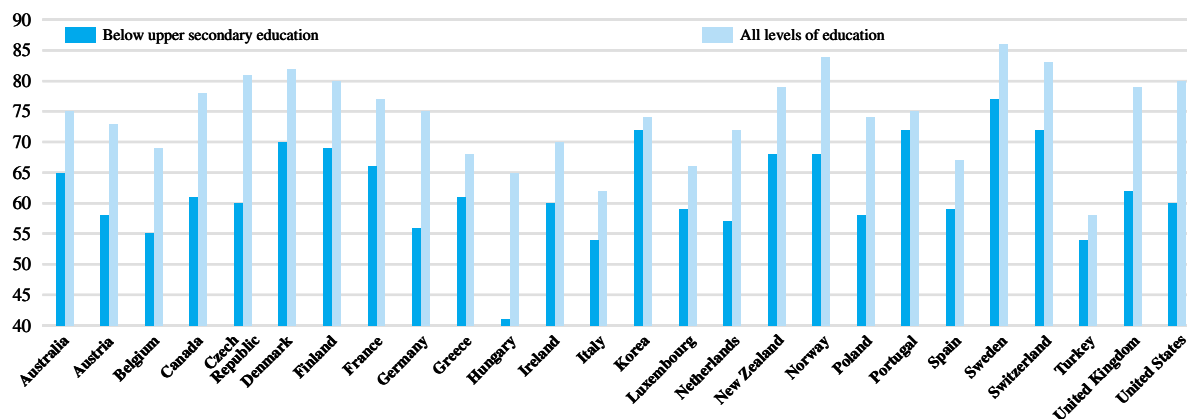
Earnings of those with only basic education are comparatively low in many countries (Figure V.2, lower panel). In several OECD countries (Canada, Hungary, Korea and the United States), more than a fifth of all full-time workers and more than a tenth of all prime age workers fall into the low pay category, low pay being defined as earnings less than two-thirds of median earnings. A significant proportion of these low-skilled workers remains in low pay for a prolonged period of time.<sup>4</sup> Low pay for an individual does not, however, necessarily imply that he or she is below the poverty

3. While the unemployment rate of the lowest educated is very high in the United States and the Czech Republic, the fact that the lower educated make up only a relatively small proportion of the total labour force in both countries implies that there are only few unemployed persons with low educational attainments compared to the total labour force.

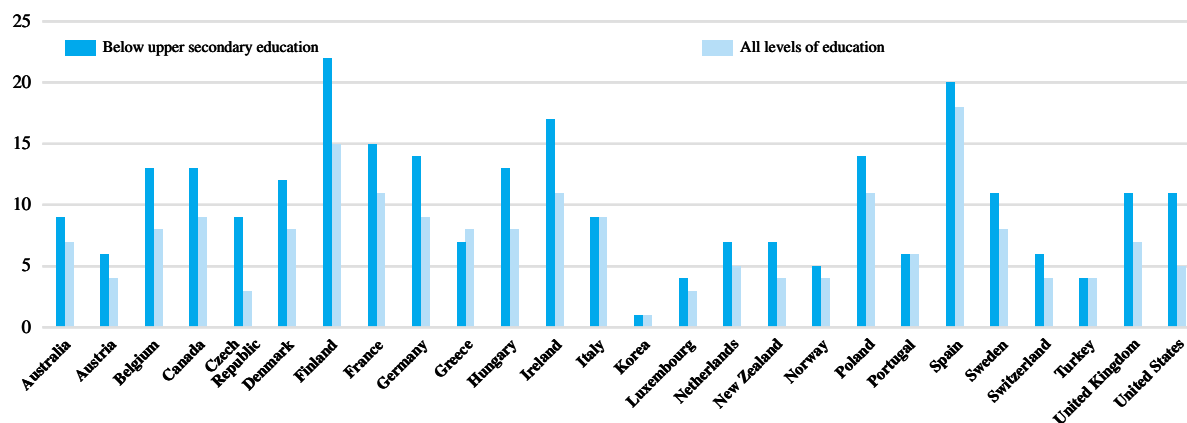
4. See e.g. *OECD Employment Outlook*, Paris, 1998.

Figure V.2. Economic conditions of individuals with lower secondary education or less, 1996

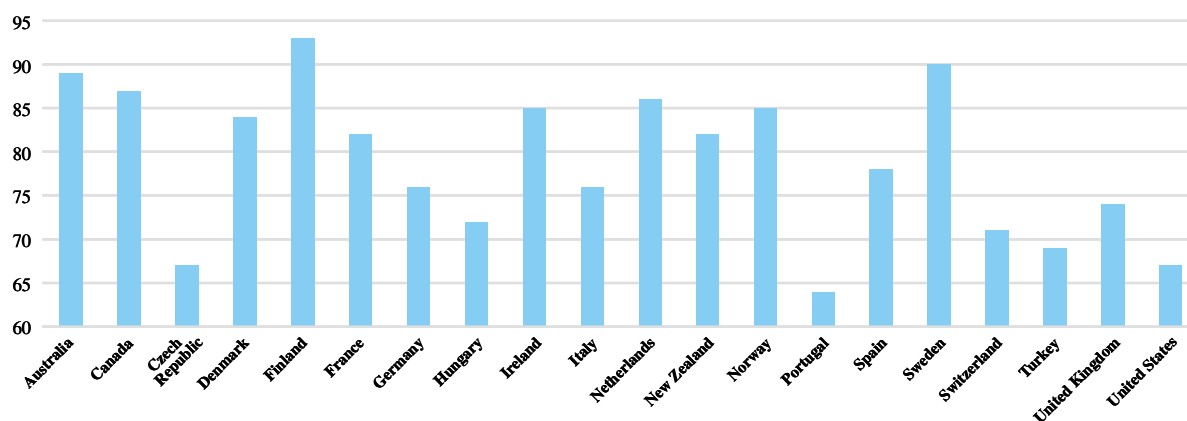
Labour force participation rates in age group 25-64



Unemployment rates in age group 25-64



Relative annual earnings<sup>1</sup> of less educated in age group 25-64



1. Ratio of mean earnings of those with only lower secondary education or less to that of those at upper secondary education (upper secondary education = 100).  
Source: OECD, *Education at a Glance – OECD Indicators*, 1998.

line.<sup>5</sup> In fact, the majority of all persons receiving low pay is living in households that are well above the poverty line. Nevertheless, in some countries (United States, Italy) a quarter to a fifth of all persons with low pay live in poor households.

## Making work pay policies in the 1990s

*There has been renewed interest in making work pay policies in the 1990s:*

The desire of policymakers to address the problems of economic exclusion, high unemployment and low pay of the lower skilled has renewed interest in the use of the tax and benefit systems to improve their situation. While the basic problems and policy objectives are broadly similar, countries have followed two different routes in their policy interventions, depending on their initial situation. On the one hand, those most concerned with high unemployment of the lower skilled have focused on measures to increase labour demand for such workers without lowering their wages. On the other hand, countries with a high incidence of low pay have concentrated on re-distributing income in favour of those on low pay. In both cases, people with low earnings capacity will have greater incentives to participate in the labour market. However, since all the countries that have increased the subsidisation of work at low pay have statutory minimum wages, the increase in labour supply does not exert downward pressure on wage levels.

*Employer social security contributions on low pay have been reduced in many countries...*

Measures to increase demand for low skilled workers have primarily taken the form of reducing employer social security contributions on low earnings.<sup>6</sup> This approach has been used extensively in France and the Netherlands (Figure V.3). The reductions in social security contributions in these countries currently apply to workers earning up to 115 per cent of the statutory minimum wage in the Netherlands and up to 130 per cent of the official minimum wage in France,<sup>7</sup> and the reductions tend to fall with higher incomes.<sup>8</sup> At the level of the minimum wage, the reduction in total labour costs is around 12-13 per cent in both France and the Netherlands. Reflecting the compression of the earnings distribution in these countries, a large number of employees are covered by these concessionary contribution rates, one in six in the Netherlands and one in four in France. However, thanks to the phasing out of the reduction in contributions with higher earnings, the budgetary costs of these measures have been modest, with the French scheme being the more expensive (0.6 per cent of GDP in 1997). The recent overhaul of the contribution rates in the United Kingdom has also lowered employer contribution rates on low earnings.

*... and in-work benefits or tax credits have been expanded or introduced*

Measures to increase the income of persons with low earnings capacity have centred on the expansion or introduction of in-work benefits or tax credits to top up low wages. In contrast to the reduction in social security contributions, in-work benefits or tax credits can be narrowly targeted on groups with particular family circumstances. Prominent examples include:

- The Earned Income Tax Credit (EITC) in the United States is currently differentiated according to whether taxpayers are without dependent children, with

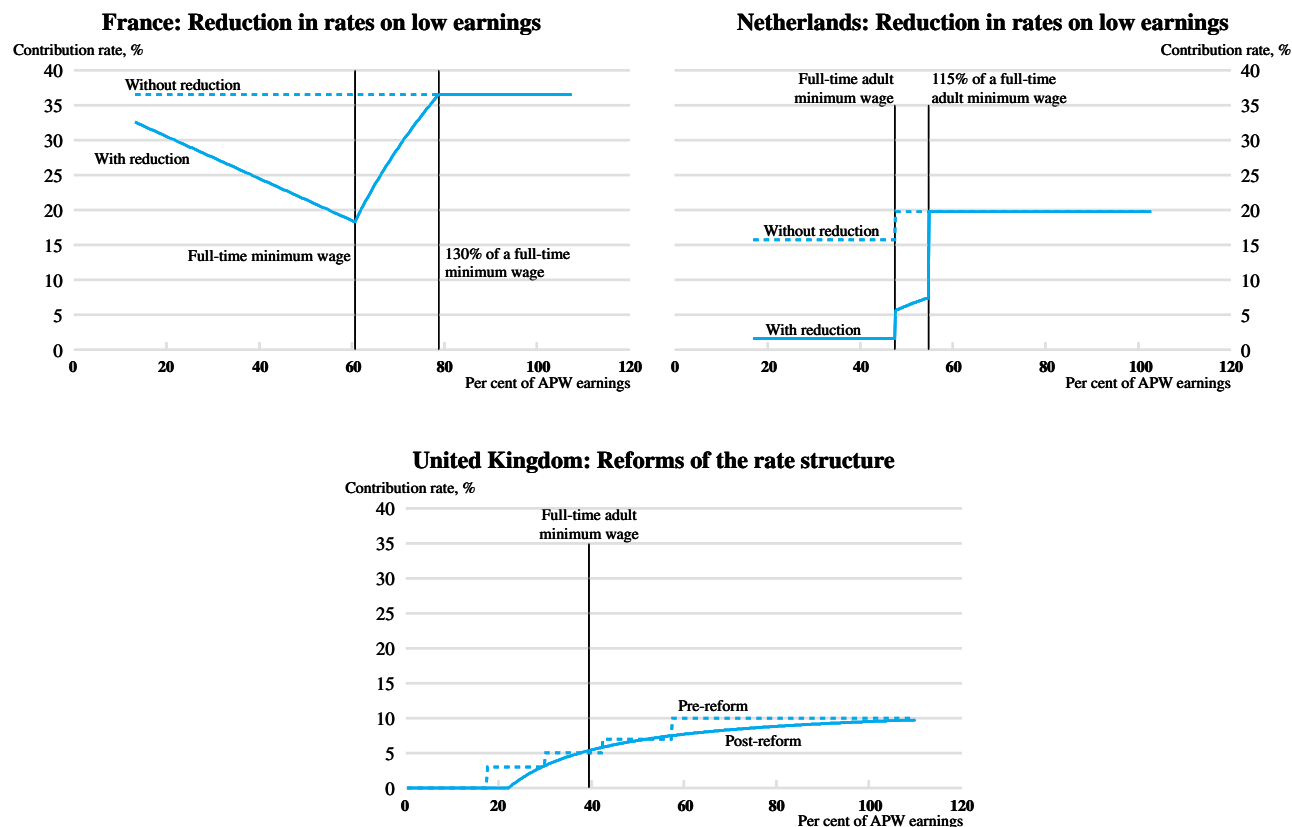
5. The poverty line is defined as less than half of median household income for all individuals.

6. Apart from the countries mentioned in this paragraph, reduced payroll taxes on low-paid workers have been introduced in Austria, Belgium, Greece and Mexico, see OECD, *Implementing the OECD Jobs Strategy – Assessing Performance and Policy*, Paris, 1999, p. 121.

7. The French government has recently proposed an extension of this scheme to cover workers earning up to 180 per cent of the minimum wage.

8. In France, the downward sloping schedule up to the full-time minimum wage reflects that the rebate in this particular scheme declines with less hours worked. However, another scheme provides additional reductions in payroll tax rates for part-time workers.

Figure V.3. Employer social security contribution rates in 1999: Reforms in selected countries



Note: APW earnings represent estimated full-time earnings of an average production worker in 1999. Changes in earnings up to the full-time minimum wage reflect variations in hours paid times the hourly minimum wage.

Sources: National sources and OECD.

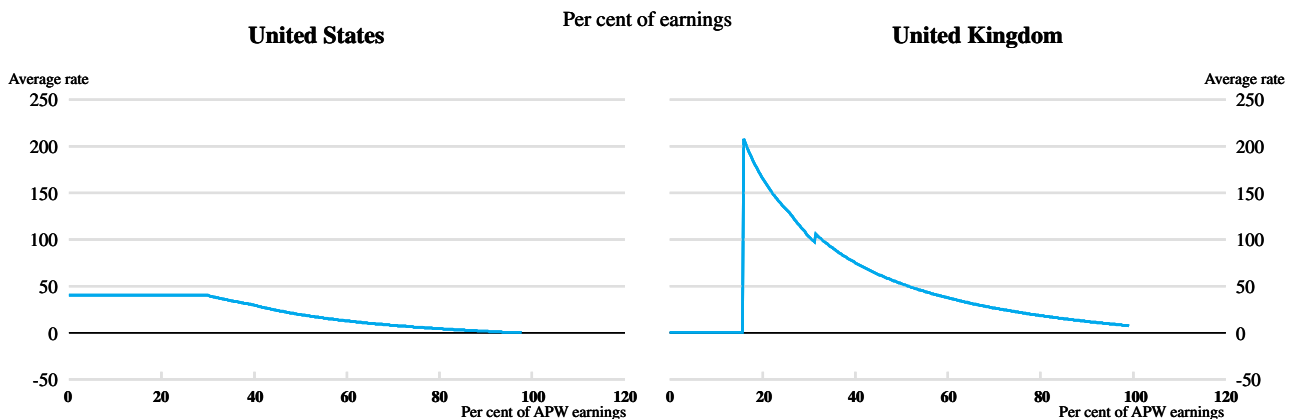
one child, or with more than one qualifying child. The EITC has become more targeted since it was introduced in 1975.

- The recently introduced Working Families Tax Credit (WFTC) in the United Kingdom is strongly targeted, providing a tax credit for each child differentiated according to age, an additional childcare tax credit, and an extra tax credit for working 30 hours or more a week.
- Several countries have increased child care allowances to working parents (Australia, Canada, Finland) to encourage labour force participation.

The structure of in-work tax credits in the United States and the United Kingdom differs in important respects (Figure V.4), partly reflecting different aims of the programmes:

- Tax credits in the United States are available from the very first dollar earned and thus encourage any work attachment, while tax credits in the United Kingdom are conditional on one family member working at least 16 hours per week.
- Beyond 16 hours of work, the size of the tax credit is higher, and the associated incentives to join the labour force are accordingly stronger, in the United Kingdom than in the United States. This is notably so at very low levels of

Figure V.4. In-work tax credits in the United States and the United Kingdom in 1999



*Note:* The schedule for the United States refers to Earned Income Tax Credit for taxpayers with more than one qualifying child. The schedule for the United Kingdom refers to Working Families Tax Credit for a family with two children under 11 and childcare costs of 60 pounds a week. Extra tax credit for working 30 hours or more a week comes into effect at 30 times the hourly adult minimum wage.

*Sources:* National sources and OECD.

earned income, where the tax credit can amount to more than 200 per cent of earnings in the United Kingdom compared with 40 per cent in the United States.

- The withdrawal of tax credits commences at relatively low earnings, and the withdrawal rate is comparatively high,<sup>9</sup> in the United Kingdom, implying that most low paid workers are faced with high effective marginal tax rates, with possible adverse consequences for hours worked.

The prompt withdrawal of the tax credits, together with the targeting, has helped to contain the budgetary costs of these programmes. The United States spends around 0.3 per cent of GDP on the EITC, whereas the United Kingdom expects that the introduction of the WFTC will raise the costs of in-work financial support to 0.6 per cent of GDP.

## The impact of making work pay policies

*Making work pay policies appear to have stimulated employment...*

Making work pay policies appear to have been successful in increasing employment of targeted groups and thereby reducing the risk of social exclusion. The expansion of the EITC in the United States has been found to promote employment, especially among single parents, but the increase in overall employment has not been substantial. In the United Kingdom, estimates of the ultimate employment effects of the WFTC programme range from ten to one hundred thousand persons. An expansion of the Family Credit programme, the predecessor to WFTC, in the late 1980s, is also estimated to have increased employment, notably of single mothers. Indirect evidence suggests that the employment effects of reductions in social security contributions on low earnings may have been significant. Thus, employment growth in France has accelerated since the contributions were cut in 1994, and lower contribu-

9. The withdrawal rate in the WFTC is 55 per cent, rather than the 70 per cent in its predecessor (Family Credit).

tions in the Netherlands also appear to have played a role in its fast employment growth.

While in-work benefits and tax credits appear to have encouraged more people to take up gainful activity, high benefit withdrawal rates may have induced those with higher earnings to reduce the number of hours worked. A simulation study<sup>10</sup> on the expansion of the EITC in the mid-1990s indicated that the negative effect on working hours due to steeper withdrawal rates for a larger number of families could offset around one third of the effect of increased participation. Changes in the Family Credit programme in the United Kingdom in the late 1980s are also estimated to have been accompanied by negative effects on hours worked, partially offsetting the positive employment impact.

*... but total labour supply effects have been partly offset by disincentives further up the earnings scale...*

An assessment of the overall labour utilisation effects of making work pay policies must take into account that the financing of such programmes may entail cuts in hours worked. Where tax credits and reduced payroll tax rates are financed by increasing taxes and social security contributions on those further up the earnings scale, the latter may reduce hours worked. There is no assessment available on the overall hours effects of current making work pay policies. A recent study<sup>11</sup> on a hypothetical introduction of a stylised EITC in four countries suggests that the impact on overall hours worked is likely to be positive in countries with a wide earnings dispersion. Under these circumstances, few workers will be eligible for receiving the tax credit and the required increases in taxes will accordingly be small. However, the introduction of EITC could have a negative overall impact in countries with compressed earnings distributions, since taxes further up the earnings scale would have to rise significantly. Such negative effects may be compounded where the tax pressure is already high at the outset.

*... and higher taxes needed to finance making work pay programmes*

In-work benefits and tax credits appear to have been successful in redistributing income towards low-income households. Because of the targeting on needy groups, about a half of all EITC payments in the United States go to families with incomes below the poverty line. It is estimated to have lifted 4.3 million persons out of poverty in 1997, more than twice as many as prior to the expansion of the scheme in the mid-1990, and to have played a major role in alleviating child poverty.<sup>12</sup> The increased generosity of in-work support in the United Kingdom with the introduction of the WFTC is estimated to be directed almost fully to families in the bottom half of the income distribution, with gains being concentrated in the second and third deciles.<sup>13</sup>

*In-work support has often been an effective anti-poverty tool*

Given the absence of targeting, a reduction in employer social security contributions is not a very effective anti-poverty tool. Individuals that get hired as a result of such measures will have more income than they had before, provided that out-of-work benefits are lower than earnings from work. However, as noted earlier, there is

*... in contrast to lower payroll taxes*

10. See J.K. Scholz, "In-work Benefits in the United States: The Earned Income Tax Credit", *Economic Journal*, 106, 1996, pp. 156-169.

11. See A. Bassanini, J.H. Rasmussen and S. Scarpetta, "The economic effects of employment conditional income support schemes for the low-paid: An illustration from a CGE model applied to four OECD countries", *OECD Economics Department Working Papers* No. 224, 1999.

12. See Box 3-3 in *Economic Report of the President*, Transmitted to the Congress February 1999, Washington D.C.

13. Not all in-work financial support schemes redistribute income towards low-income households. For example, the Irish employment-conditional benefit, Family Income Supplement, tends to be received by those in the middle of the income distribution, see *OECD Employment Outlook*, Paris, 1996, p. 46.

only a weak correspondence between low pay of individuals and family poverty. Thus, a significant proportion of those that are helped into work by lower employer social security contributions is likely to be in families that are not poor. There is, however, no formal study available on the distributional impact of the large schemes run in France and the Netherlands.

*The dynamic effects of making work pay policies are uncertain*

It remains to be seen if making work pay policies will help to lift low productivity workers out of benefit or subsidy dependency on a sustained basis. By assisting the low skilled to gain a foothold in the labour market from which they may acquire on-the-job experience and training, in-work financial support and hiring incentives can put them on a career path that may ultimately make government intervention unnecessary. However, notwithstanding significant upward earnings mobility in many Member countries, there is a noticeable proportion of workers that remains trapped in low pay, and those brought into employment as a result of making work pay policies could fall into that category. By increasing employment and income prospects of the lower skilled, such policies may also undermine incentives for such individuals to increase their human capital, thus increasing benefit and subsidy dependency.

## Enhancing the effectiveness of making work pay policies

*Effectiveness depends on the stance of policy in several areas*

The effectiveness of making work pay policies in achieving their stated objectives depends importantly on the economic environment in which payroll tax cuts and in-work financial support are pursued. Strong and stable macroeconomic conditions are likely to enhance such policies, prompting employers to hire more workers and encouraging more people to enter the labour market. However, the success of making work pay policies will crucially depend on the stance of policy in areas such as out-of-work benefit generosity and administration, the tax system, employment protection legislation and statutory minimum wages. Where the traditional stance of policy has encouraged relatively high wage floors and the problem for the lower educated manifest themselves primarily in a lack of jobs, the most effective making work pay measure would be to stimulate the demand for such workers via cuts in payroll taxes and/or targeted wage subsidies. On the other hand, in-work financial support would be more effective if the principal problem of the lower educated is low pay and lack of labour force participation.

*Labour supply must be mobilised*

Policies aimed at increasing the demand for low skilled workers need to be accompanied by adequate incentives for such workers to enter into employment. In particular, a move into a job must be financially rewarding and a job must be actively sought. However, unemployment and social benefit systems in many countries provide income for people with low earnings potential that is close to, or even exceeds, their potential take-home pay from work. Moreover, though benefit eligibility conditions have been tightened in a number of countries in recent years, work availability and job search requirements appear to be weak in many countries. Thus, the introduction or expansion of payroll tax reductions on low earnings may have to go hand in hand with measures to strengthen eligibility conditions, in particular with respect to job search and the acceptance of job offers.

*... and hiring constraints eased*

Increasing the incentives for people with low earnings potential to enter the labour market will only show up in higher employment if employers have adequate incentives to hire. This requires, in particular, that labour costs for such workers are



sufficiently low to make it profitable for employers to hire. It also requires that employment protection legislation and restrictions on part-time work do not act as barriers to hiring.

The combination of in-work financial support and stronger hiring incentives may be mutually reinforcing. Thus, lower payroll taxes could succeed in expanding employment if in-work benefits at the same time strengthened work incentives despite high out-of-work benefits and lax benefit eligibility conditions. In-work financial support could similarly succeed when combined with payroll tax reductions even if wage floors remained high and employment protection tight. However, cost constraints are likely to prevent large-scale subsidisation of both the demand for and supply of low productivity workers. Nevertheless, as a part of a comprehensive package of policy measures along the lines of the OECD Jobs Strategy, schemes to make work pay may in many cases be a useful complement to other policies aimed at improving labour market outcomes.