The Employment Tax Credit and issues for the future of in-work support

Fran Bennett and Donald Hirsch

with contributions by Frank Wilkinson, Mark Pearson and Stefano Scarpetta

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CONTENTS

Preface

This publication considers a range of issues arising from the development of means-tested support for individuals and families with earnings from work, and in particular from plans to introduce an Employment Tax Credit in 2003. It is part of the Joseph Rowntree Foundation's ongoing efforts to bring a wide range of expertise to bear on the process of welfare reform, and to look independently both at government policies as they unfold and at wider issues for policy debate. This report is based on a range of existing research evidence, on discussions with interested parties and on a JRF seminar held in May 2001 (see the first section of Chapter 1 in Part I for more details).

Part I summarises the arguments and the conclusions that the authors have drawn from this exercise. Part II considers the issues and evidence in greater detail, by reproducing three papers available at the May 2001 seminar. The first is a background paper by Fran Bennett and Donald Hirsch analysing evidence and policy options. In the second paper, Frank Wilkinson looks at in-work support in a historical context and warns of particular dangers. Third, an international dimension is introduced through summaries of chapters from an OECD report on 'making work pay'.

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Part I

Balancing support and opportunity

1 Balancing support and opportunity

Fran Bennett and Donald Hirsch

Overview

> "The government plans to bring together, in 2003, support for children into an integrated child credit, while in-work support for adults will be consolidated into an employment tax credit.
>
> "The net result will be close to a negative income tax subject to a 'willing to work' test."
>
> *(Samuel Brittan,* Financial Times*, 24 May 2001)*

The UK government is now committed to bringing in a new Employment Tax Credit (ETC), to give help to families (see Box 1.1) that have earnings from paid work but are nonetheless living on low incomes. The ETC is the latest in a series of means-tested supplements to top up incomes from employment and, for the first time, potentially creates a general mechanism for doing so, rather than one designed for specific groups such as disabled people and those with children. This paper considers the implications of such transfers, and how good they are at meeting key policy objectives such as reducing poverty, improving incentives and creating opportunities for people on low incomes.

The Working Families Tax Credit (WFTC), the Disabled Person's Tax Credit (DPTC) and their predecessors have been important

Box 1.1 Note on terminology: what is a family?

In this publication, the term 'family' is used in its wider sense, to describe units that between them encompass the whole population.

Much analysis of income distribution looks at 'household' income; but this denotes a unit wider than the nuclear family or benefit unit, which in the UK is the usual assessment unit for means-tested benefits and tax credits. (These distinctions are not always clear in government or other documents.) A UK 'benefit unit' usually comprises an individual or a (heterosexual) couple living together and any dependent children living with them. Such units are referred to in the following analysis as 'families', which include single people without children. This is wider than the meaning of 'families' in, say, Working Families Tax Credit. Only when families with children are specifically referred to is that meaning intended here.

It is of course important to note that many social security benefits, in the UK and elsewhere, are based on individual entitlement, rather than on a family means test; and following the introduction of independent taxation in 1990, income tax liability in the UK is also assessed using the individual as the relevant unit (other than for tax credits, which are usually family-based).

components of recent governments' approaches to relieving poverty among families with children and disabled people. But this paper argues that the move towards a more general means-tested employment credit has inherent limitations and also carries risks.

The advent of the ETC is a good moment to reflect on the overall strategic direction and objectives of public policy towards low income and low earnings. Means-tested support to people with paid work whose total family incomes are low may help to relieve poverty, but may also fail to tackle – or in some cases may even help to entrench – some of its underlying causes, such as low pay, low investment in human capital and limited opportunities, particularly for women.

This paper does not argue for or against the implementation of the ETC as such. It takes as given the current government's declared plan to introduce this kind of payment. (For families with children and disabled people, in particular, it is also important to remember that the existing structure of entitlements creates the context for future policy: to reduce entitlements on which these groups have come to depend could cause them serious difficulties, at least in the absence of compensating measures.) Its aim is rather to examine the longer-term implications of moving further in this policy direction and to suggest giving due weight to other measures that aim to tackle underlying issues in order to help people overcome poverty and improve their incomes through paid work and adequate social protection. Overall, it argues that it is time to move beyond a focus on means-tested supplementation to the more fundamental long-term task of removing obstacles to opportunities, and beyond a focus on helping 'workless households' to acquire at least one earner to a more comprehensive approach that aims to support individuals' efforts to improve their incomes over their lifetime.

The paper starts by outlining its **background** and purposes.

Next it analyses the proposal to introduce an **Employment Tax Credit** (ETC).

The third section sets out a range of **issues** raised by the introduction of ETC.

The next section examines the implications of trying to tackle these issues within the **framework of ETC**.

Next, the paper looks at some of the **underlying problems** that ETC is trying to deal with.

Finally, it suggests how to **balance priorities** and policies to tackle these underlying problems.

Background

The Joseph Rowntree Foundation (JRF) has been tracking the progress of 'welfare reform' since the publication of the welfare reform Green Paper in 1998. It has aimed to make an independent, constructive contribution to the debate about policies and their implementation, and to bring together in open discussion a wide range of people with knowledge and influence in this area.

Two central themes in the reforms have been 'welfare to work' and 'make work pay' policies, which between them aim to help unemployed people and those outside the labour market to move into jobs and to escape poverty.[1] JRF publications in this area have both looked at such strategies in the round[2] and tracked early progress of the New Deals.[3]

The Foundation has made a particular contribution to the debate about introducing tax credits as a new method of making work pay and combating poverty. Before the announcement of the WFTC in 1998, it considered the lessons to be learned from other countries about such strategies,[4] and it has recently looked more extensively at issues and international lessons for the reform of children's benefits relevant to the introduction of the Integrated Child Credit (ICC),[5] planned for 2003 as part of the restructuring of benefits and tax credits.

During 2001, the Foundation has gone on to consider the issues arising from the widening of financial support for low-income families with an earner, in which the planned introduction of the ETC represents a highly significant step. This exercise, including the present publication, concentrates on general issues of in-work support and on the implications of extending it to new client groups, and does not look at issues specific to families with children or disabled people. In May 2001, the Foundation brought together a group of leading economists, social policy experts and members of interested groups in a seminar to discuss the issues arising from the ETC proposals in the context of 'make work pay' policies more generally. The seminar was informed by a detailed background paper analysing the development of such policies and the choices ahead and reviewing evidence to date, and by other supporting papers and notes by participants. The background paper had been informed by prior discussions with individuals and by published evidence on outcomes of existing 'make work pay' schemes in the UK and elsewhere.

Some of the papers presented to the seminar are published in Part II of this report. The present paper (Part I) has been written after the seminar, and draws on the discussions there and on other material to develop some key arguments about future development of the ETC and related policies. Although these arguments have been strongly influenced by the insights of others, the views expressed are those of the authors.

The purpose of this publication is therefore to be a guide to debate as the ETC and related policies develop. Although it was mainly written before the Treasury's consultation paper, *New Tax Credits: Supporting Families, Making Work Pay and Tackling Poverty* (Inland Revenue, July 2001), it offers an independent analysis of some of the issues addressed by that paper. But its longer-term purpose is to encourage an informed and reflective approach to the development of policy in this area – and particularly to encourage clarity about the purposes of particular measures and consideration of alternative means of achieving these goals.

The Employment Tax Credit (ETC)

The ETC is a development of two existing transfers to poor families with someone in paid work: Working Families Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC). (Although its name is similar, it is very different in structure from the Employment Credit – part of the New Deal for the 50plus.) The reform that introduces it will do two key things. First, it will separate out the children's element from the WFTC and DPTC, combining it with other payments for children to create the Integrated Child Credit. Second, the remaining 'adult' portion (with the exact amount as yet unknown) becomes a general credit which will not be restricted only to parents and disabled people but will be extended to some other groups.

The creation of a new mechanism does not necessarily require the government to extend it to new beneficiaries. In practice, the government has indicated that it is unlikely to make the ETC available to all categories of low-paid people or poor working adults. The key features of the ETC as currently planned by the government are summarised in Box 1.2.

The ETC is part of an overall trend towards extending means-tested income transfers to families with low income from work – with the dual objective of improving incentives to work and improving the living standards of those who do work. The history of this trend, in the UK and elsewhere, is reviewed in the background paper in Part II (Chapter 2). This report analyses the ETC not just in itself but in the wider context of the growth in such transfers over a long period, since the introduction of Family Income Supplement in 1971.

Yet, the ETC marks an important point in the development of policies to 'make work pay', since it is the first more general subsidy paid on a national basis to families with low income from paid employment, and is more explicitly linked to such

Box 1.2 Key features of planned ETC

- Paid only to families with at least one person in paid work at the time of qualifying (though based on income in the previous tax year).
- For families with children and disabled people, it replaces the 'adult' portion of WFTC/DPTC, and may be higher for disabled people.
- Extension to families without children or entitlement to disability benefits, bringing in new (additional) beneficiaries.
- Means-tested against family income and tapered as income rises.
- Likely to be age-limited – excluding young adults (under 25).
- Likely to be hours-limited – excluding part-timers except for parents and disabled people (and possibly other limited groups such as carers in future).
- Delivered through the pay-packet.

employment than its predecessors, whose focus was on helping children/disabled people. (The Earnings Top Up – ETU – was also a more general subsidy of this kind, but was piloted in some areas in the late 1990s and then not pursued.) This is therefore an appropriate time to step back and consider the longer-term impact both on the labour market and on the structure of social protection of the steady growth in this kind of 'make work pay' mechanism.

At one level, the transfer of income to a group whose incomes are low has the straightforward effect of helping to reduce poverty among its recipients (though, as with many means-tested benefits, it is unlikely to reach all the potential target group, because of incomplete take-up). The Treasury has identified extensive problems of low in-work income and disincentives to work in families without children, particularly couples, as well as for those with children who are helped at present (see sources cited in Part II). But, as spelt out in the following section and in the background paper, the wider effect of extending such transfers must also be taken into account. Their existence can affect other decisions by employers, governments, families and individuals. For example, it is possible that the more the state ensures that 'work pays' by topping up income, the less pressure there may be on employers to set wages adequate to make work pay. Governments may potentially contribute to this process if they come to believe that means-tested protection is a reasonable substitute for raising minimum wages and/or for providing social protection for individuals to maintain their income levels. If such means testing becomes sharp and visible, individuals may also think it is not worth taking steps to enhance their earnings, and some with partners in work may think it is not worth working at all.

None of these consequences is clear or inevitable; but neither can such possibilities be completely discounted. The present proposal to extend credits to non-parents is modest in scope, but many modest steps in one direction can eventually add up. Government interventions to 'make work pay' can be seen in one sense as a 'second-best' solution to working poverty. The ideal is for workers to have the opportunity to lift themselves out of poverty through their earnings, raised as a result of higher productivity and responsible behaviour by employers. Where this is not the case, benefits/tax credits can help prevent poverty. But it would be unfortunate if the deployment of a particular safety net discouraged behaviour that might reduce the need to use it.

Issues raised by the Employment Tax Credit

Transfers to people in work with low family income can make a significant contribution to the relief of poverty, and more generally to the redistribution of income to poorer families. For example, the replacement of Family Credit (a means-tested in-work benefit for families with children) with the more generous WFTC helped ensure that poor families with children were among the biggest gainers during Labour's first term in office: children's measures announced by the government and taking effect by April 2001 brought gross gains of above £30 a week to families in each of the bottom two decile groups, compared to under £5 to those in the top decile group. All working age households in the bottom two deciles gained an average of about £20 as a result of personal tax and benefit reforms.[6] One illustrative model of extending the ETC to non-parents shows that it is possible that those in the bottom decile group may gain anything from 1 to 6 per cent of income, depending on its generosity.[7] (The amounts of ETC are not yet known.)

Moreover, the problem of low incomes amongst childless people in employment and their partners is not insignificant. The evaluation of Earnings Top Up (ETU)[8] revealed the extent of this problem – especially prior to the introduction of the national minimum wage – and showed the contribution made by ETU to meeting need and reducing hardship amongst this very disadvantaged group. A high percentage of beneficiaries received the maximum payment, demonstrating the very low level of their earnings. The extension of ETC to childless people will also compensate for the fact that this group gained little from tax/benefit measures during Labour's first term.[9] The Treasury has also identified that the UK has a particularly high number of childless, working-age couples without work, and is concerned about the disincentives they may face.

But many people are uneasy about the extension of means-tested in-work supplementation on this scale, and its potential for not preventing, or indeed facilitating, the further development of a certain kind of labour market and social protection system. The ETC faces a range of issues in its task of improving the well-being of poorer groups over the longer term. Some of these are as follows.

Effects on labour market behaviour

The most fundamental concern is that wages will end up lower than they otherwise would be, because employers and employees both realise that a job with a given wage is associated with higher disposable income than would be the case without the transfer. This means in effect that the employer is pocketing part of the subsidy. Such a danger is not unique to the ETC, but a wage effect may be more likely to the extent that such in-work credits become more widely available, rather than just being paid to specific groups. Such an effect may also be more likely in areas with depressed labour markets, where ETC may have widespread coverage and there may be more downward pressure on wages.[10]

The government hopes that the incentive provided by ETC will encourage more people to work. Evidence on the direct incentive effects of in-work supplements has been mixed, and is not yet available on tax credits; in part, their impact is likely to depend on the relationship between rates for single people and couples. Simulations have tended to suggest a modest net increase in employment from WFTC; married women tend to be more affected by work incentives/disincentives than other workers, however, and their employment may decrease (see Part II). In general, if income levels do affect their decisions, people seem to take labour market factors into account more than the benefits system. What we do not yet know is whether in-work tax credits are perceived as such labour market factors or not. Neither do we know the effect on ETC as a work incentive of being based on income in the previous tax year (especially given the likelihood of lower entry wages).

A third possible effect on labour market behaviour is that, even though the incentive may encourage more people into work, the income taper may then operate to discourage more work within a family (either by one person working longer hours or by a second person working at all). Finally, specific hours and eligibility rules might affect what kind of work is on offer and to whom: for example, if (apart from parents and disabled people) the subsidy is paid only to over-25 year olds working 30 hours a week or more, this may make it harder for people aged 24 or working 29 hours a week to find employment.

The wider effect of steep withdrawal rates

As mentioned above, the sharp tapering of means-tested benefits, which may mean that low-income people in paid work keep less than half their additional income at the margin, can affect decisions about how much to work. But, more generally, it risks creating traps that limit the opportunities for individuals and families to improve their lives. In the short term, this can occur because a large part of any increase in earnings is clawed back in reduced entitlements. In the longer term, it might reduce the degree to which people invest in skills and career progression. (The clawback may also be seen as unfair by those affected, and thereby contribute to a sense of injustice about the balance of market rewards.)

The effect of joint assessment

The government wants tax credits to be associated with in-work income, which is individually based, and income tax, which is also individually based; but tax credits are based not on the individual but on the family unit. Since 1990, individual assessment for tax has reduced dependence within couples. Some of this gain of independence, especially for women, could be offset by the wider scope of a tax credit subjected to a family means test (and hence jointly assessed). This could deter the partner of a low-paid earner from taking paid work and, more generally, from developing their own potential (see above). It could also in theory deter people from forming couples (or saying they were a couple), since assessment on a higher joint income could reduce entitlement – although evidence of any impact of tax/benefit rules on family formation is at best weak. And it undermines the autonomy of individuals who, it could be argued, should be able to feel that changes in their partners' situation do not automatically have an impact on the level of their own income. Joint assessment treats the family unit as a 'black box' and does not enquire into the distribution of income within it. Paying additional support to couples via the pay-packet adds to the resources of the partner likely already to have the bulk of resources within the family.

New complexities in the tax and benefits system

A crucial difficulty with in-work means-tested supplementation of incomes in countries where it has so far been applied has been its administration. The proposals for ETC raise some complex issues about qualifying rules and interaction with other benefits. New confusions could arise if there are different types of entitlement for different groups of people, with a complex matrix of qualifying rules. A key issue is how well co-ordinated the ETC might be with Housing Benefit, for example in terms of assessment and award periods, and taper rates. Compliance costs for claimants are rarely taken into account in the assessment of proposed measures. Despite their 'light touch' administration, the new generation of tax credits may involve complicated processes for claimants themselves – even in some cases including forecasting of future earnings, as self-employed people claiming WFTC already have to do. (In contrast, one of the advantages favoured by claimants of the Employment Credit in the New Deal 50plus, as demonstrated in the recent evaluation of the scheme, was its simplicity.[11])

Limited take-up

Take-up of WFTC seems to have been incomplete so far, with early estimates suggesting that 1.1 million people received it compared with a potentially eligible population of 1.4 million, meaning that only about half the planned increase in recipients compared to Family Credit had materialised.[12] The fact that take-up is below 100 per cent is not in itself a reason against introducing a credit or benefit. But it should lead to caution about regarding, or labelling, such a measure as a 'guaranteed' safety net, and about putting too much emphasis on it compared with other more certain ways of boosting income. (Child Benefit, for example, reaches far more poor families than any of the targeted benefits designed specifically for them.) Unlike, say, the basic personal tax allowance, it is not possible to make simple calculations about the automatic relationship between initial and take-home income among eligible groups.

Payment as a tax credit through the PAYE system

Many of those receiving tax credits in employment will be self-employed. However, both employers and critics of the WFTC have pointed to the extra administrative burden involved in paying tax credits through the pay-packet, which can be particularly problematic for small employers. Payment via the employer is also not flexible enough in practice to take account of claimants' needs, so that, under both the current and future tax credits systems, payments need to be made direct in various circumstances. In addition, important issues arise about privacy and about the power of employers in relation to their employees. Giving employers information about family circumstances will not always be comfortable for employees. Wage levels may also be more likely to adjust to take account of the credit if it is more visible by being paid via the pay-packet.

The evaluation of the Employment Credit in the New Deal 50plus showed that recipients valued the fact that it was not paid via their employer.[13] Evidence so far also shows that some 700,000 families are receiving WFTC through the wage-packet – suggesting that many couples on WFTC have opted for it to be paid as a benefit instead.[14]

It should also be noted that the administration of this form of assistance through the Inland Revenue rather than the Working Age Agency represents an important decision about the nature of help that is being given. For people looking for work, a key policy objective in recent years has been to integrate assistance in the labour market with financial support. In the case of families where there is already someone working, in contrast, the financial helping hand is not being combined with assistance in improving one's situation: it is not in the Inland Revenue's brief to help people increase their earnings. Thus, the poverty relief represented by the ETC alone has been described by some commentators as being more in the old style of 'passive' income maintenance, rather than the 'active' combination of different forms of help now offered to unemployed people.[15] Although the counterposing of 'active' and 'passive' forms of welfare in this manner can be an unhelpful distinction, the strategy of offering assistance beyond financial support has been valuable to many claimants.

Can the Employment Tax Credit be designed to deal with these issues?

The impact of the ETC, like that of other tax and social security measures, will depend in part on the details of its design. This section looks briefly in turn at each of the difficulties and risks raised above and assesses the extent to which they can be resolved by decisions about the design of the ETC. Some of these issues are discussed in the consultation document about the new tax credits issued by the Inland Revenue.

Labour market behaviour

Earnings top-ups will be less likely to entrench, or exacerbate, the problem of low pay in the UK labour market if they are modest, both in level and in coverage. In terms of coverage, previous governments have obviously recognised a strong case for limiting them mainly or entirely to two groups: low-income families with children and disabled people with an earner. The focus on low-income families with children could be justified in terms of poverty, because of the consequences of their low income on children, and/or in terms of work incentives, and because of their relatively high benefit entitlements when out of work in relation to their likely income in work. (With the introduction of ICC, probably to be set at a similar level for families with children in and out of work, any incentive issues for parents will have to be dealt with via the ETC.) The focus on disabled people could be justified in terms of their labour market disadvantage; it could of course also be argued that families with children suffer labour market disadvantage, in terms of trying to combine paid and unpaid work.

The government seems to have decided to make the extension of the coverage of tax credits via ETC modest, at least initially. One proposed limitation is by age – especially to exclude young people under 25 if they do not have children and are not disabled. However, this could be seen as compromising the achievement of the government's objective of tackling in-work poverty, both in the short and longer term. For a start, the government's analysis of poverty has been based on thresholds for which no distinction is made for younger adults. Moreover, over the longer term, youth unemployment is known to have a scarring effect. Different age cut-off points for the youth minimum wage rate and the ETC may also cause confusion.

In terms of the *level* of payment, insofar as means-tested supplements are extended to groups other than parents and disabled people, they could be kept at a low level (though introducing differential payments for different categories would add to complexity). However – in addition to compromising the success of its anti-poverty objectives – if the government does 'target' the ETC precisely in terms of coverage to very limited groups, and introduce it at a modest level in terms of amounts, it may find that take-up levels are compromised (see under sub-heading, 'Take-up', later in this section).

The government could have decided to limit the *length of time* for which ETC was paid, which would have matched the Employment Credit for the over-50s more closely, would have been geared towards achieving the government's objective on incentives, and would have kept the scheme modest. The evaluation of Employment Credit suggested that, even when it represented 'dead-weight' expenditure, in the sense of not operating as an explicit incentive to take employment, it allowed many people either to cope with the transition costs of going into employment or to pay off their debts once they got into work. However, it would be difficult to make such a payment temporary – especially for those who had been receiving WFTC or DPTC in the past. The Employment Credit evaluation also showed how worried recipients were about the termination of the payment after one year – with some even wondering if they would have to leave work. The government is now proposing instead to replace the Employment Credit with a supplementary, time-limited payment to the over-50s within ETC, which will, however, eliminate some valued elements of the current credit (see below).

In order to limit undesirable effects on labour market behaviour, it is also preferable in the presentation of the ETC to make it look as little as possible like a wage subsidy. Family-based means testing in fact goes some way to doing this (leaving aside its other disadvantages). But ministers have had a tendency recently, when talking of the minimum wage, to quote an effective 'rate' for parents which incorporates the WFTC,[16] implying that the credit is indeed a wage subsidy. This should be discouraged, in part because of the psychological effect that it has on employers and in part because it confuses two very different issues: gross hourly pay for individuals and net weekly income for families. (The latter issue is explored in more detail in Part II of this volume.) Another reason for avoiding such language is its possible effect on Chancellors themselves when it comes to setting the actual minimum wage rate in future.

However, 'make work pay' policies (and means-tested wage supplementation in particular), together with benefit sanctions aiming to get people into work, have a central place in the government's strategy of moving towards 'full employment'. In introducing the WFTC, the Chancellor argued that there was now 'no excuse for those who can work not to work'. Policies such as the WFTC/ETC are often seen by economists as necessary in order to make labour market policies of compulsion and sanctions acceptable (and operable by staff), providing the 'carrot' to complement the 'stick'. The extension of in-work means-tested support, via the introduction of ETC, makes this strategy more comprehensive – and therefore also makes it less likely that the government will abandon the language linking ETC to demonstrable in-work rewards.

More generally, it might be hard in the longer term to control the effects that the ETC could have on the labour market and labour market behaviour. Recruitment and pay practices can develop in particular and unpredictable ways depending on conditions at any one point of time and place. For example, cut-offs in terms of hours and age range, introduced precisely in order to keep the ETC modest, could come to influence behaviour in particular ways. Certainly, overseas experience indicates that some quite fundamental changes in employment patterns can happen in a short period of time: in Belgium and Norway, changes in social security rules led very quickly to an increase in part-time work.[17] In the UK context, the more generous the ETC and the sharper the tapers, the more likely it is that individuals and employers make decisions that *reduce* working hours to the thresholds of 16 hours a week for parents and disabled people and 30 hours for others.

Incentives and opportunities

The most straightforward way of reducing the impact of steep tapers that may affect incentives is, of course, to make tapers less steep: to withdraw credits less sharply as income rises. The downside of this, as has been seen in the WFTC, is that means testing and still higher than normal effective marginal tax rates are spread to an ever-increasing section of the population, and it becomes difficult for a family with a low-paid earner to escape them entirely. The consultation document does not make clear what taper rates will be applied to ETC, and on what definition of income they will operate (although gross income seems to be preferred, on the grounds that this mirrors the operation of income tax).

The granting of in-work credits over a relatively long award period, as proposed in the consultation document, does mean that in many cases there may not be an immediate effect on take-home pay of earning higher amounts; the jaws of the 'poverty trap' do not bite so fiercely. This seems desirable – and was in operation for 17 years under Family Income Supplement, the predecessor of Family Credit, which had an award period of a year – although the downside is that, if a family increases their earnings and gets used to a particular level of disposable income, the drop at the end of the award period could be more painful. (There are also clearly some limits to how long means-tested support can continue being paid to families who may no longer be living on the low incomes that allowed them originally to qualify, and still be regarded as 'targeted'.) Any move to a longer assessment period (e.g. over the previous tax year, as proposed in the consultation document, rather than, as now, a few months at maximum) could also come up against the problem of 'rough justice'.

These effects can of course be countered by multiple arrangements, as envisaged in the consultation document, including forecasting of future earnings, and reviews and reassessments of awards triggered by certain changes of circumstances; but the more of these there are, the more the government's aim of creating 'light touch' administration of means testing would be compromised. It is indeed possible – depending on what changes in circumstances and income levels are chosen to trigger changes in award – that, despite the nominal length of awards, there may be greater instability in payments of ETC than there has been in WFTC/DPTC levels, which currently continue unchanged for six months. This may mean that disincentives are more of an issue in practice than under the current system.

Whatever the structure of the ETC, it is impossible to escape entirely the effect on incentives and opportunities of encouraging people to work for earnings that need to be topped up on a means-tested basis in order to create an acceptable standard of living. Under a system of means-tested supplementation, attempts to overcome disincentives are inevitably traded off against other objectives, such as responsiveness, ease of administration and lack of intrusiveness for claimants.

Dependence within couples

Since the ETC was first proposed, most commentators have assumed that it will be assessed on the income of families rather than individuals, and this has now been confirmed in the recent consultation document. But it is possible to imagine a similar mechanism based on the earnings of an individual instead, possibly operating over a fairly long period, and thus resembling more closely an allowance within the tax system. This would have the advantage of ensuring that each person in a couple would be able to receive the credit directly to compensate them for low earnings.

However, this would create a corresponding disadvantage, since the direct relationship between earnings, the credit and take-home pay would be more obvious, and therefore potentially more likely to put downward pressure on wages. In addition, it would perhaps seem rather unnecessary to devise a complex means test to prove individual entitlement – especially given the well-known administrative problems of in-work means-tested support. Such a test might seem even more cumbersome if eligibility were already circumscribed by having age limits, hours rules, etc; if the capital rule were to be abolished, meaning that only income was being means-tested; and if long assessment and award periods were increasingly divorcing circumstances at point of entitlement from circumstances in reality. These conditions all seem likely to be met in the current proposals for

ETC as set out in the recent consultation document.

If ETC is instead assessed jointly for couples, as proposed, it should be structured in a way that avoids the worst effects of such joint assessment. It would be possible, for example, to introduce a disregard on the earnings of a second earner – and/or to make it possible for couples (at least those with children) to share the hours needed to qualify for a proposed bonus for 'full-time' employment. Using gross rather than net income for calculations could also have less impact on incentives for second earners – although there is no indication about how this would impact on the interaction of tax credits with other benefits, which are usually assessed on net income. The amounts allowed for single people and couples, and the rationale for any differential between them, will also need to be fully debated with incentives for 'second earners' particularly in mind.

But there may still be some disincentives to (re)partnering in a jointly assessed system. Some thought may also need to be given to the rules which mean that some couples are debarred from claiming income support/means-tested Jobseeker's Allowance when one partner works 24 or more hours a week, but could be eligible for ETC precisely because one partner works 30 or more hours a week. And, given that the recent abolition of the married couple's allowance signalled the government's opposition to subsidising married partnerships per se regardless of the presence of children, the position of dependent adults within couples on ETC may not feel a secure one. This perception may be heightened by the new requirement for both partners in couples on means-tested Jobseeker's Allowance to meet the eligibility conditions.

In general, the consultation document does not seem to have taken fully on board the fluidity of current family forms, and the complexities that this may create for joint assessment, especially when coupled with long assessment and award periods. This may be partly due to the evident desire to see tax credits as part of the income tax system. But it may lead to an underestimation of the frequency of partnership/family changes, which are particularly prevalent amongst low-income groups and have a significant relationship with moves in and out of family poverty. Recent experience of operating the child support scheme could contain valuable lessons here.

Complexity

Potentially, the reform that includes the introduction of the ETC creates the opportunity to design a more straightforward system, especially for families with children. The first step is to ensure that all benefits linked with children's needs are readily identifiable and paid to the main carer. A further step could be to ensure that other forms of in-work support means-tested against family income are better co-ordinated – in particular that Housing Benefit (HB) and ETC are brought together to some extent, in terms of tapers and assessment/award periods, etc. (Similar issues are raised in terms of the interaction of ETC with Council Tax Benefit – CTB.) The drawback is that, whereas this might create a simpler system for claimants were the fusion to be absolute, a partial fusion might actually make things seem more complicated.

For example, it does not seem feasible in the near future to replace HB with a flat-rate housing allowance regardless of rent; instead, there have been suggestions that an allowance within ETC might replace part of HB. This may be one way to reduce the numbers potentially affected by the well-known administrative problems, and policy stasis, which currently characterise HB. But the scope for people misunderstanding their entitlements could be even greater within such a system than it is today. And the more other payments such as HB were absorbed within the structure of ETC, thus increasing its range, the less likely it is that ETC would be a modest payment for a well-defined group of beneficiaries.

In addition, if tax credits are based on gross income, the implications for other means tests such as that for HB and CTB, currently based on net income, are not clear. The government does not want to see the benefit of tax credits being lost when these are offset against HB and CTB. On the other hand, if they are ignored, the relationship between different forms of tenure is altered.

Take-up

A similar dilemma is apparent in considering the issue of take-up. We are aware from previous research that the more any benefit resembles a universal payment, in terms of both eligibility and amount, and the less it approximates to a form of minimal poverty relief, the higher take-up is likely to be. One lesson from the evaluation of Earnings Top Up is that payments of this kind, which apply only to a narrow range of claimants, do not attract the kind of popular attention needed for high levels of take-up.[18] It is therefore possible that the modesty of the design of the ETC could threaten the achievement of its anti-poverty and work incentive functions. On the other hand, the more ETC eligibility is spread and its rates increased to promote higher take-up, the less modest it will be; its potential effects on labour market behaviour will be greater; and it would be more difficult for the government to row back from broad entitlement criteria should it want in the future to minimise such effects. On the evidence of the consultation document, the government has gone for modesty; take-up does not seem to be considered as a major issue for investigation in the document.

Payment as a tax credit

It is in principle conceivable to have a similar structure of entitlements as the ones being proposed under the 2003 reforms, but paid not as tax credits but as benefits (as with Family Credit, the means-tested in-work supplement which preceded WFTC for families with children – see Part II). The government has already been able to overcome its preference for payment via the pay-packet when pursuing the more important goal of ensuring that additional resources benefit children to the greatest extent possible, in that it has decided to pay ICC to the main carer. (It is worth noting, however, that, if all ICC payments have to be made into bank accounts from 2003 as proposed, it is possible that they may not in practice be received by the main carer, since some families may only have joint bank accounts, or a bank account in the main earner's name.)

A big advantage of paying the ETC as a benefit, for parents and non-parents, is that it could allow the Working Age Agency to take a more continuous interest in helping people towards jobs that lift them out of poverty in the longer term, rather than losing interest in people once they have found work, however imperfect and transitory. Continuity of a relationship with the benefits system can make sense in a world of unstable employment, and the difficulties of re-establishing that relationship – most particularly in terms of making a claim – can be a serious disincentive to taking work that does not last, despite the recent improvements introduced by the previous government.

However, a change from a credit to a benefit would necessarily compromise certain other government goals for the welfare system (leaving aside other factors such as the utility of counting expenditure as foregone revenue, and the ability to count increased payments as a reduction in the 'burden' of taxation – see Part II). One is to make fewer people feel 'dependent' on benefits, rather than paying less tax (or receiving additional money from the Inland Revenue via their employer) – a largely psychological distinction which nonetheless seems important to the government in its strategy for welfare reform. Another is to encourage people on low incomes to take up what they are entitled to, without regarding it as a so-called ‘handout’ (with the implication that it is undeserved) – although evidence from the evaluation of the New Deal 50plus, that claimants of Employment Credit viewed it positively and appreciated the fact that they received it directly rather than via their employer,[19] suggests that any perceptions of stigma may be more apparent to the government than to recipients.

All the difficulties looked at in this section suggest that the problems thrown up by the ETC are not easy to overcome through policy design, since they represent certain dilemmas inherent to the fundamental characteristics of in-work means-tested support. Even where it is possible to solve one problem, either wholly or partially, the solution may create another.

Addressing underlying issues?

> “If we ask who are the poor today, we are led to questions about the socio-economic identity of the existing poverty population. Looking to policy, we then typically emphasise income supplementation strategies. The obvious strategic solution to poverty is to give the poor more money. If instead we ask what leads people into poverty, we are drawn to events and structures, and our focus shifts to looking for ways to ensure people escape poverty.”
>
> *(David Ellwood, 1998, quoted in Richard Berthoud, ‘A childhood in poverty: persistent versus transitory poverty’,* New Economy*, Institute for Public Policy Research/Blackwells, spring 2001)*

The debate on measures such as the ETC should not, at this crucial juncture, take it for granted that a particular solution is the best or only way of addressing a problem, and thus get bogged down in design issues rather than wider issues about policy approaches. It is worth reminding ourselves about the underlying causes of in-work poverty. ETC may only be able to compensate for such problems by addressing their symptoms; in some cases, it is not capable of dealing with them at all; in a few cases, it may even exacerbate them.

Lack of employment is the biggest single cause of poverty, and the present government has thus made 'welfare to work' a central part of its mission. In some cases, a barrier to work can be that, without government top-ups, income in work is too low to create an incentive compared to income out of work. The government is laying great stress on this problem as a reason for the extension of ETC beyond parents and disabled people. Before putting too much weight on introducing a more general in-work tax credit as the best way to prevent this, however, several other points must be borne in mind:

- Earnings in work for families without children with someone working full time on the minimum wage will normally always exceed basic out-of-work benefits; a diagnosis which emphasises disincentive problems therefore refers to the wish to achieve a desirable margin above out-of-work income for certain groups of people.

- Extra in-work costs can increase the disincentive. These costs could be subsidised as they are already in the case of child care. But the combination of means-tested top-ups to in-work income with measures which subsidise in-work costs threatens to combine downward pressure on wages with upward pressure on prices, thus exacerbating the original problem.

- Housing cost disincentives can also be important, either in reality or in terms of people's perceptions – but they would be less so if more effort were made to make people aware of their in-work HB entitlements; in any case, without fundamental change, ETC will not be able to tackle these problems with great success (other than by lifting some people above the qualifying level of income for HB altogether).

- Non-financial barriers to work can often be more important for some groups, as demonstrated in the evaluation of the New Deal 50plus[20] and the ETU.[21] An in-work benefit/tax credit will not be able to tackle lack of confidence, ill-health, outdated skills, discouragement and many other obstacles to employment; other policies are needed in order to do so. The government is in fact beginning to tackle some of these barriers. The issue of health problems is particularly challenging, however, especially given the increasing intolerance in the workplace for such problems.

Low pay is an important contributor to in-work poverty. In the long term, it is well recognised that producing a productive and well-paid workforce (above and beyond the minimum wage) is the best solution to this difficulty, and arguably the best route to competitiveness for the country as a whole. The ETC cannot effectively address this underlying problem.

Low levels of human capital are now recognised as being an underlying contributory cause of persistent low pay, lack of career progression and long-term poverty, whose significance as a disadvantage could become ever more important in the 'knowledge-oriented economy' (though some people would put greater emphasis on discrimination within the labour market which results in the under-valuing of low-paid workers' skills – see below). Helping people to escape low income through means-tested top-ups is likely to do little to address these low levels of human capital.

Weak or inadequate employment/social protection can also contribute to situations that lead families with at least one earner to be poor. Underlying the financial pressures experienced by some single-earner couples on low incomes are other problems, such as the lack of employment/social protection for the other partner when their original source of income fails. An in-work means-tested supplement does not address this, but instead tries to compensate for it by topping up the income of the partner still in employment – arguably an inappropriate (even perhaps 'untargeted') policy response.

The gender pay gap and pay inequalities are also underlying causes of much in-work poverty. The paper by Frank Wilkinson in Part II argues that, rather than having low or no skills, low-paid workers are discriminated against because their skills are not recognised. Few would dispute the proposition that discrimination against certain groups, including the effect of the 'female forfeit' and race discrimination, does affect relative rewards from work. The minimum wage provides a floor to prevent wages falling below a certain point, but does not adequately tackle such discrimination by itself; additional measures are needed, which Labour has already started to introduce. The ETC cannot do so; indeed, if the proposed age and hours limits to eligibility are implemented, this will increase the differentials in final income between different groups of workers, such as young/adult and full-time/part-time, rather than addressing market inequalities.

High housing costs have become an ever more important contributory cause of poverty, with rising rents in the past two decades linked to reduction of subsidies to the social rented sector and the deregulation of the private rented sector. The ETC might be part of the solution to reforming the means-tested Housing Benefit system, but cannot itself solve the underlying issue of how to end the propping up of high rents without causing hardship among tenants who are charged them.

Limits to options to work part time can constrain the earning options for some families. The qualifying rules on hours of work for ETC are likely to help some groups (e.g. lone parents) to do part-time work of at least 16 hours a week, as WFTC did, while encouraging others (e.g. people without children) to work at least 30 hours in order to receive it. Such rules may influence or constrain people's options to work part time – although the current situation includes numerous anomalies and contradictions, and part-time workers find that added to their insecure position in the labour market is inadequate protection in the welfare state. ETC under current plans will not be able to give all part-time workers adequate security – and, if it were to do so, would no longer be modest.

Lack of career progression is one of the most fundamental causes of persistent poverty among unemployed people who find jobs. One study found that three-quarters of them move into unstable employment,[22] and too often finding a job is not the first of many steps towards an improved standard of living, but rather part of a merry-go-round of persistent poverty. The latest OECD study found many people cycling in and out of poverty over an eight-year period, rather than escaping successfully once and for all.[23] There is some evidence that Family Credit may have been a factor in some lone parents remaining in jobs below their potential earnings level, rather than progressing.[24] Until the advent of the national minimum wage, the earnings profile of ETU recipients was also flat.[25] Any such subsidy is not designed specifically to help career progression, and could possibly hinder it.

Much of the above argues that in-work means-tested supplements such as the ETC can only tackle symptoms, rather than addressing underlying causes, or that it is not capable of dealing with some problems at all. Indeed, in some cases, too great an emphasis on such policies may exacerbate some problems. In particular, in-work supplementation may detract from pressures to invest in human capital and improve workers' opportunities by creating the impression that their problems are already being dealt with satisfactorily.

Box 1.3 On current plans for the ETC, a recipient couple might be:

An owner-occupier couple, aged 50plus, who bought their council house. The woman is the main breadwinner. The man has been made redundant; he has health problems, but has failed the new, more stringent, test for incapacity benefit.

They live on a relatively low income; but they are debarred from existing systems of financial help (except perhaps Council Tax Benefit) in various ways:

- The woman cannot get Employment Credit (EC) for the 50plus because she has worked steadily (albeit in low-paid jobs) since their children grew up; she has not been signing on as unemployed for six months, so EC is irrelevant to her situation.
- The man cannot get contributory Jobseeker's Allowance any longer – he received it for six months, but it has now ended.
- They cannot get Income Support or means-tested Jobseeker's Allowance because of joint assessment.

Continued

Box 1.3 continued

- They do not get help with their mortgage interest, as there is no benefit for low-income wage-earners (other than the new temporary support for job entrants).

- Married couple's allowance and mortgage interest tax relief no longer exist.

This couple could be brought into eligibility for ETC because the woman works over 30 hours per week. This would be paid to her by her employer. This could boost their income, meet their needs more adequately and relieve the hardship they must be suffering. But, if ETC is the answer, it is perhaps relevant to ask what the question was. Highlighting different elements of the above situation could lead to a variety of solutions to this couple's current difficulties which would involve improving other elements of employment and social protection. (See following section for some suggested measures.)

Fulfilling fundamental objectives

If the government goes ahead with its plans to introduce ETC and extend it beyond families with children and disabled people, we have suggested above that this could be done in a modest way to try to avoid undesirable effects – although this would risk conflicting with some of the government's other objectives. We have also noted various ways of improving its operation, although we have pointed out that it is difficult to solve some problems satisfactorily within a means-tested approach and that, in many cases, ETC does not address the underlying causes of in-work poverty.

However, given the government's intention to proceed with ETC, including its extension to groups other than parents and disabled people – and given the inherent limitations and risks of means-tested in-work supplementation of incomes which we have explored above – we would also emphasise the need for the government to:

- *Develop a considered balance of priorities*, incorporating rational decisions about the emphasis given to different groups' needs: it would appear that there is strong support, both from social commentators and from the public, for devoting available resources in particular to children. This could be done via ICC and especially Child Benefit. In this way, parents and children would not lose out if ETC were introduced in a modest form. (A similar priority could be given to additions to ETC payments for disabled people.) Some people have argued that questions of equity may arise if the introduction of ICC results in more generous payments for children. But the eligibility rules for ETC will raise many questions about equity of reward for different groups, not just issues about the balance between those with and those without children; and opinion polls suggest that there is public acceptance of the case for helping parents in work on low incomes which does not extend to other groups. (See Part II.)

- *Develop a considered balance of policies*, in particular between those that address symptoms and those that address root causes: there is a strong case for emphasising the latter, rather than focusing on the symptoms of low pay and low income in work. In particular, there is a need for the government to do the following:

– *Continue progress with the minimum wage*: the increases in the adult and young people's rates announced recently are very welcome, helping to make up for what many people thought was initially too cautious a starting level. This progress should be continued in future, in particular because it is more likely to result in an incentive for employers to invest in increasing the productivity of their workers, and so move in the direction of creating a well-paid, more productive workforce.

– *Encourage investment in human capital*: currently, low-paid and part-time workers are those least likely to attract training investment from their employers. Lifelong learning must be geared towards the needs of these workers in particular. Effective solutions to low skill levels in the workforce need to co-opt workers and employers as partners of government and other agencies to invest in skills – a sharing of the costs between these partners is widely recognised as the best way forward. They also need to ensure that employers learn to value employees – to recognise and use their potential.[26] There is interest amongst low-paid employees in improving their skills: evaluation of the Employment Credit for the over 50s, for example, found that the level of interest in grants for training was much higher than their actual take-up.[27]

– *Offer help and advice beyond the New Deals*: the evaluation of the New Deal 50plus also found that participants regretted the abrupt cessation of the help provided by the scheme once they were in work, and would welcome follow-up advice and support. The government's current strategy is to move on from the emphasis on the first step into employment represented initially by the New Deals, to give more attention to subsequent steps by emphasising job quality and career progression. (See, for example, the recent Green Paper on employment, published earlier in 2001, which emphasises the importance of achieving fulfilling, as well as full, employment.) To do so, it will need to address actively issues not just about the level of family income of people in work, but also about their opportunities to improve their earnings. This will require some mechanism (like personal advisers for people out of work) to give active assistance to individuals, alongside more general measures to enhance their incomes such as a more adequate minimum wage and in-work training, etc.

– *Put more emphasis on women's working opportunities*: the New Deal for Partners is bringing more people into the scope of employment services. But there is an urgent need to ensure that this is seen as positive help, rather than policing. (Such a message is much more difficult to get across if the increasing trend towards joint assessment of benefits/tax credits means that the earnings of one partner make the couple little better off.) The emphasis of policy needs to be shifted away from a priority on investment in those elements which may be seen as being geared towards reducing benefit expenditure (such as the New Deals for young people and long-term unemployed people) towards support for any groups with difficulty getting into and progressing in the labour market. Better opportunities for women, including women returners in particular, would be one of the most effective ways of reducing in-work poverty for families (and thereby the need for in-work supplements), as well as helping to achieve the government's aim of improving productivity.

– *Review the treatment of part-time work within the social security system*: a review of how part-time work is treated within the social security system is long overdue. One of the advantages of the ETU pilots was judged by participants to be the way in which ETU allowed them to engage in socially useful tasks, such as caring or voluntary work, alongside fewer hours of paid employment. If it were possible to reach general agreement on which activities would be deemed 'socially useful' in this sense, a benefit for part-time workers might be devised that would perform the role that ETU was fulfilling, but without the disadvantages of means-tested supplements One route is to select specific groups who could qualify for such a payment. To some extent, we already have such payments for some groups: the earnings limit on Invalid Care Allowance has been raised; and there will in future be more flexibility to earn money while on Incapacity Benefit. One undoubted advantage of each of these payments to the recipient is that they are non-means tested and individual, in the same way that labour market income is. Another route is to pay it to everyone doing certain activities (as in the suggestion by Professor Tony Atkinson[28] of a 'participation income').

– *Consider more direct subsidy to providers* to reduce in-work costs such as child care and public transport, without the dangers of demand-side subsidies boosting prices that are inherent in such mechanisms as the current child care tax credit (though limited by the ceilings on amounts). For example, public funding for a nursery may be a more reliable way of giving access while containing costs.

Conclusion

The Institute for Fiscal Studies, amongst others, has highlighted the dilemmas inherent in means-tested support. In its recent analysis of Labour's manifesto, it drew attention to the scale of the plans for increasing the scope of means testing in the second term. The House of Commons Library (in calculations quoted in *The Daily Telegraph,* 17 April 2001) has estimated that, by 2003, about two-fifths of all families may depend on means-tested benefits/tax credits (with the figure for pensioners being even higher). We have argued above that we need to be wary of continuing down the road of increasing emphasis on means-tested support via tax credits, as it cannot tackle the underlying causes of in-work poverty. The risks of damaging effects on the labour market may be lessened by the tight boundaries that the government proposes drawing around ETC eligibility. But, in the longer term, the boundaries may become looser. And, in the meantime, the policy emphasis on designing and implementing in-work means-tested supplementation may distract from the necessary focus on tackling the fundamental issues underlying in-work poverty – and on achieving the wider and more ambitious objectives of the government.

And the government should be aiming higher in its second term. While its first priority may have necessarily been to help workless households to get at least one person into employment, it should now be focusing on helping all individuals to make the most of their life chances and opportunities. Whilst the government's first priority may have had to be addressing the symptoms of in-work poverty, it should now be focusing on addressing its causes. Means-tested in-work supplementation is likely, we believe, to make at best a limited contribution to these longer-term tasks.

Notes

1 'Work' in the context of this paper means paid employment.

2 F. Bennett and R. Walker, *Working with Work,* YPS for Joseph Rowntree Foundation, 1998; D. Hirsch, *Welfare Beyond Work: Active Participation in a New Welfare State,* YPS for Joseph Rowntree Foundation, 1999.

3 Jane Millar, *Keeping Track of Welfare Reform: the New Deal Programmes,* YPS for Joseph Rowntree Foundation, 2000.

4 Pamela Meadows, *The Integration of Taxes and Benefits for Working Families with Children*, YPS for Joseph Rowntree Foundation, 1997.

5 Donald Hirsch, *A Credit to Children: The UK's Radical Reform of Children's Benefits in an International Perspective*, YPS for Joseph Rowntree Foundation, 2000; Ken Battle and Michael Mendelson (eds), *Benefits for Children: A Four-country Study*, The Caledon Institute, 2001.

6 HM Treasury, *Budget 2001*, HC 279, 2001, pp. 85–6.

7 Preliminary calculations by Mike Brewer, Institute for Fiscal Studies, presented to JRF seminar.

8 Alan Marsh, *Earnings Top Up Evaluation Synthesis Report*, DSS Research Report 135, Corporate Document Services, 2000.

9 Alissa Goodman, ‘Inequality: what has happened under New Labour?’, *New Economy,* Institute for Public Policy Research/Blackwells, spring 2001.

10 See Frank Wilkinson’s arguments in Part II, Chapter 3.

11 Jenny Kodz and Judith Eccles, *Evaluation of the New Deal 50plus: Qualitative Evidence from Clients: Second Phase*, ESR70, Employment Service, March 2001.

12 DSS, *Opportunity for All*, Corporate Document Services, 2000, para. 2.11. (However, figures quoted in a presentation about ETC to a consultation meeting in July 2001 suggested that this has now risen to over 1.2 million. Take-up of Family Credit also rose following initial problems after its introduction, although it never reached 100 per cent.)

13 Kodz and Eccles, 2001, op. cit.

14 Letter from Andrew Smith, MP, Chief Secretary to Treasury, to participant in meeting of All Party Parliamentary Group on Poverty, 25 April 2001.

15 Martin Evans, *Welfare to Work and the Organisation of Opportunity: Lessons from Abroad*, CASEbrief 20, Centre for Analysis of Social Exclusion, London School of Economics, 2001.

16 Gordon Brown, for example, in announcing the latest increase in the Working Families Tax Credit in his 2001 Budget, commented: ‘This takes the hourly minimum rate for those on the Working Families Tax Credit not just to £4.10 an hour but to £6.40 an hour.’

17 See *OECD Jobs Study: Evidence and Explanations, Part II: The Adjustment Potential of the Labour Market*, OECD, 1994, pp. 198–200.

18 Alan Marsh, 2000, op. cit.

19 Kodz and Eccles, 2001, op. cit.

20 Kodz and Eccles, 2001, op. cit.

21 Alan Marsh, 2000, op. cit.

22 Michael White and John Forth, *Pathways through Unemployment*, YPS for Joseph Rowntree Foundation, 1998. These jobs were temporary, part-time, self-employed, or at a lower skill level.

23 'Poverty dynamics', in OECD, *Employment Outlook*, OECD, 2001.

24 Alex Bryson, 'Lone mothers' earnings', in Reuben Ford and Jane Millar (eds), *Private Lives and Public Responses: Lone Parenthood and Future Policy in the UK*, Policy Studies Institute, 1998.

25 Alan Marsh, 2000, op. cit.

26 See, for example, OECD, *Lifelong Learning for All*, 1996, Chapter 8.

27 Kodz and Eccles, 2001, op. cit.

28 Tony Atkinson, 'The case for a participation income', *Political Quarterly,* No. 67, 1996.

Part II

Further evidence and arguments: documents presented at JRF seminar on Employment Tax Credits, 14 May 2001

2 The Employment Tax Credit and in-work support: fighting poverty, making work pay or distorting the labour market?[1]

Donald Hirsch and Fran Bennett

Overview

The UK is planning to introduce an Employment Tax Credit in 2003, extending means-tested support for working families to include those without children or access to disability benefits. This is the continuation of a trend towards topping up the income of working families with low incomes, at a time when widening inequalities have created hardship for the poorest of them. Like 'make work pay' policies in other OECD countries, the aim is both to improve work incentives and labour supply and to reduce in-work poverty. Over the long term, such policies could have a profound effect both on low-paying labour markets and the fortunes of low-income families.

The evidence shows that such policies do indeed usually cause an increase in labour supply, although not by much relative to their cost. The greater number of people who work as a result is partly offset by disincentives to work longer hours caused by sharp withdrawal of assistance as income rises. An important factor in the UK and a number of other countries with similar policy approaches has been the relief of low *income* rather than low *pay* – the means test is applied to family income. This helps focus on family poverty (though not necessarily the 'hidden' poverty of individuals *within* families with total incomes above the qualifying level), and excludes low-paid individuals in well-off families; but it can also cause a particular disincentive for a second person in a couple to work. An important danger with any in-work subsidy (although arguably less with one based on family income than on individual pay) is that employers will cut wages, or that wages will drift downwards. There is little evidence to suggest whether such an effect will result in most of the benefit being diverted to employees or employers. (The danger of downward drift might also arguably apply to self-employed people; although direct cuts in wages are obviously not of concern in the same kind of way, contract workers are in some ways in an analogous situation to employees.)

Means-tested in-work subsidies have been better at helping people take the first step in the labour market (into a job) than the second (into a better job). In other words, there may be a trade-off between the strength of this form of means-tested provision and the creation of conditions that help and encourage people towards better opportunities to raise their living standards through work. In practice, in-work support of this kind has also had the effect of catching people when they fall – for example, when one person in a couple loses a job – or at least of letting them down gradually. But there may be alternative means of protecting income in some of the situations that attract in-work subsidy; enhancing the income of a single breadwinner in a couple is not the same as giving their partner access to income in their own right.

The first part of this paper describes the rationale for and development of 'make work pay' policies in the UK and other countries. It describes the features of UK policies to date, in particular means-tested in-work support, and the overall framework of the proposed Employment Tax Credit. The second part discusses issues that arise from these developments, and evidence of their impact so far. It looks successively at possible labour market effects of in-work income supplementation, at some key policy issues around the social purposes that ETC will fulfil, at a series of specific design and implementation issues, and finally, briefly, at some broader political considerations.

'Make work pay' policies: rationale and recent development

'Make work pay' policies in OECD countries – rationale and options

In recent years, OECD governments have felt under increasing pressure to intervene to promote employment at the lower end of the labour market. The decline of stable employment opportunities in unskilled and other manual occupations has been associated with a growth of worklessness and an ongoing debate about how to promote new jobs. The pure free-market solution of obliging people to take jobs at whatever employers will pay, by reducing or restricting access to out-of-work benefits, is opposed by those warning that it will create a struggling army of working poor, and exacerbate the growth in income inequality. On the other hand, policies seeking to protect the incomes of the working poor by setting minimum wage levels high enough to allow most working families to obtain a reasonable income are opposed by those who say that raising the price of labour to such a level will prevent jobs being created.

A third way being adopted by many governments – often in conjunction with elements of the other two – is to use fiscal transfers (reduction of taxes or payment of subsidies/benefits) to employees or employers, to enable the incomes of the working poor to rise while containing the costs of labour to their employers. Such measures create a greater incentive for people on a given level of out-of-work benefit to take work, and should therefore increase labour supply. They are often collectively referred to as 'make work pay' policies. Such policies, in the UK and elsewhere, parallel other efforts to get unemployed people into work, through more active attempts to help them find jobs and often more stringent requirements to look for work.

(It is important here to note that 'make work pay' policies have not been given equal emphasis in all countries. Indeed, they have been concentrated in countries including France, the UK and the United States in which earnings distributions are relatively dispersed. In countries with greater earnings equality, such as the Nordic countries and the Netherlands, there have been two reasons for not topping up the incomes of low-earner families. The first is that there is less need to do so: their original incomes from earnings (sometimes combined with certain universal family benefits) goes further towards meeting their needs. The second is that it would not be practicable to do so: where the earnings distribution is relatively flat, a means-tested payment would either have to be withdrawn at unacceptably high rates with rising income, or end up going to people on average or even higher earnings and thus make little sense.)

Two important distinctions can be made about the overall structure of 'make work pay' policies. The first is whether the payment goes to the employer or the employee. In very general terms, in continental European countries with relatively equal distribution of pay, often associated with relatively high minimum wages and relatively high non-wage labour costs, the emphasis has been on keeping the cost to employers down. A typical way of doing this is to reduce employers' social security contributions for lower-paid workers. In most English-speaking OECD countries, on the other hand, wage rates are relatively dispersed and the cost of labour at the bottom end of the market is relatively attractive, but consequent in-work poverty has been a bigger problem, and work incentives are affected by a narrow or non-existent gap between out-of-work benefits and potential earnings – especially for families with children. In these countries, therefore, the emphasis has been on increasing the incomes of low-paid workers and less on reducing employers' costs. Direct government transfers to individuals in these countries seem particularly attractive to anyone who thinks that a narrowing of wage dispersion is either an unrealistic or an undesirable goal, although others would see a reduction in low pay as a crucial policy goal. (Of course, the distinction between employer and employee payments is not relevant for the growing number of self-employed people who could benefit.)

The second key distinction is between policies directed at low-earning *individuals* and those that help low-income *households* or *families*. The former are a more direct form of intervention in the labour market, making it cheaper to employ someone receiving a given amount in return (and can therefore be expected to have a more direct effect on how employers and employees behave). Measures to reduce the cost of labour to employers all come into this category. But payments to workers may be directed either to low-*paid* employees as an individual wage bonus, or to low-*income* families with at least one worker to help them escape poverty.[2] Most English-speaking countries have chosen the latter course, which is seen as a more efficient way of directing money at those who need it most, since many individuals with low earnings or low wages live in families that are not poor. This moves such policies further in the direction of becoming a form of income maintenance/social protection, rather than a labour market measure. Yet, there is still a tendency, deliberately or inadvertently, to confuse the two. Gordon Brown, for example, in announcing the latest increase in the Working Families Tax Credit in his 2001 Budget, commented:

> "This takes the hourly minimum rate for those on the Working Families Tax Credit not just to £4.10 an hour but to £6.40 an hour."

An interesting exception to these patterns has recently been seen in France with the announcement of a *prime pour l'emploi* or job bonus paid to individuals. France uses family income as the basis for tax assessments, but the *prime* will be explicitly linked to individual earnings – albeit taking other family members' earnings into account (spouses of people earning at least 40 per cent above the minimum wage will not be eligible). The individual aspect of the assessment could potentially cause the payment to interact more directly with wage-setting than measures that relate only to family income standards, and some French socialists are apparently enraged at the prospect that employers may in future feel that they need pay only the minimum wage for jobs that presently attract up to 40 per cent above the minimum.

In fact, the varying design of 'make work pay' policies in different countries is due to a considerable degree of complexity in objectives that lies behind the two most straightforward ones of improving labour supply and reducing in-work poverty. For example, once governments get into this realm, they start to get increasingly embroiled in making judgements about what best serves the welfare of various groups and what represents desirable labour market outcomes.

Take, for example, lone parents. One of the 'make work pay' programmes that have reportedly enjoyed the greatest success in terms of increasing both labour supply and earnings of low-paid workers has been Canada's experimental Self-sufficiency

Project (SSP), which, in two provinces, offers earnings supplements to lone parents who have been receiving social assistance for at least a year, on condition that, within one year of being selected for the programme, they leave welfare for full-time work. An important feature of this programme is the strong incentive it gives to lone parents to work full time, by providing generous assistance on condition that they work at least 30 hours per week.[3] This contrasts strongly with the WFTC, which gives a big incentive to work at least part time (16 hours) but which can along with other benefits involve a sharp withdrawal rate that potentially deters parents from working more hours. (Following lobbying from various groups, a bonus for work of at least 30 hours per week was introduced into the UK system.) Such variations in programme design implicitly bring a set of public values into the terms of the trade-off for parents between time spent earning and time available for parenting.

Finally, it is important to note that, in the international context, the concept of a *general* transfer to working people in poverty is not so far a familiar one. In the United States, for example, the Earned Income Tax Credit is primarily designed for families with children: those without are also eligible, but get a tiny amount in absolute terms, whose maximum is of the order of 10 per cent of the maximum for a family with two children. On the other hand, France's planned job bonus, referred to above, is intended for all categories of family, though its details still have to be worked out. At present, Australia comes the closest to general means-tested support for the working poor, by allowing people on low earnings to continue to receive the same benefits as the unemployed, tapered with rising income. However, the effect of this measure on labour supply and on wages has not been well researched – and it is difficult to do so for lack of a control group. There is thus a dearth of evidence to draw on in projecting what would be the effect of extending means-tested benefits for poor working families to include those without as well as with children.

Fuller discussion of the international context can be found in a recent OECD study, summarised in Chapter 4 of this volume.[4]

UK provision to date

'Make work pay' policies in the UK have included a wide range of the types of measure referred to in the above discussion.

The following description of such policies has to be understood alongside the evolution of other measures to encourage people to move into work (which are, however, outside the scope of this paper). First, governments have tried increasingly to tighten the obligation to seek work among unemployed claimants. The present government has gone further, by obliging even claimants who are not required to seek work (such as lone parents) at least to *consider* it, through a work-focused gateway to benefits. Second, a series of schemes has given active assistance to people looking for work, whether through advice, training or assistance with job search. Here, again, the present government, through its New Deals, has extended the policy further to cover groups traditionally seen as 'inactive' rather than 'unemployed' – i.e. not actively seeking work. As work has been put at the centre of welfare policy, as 'the best route out of poverty', it has become essential for the government to demonstrate unequivocally to benefit claimants that working makes you better off. (The same is likely to be true for officials at the 'front line', where they interact with claimants.) This helps explain the growing importance of making work pay.

Support for individual low-paid workers

Over the past decade, governments have tried to improve take-home pay for workers on low earnings. The present government, for example, has helped make work pay for the individual low-paid worker by:

- *reducing national insurance contributions (NICs) for low-paid employees* – both by imposing contributions only on earnings above the Lower Earnings Limit, and by aligning this level with the personal tax threshold by increasing it from April 2001

- *reducing NICs for self-employed people* at the lower end of the labour market

- *reducing income tax payments for low-paid workers*, by introducing the 10 per cent starting rate and reducing the basic rate of income tax

- *introducing the minimum wage*, improving gross income levels for many low-paid workers – and subsequently increasing the adult rate above the rate of earnings growth (but this could be seen as partly compensating for a cautiously low initial rate)

- *introducing an 'Employment Credit'*, which is a year-long payment for long-term unemployed people over 50 taking up a low-paid part-time/full-time job, payable to those with earnings under £15,000 per year; although this payment is often bracketed with other tax credits (see below), it is in fact rather different, since it is available for a limited time only, and is paid to individuals with low earnings rather than being assessed on family income[5] (it is, however, offset against Housing Benefit and Council Tax Benefit in the same way as other tax credits).

Support for low-income working families

One should clearly distinguish the above measures affecting individuals from *in-work benefits/tax credits* that relate to the income of the family or benefit unit. There is often confusion in political and public debate between these different types of measure – although they obviously also overlap to some extent, especially for single people. This crucial issue, already referred to, recurs throughout this paper.

Governments in the UK have over the past 30 years used in-work means-tested benefits and tax credits to 'make work pay'. The objective of the benefits and tax credits has been both to improve incentives to work and to relieve in-work poverty. Both work disincentives and poverty have been seen as particularly worrying problems for families with children, and it is to these families that the help has been primarily directed.

Family income supplement (FIS) was introduced in 1971 by a Conservative government (quickly and as a temporary measure, because the Heath government was planning to introduce tax credits).[6] Family Credit (FC) succeeded FIS from 1988 as part of the Conservative social security reforms which brought the structures of in-work and out-of-work means-tested benefits closer together. Before its defeat in 1997, however, the Major government initiated a series of pilots to test out a broader in-work benefit, for those without as well as with children – Earnings Top Up (ETU); the evaluation studies of these experiments have recently been published.[7]

The incoming Labour government in 1997 set off on a different tack, though arguably one pointing in a very similar overall direction. Ministers were impressed by the Earned Income Tax Credit (EITC) in the USA, and decided to introduce a similar policy instrument in the UK. Very little more was heard about the ETU pilots, even though they were still continuing. Instead, the government announced plans to introduce the *Working Families Tax Credit* (WFTC), a new type of payment to replace FC for families (with children) on a low income and with at least one earner working 16 hours or more per week. WFTC was introduced in October 1999. Labour has also introduced a similar payment known as the *Disabled Person's Tax Credit* (DPTC), for disabled earners with low incomes, replacing the Disability Working Allowance (DWA).

The extent to which these payments are true 'tax credits' in terms of either assessment or delivery is, we would argue, debatable. One view of true tax credits is that they would be assessed and delivered through the income tax system. Whilst WFTC and DPTC are described as 'tax credits', and for employees are usually paid by employers through pay-packets, they are in practice assessed by the Inland Revenue in the same way as means-tested benefits, rather than via the PAYE system. They are also paid as an identifiable sum (or deduction from total income tax payable) on payslips, rather than through adjustments to tax codes. Lone parents must have WFTC paid via their employer. But it can be paid via benefit order books, etc., rather than via the employer, for self-employed people – as well as for couples who elect for the main carer rather than the main earner to receive it. In addition, benefit payments of WFTC are also made by the Inland Revenue in other circumstances, either when the claim is being renewed or when difficulties are experienced with employer payment. Nevertheless, what is not debatable is the government's desire that they be seen as tax credits, and therefore wholly different in kind from the in-work means-tested benefits they replaced.

In addition to these general transfers to low-income families with children, one should not forget that many low-income families with earners (with and without children) are eligible for means-tested help with rent and council tax payments. *Housing Benefit* and *Council Tax Benefit* each go to about 450,000 working claimants (as of May 1999). Housing Benefit is tapered sharply once (net) income rises above the amount the family would get out of work – at 65p in the pound. Nevertheless, working claimants receive on average about 80 per cent of their rent in benefit, a not inconsiderable £45 a week on average. The equivalent for Council Tax Benefit is £8.20.[8]

Finally, a *Children's Tax Credit* is being introduced in 2001, to replace (after a year's gap) the Married Couple's Allowance for couples and Additional Personal Allowance for lone parents. This payment is more of a true tax credit than the WFTC and the DPTC, since it is a deduction from individual tax liabilities rather than being means-tested in relation to the benefit unit. In one sense, it is means-tested against family income, since it is tapered away if any parent pays higher rate tax; but the mechanism for doing this is to oblige that parent to be the one who claims it, rather than having any cross-reporting of family income. Although this credit excludes rich families, it gives to other taxpaying families according to whether they have a child/children or not rather than according to their incomes, and is thus not focused on low-income working people. Indeed, those with incomes below the tax threshold cannot benefit from it, as it is not refundable (unlike tax credit support for those on low incomes); and those on WFTC or DPTC may not benefit fully from it either, as a higher net income results in a lower award on renewal. (The increase in WFTC rates which was announced recently is intended to compensate families for this.)

Looking ahead: the Employment Tax Credit

From April 2003, according to government plans at the time of writing, two important changes will be made in the UK's emerging tax credit system for low-income families. The following description of the reform was written before the publication in July 2001 of detailed proposals,[9] but is consistent with the present government proposals.

First, the Children's Tax Credit will be integrated with the various means-tested payments for children to become the *Integrated Child Credit* (ICC), paid alongside Child Benefit to the principal carer.[10] This is intended as a 'seamless' means-tested system of financial support for children with parents in and out of employment. The second change is the introduction of an *Employment Tax Credit* for low-income working families, paid through the pay-packet. At one level, the need for such a credit arises from the ICC reform: families with children who presently receive Working Families Tax Credit will get only the 'child' portion of WFTC through the ICC – a remaining 'adult' element would have to be paid separately for them not to lose out. However, this administrative separation has raised a further prospect which is not an inevitable corollary of the ICC reform: the extension of such support for low-income working adults to cover families without children in addition.

What then is the purpose of this extension? Public opinion appears to have supported measures such as the WFTC largely because of sympathy for children, rather than because people believe in transfers to low-paid workers *per se*: there is considerable concern that this will just lead to wage cuts. Only one in four people believe, for example, that the government should top up wages for a low-paid couple without children who find it hard to make ends meet.[11] The government, however, states its aims for the ETC as:

- improving incentives to work, and thereby increasing labour supply. (Note that, if payments for children are set at a single level for all families below a certain income, whether or not there is someone in work, the burden of improving incentives will shift to the adult payment)
- improving the in-work income of single people and couples with or without children who have an earner in the family.[12]

Other, less explicit, aims of improving in-work incomes in this way may include:

- taking a further step towards the declared aim of integrating tax and benefits
- as with WFTC – but in contrast to ICC – clearly distinguishing in-work support from benefits for people out of work, to increase its attractiveness to potential recipients
- creating a new mechanism for 'targeting' tax cuts at a group of people whom the government wants to help
- being able to do this in a way that does not increase public expenditure totals, and that reduces the ostensible tax burden on individuals/families, because of the designation of tax credits as revenue foregone rather than as spending
- moving towards 'full employment' – ensuring that there is no financial reason for people to refuse employment opportunities (and with the operation of benefit sanctions for those out of work made easier by separating off children's payments).

Potentially, eligibility for ETC could have been extensive – and, according to the Institute for Fiscal Studies (IFS), expensive. The government pointed out that there were 1.25 million individuals in 700,000 households without dependent children with someone in work but household income below 60 per cent of the median.[13] The IFS also suggested that 'extending the adult component of WFTC … to all working adults in low-income families would be … not well targeted on those with the lowest living standards: the largest gains would go to people in the third quintile of the household income distribution'.[14] The government's public plans suggest that eligibility is likely to be much narrower, in the first instance at least focusing on those it sees as priority groups.[15] We discuss this issue further below.

Issues arising

Impact on wages, employment and labour market behaviour

What is the effect on labour markets of public transfers of income to workers with lower family incomes?

As noted above, the main *intended* effect is to improve labour supply. By labour supply, economists mean the quantity (and also, potentially, quality) of labour that is offered at a given wage: if higher benefits or lower taxes make workers better off than they would otherwise have been at a going wage rate, they are more likely to take work at that rate, other things being equal. In this case, the total quantity of employment can be expected to rise,[16] benefiting both workers and the economy.

But (even leaving aside the rather problematic definition of 'workers') other things are not always equal. Other policy measures might also come into play, including the strength of sanctions imposed on recipients of out-of-work benefits who do not take jobs, and the setting and level of a minimum wage. The development of in-work benefits may also interact with private behaviour – whether by employers on the 'demand' side of the labour market or by individual workers on the 'supply' side. And 'workers' are not isolated individuals: within families, households and communities, there may be many other influences at work, as people on low incomes work out their most viable livelihood strategies.

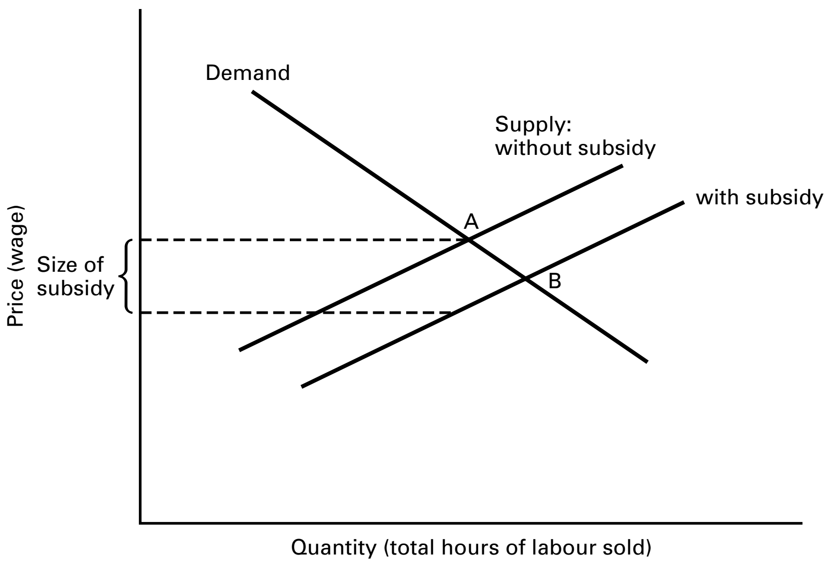
Two types of unintended effects arising from private behaviour are particularly important to consider. On the demand side, the existence of in-work benefits could put downward pressure on wages. Whether it does so may depend on the existing level of labour demand: where employers are finding it harder to obtain labour, the downward pressure will be less than in cases where labour is relatively plentiful and jobs relatively scarce. A broader and longer-term issue of labour demand concerns the character of jobs that are on offer. A wage subsidy may potentially encourage the development or continuation of strategies by employers that emphasise the use of cheaper, lower productivity labour rather than seeking more highly productive, better paid workers.

Second, on the supply side, the extra incentive to work may not automatically increase labour supply. A payment that makes it worthwhile to bring at least some earned income into each family may nevertheless deter individuals/families from *increasing* their earnings from work (whether by having more earners, by individuals working longer hours, or by upgrading their skills), because for each extra pound earned a substantial proportion is lost in declining benefits.

'Make work pay' policies and wage levels

Basic economics predicts that a subsidy to suppliers results in more goods and services being supplied at a price that is reduced, but not by as much as the subsidy. In the case of a wage subsidy, this would mean that employers and employees would share the benefit, in that the price of labour would be reduced and the net income from working a given number of hours would increase. This is predicted by the basic operation of supply and demand as illustrated in Figure 1.

Figure 1 Theoretical effect of wage subsidy on wage rate



Basic economics says that a wage subsidy to workers would lower the wage at which a given number of them would be willing to supply labour. The result would be to move from A to B, with more labour sold at a lower price, but the wage reduction being smaller than the subsidy.

But who in practice will benefit, employees or employers? That will depend on various influences, and perhaps most importantly on three things.

First, the degree to which the transfer is perceived as a *wage subsidy*. Income-tested transfers to low-earning families/households in the UK, such as Family Credit and Housing Benefit, do not appear to have been perceived in that way. One reason is because they are tested on weekly family income, rather than on individual hourly wages. A young single person working long hours on a low wage may not be judged to be 'needy' on the basis of income, while a single earner with a large family with higher wages falls below the means-tested threshold. The Employment Tax Credit may seem less oriented to 'family' needs than WFTC (children's needs will be met elsewhere), and a wider range of low earners, many without children, could be covered. Nevertheless, there will remain crucial differences between such a topping up of family income and a direct wage subsidy. For example, with the ETC, even two workers on the same hourly wage rate in identically composed families could get very different levels of top up according to how many hours they (and perhaps also their partners) worked.

Another reason why means-tested in-work support might not be seen as a wage subsidy is because of how it is presented and administered. The linking of the proposed French job bonus, described above, to minimum wage levels helps make it look more like a pay subsidy, even though it also takes account of other family members' earnings. In contrast, Housing Benefit in the UK is presented and administered in a way that makes it seem more like help with the rent than compensation for low pay (even though it is presently the in-work benefit which is *de facto* most closely tied to earnings, in the sense that it is withdrawn the most rapidly as earnings rise). The fact that HB is also available to people out of work is crucial here – in fact, research shows that many people thinking of entering employment do not know that HB is available in work, although it has been described as, in effect, an in-work subsidy to those without entitlement to WFTC. The move to tax credits delivered through pay-packets, initiated by the WFTC, may, however, start to cause people to associate subsidies more directly with wages rather than just family income. The ETC goes further by not mixing in support for children with this employment-oriented payment delivered by the employer.

Second, the evolving *character of the labour market*. There has been much debate about the role of low-paying labour markets in modern economies. Are low-paid jobs mainly used for employing young people who have not yet gained experience, and for people wanting temporary or casual work? Or are they 'dead-end' jobs from which it is difficult to escape? And what factors determine the relative pay of better and worse paid jobs?

Research on low-paid labour markets in the UK[17] has shown that, in practice, the picture is highly varied. There is a great diversity of experience, which makes it hard to generalise about low-paid work in the UK. However, some salient features are relevant:

- Earnings (defined, for example, as weekly earnings of full-time employees) are more unequally distributed in the UK than in most other European countries.[18]

- People with low pay are more likely than others to have low levels of education – although by no means all are poorly educated.[19]

- The most important influence on employers in setting wages for low-paid workers was how much they thought the workers were willing to accept (three-fifths cited this factor in one recent study).[20]

- Although low-paid jobs often do not last a long time, they are more likely to be interspersed with unemployment than with better-paid jobs (at least when they follow a spell of unemployment).[21]

- Employers know that investing in workers at the lower end of the labour market, through better pay and training, can have pay-offs, in particular through lower turnover; but, according to one study, they often calculate – correctly – that the cost of such measures to individual employers in fact exceeds their tangible benefits.[22]

Put together, these characteristics suggest that people with few or no recognised skills find themselves in a generally unfavourable position on the labour market (although the research that shows this has not, on the whole, looked at the very tight labour market conditions applying in some parts of the country in the past two years or so). Employers often pay the minimum required to obtain labour rather than basing pay on some other standard or norm, or on a desire to build loyalty and skills among workers who stay with the company. This suggests at least a clear possibility of supply-side subsidies resulting in downward pressure on wages.

Third, the effect of the *minimum wage*. The existence of a minimum obviously limits the degree to which wages can fall as a result of subsidies. But this would modify the effect less than in countries where the minimum wage is a standard baseline for wages: in the UK, almost all entry-level jobs in large service sector companies surveyed just before the introduction of the minimum wage paid more than that level.[23] The existence of government support to low-income earners could help lower wages to the point at which the minimum does become the norm, or maximum, for certain types of job. This may be more likely in the case of small firms, where low-paid workers may be more vulnerable to wages being lowered to the minimum (or even illegally being paid below the minimum).

Putting together these three types of consideration, one may conclude that a serious effect on wages is a strong possibility, even if it is not inevitable. An extreme case of how such an effect has operated in the past is described by Frank Wilkinson, in his paper later in this volume. In the Speenhamland system of the late eighteenth and early nineteenth centuries, it appears that wages fell directly as a result of income top ups for poor working families, which made the top ups more expensive for local communities to bear, and so caused the top-up level to be lowered and labourers to be worse off than they were in the first place. This is an extreme illustration of the dangers that such reforms could hold and, if something like this did occur, it would jeopardise the achievement of the government's child poverty targets and other policy objectives. Three differences in conditions in the UK today are the existence of the minimum wage, the much more varied patterns of family household composition and of employment, so that family income cannot be related as directly to the wages of a breadwinning male labourer, and a more developed public notion of welfare, underpinned by national taxation rather than local goodwill. Nevertheless, the experience shows how labour market relationships can adjust over time to the existence of public subsidies to workers, in ways that undermine the purpose of those subsidies.

Incentives at the margin

Subsidies to make work pay are intended to increase the supply of labour. However, where they are means-tested against earnings or income, they also have the scope to do the reverse. The withdrawal of the subsidy as income rises reduces the net gain to a worker or family unit from increasing hours worked. So, even though means-tested in-work support might improve the gain from working compared to not working, it may be a disincentive to produce more income from work within a family – whether by an individual working longer hours, by a second person starting to earn, or by seeking to improve one's hourly earnings.

One important influence, of course, is the *withdrawal rate*, or taper. The Working Families Tax Credit has a lower taper (55 per cent) on net income than Family Credit (70 per cent). It has also raised many families above the level at which they qualify for Housing Benefit and/or Council Tax Benefit, and so further reduced the number with very high total withdrawal rates of 90 per cent or more. However, by making more families eligible for some in-work benefit, it has increased substantially the total who lose at least 60 per cent of earnings at the margin – in the first instance by about a third, to over one million people. The Employment Tax Credit is likely to increase the numbers further. Considering the concern about the effect of even a 50 per cent top marginal tax rate on incentives for the rich, such work disincentives for the poor need to be taken very seriously – whether for economic reasons (effect on labour supply) or moral ones (double standards for incentivising rich and poor).

A second factor that influences the significance of this kind of disincentive is the *unit* on which in-work support is calculated. A means-tested subsidy based only on the earnings of an individual could influence some people's choices about working longer hours, but would, for example, have little impact on decisions by someone working full time out of choice and no opportunities for overtime. But family-based payment can go further, by influencing whether a second person in the family works at all (and might also influence whether someone who is already working repartners or not).

A third influence, which is likely to be very important in the design of the ETC, is the *timing* of the payment and of its calculation. Indeed, this factor is crucial to the way marginal disincentives work out in practice. A theoretical graph showing steep marginal withdrawal rates is unlikely to deter many people from working more, unless, in practice, they notice that, after increasing their hours, their net income barely changes. But, if the means test is applied relatively infrequently, the clawback in benefits will not be felt so directly. In North America, the means test is applied retrospectively through annual adjustments to the tax bill. The UK is not likely to use such restrospective payments because of differences in its taxation and benefit payment traditions. But there is an important decision to be taken about the award period. If, once an entitlement has been established, it is retained for several months or even a year, the disincentive to work at the margin would be greatly reduced. (For the WFTC, the award period is six months.) Such conditions give families a base on which to build during a given period, and potentially the prospect of reaching a level at which the credit is no longer as essential to the family budget by the time the award expires – for example, because a second earner has become established in work. (This issue, including potential trade-offs, is discussed in more detail below, as are other aspects of the design of the ETC.)

A final important influence is the number of *weekly hours* needed to qualify for the tax credit or benefit. As referred to above, a payment that requires someone to work full time such as the 30-hour threshold in Canada's experimental Self-sufficiency Project can increase hours worked, while a 16-hour threshold such as that in the WFTC might decrease them. (This consideration applies only to the first earner in a couple, who currently triggers eligibility.) In extending the ETC to non-parents, the government will have to consider whether it wants to encourage part-time rather than full-time work. The intuitive answer may be no; but there may be groups other than the rather obvious categories of parents, carers and disabled people for whom society wants to make part-time work more viable. For example, older workers approaching retirement could benefit greatly from being able to downshift, rather than face a dichotomy between full-time work and no work at all. Moreover, the evidence on Earnings Top Up, summarised below, shows that 'downshifters' sometimes use their extra time for socially useful activities of the type that the government often says it wants to encourage. But the government needs to consider very carefully whether a tax credit based on a family means test is the best mechanism of pursuing – implicitly or explicitly – such social objectives.

Evidence to date

What is the evidence of the impact of 'make work pay' policies on labour supply and on wages? It is difficult to get strong evidence of the long-term impact on the labour market. The best-evaluated specific experiment, Earnings Top Up, cannot by its nature capture the eventual effect of a generally available top up on pay norms or work preferences. Conversely, it is impossible to be precise about the impact to date of 30 years of means-tested in-work benefits for families with children, because of everything else that has happened to labour markets – and families – during those years.

The evidence that does exist indicates a marked but small effect on labour supply, and a potential but uncertain downward effect on wages.

Looking first at *labour supply*, evidence from both the UK and elsewhere is of a mainly positive effect, but a relatively small one. For example:

- Research on *Family Credit* has suggested that the benefit was likely to encourage employment among lone mothers and have relatively little impact on the probability of working full time as opposed to part time[24] (except that a significant number of lone parents reduced their hours when the minimum fell from 24 to 16 per week). Researchers also considered the impact on work choices of the introduction of a £10 bonus for working 30 hours a week or more from 1995.[25] It appeared that only marginally more lone parents increased their hours of work to more than 30 hours than those who reduced their hours to exactly 30. But, for married women, the effect was mainly in the other direction: a simulation predicted that as many women would leave the labour market altogether (because of the extra support given to their husbands) as would increase their hours.

- Assessments of the potential impact of *WFTC* on labour market participation found some positive impact on married men and lone parents' participation rates, but a negative impact on married women with partners in employment.[26] The magnitudes in both cases are relatively small: one of these studies,[27] for example, found that: 2.2 per cent of lone parents (approximately 34,000 women) would move into work; 0.2 per cent of lone parents would move from full-time to part-time work; and 0.6 per cent of women with employed partners (approximately 20,000 women) were estimated to move out of employment because of the additional income provided to their working partners.

- The *Earned Income Tax Credit* in the United States has been found to have a very similar pattern of influence on labour supply as Family Credit in the UK. Most studies find that the rise in entitlements in the Clinton era caused a modest overall increase in labour supply, with the greatest effect being on the probability that a lone mother works, partly offset by a significant reduction in work by second earners in couples.[28]

- A much more pronounced effect on employment rates was found in Canada's experimental *Self-sufficiency Project*. One group of non-working lone parents was offered a generous top up to earnings in full-time work for up to three years; the others were not offered it. After 15 months, 29 per cent of the first group and only 14 per cent of the control group were in full-time work.[29] This appears to show that the effect can be more than at the margins – it can affect the working behaviour of a large proportion of a given group – if the incentive is strong enough.

- The evaluation of *Earnings Top Up* in the UK – which, unlike the examples above, was received by non-parents – found that there were small benefits in terms both of slower movement into unemployment and faster movement out of it in areas where it operated compared to control areas. The programme was not well taken up, but people who had had disrupted work histories in the past were more likely to claim the top up.[30]

  However, many ETU recipients also said that the subsidy allowed them to work shorter hours while releasing them to follow other pursuits, including caring for a relative or other socially useful activities. It helped many to cope with poor health that limited their employment, or to recover from difficulties in their lives. A few self-employed recipients found ETU especially useful in getting a start in business or shoring up failing enterprises until prospects improved. In these ways, like the top ups for families with children, ETU sometimes allowed less, rather than stimulating more, participation in paid work.[31]

  (These findings on ETU give some general indications about possible impacts rather than being in any way pilots for

ETC. Certainly, some of the conditions are likely to be different, including minimum hours rules, age thresholds and the existence – under ETC – of a common credit for parents and non-parents. Moreover, the very character of ETU as a geographically selective pilot is likely to have affected responses to it, and awareness of it. The existence of control areas gave potential for making useful comparisons, but results were susceptible to influence by the specific local economic fortunes of pilot and control areas during the evaluation period.)

In considering the above evidence on supply-side impacts of 'make work pay' initiatives, it is important to note that, while overall they move supply in the direction intended, the effects are generally small relative to the cost and 'dead-weight' effect of the programmes. For example, if the WFTC creates 30,000 jobs compared to Family Credit (one estimate of the gross effect),[32] the cost per job could be said to be around £50,000 a year. So, the rationale for such measures would be hard to sustain if labour supply were the only purpose. It relies on also wanting to help poor working families who would have worked without the credit: their gain is not then 'dead-weight', but helps to fulfil that second objective.

Looking secondly at *wages*, evidence is more difficult to identify, since it is hard to know what employers would pay the same workers without the subsidy. Most studies have not been able to discern a definitive impact on wage levels. The Earnings Top Up evaluation is an exception: as a pilot, it was able to compare wages in programme areas with control areas (though this proved problematic in practice). There was mixed evidence on the overall effect on wages of the ETU. Employers did not appear to adopt a conscious strategy of reducing wages in response to the subsidy.

But new recruits had significantly lower wages in programme areas than in control areas. This was particularly marked where the higher of two top-up levels was being offered. The observed effect on entry wages was large, but based on very small sample sizes. The authors speculate that, with ETC, for unskilled entry-level jobs, the minimum wage could become the maximum wage.[33]

Some key policy issues for the ETC

What kind of social protection?

The more closely an in-work tax credit is linked, via tighter eligibility rules, to enhancing low weekly income for certain categories of individuals/family units with an earner – rather than supplementing low hourly pay for individuals – the more it may be performing a variety of functions above and beyond 'making work pay'. Some of these functions are discussed below. They are relevant to couples in particular.

- *Acting as a 'parachute', rather than a launch-pad*: research has demonstrated[34] that Family Credit performed various functions for families with children, only one of which was to act as a work incentive. It was also operating as a 'parachute' in several ways, such as cushioning total family income in a two-parent family in some circumstances, such as when the main wage-earner lost their job. Presumably, the combination of ICC and ETC will continue to function in these ways for families with children.

- *Compensating for gender inequality in pay levels*: in addition, the same research showed that a claim for FC was more likely when the woman was the main wage-earner, because the low level of her wages was more likely to bring the family within the range of FC entitlement. Thus, one of the functions of ETC could be to compensate for the lower income levels of couples with female single earners caused by gender inequalities in the labour market.

- *Supporting single-earner couples without children*: ETC will be paid to some categories of people without children. For such couples, one relevant question to ask is why there is only one (insufficient) income coming in. In the case of FC/ WFTC, this often seems to be related to the presence of young children (although the in-work supplement may work to prolong this sole breadwinner stage in the family lifecycle). But with the extension of in-work support to non-parents, the reasons for non-participation in the labour market may be less clear. Simulations produced by the Institute for Fiscal Studies show that, under certain assumptions, while most childless ETC claimants would be single people, if ETC is restricted to the over-40s, up to a third of claimants are likely to be in couples.[35] Some of these couples (though probably a declining number) may be traditional families in which the woman gave up paid employment on marriage and has been keeping house. In others, however, one person may have lost their job through unemployment/ill-health, whilst the other remains in employment.

One view of the issues raised above is that ETC will be a multi-purpose benefit, flexibly providing additional resources for people with a low total family income in a variety of situations that cannot be predicted in advance. But, another view is that ETC will be a rather *un*targeted benefit that will be attempting to cover for a variety of gaps or shortcomings in the rest of the UK's labour market and social protection system which should instead be addressed directly. Looking at the functions described above, one might argue, for example, that such problems as reduced income through job loss for one partner should be prevented in other ways, before poverty strikes the couple, and that gender inequality in pay levels should be tackled head on. In addition, it is surely questionable whether a means-tested supplement to earnings, paid to the remaining wage-earner, is the best way to boost total family income in the situation in which one partner is out of the labour market for legitimate reasons; the alternative is to give individual entitlement to a non-means-tested benefit. ETC may be a 'second-best' policy solution.

What are the implications of joint assessment?

The figures used to support the case for in-work supplements have often treated couples as one undifferentiated unit. Thus, in the Pre-Budget Report published in November 2000, the government argued that, in 1997, *a couple* with two children needed nearly £260 per week to be £40 better off in work, and would therefore have to be earning £7.50 per hour for a 35-hour week (apparently implicitly assuming only one wage-earner). Similarly, making the case for extending in-work supplements to people without children at the time of the 2000 Budget, the government noted that, for couples without children, the gains from low-paid jobs in comparison with worklessness are still not large (and then quoted Paul Gregg's calculations that the national minimum wage would have to rise to £5/£5.70 per hour for *one full-time worker in a couple* to generate an income *for the couple* equal to half average income).[36]

It seems clear from government documents that assessment of entitlement for the Employment Tax Credit will be based on the 'benefit unit'/family (see Box 1.1 in Chapter 1 in Part I) rather than the individual; this is certainly the assumption made throughout this paper. This is described as 'not old-style means-testing through the benefit system but through the tax and benefit systems together'[37] (though it is not yet clear what this will mean in practice). In this context, the following evidence and arguments are worth noting:

- Some commentators seem to suggest that joint assessment is inevitable for social security benefits.[38] But, as noted in Box 1.1 (in Chapter 1 in Part I) earlier in this volume, this is only the case for means-tested benefits, with many other benefits being assessed largely on an individual basis.[39] In addition, current social trends, and policies in other areas of welfare reform, would suggest a greater emphasis on individual entitlement and a goal of economic independence for individuals over the lifecycle. The introduction of Employment Tax Credit, by contrast, moves in the opposite direction.[40]

- The Treasury sees the Employment Tax Credit as a step towards an integrated tax/benefit system. Some commentators have certainly seen the extension of means-tested benefits up the income scale, via tax credits, as threatening the future of independent taxation. It could also be argued that ETC raises this issue in a more acute form than the Integrated Child Credit does, since it affects the individual's tax liability, rather than involving assessment for a payment for children. However, so far there have been no indications about how entitlement might actually be assessed via information submitted for tax purposes, rather than via a separate means test as with current tax credits.

- Another issue raised by joint assessment is the definition of benefit/family unit. This has always been problematic in the means-tested benefits system, necessitating a 'cohabitation rule' and being implicated in fraudulent claiming because of the inherent disincentives to (re)partnering. The greater fluidity of family forms in recent years has increased the problems. With the extension of joint assessment under the new generation of tax credits, this issue affects ever larger numbers of people, and presents a formidable challenge to a government committed to the introduction of 'lighter touch' means testing.

Is this the best route out of poverty?

ETC will certainly be boosting low individual/family income to a higher level. However, in the light of the discussion about labour supply and work incentives, it is also possible to argue that ETC may not provide the best and most sustainable route out of poverty for couples. Research carried out when Family Credit was available demonstrated that the earnings of someone else within the household were far more likely to take a low-paid earner's household out of poverty than any other additions to income.[41] (The importance of the earnings of other household members – compared, for example, to the structure of taxes and benefits – in affecting incentives and income also seems to be borne out across several different European countries in preliminary findings from Euromod.[42])

When couples managed to get off FC, this was usually because of having a second earner whose income was sufficient to ensure that they leapt clear of the poverty trap, rather than because of progress in the labour market for the main wage-earner.[43] A recent government study of parents and employment showed that it was often very difficult for both partners to get jobs at the same time; but it also found that taking part-time work, even for a few hours a week, improved people's chances of being able to take advantage of better employment opportunities later.[44] But, because of the taper on extra family earnings, Family Credit seems to have kept many claimants' partners out of part-time employment.[45] (This disincentive effect can of course be mitigated by different definitions of income, taper arrangements, disregards for second earners' incomes, etc.; but it is difficult to see how it can be entirely solved under a jointly assessed means-tested system.) Will ETC operate to facilitate or frustrate a sustainable escape from poverty for low-income couples?

Some issues for the design of the Employment Tax Credit

This paper has aimed primarily to discuss the wider issues raised by the spread of means-tested support to low-income families with an earner, rather than to address the detailed design of the ETC. However, as the analysis has already indicated, the impact of such measures can be strongly affected by specific design features. This final section therefore highlights a series of design aspects where the option chosen will have an important impact on outcomes.

Who is eligible

In principle, an Employment Tax Credit could be made available to anyone who is working and fails to earn (with any other income they have) above a specified threshold adjusted for family composition. In this way, it would be an extension of Income Support, just as, in Australia, out-of-work benefits disappear only as in-work income rises. However, the Treasury has suggested some *possible* restrictions:[46]

- to people working at least a minimum number of hours per week – for example 30 – except for certain categories (e.g. parents, disabled people and possibly carers as well) who would be able to qualify with only 16 hours' work per week or more

- to people over a certain age – for example 25 (or 40).

The Pre-Budget Report, published in November 2000, estimated that extending an ETC to over-25s with at least one wage-earner working 30 hours per week or more, with different rates for couples (jointly assessed) and for single people, would reach about 300,000 to 400,000 additional people (on top of those entitled to WFTC or DPTC). It would exclude about as many people again who are in families on low incomes with an earner but who fall outside these criteria.

Partial coverage initially could mean that in practice ETC could comprise a rolling development programme of in-work tax credits, which could be extended to other groups as and when required. But, if so, it should not be taken for granted that the final aim is to cover everyone below a certain income level: as argued elsewhere in this paper, that may not be a desirable final outcome.

What is clear, however, is that joint rather than individual assessment, high hours rules for many claimants, and differential rates for/exclusion of the under-25s could exclude a majority of low-*paid* individuals from eligibility, whilst targeting some categories of low-*income* family with an earner. This would therefore reinforce the principle, established with WFTC and DPTC and their predecessors, of giving priority to certain groups with low incomes, rather than compensating people directly for low pay.

Debates about the relationship, or lack of it, between low pay and low income are far from new. Those who opposed the abolition of Wages Councils, for example, sometimes tended to equate low pay with poverty, while abolitionists often claimed that low pay rates were not significant for those who received them, since they were young/part-time workers and were either single or 'second' earners, with other incomes coming into their family/household.

The differences between low *pay* and low *income* turn on:

- the time unit of measurement (usually hourly for low pay, weekly for low income)
- what is being measured (usually gross for low pay versus net income, and income from one source for low pay compared with income from several sources)
- the unit under consideration (individual versus individual/ benefit unit/household).

Recent research, however, whilst continuing to draw a distinction between low pay and low income, has tended to suggest a degree of convergence between the two over recent years,[47] with the low paid and those on low incomes increasingly overlapping. The Low Pay Commission received evidence which confirmed this trend.[48] Nonetheless, the two issues remain distinct, despite some degree of overlap, and the design of policy instruments to tackle them is therefore also likely to differ.

Interaction with other benefits

Family Credit and WFTC have not always proved as generous as they first sound, partly because they can cause the withdrawal of other in-work benefits. Marsh and McKay found that one in five FC claimants were in severe hardship despite receiving FC, especially due to the loss of Housing Benefit (HB) and Community Charge Benefit, combined with additional travel and childcare costs.[49] The WFTC is more generous and has helped alleviate this hardship to some extent, by 'floating' some families with children off HB and Council Tax Benefit (CTB) altogether (with 70,000 lifted off HB, according to the latest Pre-Budget Report). It has done this by raising their income above the eligibility level for HB/CTB, thereby making them better off in total than before. But other WFTC recipients with continuing eligibility for HB and CTB have felt much less financial benefit from WFTC and – despite the lower taper for WFTC withdrawal – have in theory been subjected to a 'poverty trap' of benefits withdrawal in combination with tax and national insurance deductions hardly less severe than under FC.[50] In some cases, because of this experience, they feel that the promises of additional income from WFTC have been deceptive.

The evaluation of ETU showed that those who benefited from it were largely young people living with their parents, who thus were assumed not to have housing costs.[51] ETC could draw in some people with mortgages rather than rent to pay. However, other proposed restrictions on ETC (such as a lower age limit) are likely to exclude many of those without housing costs.

Some commentators would argue that the fact that WFTC has floated significant numbers off HB (and CTB) is one of its main advantages. This is because the continuing administrative problems of HB show no sign of decreasing in severity, and because the government appears to have no immediate plan for structural reform of HB. Thus, even if much of the benefit of ETC were to be nullified for tenants by the withdrawal of HB, this could be seen as a way of circumventing the problems of HB.

Means of delivery

One of the major concerns about the replacement of FC with WFTC was the government's intention that WFTC should be paid through the pay-packet. It was argued in particular in relation to couples that research evidence had shown that money which was perceived as being for the family/children, and which was paid via the main carer (like child benefit and FC), was more likely to benefit the children.[52] Initially, the government responded to these concerns by allowing couples to choose which of them claimed, and therefore received, WFTC – the main earner via the pay-packet or the main carer via a benefit payment. Lone parents have no choice but to receive their WFTC through the pay-packet. The introduction of ICC, which will be paid to the main carer, can be seen in part as a response to continuing concerns that in some two-parent families it would be difficult for the main carer (usually the woman) to assert her claim to get WFTC.

The government has, however, indicated that, with the payment of ICC to the main carer, the case for payment of ETC through the wage-packet for employees is clear. It should probably be assumed at this stage that this will be compulsory. If this does turn out to be the case, this method of payment would have different implications for different groups (leaving aside self-employed people):

- Lone parents currently on WFTC, who have no choice over payment methods at present, will see more money via the benefits system (ICC) and none/less via the paypacket (ETC).
- For two-parent families who currently receive WFTC via the main wage-earner's pay-packet, the main carer themselves will in future receive ICC, leaving the main wage-earner with only ETC.

- The government has said that some families with children currently on WFTC will in future only qualify for ICC, with no ETC in payment (if ETC is phased out first).

- For those couples in which the main carer has been receiving WFTC as a benefit payment, and who do get ICC *and* ETC, it is possible that the splitting off of ETC into the pay-packet will mean that this will then be seen as belonging to the wage-earner him/herself, for personal expenditure, rather than being available for expenditure on household and children;[53] this possibility must reinforce the case for ensuring that the amounts payable in ICC are adequate from the start, and also for putting more emphasis on additional resources for ICC than ETC, given the high priority on safeguarding children's welfare and tackling child poverty.

- For single people and childless couples, ETC will be paid through the pay-packet from the start.

The government estimates that the number of employees receiving tax credits through the wage-packet will be broadly similar under the next generation of tax credits, because some families currently getting WFTC will only receive ICC, paid to the main carer, and because some people on ETC will be self-employed.[54]

It could be argued that the method of delivery of in-work support – as a benefit payment, or via the paypacket – is a relevant concern to people without children, as well as those with. The government's case in favour of in-work tax credits relies in part on their being perceived as part of rewards for paid employment and/or the tax system, rather than the benefits system. But the evidence from Citizens' Advice Bureaux about WFTC, for example, suggests that delivery through the pay-packet is perceived by some employees as giving their employers too much information about their lives and/or too much control over their weekly income.[55]

The delivery method could also affect the impact of the taper on work incentives and behaviour. As Marsh and McKay pointed out in relation to FC,[56] the effects of the 'poverty trap' were in effect split between partners in two-parent families, with the main wage-earner having increased deductions from gross pay and the main carer finding their benefit reduced. With the introduction of WFTC, those wage-earners receiving the payment via their pay-packet feel both effects. This may have made the operation of the poverty trap more visible to wage-earners (though evidence is not yet available from the evaluation of WFTC). With ICC/ETC, the situation will change again, with ETC withdrawn before ICC, and couples with children will see the main wage-earner's income being reduced, whilst ICC is usually maintained. Traditional economic models analysing incentive effects often do not look inside the 'black box' of the family to assess these differential effects.

Definition of income and treatment of capital

The government says that the next phase of modernisation provides an opportunity to review the treatment of income and capital. If it is to achieve its aim of creating a seamless system of tax credits, the definitions of income and capital in ICC and in ETC will presumably have to be the same.[57] However, the additional constraint is that the treatment of income and capital under ICC will already have to bring together the different systems under Income Support, income-related Jobseeker's Allowance and WFTC (e.g. the treatment of child support, which is disregarded completely under WFTC, but only £10 per week of which is disregarded under IS).

In-work tax credits assessed on net income, like means-tested benefits, reduce the impact on their recipients of improvements in more general forms of public support. This has been made clear in recent Budgets, as successive Chancellors have found it difficult to extend the full effects of tax cuts to low-income families. Those families on WFTC do not get the full benefit of the introduction of the Children's Tax Credit from April 2001, for example (one reason for the recent increase in WFTC rates). Similarly, other broader policies to increase net incomes from 2003 onwards would have only a marginal impact on the incomes of the increasing numbers on in-work tax credits. A higher personal tax allowance, for example, would be clawed back at the rate at which the benefit was tapered.

Commentators initially assumed that the government would continue with the more recent tradition of using net income as the basis for in-work means-tested support; but, if the intention is to move towards integration of tax and benefits, it may be more likely that gross income is used, to match income tax calculations. (The government's consultation paper still leaves it open, but leans towards gross income.) The implications of a return to gross income (the definition of income used for Family Income Supplement – FIS – which preceded FC) for interaction with other benefits, and with taxation policy, would need to be considered in some detail. Basing the calculation on gross income could decrease the disincentives for second earners, for example; but, with FIS, deductions from gross income combined with benefit withdrawal resulted in 'marginal tax rates' of over 100 per cent in some cases.

The government is moving towards a different view of how to treat the capital one can hold and be eligible for means-tested benefits or tax credits. There is increasing discussion of the positive advantages of 'asset-based welfare'. In this context, it is possible that, in means-tested benefits and tax credits for non-pensioners, including ETC, the government will move to abolish both the capital limit and the tariff income rule which applies to capital below that limit, and just take into account income from savings. (Non-means-tested benefits, of course, rarely contain any penalty for owning capital/savings.)

Period of assessment and length of award, review, etc.

The government's plans for the period of *assessment* for ETC were not yet clear at the time of writing. At present, WFTC is assessed on the basis of several weeks' or several months' payslips. The experience of the child support system has shown us that the circumstances of many low-income individuals can be very changeable – including the formation and dissolution of 'families', as well as alterations in employment status and income levels.

It can be argued that in-work supplements such as FIS, FC and WFTC have been favoured by many claimants because of the stability provided by the length of award – one year for FIS, and six months for FC and WFTC. This is also the reason why the poverty trap does not bite in practice as sharply as it does in theory; in effect, the fixed amount becomes a platform of income on which to build for the period of the award. In its plans for the Pension Credit, the government has argued that pensioners should not have to be means-tested every week, as they are (in theory at least) for Income Support, and that to have a fixed period of award following an assessment resembles the tax system more closely;[58] whilst this is true, such a system has in fact also existed within in-work benefits for nearly 30 years.

The government notes that around 60 per cent of FC claimants renew their awards and see a change in payment of less than

£10 per week[59] (although, with the vulnerability to hardship which is likely at such low income levels, three out of five may not seem a very high figure). It argues that there is a case for an annual award of the new tax credits – and that this also opens up the possibility of Inland Revenue assessments based on income data from employers in the future. However, the government notes that there would then be a need for greater potential responsiveness within award periods. There could also be a trade-off with amounts of payment, as a greater degree of 'rough justice' at low income levels might be seen as acceptable only in the context of more generous awards.

It has been argued that, in order to prioritise different aims for different groups, there is a good case for different lengths of award, with (generous) payments for children (via ICC) being awarded for longer periods than payments for adults (via ETC). This could mean putting a premium on income stability for children, but more priority on employment/incentive issues for adults. However, it may not be easy to square this with the government's aim of providing a seamless taper for ICC/ETC which does not result in both of them being withdrawn at the same time. And, from the perspective of the poverty trap, more frequent reviews of awards for adults could cause more concern about incentive issues.

Policy and politics – some last reflections

An important part of the political background to recent developments in 'make work pay' policies in the UK is the redesign and redesignation of in-work supplements as tax credits. Are such measures sustainable in the longer term, and do they make policy more flexible or more constrained? The government argues that this change from benefits to tax credits will make them simultaneously less stigmatising for recipients and more acceptable to voters. Some commentators argue instead that turning in-work support into tax credits, far from helping to integrate the tax and benefits systems, threatens to confirm the second-class status of benefit claimants out of work compared with taxpayers/tax credit recipients in work. It has also been argued that to strengthen the artificial distinction between cash payments (bad) and tax breaks (good) is to perpetuate arcane and archaic conventions which, in the longer term, act to restrict creative public policy making. The further extension of tax credits represented by ICC and ETC will ensure that these debates continue into the future.

A different possibility is that the extension of means testing for people in work will make them more dependent on public largesse to those on low incomes (which is fragile at best), rather than benefiting from general improvements in incomes. Past experience has shown such risks in a separation of mechanisms that help the poor minority and those that help a better-off and more numerous majority: there is scope for the former to be neglected, without serious political fallout. During the 1980s, for example, real income rose for most people in work, whereas those dependent on benefits fell behind the rest of the population as these were largely increased only in line with prices. The counter-argument is that it is precisely the extension of targeted support to greater numbers that creates a political constituency no longer able to be marginalised in this way, and a wider acceptance of 'welfare' measures amongst the population at large. But this is at best a risky route along which to be travelling steadily ever further.

Notes

1 Background paper for seminar on 14 May 2001 (revised and updated, June 2001). While this paper covers broadly the

same themes as the discussion in Part I of this volume, it also looks in more detail at the background, and brings in a range of evidence, from the UK and elsewhere.

2 This is to accept the traditional definition of poverty, which is usually measured on a family basis (see Box 1.1 in Chapter 1 in Part I). There is an alternative way to look at poverty, outlined by Tony Atkinson, Bea Cantillon and Brian Nolan in a draft paper for the Belgian Presidency of the European Union in August 2001 on indicators of poverty and social exclusion. This approach emphasises the amount of resources that individuals have access to and a right to dispose of; this means that the focus shifts from the family/ benefit unit to the individual.

3 A 30-hour qualifying rule for one earner in couples – or a bonus for families in which one earner works 30 hours per week – can discourage couples from sharing the caring and earning tasks. On the other hand, the Netherlands has an explicit government policy to encourage such a sharing model and the UK government has said in the tax credits consultation document that it is considering whether couples can share the qualifying hours needed for the bonus.

4 *Economic Studies*, Vol. 31, No. 2, OECD, 2000.

5 The Chancellor sometimes gave the impression that the ETC would be an expansion of the Employment Credit in the New Deal for the 50plus (e.g. in the All-Party Parliamentary Group on Poverty meeting held on 7 February 2001).

6 Alan Marsh and Steve McKay, *Families, Work and Benefits*, Policy Studies Institute, 1993.

7 Alan Marsh, *Earnings Top Up Evaluation Synthesis Report*, DSS Research Report 135, Corporate Document Services, 2000.

8 DSS, *Housing Benefit and Council Tax Benefit, Annual Summary Statistics, May 1999,* 2000, Tables 3.3, 3.7, 4.2 and 4.4.

9 *New Tax Credits: Supporting Families, Making Work Pay and Tackling Poverty*, Inland Revenue, July 2001.

10 For a full discussion of this change see Donald Hirsch, *A Credit to Children*: *The UK's Radical Reform of Children's Benefits in an International Perspective*, YPS for Joseph Rowntree Foundation, 2000; Mike Brewer, Michael Myck and Howard Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary 82, Institute for Fiscal Studies, 2001.

11 J. Hills and O. Lelkes, 'Selective universalism and patchwork redistribution', in R. Jowell *et al.* (eds), *British Social Attitudes: The 16th Report – Who Shares New Labour Values?*, 1999/2000 edition, Avebury, 2000.

12 HM Treasury, *Tackling Poverty and Making Work Pay – Tax Credits for the 21st Century: The Modernisation of Britain's Tax and Benefit System, Number Six,* 2000.

13 HM Treasury, 2000, op. cit.

14 L. Chennells, A. Dilnot and C. Emmerson, *The IFS Green Budget: January 2000*, Commentary No. 80, Institute for Fiscal Studies, 2000, cited in Mike Brewer *et al.*, 2001, op. cit. (see note 10). This modelling, however, as the IFS notes, assumes that income is shared between all adults in a household, rather than just a benefit unit, and that a young adult living with his/her parents therefore shares the same living standards. (A

'household' can include several 'benefit units', i.e. an individual/heterosexual couple and any dependent children; a young adult living with his/her parents means two benefit units; see Box 1.1 in Chapter 1 in Part I.) A more fundamental traditional assumption is that it is appropriate to measure living standards by family/household, disregarding any questions of unequal sharing of resources inside the family.

15 See HM Treasury, 2000, op. *cit.*; HM Treasury, *Building Long-term Prosperity for All* (Pre-Budget Report), Cm. 4917, The Stationery Office, 2000.

16 The notion that creating a job for one person will simply take one away from another, because the total number of jobs is fixed, flies in the face not just of economic principles but also of real experience: the percentage of working-age adults in employment in OECD countries has varied substantially, both across countries and over time. This does not, however, mean that displacement does not happen, particularly in local labour markets and over the short term.

17 See, for example, DSS Research Report No. 95, *Low Paid Work in Britain: Baseline Surveys from the Earnings Top Up Pilot Evaluation*, 1999; Donna Brown, Richard Dickens, Paul Gregg, Stephen Machin and Alan Manning, *Everything under a Fiver: Recruitment and Retention in Lower Paying Labour Markets*, YPS for Joseph Rowntree Foundation, 2001.

18 OECD, *Employment Outlook*, July 1996, p. 70.

19 DSS, 1999, op. cit.

20 Ibid.

21 See Michael White and John Forth, *Pathways through Unemployment: The Effects of a Flexible Labour Market,* YPS for Joseph Rowntree Foundation, 1998.

22 Donna Brown *et al.*, 2001, op. cit. (see note 17).

23 Donna Brown *et al.*, 2001, op. cit.

24 P. Bingley and I. Walker, 'The labour supply, unemployment and participation of lone mothers in in-work transfer programmes', *The Economic Journal*, September 1997.

25 A. Duncan and C. Giles, 'Labour supply incentives and recent family credit reforms', *The Economic Journal*, January 1996.

26 R. Blundell, A. Duncan, J. McCrae and C. Meghir, 'The labour market impact of the working families tax credit', mimeo, Institute for Fiscal Studies, 1998; P. Gregg, P. Johnson and H. Reed, *Entering Work and the British Tax and Benefit System*, Institute for Fiscal Studies, 1999.

27 Blundell *et al.*, 1998, op. cit.

28 Summarised in Chennells *et al.*, 2000, op. cit., Chapter 6.

29 Social Research and Demonstration Corporation, *When Financial Incentives Encourage Work*: *Complete 18-month Findings from the Self-sufficiency Project*, September 1998.

30 Alan Marsh, 2000, op. cit.

31 Ibid.

32 Blundell *et al.*, 1998, op. cit.

33 Alan Marsh, 2000, op. cit.

34 Marsh and McKay, 1993, op. cit.

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50 The parenthesis of 'in theory' is necessary when discussing the poverty trap, as the combination of fixed awards over time with changes in employment and family circumstances, and in benefit rates and rules, means that for many families the full effects of the poverty trap may never be felt in practice.

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3 The theory and practice of wage subsidisation: Some historical reflections

Frank Wilkinson

Introduction

The view in government circles is that the economy has now been brought under control by prudent macroeconomic management. A major remaining problem is the high level of poverty resulting from the persistence of high unemployment and the growth in the number of the working poor. The policy response to this is to make the payment of social welfare dependent on labour market participation by a variety of means, including topping up earnings to some minimum level by means of *tax credits*. The idea of in-work benefits as an answer to unemployment and in-work poverty has its roots in the belief that it is *unemployability* at the wages demanded by workers rather than *unemployment* that explains joblessness; and that it is poor labour quality combined with family size which explains in-work poverty rather than exploitation. Attaching benefits to work, it is asserted, makes the offer of jobs affordable to employers while making work pay for prospective employees. This helps break the cycle of welfare dependency by creating greater incentives for the poor to work by making up the difference between their household needs and the market valuation of their capabilities.

In-work benefits had been out of policy favour between 1834, when the Poor Law Reform put an end to the Speenhamland System, which similarly mixed wages and welfare benefits, and 1971, when Family Income Supplement was introduced as an anti-poverty measure. Their policy importance increased as unemployment grew after 1979 and when, in 1988, Family Income Supplement was replaced by Family Credit (Deakin and Wilkinson, 1991). Attaching welfare benefits to labour market participation has since become a central focus of the current Labour Government's welfare-to-work strategy. The more generous Working Family Tax Credit has been substituted for Family Credit, and the plans are to extend eligibility to include households without children. There is now such a strong consensus in support of welfare to work as a solution to unemployment and in-work poverty that any discussion of its drawbacks or of alternatives is muted.

The consequences of going further down the road towards a general in-work benefit strategy are sufficiently uncertain to warrant a public discussion about all the possible issues involved. This paper is a contribution to this debate. Its purpose is to assess present-day policy from the point of view of historical experiences of, and arguments about, wage subsidisation, the lessons of which are being, unaccountably, forgotten. The second section briefly re-examines the debates surrounding the Speenhamland system of wages subsidisation and how it impacted on poverty and the working of the labour market. Sections 3 to 6 chart changes in labour market theorising and how these relate to the ebb and flow of unemployment and poverty, and their social and political consequences. Section 7 outlines contemporary arguments in favour of wages subsidisation. Section 8 outlines an alternative perspective on the labour market and how that might be used in the teaching of the lessons of history, and for designing effective labour market and social welfare policies.

The Speenhamland System: an experiment in wage supplementation

The pauperisation of the poor in the eighteenth century

During the eighteenth century, the enclosure of land, its consolidation into large holdings, the elimination of small-scale farming, the exclusion of the poor from common land, the loss of customary rights and the decline of domestic industry had a major impact on the structure and working of labour markets. The loss of land and customary rights increased wage dependency. The decline in the traditional paternalistic employment relations and the move to arable farming, with greater seasonal variation in labour demand, increased job insecurity. Alternative employment, and particularly that of women, disappeared with the loss of domestic industry, customary rights (e.g. gleaning), and access to common land and the *wastes*. Together, these reduced the standard of living of those in work, increased unemployment and under-employment, and generally impoverished a growing proportion of the working population. The burden of this growing poverty fell upon the local *poor rate*, a local tax levied on property holders, out of which *Parish Relief* was paid to the destitute under the provisions of Elizabethan Poor Law legislation. This, together with Statute of Artificers, provided a legal framework for the labour market which imposed a duty to work on the poor (backed up by draconian anti-vagrancy laws), a responsibility on the parish to find work for the unemployed and a right to subsistence for the impotent poor (the widows, orphans, sick and aged). Despite legislative and less formal attempts to enforce the duty to work, either in workhouses or by public works, the main burden of the burgeoning poverty in the second half of the eighteenth century fell on outdoor relief (de Schweinitz, 1961; Slack, 1988; Geremek, 1994).

The Poor Law was administered by the parish officials under the supervision of the Justices of the Peace. Entitlement to Parish Relief was regulated by the Settlement Laws, which provided access to social welfare only in the parish in which individuals were *settled.* The Settlement Laws, which were increasingly strictly interpreted with the growth of rural poverty (Deakin, 2002), impeded labour market mobility beyond the immediate locality. This protected parishes from pauper migrations and secured the supply of labour for the local employers but, by geographically segmenting labour markets, closed off possible escape routes for the unemployed and those who were trapped in low-paid employment.

An important way by which settlement was achieved was by annual hiring. But this fell out of favour both because of the risk of further burdening the local taxpayers, and because the increasingly important arable farming required a more flexible workforce to meet the seasonal pattern of its labour demand. This growing gulf between the interests of capitalist farmers and their landless labourers further eroded the traditional paternalist employment relations and added to job and income insecurity, a tendency accelerated by the Napoleonic Wartime boom (Hammond and Hammond, Vol. I, 1947). With casualisation, the Poor Law became increasingly a means of supporting able-bodied workers laid off by their employers who 'hired as little and as briefly as he could, relying on the parish to maintain the unemployed' (Hobsbawm and Rude, 1993, p. 72).

The emergence of Speenhamland

The effects of labour market restructuring on poverty levels was exacerbated in the 1790s by high and rising prices resulting from a series of poor harvests and the Napoleonic War inflation. Various solutions were proposed to relieve the distress of the poor, including dietary changes towards cheaper food, the provision of allotments to restore to the poor a degree of pre-market self-sufficiency, and a minimum wage to insulate wages against rising prices and wage subsidies (Hammond and Hammond, Vol. I, 1947). Dietary changes proved impractical and the value of land was rising too rapidly for it to be reparcelled out, so the main debate centred around the imposition of a minimum wage (which the Justices could fix under then existing legislation) and the extension of Parish Relief to those in private employment. In 1795, Whitbread unsuccessfully introduced a Bill into Parliament to reactivate the obligation of the Justices to protect living standards by fixing minimum wages. In opposing the Bill, Pitt argued in favour of the free market for labour and against the legal minimum wage. He added:

> "By the regulation proposed, either the man with a small family would have too much wages or the man with a large family who had done most service to his country would have too little. So that were the minimum fixed upon the standard of the large family, it might operate as an encouragement to idleness on one part of the community; and if it were fixed on the standard of a small family, those would not enjoy the benefit of it for whom it was intended. What measure then could be found to supply the deficit? Let us, said he, make relief, in cases where there are a number of children, a matter of right, and an honour instead of a ground for opprobrium and contempt. This will make a large family a blessing, and not a curse; and thus will draw a proper line of distinction between those who are able to provide for themselves by their labour, and those who after having enriched their country with a number of children, have a claim upon its assistance for support."
>
> (Quoted in de Schweinitz, 1961, p. 73)

In this speech Pitt recognised that the benefits of children ultimately extended beyond their immediate family and marshalled arguments which have a familiar modern ring: the market determination of wages, ineffectiveness of the minimum wage for relieving poverty, the rights of individuals (and especially families) to social welfare, the importance of targeting social welfare and its possible disincentive effects.

The Speenhamland System of wage supplementation emerged from the debate over alternative ways of relieving poverty. The meeting at the Pelican Inn, Speenhamland on 6 May 1795 was originally convened to fix a minimum wage after concern had been expressed at the General Quarter Sessions about the 'miserable state of the labourers and the necessity of increasing their wages to subsistence level, instead of leaving them to resort to the parish officer for support for their families' (Hammond and Hammond, Vol. I, 1947, p. 138). However, the resolution proposing a minimum wage was not carried and what emerged from the meeting was, in modern parlance, a minimum income guarantee linked to the price of bread by a sliding scale. Thus:

> "… when the gallon loaf of second flour, weighing 8lbs 11oz. shall cost 1 shilling, then every poor and industrious man shall have for his own support 3s weekly, either produced by his own or his family's labour or an allowance from the poor rates, and for the support of his wife and every other of his family 1s 6d. When the gallon loaf shall cost 1s 4d, then every poor and industrious man shall have 4s weekly for his own, and 1s 10d for the support of every other of his family."
>
> (Hammond and Hammond, Vol. I, 1947, pp. 159–160)

Thus, the minimum weekly income was to rise or fall by 3d. for the man and 1d. for every other member of his family with every 1d. increase or reduction in the price of a gallon loaf of bread, and any difference between this level and the weekly wage was to be met from parish funds. The Speenhamland System was buttressed later in 1795 by an enabling amendment to the Poor Law which permitted His Majesty's justices to order relief 'to any industrious poor person or persons; and he, she, or they shall be entitled to ask and to receive such relief at his, her or their homes' (de Schweinitz, 1961, p. 73).

Of the Speenhamland system Polanyi (1957) wrote:

> "No measure was ever more universally popular. Parents were free of the care of their children, and children were no more dependant on their parents; employers could reduce wages at will and labourers were safe from hunger whether they were busy or slack; humanitarians applauded the measure as an act of mercy even though not of justice and the selfish consoled themselves with the thought that though it was merciful at least it was not liberal; and even the ratepayers were slow to realise what would happen to the rates which proclaimed the 'right to live' whether a man earned a living wage or not."
> (Polanyi, 1957, pp.79–80)

Speenhamland in operation

The Napoleonic War boom lasted until 1815 and, as long as prices kept up, the full implications of Speenhamland remained hidden. The incomes of the poor were insulated from rising prices by the

Speenhamland allowance, but this also served to keep wages down by checking demands for their increase. Therefore, although the working poor were to a degree protected against rising prices by the Speenhamland system, they failed to share in general prosperity which enriched those in receipt of profits, rent and tithes: capitalists, landlords and the Church of England parsons respectively. The ending of the war brought deep recession, with rapidly rising unemployment and falling prices and profits, although poor harvests kept food prices high. It was then that the full potential of Speenhamland for generating poverty and destitution became apparent (Hobsbawm and Rude, 1993, Chapter 4).

In the Speenhamland era there were four ways by which able-bodied workers were aided outside the workhouse: the *allowance in relief of wages* (supplementation of wages by parish relief), the *roundsman* system, the *labour rate* and *public works*. Allowance in relief of wages was the application of the Speenhamland principal to those already in employment, and the other three applied to the unemployed who looked to the parish for help. The *roundsman* system included various ways whereby the parish provided workers to local employers, and made up the difference between what the employer paid and a minimum income. An unemployed person could be sent round by the overseers to the households in the village to seek employment at terms that were supplemented from the rates. In other places, the parish acted as labour-only contractors for whatever price they could get and the participants were paid out of the rates. Elsewhere, the hiring rate (and hence the make-up to the minimum income from the rates) was fixed at auction. The *labour rate* located the responsibility for creating work directly with the employers. The parish set the rate and parcelled out the unemployed to employers who were required either to find them jobs or pay higher taxes. *Public works* was a relatively rare means of creating employment. In 1832, barely 5 per cent of relief expenditures was accounted for by make-work schemes, including road work and that in the workhouses (de Schweinitz, 1961, p. 75).

An immediate effect of the Speenhamland System was to put upward pressure on the number on outdoor relief by throwing subsidised workers into competition with independent labourers and forcing the latter on to parish relief. Workers with small amounts of property were also discriminated against. The administrative rules of the Poor Law made property owners ineligible for support so that those with only scraps of land could get neither relief nor compete for work with those in receipt of the Speenhamland allowance. The pressure was then on for them to qualify for relief by selling what they had. By these processes, the supply of labour increased relative to demand and this drove wages down. A Committee on the Agricultural Wages, chaired by Lord John Russell, reported in 1824 that wages in the North, where Speenhamland had not taken full hold, were substantially higher than in the South where wage supplementation was widespread (Hammond and Hammond, Vol. I, 1947, pp. 180–1).

Under the pressure of the widening coverage of in-work benefits, the related fall in wages and the resulting growing burden on the rates, the conditions for receipt of Parish Relief were continuously made more degrading, and allowances were reduced (Hobsbawm and Rude, 1993, Chapter 4). By 1830, the value of the minimum weekly income guarantee for a family of four had fallen to five gallon loaves from the seven-and-a-half guaranteed by Speenhamland (Hammond and Hammond, Vol. I, 1947 pp. 181–2).[1] The cumulative processes of falling wages and cuts in parish relief increasingly humiliated the labouring poor and condemned them to abject poverty, a plight from which they were powerless to escape. This, together with their loss of independence, was destructive of motivation, ambition and productivity.

The effect of the fall in wages was therefore to transform the wage supplementation into a direct subsidy to employers. They also became dependent on Parish Relief to make up the difference between what they paid their workers and what the latter needed to live on. Any employer that failed to take advantage of this subsidy was put at a competitive disadvantage in the product market, in much the same way that independent workers were in the labour market. However, any advantage of cheap labour to the employer was offset, at least in part, by the increased local poor rate they had to pay. This net advantage varied between employers to a degree determined by the rateable value of their properties compared with the size of their workforce. It therefore tended to favour large-scale producers with many employees and discriminate against those who relied on their own and their family's labour. These advantages were increased by the political power exercised in the parishes by the large employers and landowners. And the system was further corrupted by its lay administrators who could turn the levying of the rate, the provision of relief and the allocation of the labour of the parish poor to their own and their friends' advantage.

For the workforce, and especially the rural workforce in arable farming areas, pauperism, degradation, desperation and discontent were universal and this fed the rise in crime and social unrest. From 1810, economic crimes, especially poaching, rose continuously except in years of better harvests when the plight of the poor was temporarily eased. Machine breaking and arson were more sporadic and coincided with times of deep distress, reaching a peak in 1831 and 1832 with the rise in social unrest associated with the *Swing riots* (Hobsbawm and Rude, 1993).

The rising wave of crime and social unrest was met by increasingly Draconian responses in what can be regarded as a social *arms race*. As the plight of the poor worsened, they resorted to more desperate means, to which the law responded by ever more savage measures. This reflected the feeling in governing circles that economic and social degradation had eroded the deterrent effects of judicial punishment – a view 'founded on the belief that as human wretchedness was increasing, there was a sort of law of Malthus, by which human endurance tended to outgrow the resources of repression' (Hammond and Hammond, Vol. I, 1947, p. 201).

There is general agreement that Speenhamland had the effect of economically and socially degrading the poor and adding to their increasing exclusion by widening the social distance between the haves and the have-nots. This was quite the opposite to its original intention:

> "The Speenhamland law which had sheltered rural England, and thereby the labouring population in general, from the full force of the market mechanism was eating into the marrow of society. By the time of its repeal huge masses of the labouring population resembled more the spectres that might haunt a nightmare than human beings. But if the workers were physically dehumanised, the ruling classes were morally degraded. The traditional unity of a Christian society was giving place to a denial of responsibility on the part of the well-to-do for the conditions of their fellows. The Two Nations were taking shape. To the bewilderment of thinking minds, unheard-of wealth turned out to be inseparable from unheard-of poverty. Scholars proclaimed in unison that a science had been discovered which put the laws governing man's world beyond any doubt. It was at the behest of these laws that compassion was removed from the hearts, and a stoic determination to renounce human solidarity in the name of the greatest happiness for the greatest number gained the dignity of a secular religion."
>
> (Polanyi, 1957, p. 102)

Political economy, politics, policy and the 1834 Poor Law Reforms

The assault on the Speenhamland System came from political economists who theorised that it breached the natural laws of supply and demand. There were two sides to classical political economy's labour supply side theory and its explanation of poverty. From the late seventeenth century, poverty was regarded by many European writers as a stick needed to get from the growing population of labourers the work necessary to make wealth productive (Geremek, 1994).[2] However, the pauperisation of the later eighteenth century spawned an alternative theory, popularised by Townsend and systematised by Malthus. This had it that poverty resulted from population growth, driven by a lack of moral restraint on the part of the poor, pressing on the food supply. Food supply grew less rapidly than population because of the diminishing marginal productivity of land, so ultimately starvation kept the labour supply in check. It was further supposed that the demand for labour was constrained by the *wage fund* – a fixed part of aggregate capital set aside for the payment of wages – which meant that if employment were to rise wages would need to fall.

Therefore, according to classical political economy, what determined the well-being of the mass of the population was the natural fertility of the soil, the willingness of the poor to work, their propensity to breed, the rate of accumulation of the capital and the fixed *wage fund*. These operated through supply and demand for labour determining the level of wages and employment.[3] Any attempt to interfere with these *natural laws* by, for example, attempting to alleviate poverty is countered by increasing population which absorbs any surplus and generalises the poverty. The fixing of a minimum wage above that determined by supply and demand reduces employment because the wage fund is fixed. Countering the resulting unemployment by job creation out of taxation (forced saving from the rich which effectively increased the wage fund) would only increase population and, if persisted in, 'taxation for the support of the poor would engross the whole income of the country; the payers and the receivers would be melted down into one mass' (Mill, 1909, p. 364).

The Speenhamland System,[4] Mill argued, provided a wage subsidy at the expense of parish rate payers and this resulted in the system's generalisation. By providing families with higher benefits than single people it offered a direct incentive to breed. But, in addition to this, it was just another way of fixing a minimum wage 'however numerous they [the workers] may be' and it removed 'positive and prudential obstacles to an unlimited increase' (p. 367). And, argued Mill, it had an additional absurdity; it reduced the wages paid by the employer by what it added in wages supplementation. The labourers, Mill argued, were habituated to living on the pre-allowance wage so that the effect of the allowance was to 'people down' (p. 368) the wages paid by employers by increasing the supply of labour (through increasing the population or by mobilising surplus population trapped in workhouses). These labour supply effects were so strong that the wage plus allowance fell to below the wage level prior to Speenhamland. Mill summed up:

> "When the labourer depends solely on wages, there is a virtual minimum. If wages fall below the lowest rate which will enable the population to be kept up, depopulation at least restores them to the lowest rate. But if the deficiency is to be made up by a forced contribution from all who have anything to give, wages may fall below starvation point; they may fall almost to zero."
>
> (Mill, 1909, p. 368)[5]

Mill concluded:

> "All subsidies in aid of wages enable the labourer to do with less remuneration, and ultimately bring down the price of labour by the full amount, unless a change can be wrought in the ideas and requirements of the labouring class; an alteration in the relative values which they set upon the gratification of their instincts, and upon the increase of their comforts and the comforts of those connected with them."
>
> (Mill, 1909, p. 369)

The *natural* laws of labour supply and demand resonated with the rising middle classes. The idea that poverty was caused by the poor and that relieving it threatened progress allowed a comforting sense of moral outrage and denial of responsibility. To the politician and administrator, *laissez faire* ensured law and order at a minimum cost and effort. 'Let the market be given charge of the poor, and things will look after themselves' (Polanyi, 1957, p. 117). Further, the idea that how things turned out depended on the degree of restraint exercised by the poor allowed the shifting of responsibility to those denied any political power.

The theories of classical political economy were quickly put into policy practice after the 1832 constitutional reforms had brought the middle classes to power. The work of the Poor Law Commission was directed by classical political economy and its findings were tailored to justify this theory's predictions. The Commission's report 'placed the burden of destitution upon the shoulders of the individual. Poverty was regarded as essentially an indicator of moral fault in the person requiring relief. He was held very little short of exclusively responsible for his condition' (de Schweinitz, 1961, p. 126). These findings were rushed into law. The 1834 Poor Law Act abolished wage subsidies but stopped short of abolishing all social welfare. Rather, a right to subsistence was retained but was 'only made available on terms which made the recipient *less eligible* than the lowest paid person in the labour market and on conditions which were so restraining and humiliating as to be tolerable only to those in the most desperate need' (de Schweinitz, 1961, p. 126). In effect, the poor lost any right to subsistence above the very meanest level and retained only the duty to work.[6]

The refutation of the Classical 'iron law' of wages and the reconstruction of labour market theory

Classical political economy united Malthus' population theory, notions of the *natural* indolence of the poor, Ricardo's theory of diminishing marginal productivity of land and the wage fund theory into what were conceived as natural and immutable laws of labour supply and demand, which condemned the mass of the population to abject poverty. However, events progressively weakened the empirical foundations of these laws and cast growing doubt on the 'Iron Law' of wages. The scourge of famine was lifted by technical progress in food production and transport, which opened up new fertile land for cultivation. With this increased supply of food, its price fell, real incomes rose but the predicted population explosion did not happen because family sizes fell. The decisive nail in the 'Iron Law's' demand side came with the refutation of the wage fund theory in the 1860s, which showed the idea of an invariable fund for the payment of wages to be a nonsense.

The wage fund theory had constituted a powerful propaganda tool against wage fixing by law or by trade unions. 'On the authority of that doctrine, employers and their political spokesmen could argue that trade union action was not simply economic nonsense, but that it ran against the true interest of an ill-advised and ignorant workforce' (Biagini, 1987). Its refutation lifted the political economy objection to institutional wage determination and this played a part in the campaign by trade unions and their middle class supporters which eased many of the legal constraints on trade union activities in the 1870s. But this relief for working class organisation from the strictures of political economy was short-lived. The demise of the wage fund theory and the threat posed by Marx's exploitation theory of distribution[7] triggered the development, in the 1880s, of the *neo*-classical theory of wages.

This extended Ricardo's theory of diminishing marginal productivity of land to labour. But, whereas Ricardo's theory was based on the natural variability of the fertility of land, the restraint on the productivity of labour is technical. The increase in the employment of equally productive labour relative to the amount of capital causes the output per head to fall. If, then, employers are to employ more labour profitably, wages must fall in proportion to the fall in labour productivity. This reconstitution of the demand for labour theory reinstated the primacy of the market in determining wages and employment. If the market is free, there is no possibility of capitalist exploitation because excess profits will be competed away. At the same time, any worker can enter the market provided they are prepared to accept a wage equivalent to their marginal product. By this theoretical rejigging, the central role of the market in ensuring the greatest happiness for the greatest number was reinstated.

The advantage of marginal productivity theory to economic orthodoxy is clear. It disposes of the thorny problem of income distribution between competing claimants by linking it to their contribution. However, it has little or no empirical support. In fact, 'the pro-cyclical pattern of productivity movements has been solidly established in dozens of empirical studies' (Okun, 1981, p. 16), precisely the opposite to what is predicted by diminishing marginal productivity theory. This revealed tendency for labour productivity to rise as output and employment increases is readily explained by the fact that the level of efficiency of the operation of plant and machinery is higher the closer it is to technically and organisationally determined full capacity of operation. Any increase in output beyond full capacity requires investment in new equipment, which can be expected to incorporate the latest techniques. This *embodied* technical change further enhances productivity and is more likely to come into operation when demand and output are growing. This means, as the evidence implies, that there are increasing rather than diminishing returns to labour input so that the idea that wages must necessarily fall if employment falls, because of diminishing marginal productivity theory, has no more credibility than the wage fund doctrine. Nevertheless, despite this fatal weakness, neo-classical wage theory has retained its place as the orthodox explanation for how the labour market works.

This reconstitution of wage theory rehabilitated the conclusions of the wage fund theory, that wages need to fall if employment is to rise, with one major difference. Wages were now directly linked to the productivity of labour, which determines what employers can pay, and which declines as employment grows. Any institutional impediment to the downward movement of wages to this level creates unemployment as does any social welfare benefit which provides a credible alternative to wage income. Marginal productivity theory therefore underscored the principle of less eligibility in the administration of social welfare and put *laissez faire* on a more *scientific* basis. Unemployment and poverty could once again be blamed on trade unions, misguided charity givers, wrong-headed protective legislation and especially the poor and unemployed themselves.

This reassertion of key beliefs gave renewed vigour to the central idea of Victorian social policy that the solution to poverty depended on the individual effort of the poor. Their need was to follow the example of *liberal economic man* who 'is remarkable for his foresight and self-control'. But 'in the residuum [the mass of really poor families] these qualities are entirely absent' (Mrs Bosanquet, quoted in Briggs, 1961, p. 21). The salvation of the poor therefore, required them to be 'turned into "liberal economic man", and once they were converted they would, of course, cease to be poor' (Briggs, 1961, p. 21).

The notion that the poor were responsible for their own plight was challenged by the research of Booth and, especially, Rowntree who demonstrated that, even with exemplary behaviour, 10 per cent of the poor of the population of York could not reach even the lowest possible subsistence level. This refutation of Malthusianism opened the way to the development of economic theories supportive of Rowntree's recommended solution to poverty: high wages, full employment and social security (Briggs, 1961).

The Keynesian revolution, involuntary unemployment and social citizenship

The high levels of unemployment and poverty of the inter-war years cast increasing doubt on *laissez faire* and laid the foundation for a revolution in economic theory which was carried into policy practice by the social accord engendered by the Second World War. This ushered in a commitment by governments to full employment and the welfare state. This policy revolution was based on the Keynesian notion that unemployment is caused by too low effective demand, which can be countered by government intervention, supported by a political belief in *social citizenship*: that having a job, decent health provision, a good education and social protection is the right of all (Marshall, 1992).

Supported by the *grand accord,* post World War II Keynesianism combined progressive taxation with benefits designed to provide a minimum social wage. This served to reduce income inequalities and to prevent the marginalisation of those on low incomes. This redistributive tax-benefit system helped to underpin aggregate demand in the economy, and hence the achievement of full employment and higher economic growth. This, in turn, widened job opportunities and led to progressive labour market upgrading, especially amongst those hitherto deprived (Tarling and Wilkinson, 1997). It was therefore not coincidental that the golden period of Keynesianism, from around 1950 to the early 1970s, witnessed historically high rates of economic growth and declining income disparities. However, the golden age of social citizenship underpinned by rapid economic growth ended with the rapidly escalating prices and rising unemployment in the second half of the 1970s.

The neo-classical counter reformation and the return to mass poverty

The response of the economic orthodoxy to this crisis was the abandonment of the core Keynesian belief that, without intervention, the labour market could not be relied upon to guarantee full employment. This retreat to neo-liberalism rehabilitated the marginal productivity theory of wages and its central proposition that, if employment is to rise, real wages (money wages deflated by product prices) need to fall. Unemployment, the neo-liberals reasserted, results from trade union wage pressure and restrictive practices, government labour market regulation and too high social welfare benefits. These labour market imperfections create a *natural,* non-zero level of unemployment and any attempt to lower it below this level merely crowds out existing employment or adds inflationary pressure. The state's contribution to full employment is therefore confined to prudent macroeconomic management, deregulation to eliminate labour market imperfections and parsimony in the provision of out-of-work benefits

Neo-liberalism, which was progressively adopted as policy from the mid-1970s onward, predicts that monetary control will contain inflation, and that labour market deregulation combined with regressive tax and benefit reform will secure full employment. The expectation is that the more unequal redistribution of income and the freeing up of markets will dramatically improve economic performance, and that the benefits of this higher rate of growth will *trickle down* the income distribution, benefiting everyone. But, although the conditions for this *renaissance* were created, by cuts in the relative pay of the lowest paid, extensive deregulation of labour markets, the weakening of trade unions, cuts in welfare benefits and reforms to make them more conditional on active job search, the promised improvements have failed to materialise (Wilkinson, 2000). Unemployment has remained high and relative poverty has increased dramatically. Deindustrialisation and continuous downsizing by increasingly unregulated firms have eaten into the number of jobs in the middle range of incomes and therefore the job prospects of workers trapped in poorly paid jobs or in unemployment. The polarisation of economic opportunities has been exacerbated by the growth of jobs at both extremes of the earnings distribution. Meanwhile, productivity growth has slowed, the balance of payments on the current account has progressively worsened despite the benefits of North Sea oil, real interest rates have been forced up as borrowing abroad has been used to prevent a collapse of sterling and manufacturing investment has shrunk as a proportion of GDP.

Despite these policy failures, the confidence that policy makers and their economic advisers have in the monetary control of inflation and market deregulation to improve economic performance has not wavered. Rather, the growth of poverty is explained by a deterioration in the quality and motivation of the poor because of the deskilling effects of unemployment, obsolescence of traditional skills, low levels of education, limited work experience and so on.

The case for wage subsidisation and wage supplements

Neo-classical theory of the labour market has two core beliefs. First, that left to itself the market will establish equitable pay and conditions of work in the sense that they will reflect the quality and quantity of the labour input of individuals. Second, providing workers are prepared to accept the wage on offer, and meet employers' skill and effort requirements, anyone can get a job who wants one. The wide dispersion of wages, some of which may be insufficient to sustain a reasonable standard of life, is a demonstration, neo-classical economists would argue, of how widely dispersed are individual capabilities (Hirsch and Addison, 1986). They attribute unemployment to a reluctance to work, unemployability because of poor labour quality, trades union bargaining and legally imposed minimum wages which raise wages above the market clearing level, labour market regulation which adds to labour costs and social welfare benefits which, by raising out-of-work income, discourage labour market participation.

These core beliefs underlie the arguments for wage subsidisation. Labour market imperfection (social welfare benefits and institutional barriers to wage reductions) combined with poor skills and motivation has, it is argued opened a gap between the supply price of labour, based on the income needs of the poor, and the demand price of labour, based on their low marginal productivity. A longer-term solution may be to raise productivity by education and training, and to inculcate an improved work ethic. But a shorter-term solution is to either pay a wage supplement to workers to bridge the gap between their income needs and their marginal productivity, or a wage subsidy to employers to lower the cost of wages demanded to the level of the marginal productivity of perspective employees.

Even if marginal productivity theory were a valid explanation of the determinants of employers' demand for labour, unless wage subsidies are carefully targeted at supply side imperfections, they may introduce imperfections of their own. For example, if low pay results from a demand side imperfection (e.g. *monopsony* – employer buyer power), a wage subsidy/wage supplement will compound the imperfections by further lowering the price of labour below its marginal productivity. In this case, the appropriate action is to raise wages by establishing a minimum wage or the encouragement of the countervailing power of trade unions. Moreover, if unemployment is involuntary, subsidisation risks merely replacing those currently in employment rather than creating new job opportunities. Serious doubts can therefore be entertained about the validity of the neo-classical case for wage subsidisation. There is clearly no overwhelming theoretical reason for supposing that high levels of unemployment and in-work poverty can be readily countered by topping up wages for workers or marking down costs for employers – a conclusion supported by the evidence of considerable dead-weight effects and labour market *churning* associated with such policy interventions. And, once neo-classical theory is left behind, the objections to wage subsidisation become fundamental.

The alternative perspective

There is something profoundly pessimistic about the idea that the ills of an economic system can be explained largely by the quality and motivation of an *underclass* comprised of the poorest of the population. This is particularly so because this *residuum* apparently disappeared between the 1930s and the 1970s only to reappear in the 1980s. What can possibly explain this social improvement followed so quickly by the social degeneration? The explanation can be found not in the phenomenon itself but in how the phenomenon has been theorised and portrayed. What is particularly instructive in this respect is that Keynes, as he formulated his theory of unemployment, progressed from neo-Malthusianism to *involuntary* joblessness as the explanation for poverty (Toye, 1997). The return journey to theories of voluntary unemployment and unemployability involves a regression to neo-Malthusianism. This U-turn is explained by the renewed belief in the efficacy of markets. If it is taken to be self evident that, providing individuals are prepared to accept market judgement on their value, labour markets clear, it becomes convenient to identify the *imperfections* of individuals as the reason for non-market clearing and income inadequacy.

But there is clearly nothing 'natural' or inevitable about the allocation of income and resources arrived at through the play of market forces. There is no such thing as a 'free' labour market, and the idea that market equilibrium can be restored through deregulation is an illusion. The roots of social and economic disadvantage are found not in the differing capacities of individuals, but in the way markets work. In particular, relationships in the labour market are permeated by inequalities of bargaining power, structural barriers to mobility and institutionalised discrimination, which together lead to the systemic *undervaluation* of the labour of disadvantaged groups, the value of whose work is not socially recognised. Whether or not there is an 'ideally' efficient free labour market system which can be theoretically modelled is of little relevance to the formulation of policy in a world where the distribution of income and economic opportunities is largely determined by power relationships and institutional forces.

From this alternative perspective, the events of the 1980s and 1990s are easily interpreted. The change in policy in the late 1970s shifted the balance of power against the weakest in society and intensified their exploitation, triggering a downward economic and social spiral. Far from becoming welfare dependent by some unspecified social process, an increasing number of people have been forced into poverty and away from self-sufficiency as a consequence of the undermining of the job market and a progressive erosion of employment and social rights.

In the neo-classical story, wage subsidies and wage supplements benefit society by counteracting labour market imperfections, but they increase the imperfections of the labour market which are deeply segmented. In such labour markets, the freedom afforded to women, ethnic minorities, older workers and others who are socially and economically disadvantaged and who lack bargaining power is the freedom to be discriminated against and to be exploited. As a result, they are employed at wages well below their value.[8] In effect, these labour market imperfections already provide subsidies which keep inefficient firms in business, add to the profits and stock market valuations of some of the largest firms, keep the prices of consumer goods and services down and allow essential public services to be supplied on the cheap to the benefit of the taxpayer. Wage supplements risk adding to this hidden levy and its redistributive consequences if, as seems likely, the weak bargaining power of the lowest pay fails to prevent the wage top ups being passed on in lower wages and forward into higher profits and lower prices.

The Speenhamland experiment is instructive of the risks involved in subsidising wages in segmented labour markets. The Settlement Laws divided the parish labour forces into non-competing groups and this was reinforced by declining employment in arable farming throughout the South and East.

Long-distance migration was needed to secure alternative work and this was impeded by the risk of loss of relief in their parish of settlement and the possibility of their forcible repatriation back from the parishes of destination. In the industrialising north, Speenhamland had little impact because demand for labour pressed hard on supply and, despite the illegality of combination, workers were better organised (as they showed later when they resisted the workhouse). In these areas, lower levels of unemployment and more dynamic labour markets meant higher wages and less need for parish relief. In a similar way, until 1815, when the Napoleonic War boom finally broke, high demand for labour, even in the arable farming areas, prevented the full springing of the Speenhamland trap. However, the allowance system had 'taken away the labourer's safest guarantee, a living wage, and substituted the much weaker one of a minimum family income for paupers' (Hobsbawm and Rude, 1993, p. 72). After 1815, the pernicious effects of subsidising undervalued labour became only too apparent. The excess supply of labour drove wages down and the cost of wage supplementation and the resulting pressure on the rates led to a cut in allowances and the attachment of more humiliating conditions for eligibility.

The response to this coincidence of growing social and economic degradation and the rising fiscal costs of its increasingly inadequate relief was to hold the victims responsible for their own poverty and to use this argument to support policies to cut the cost of social welfare. As a consequence, the 1834 Poor Law Reforms threw the poor on to the mercies of the *free* labour market, an act which completed the emerging class structuring of British society. The social effects of the dramatic events of the early nineteenth century were only slowly ameliorated as the political and economic power imbalance in favour of capital was gradually redressed by the political and industrial organisation of labour, and as empirical research and development in social and economic thought undermined the theoretical basis of *laissez faire.*

This progress has been reversed over the past 30 years with the neo-liberal revival, and there are important parallels between these events and the unfolding of the Speenhamland catastrophe. Since the late 1970s, the labour market has been progressively restructured with an increasing polarisation of job opportunities, earnings and wealth. This growing divide is widened by the high levels of unemployment, economic decline and growing poverty in the old industrial areas and inner cities where the poor are trapped by the multiple disadvantages which include the high costs of mobility imposed by regional house price disparities and other costs of relocation. Meanwhile, the reforms of social welfare away from universal rights towards means testing and the greater coercion of the unemployed have progressively stripped the poor of their social citizen right, rendered them *less eligible* and caught them in poverty and employment traps. These symptoms of increasing market segmentation have been partially disguised by periodic economic upswings which have done nothing to address the underlying problems. As a result, poverty and denial of economic and social opportunity were more entrenched in the early 1990s than in the 1980s, and there can be no expectation that the next recession will have any different effects.

The slippery slope towards Speenhamland has been greased by sociological theories of the *underclass* and economic theories that exalt the market and warn against pampering the poor. The immutable economic laws and utopian visions of monetarists and free marketeers serve to mystify the underlying problems and provide politicians with the justification for concentrating the cost of economic crisis on the *have-nots* whilst salving the conscience of the *haves* by reassuring them that, although the income distribution is unequal, it is efficient. The twin neo-liberal notion that higher incomes are required to motivate the rich whilst lower wages *and* cuts in out-of-work benefits and lower wages are needed to motivate the poor have been used to justify a more unequal distribution of income and cuts in taxes on high incomes. The adoption of these views as the conventional economic wisdom has lifted responsibility for unemployment and poverty from the government and shifted it on to the jobless and the poor themselves.

The idea that a more unequal distribution of income is superior on efficiency grounds also forms the basis for an opportunistic alliance between vote-seeking political parties offering tax cuts and market deregulation, and the rent-seeking contented classes, who stand to benefit from the tax cuts, the availability of low-paid labour and the opportunities for profits created by deregulation (Galbraith, 1992). Four reinforcing processes have strengthened this alliance. First, the victims of the downward economic and social spiral triggered by neo-liberalism have become increasingly alienated from the 'democratic' process, so that political exclusion has been added to economic and social exclusion. Second, this political exclusion has been progressively reinforced as political parties of the Left have abandoned their traditional loyalty to the poorest in society and embraced the new economic and social orthodoxy to compete for the so-called political centre ground. Third, the growing problems of long-term unemployment, poverty, crime and social dislocation over the past two decades have increasingly polarised society and the contented classes have found themselves more and more threatened by the *dangerous classes*. Fourth, those promoting the conventional economic wisdom to policy practitioners have continued to justify their failed predictions by developing theories explaining unemployment, under-employment and poverty in terms of labour market imperfections, welfare state dependency and the low quality and poor motivation of the unemployed, the under-employed and the working poor. By doing so, they have raised the possibility of denial of social citizenship on the grounds of economic unworthiness and provided continued justification for socially and economically damaging policies by the age-old expedient of blaming the victim (Ryan, 1971).

The apparent failure of the poor to respond to incentives and stimuli in the way predicted has led to greater insistence on the need to impose on them a duty to work. Experimentation with attaching a work test to welfare provision has shown signs of success and is encouraging pressure for its extension. But the job-creating capabilities of these new measures are greatest in the South where conditions in the labour markets are now approaching full employment, and much less so in the old industrial regions and the depressed inner-city areas where unemployment remains high (Peck, 2001). It is here where the risks of the Speenhamland effects are greatest and where the compulsion to work sugared by wage supplementation are most likely to trigger a downward spiral of pay and an upward spiral of the cost of welfare. But these effects are likely to become much more widespread as wage supplementation programmes are extended and the economy slips into recession.

The risk of the Speenhamland effect being triggered is greater:

1 the more closely social welfare benefits are dependent on labour market activity

2 the weaker the bargaining power is of the recipients of social welfare in the labour market and therefore the greater the chances are that social welfare will enter into competition and drive down wages

3 the higher the level of unemployment is and therefore the greater the possibility that workers with subsidised wages will be substituted for those without.

The answer to (1) lies in the design of tax and benefit systems. The answer to (2) lies in providing greater protection for workers in low-paid labour markets by effective trade union representation, legal minimum wages and other forms of legal protection. The answer to (3) lies in full employment macroeconomic policies. There is no doubt that training has a part to play, particularly for workers in need of rehabilitation after years of unemployment, harassment by government agencies and make-work experimentation. But, without a redesign of the tax and benefit systems, effective labour standards and full employment, subsidised training is as likely to enter into the competitive process as any other form of subsidisation.

If wage supplementation is generalised, if there is the expected recession and if the Speenhamland trap is sprung with all its disastrous consequences, what then? The workhouse?

Notes

1 See also Hobsbawm and Rude, 1993, pp. 76–7.

2 Bellers, a Quaker and early advocate of co-operative production, argued that an abundance of labour was needed to make wealth productive: 'The labour of the poor being the mines of the rich' (Bellers, 1696, quoted in Polanyi, 1957, p. 105). Soon after, Mandeville from a less sympathetic perspective added: 'All men are more prone to Ease and Plenty than they are to Labour, when they are not prompted to it by Pride and Avarice, and those that get their Living by their daily labour, are seldom powerfully influenced by either: So that they have nothing to stir them up to be serviceable but their wants, which it is prudent to relieve, but folly to cure. The only thing then that can render the labouring man industrious, is a moderate quantity of Money, for as too little

will, according as his temper is, either dispirit or make him desperate, so too much will make him Insolent and Lazy' (Mandeville, 1723/1970, pp. 209–10).

3 For a coherent statement of how these interacted, see Mill (1909, Chapter XII).

4 Described by Mill as: 'Sentiments of humanity, joined with the idea then inculcated in high quarters, that people ought not to be allowed to suffer for having enriched their country with the multitude of inhabitants, induced the magistrates of the rural districts to commence giving parish relief to persons already in private employment' (1909, p. 367).

5 Mill went on to argue that providing the poor with allotments to grow their own food had an effect analogous to that of Speenhamland. Allotments had the beneficial effect of increasing production and allowing the poor to improve their position by their own effort. But their effects on wages and population were precisely the same as Speenhamland: population increased and wages fell. 'The only difference in favour of allotments would have been, that they make the people grow their own poor rate' (Mill, 1909, p. 370).

6 Polanyi argued that: 'The abolition of Speenhamland was the true birthday of the modern working class, whose immediate self-interest destined them to become the protectors of society against the intrinsic dangers of the machine civilisation. But, whatever the future held for them, working class and market economy appeared in history together. The hatred of public relief, the distrust of state action, the insistence of respectability and self-reliance, remained for generations characteristics of the British workers' (1957, p. 101).

7 Bohm-Bawerk, one of the pioneers of the marginal productivity theory of wages, said that the Marxist theory of distribution constituted 'the focal point about which attack and defence rally in the war in which the issue is the system under which human society shall be organised' (Campus, 1987, p. 320).

8 For example, detailed studies show that only 25 per cent of the difference between male and female earnings is explained by difference in skill, while 75 per cent is accounted for by lower pay for the same level of skill. For detailed analysis of the male/female wage differentials, see Lissenburgh (1995). See also Sachdev and Wilkinson (1998).

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4 An overview: what do we know about policies to make work pay?[1]

Mark Pearson and Stefano Scarpetta[2]

Introduction

Several countries have introduced policies aimed at enhancing the employment opportunities for groups at the margins of the labour market – those with little work experience and/or low skills (henceforth referred to as the low skilled for simplicity) – while at the same time maintaining socially acceptable wage rates and income distributions. These policies to 'make work pay' are implemented either through employment-conditional benefits and tax credits or through employment subsidies and payroll tax rebates given to employers. Since these policies cut across traditional boundaries between government departments and economic disciplines, it is not surprising that the different institutions and approaches involved have not converged on one set of objectives against which policies could be assessed, and (unsurprisingly) emphasis on the various dimensions of policy differs. At the OECD workshop, which is the basis for the issue of *OECD Economic Studies* on which this chapter is based (see Boxes 4.1 and 4.2 later in this chapter), two broad motivations for such policies were identified:

- *Economic inclusion*. Policies that increase the incentives to hire or to accept work may increase employment. Of itself, employment is a prime form of inclusion; it may well also have much broader returns through reducing social problems, such as criminality and ill health.

- *Redistribution*. Spending public funds on making work pay may increase the financial resources of a part of the population which otherwise would be near the bottom of the income distribution.

Does making work pay increase employment?

Edmund Phelps in his paper offers the most ambitious objective for a policy to make work pay: 'to promote wide access to a career and a livelihood in society's mainstream economic activity'. In these terms, inclusion does not exclusively mean providing jobs but also jobs that are in some sense 'economically' rewarding. The economic rationale for this policy lies in the potential benefits of reduced outlays on benefits and increased economic output (and therefore tax revenue). However, Phelps argues that there are potentially important social and economic externalities associated with having a full-time job. First, a job is often good for individuals in terms of physical and mental health, raising self-esteem and well-being by making them feel more included in society. Second, bringing hitherto marginalised groups in society, including those who have been working in the underground economy, into mainstream economic activities may generate beneficial outcomes for society as a whole, for example through the amelioration of some social problems such as crime, drug abuse and social destitution.

Unfortunately the quantitative importance of such externalities is hard to interpret. However, as the subsequent papers in the issue of *OECD Economic Studies* on which this chapter is based show, there is much better evidence available on the impacts of existing 'make work pay' (MWP) policies on employment of target groups:

- There is evidence that the Earned Income Tax Credit in the United States (EITC, see Box 4.2 for details), which subsidises those workers who accept employment but who have low family incomes, promotes employment (see the paper by Hotz and Scholz). However, the increase in employment, whilst significant, is not substantial.
- The United Kingdom has just substantially increased the generosity of its main MWP policy (now called the Working Families Tax Credit – WFTC, see Box 4.2 for details). Simulations suggest that the expansion of the programme will promote employment, with estimates ranging from 10,000–100,000 people finding work (see the paper by Dilnot and McCrae).
- Canada has been experimenting with earnings supplements (the Earnings Supplement Programme and the Self-sufficiency Project).[3] The paper by Greenwood and Voyer reports that results vary with the details of programme design, from having little discernible impact, to having an effect on employment so large that the consequent savings in benefit spending were sufficient to finance the employment subsidy.

- Employment growth in France has accelerated since 1994, partly as a result of a change in the structure of employers' social security contributions that lowered the average tax rate on those with earnings at or just above the minimum wage level (see the paper by Fitoussi and Box 4.2).[4] Much of this growth has been in the service sector. More detailed quantitative evidence for France was provided by the Malinvaud Commission on the financing of social security, which argued strongly that restructuring the payroll tax system would promote employment of the low skilled.

The evidence suggests that some people already in the labour market reduce their hours worked as a result of MWP policies that are not tied to hourly wages. This is because reductions in earnings due to fewer hours worked are partly offset by higher in-work benefit payments. However, the message of the papers in this volume is that, even after taking account of such effects, most estimates suggest that MWP policies have a positive impact on the number of people working and, albeit smaller, on aggregate hours worked. [Text continues on p. 137 after Boxes 4.1 and 4.2.]

Box 4.1 Table of contents from *Economic Studies,* Vol. 31, No. 2, 2000 (OECD)

'An overview: what do we know about policies to make work pay?'
Mark Pearson and Stefano Scarpetta

This paper offers an overview of the discussion at the OECD workshop on policies to make work pay. Proponents of these policies argued that they can promote both efficiency and equity by increasing employment and raising the incomes of the working poor. The empirical evidence from various

Continued

Box 4.1 continued

countries supports these claims, although counselling against over-optimism about the size of the possible effects. In-work benefits or tax credits are moderately successful in increasing employment and are very well targeted on low-income households. Payroll tax reductions are less well targeted on low income, but there is some evidence that they may be effective in moving people into employment. However, cross-country differences in the effects of such policies may be substantial, depending for example on the compression of the earnings distribution, which in turn may be determined by the level of the minimum wage. Although no panacea for labour market problems, and despite administrative difficulties (which can be substantial) in implementation of such policies, the participants in the workshop concluded that making work pay is a strategy that deserves serious consideration in many countries.

'Not perfect, but still pretty good: the EITC and other policies to support the US low-wage labour market'
V. Joseph Hotz and John Karl Scholz

This paper examines policies to support low-wage labour markets in the United States. It focuses on the Earned Income Tax Credit, describing its targeting and anti-poverty effectiveness, its effect on labour force participation, hours and family structure, and its administration. The strengths and weaknesses of the Earned Income Tax Credit are then compared with alternative ways of assisting low-wage workers. We conclude that the Earned Income Credit, augmented by targeted employment subsidies, is a sensible way to support low-wage labour markets in the US. We see less wisdom in minimum wage increases, payroll tax reductions for low-income families and wage rate subsidies as proposed by Phelps, at least in the US.

Continued

Box 4.1 continued

'Experimental evidence on the use of earnings supplements as a strategy to "make work pay"'
John Greenwood and Jean-Pierre Voyer

This paper presents evidence from two randomised experiments in Canada testing the use of financial incentives to encourage labour market participation. The Self-sufficiency Project suggests that supplementing earnings from low-paying, full-time jobs can increase employment among long-term single-parent welfare recipients, can raise the earnings and incomes of these poor families, and may entail little net increase in government transfers net of taxes. In the Earnings Supplement Project, however, the offer to partially compensate unemployment insurance recipients who returned to work quickly and experienced earnings losses had no impact on the labour force behaviour of repeat users of UI (Unemployment Insurance) and only a small and short-lived impact with displaced workers. The paper concludes with a discussion of the complexity of designing a programme to stimulate work effort using financial incentives.

'The family credit system and the Working Families Tax Credit in the United Kingdom'
Andrew Dilnot and Julian McCrae

The UK has had in-work benefits/tax credits since 1971. From 1988 to 1999, the programme was called Family Credit (FC). In October 1999, FC is being replaced by Working Families Tax Credit (WFTC). WFTC will be significantly more generous than FC, and may be paid via employers alongside wages. A major part of the WFTC's effect will be redistribution to families with children where at least one adult is in paid work. WFTC will make entering the labour market more attractive for lone parents, although the effect on the hours of work of those already participating is ambiguous. For couples, WFTC will

Continued

Box 4.1 continued

tend to make labour market participation for the principal earner more likely, but WFTC discourages participation by some secondary earners. We expect the overall labour supply effect of WFTC to be positive but small.

'The importance of inclusion and the power of job subsidies to increase it'
Edmund S. Phelps

Economic inclusion – the opportunity to obtain rewarding work and to earn enough to be self-sufficient – has declined, particularly among less qualified workers. Either relative wages have fallen, or unemployment has risen, or both. No country in the OECD has entirely escaped this trend, and none has entirely recovered. A likely cause is the rise in households' income from their wealth, including their entitlements, which adds to wage pressures at all unemployment levels. Another possible cause is the increased training and experience requirements of the new information technologies, particularly among the less educated workers (whose requirements before were minimal). There are grounds to believe that employment subsidies are a more effective response than other alternative, albeit similar, policies. These adverse developments strengthen the case for government intervention to pull up pay and drive down unemployment among less qualified workers in order to boost inclusion. The inclusion objective goes beyond any incidental reduction in income inequality that results. A wide range of negative externalities, such as crime and drug abuse, arises from falling inclusion, justifying such intervention. Subsidies to businesses for their employment of low-wage workers is a particularly attractive intervention as it is non-discriminatory and cost-effective.

Continued

Box 4.1 continued

'Payroll tax reductions for the low paid'
Jean-Paul Fitoussi

A review of different theoretical models confirms that economists of opposing beliefs find themselves agreeing about the usefulness of employment subsidies. In a country with a relatively high wage floor, employment subsidies reduce the cost of labour for firms. In countries where wage floors are low, subsidies can increase the net real wage of workers. In both cases, employment is likely to rise. Generally, allowing the price system to perform its allocative function while pursuing distributive objectives through the tax system is welfare enhancing. It is therefore surprising that such a remedy has not yet been implemented on a large scale in all countries suffering from labour market problems. One reason is that there may be a problem of transition, when taxpayers must fund both the old system (unemployment compensation) and the new approach (employment subsidies), before the latter has a significant impact on joblessness. Empirical evidence suggests that reductions in taxes on labour will not solve employment and distribution problems, but will, in the long run, promise progress in both.

'The use of wage floors as policy tools'
Paul Gregg

Wage floors are in use in all industrial countries, either as negotiated minima set by employer and union bargains or through a national minimum wage. Yet among economists their use is highly controversial. This paper provides a brief summary of existing evidence and tries to highlight the key policy issues. Whilst aggregate employment rates appear to be most modestly affected by moderate minimum wage levels, there are still several concerns. First, are marginal

Continued

Box 4.1 continued

groups in the labour market unduly hurt by minimum wages? The evidence we have is that youths are most at risk but other groups (e.g. the long-term unemployed) trying to gain or regain a foothold in the labour market may also suffer. Second, whether effective lower youth minima can be used to improve the rather weak redistribution of income across households that follow from minimum wages. Third, we know relatively little about who ultimately bears the cost of a minimum wage. If it ultimately falls on consumers through higher prices, the question is who buys minimum wage goods. Improving our understanding here will ultimately suggest whether minimum wages can be an effective redistribution tool.

'Eligibility criteria for unemployment benefits'
David Grubb

To be eligible for unemployment benefits, claimants must be able to work, must not have quit a previous job or refused a job offer without good reason, must comply with calls to interview and related instructions from the employment service, and in some cases must seek work independently. This paper describes the eligibility criteria, how they are implemented and how often they lead to a benefit sanction. A strong requirement for job search or acceptance of suitable work may in theory offset the disincentive effects that arise when benefits are paid without such criteria. A few microeconomic studies have reported fairly large behavioural impacts among individuals who face a specific obligation or have suffered a benefit sanction. The European countries in which unemployment fell most sharply during the 1990s have considerably tightened benefit eligibility criteria and their implementation.

Continued

Box 4.1 continued

'Policy choices and interactions with existing instruments'
Giuseppe Bertola

This short paper argues that a proper evaluation of policy instruments meant to 'make work pay' should take into account the complex and highly heterogeneous configuration of existing labour market policies in OECD countries. Each country's current and past implementation of more traditional instruments (such as unemployment insurance, employment protection legislation, active labour market policies and wage-compressing institutions) presumably reflects structural labour market features on the one hand, and the political weight of each policy's desirable and undesirable effects on the other. The paper brings this perspective to bear on wage subsidies and in-work benefits for low-pay employment relationships, discussing in particular how the implications of such instruments for income distribution, employment creation and fiscal budgets may complement or offset those of existing policies.

Box 4.2 Selected examples of policies to make work pay

The Earned Income Tax Credit (EITC) scheme in the United States

The EITC has existed since 1975. For much of the subsequent period, it was kept at a relatively low level, but in the 1990s it has expanded enormously in importance. In 1999, taxpayers benefit from the credit if they have earned income of less than $30,095 if they have more than one child, $26,473 if they have one child and $10,030 if they have no children. The maximum subsidy for a two-child couple is $3,756, and is received when income is between $9,930 and $12,260. The

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Box 4.2 continued

credit for such a tax unit is phased in at a rate of 40 per cent below that level (i.e. overall marginal tax rates are negative) and phased out at a rate of just over 21 per cent (details vary for other tax unit types). Taken together with taxes, marginal effective tax rates can reach 50 per cent. Total cost in 1999 was $26.3 billion – about a third of a percentage point of GDP. Final entitlement to the credit is based on annual income. Most American taxpayers choose to claim their credit at the end of the year as a lump sum, although they do in principle have the option of claiming it on a monthly basis with an annual reconciliation of any over- or under-payment.

The Working Families Tax Credit (WFTC) in the United Kingdom

The WFTC replaced the previous in-work benefit (Family Credit) in October 1999. The payment is made to all low-income families with children who have at least one adult working for 16 hours per week or more (a similar programme covers disabled persons). The payments are set at a level that guarantees families a minimum income of £200 ($333) per week, with additional payments for larger families. Furthermore, 70 per cent of all child-care costs (up to £150 – $240) will be covered. A small additional payment is made if more than 30 hours are worked. When earnings exceed £90 ($150), the credit is reduced by 55 per cent of any additional earnings. However, this adjustment is only made at six-monthly periods, so marginal increases in hours worked are not discouraged, at least in the short term. This 'taper rate' is in addition to income tax and social insurance contributions. Furthermore, other in-work benefits, such as Housing Benefit and Council Tax Benefit, are also withdrawn as earnings rise, giving a theoretical maximum withdrawal rate of over 90 per cent of marginal earnings. However, in practice, very few people face such high rates. The credit is paid through wage-

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Box 4.2 continued

packets every month, unless recipients opt otherwise. The WFTC is predicted to cover 1.5 million recipients (compared with a total of around 20 million households, and a workforce of around 30 million). The WFTC will cost over £5 billion per year – about two-thirds of a percentage point of GDP.

Payroll tax reduction for the low paid in France
In October 1996, an exemption from family contributions and a reduction of social security contributions for the low paid were merged into a single degressive rebate. The latter was amended in 1998: the rebate is proportional to the number of hours worked (so as not to unduly favour part-time work) and applicable for up to 1.3 times the minimum wage (SMIC). The rebate reduces the cost of labour by 12.6 per cent at the level of the SMIC. In 1997, it covered 5.1 million employees, of whom 3.6 million were full-time, and its cost amounted to FF46.7 billion (roughly 0.6 per cent of GDP) out of a total FF82.7 billion in social contribution relief. Other tax exemptions are targeted to specific groups, including *contrats emploi-solidarité*; relief for part-time work; exemptions for first-time hires (it applies only to the first 50 jobs created); exemptions for youth employment; and exemptions related to skill training contracts and apprentices. Many of these tax advantages can be cumulated with one another.

This conclusion is based on studies that, for the most part, take account of the short-run employment effects of MWP policies. However, MWP policies often involve sufficiently large amounts of financial resources to have a series of knock-on effects throughout the economy. For example, policies that reduce the cost of low-skilled work lead to reductions in the prices charged by the employers of low-skilled labour for their output. Consumer demand for such goods and services could then rise in comparison with those produced with more highly skilled labour and the increased demand may give a further boost to demand for (and the wages paid to) low-skilled work.

There are also other important general equilibrium effects that could reduce the overall employment effects of MWP policies. As noted at the Workshop – and taken into account in some of the quantifications cited above – large employment subsidies or reductions in payroll taxes must be financed by increased taxes elsewhere and/or cuts in public spending, which themselves might have negative effects on employment.[5] However, these negative effects may be mitigated if the shift towards a more progressive tax system alters wage-setting behaviour.[6] The success of 'make work pay' schemes in raising employment also depends on the design and packaging of the schemes. For example, there may be practical difficulties in financing reductions in payroll taxes for low-paid workers by shifting the tax base. Such a change may be resisted in some countries, on the grounds that this would break the contributory principle that lies behind social insurance systems. Moreover, tax bases that do not depend on labour may be too narrow to permit a large increase in revenues in order to finance an MWP policy.

The targeting of 'make work pay' schemes is another important factor in determining their impact on employment. Payroll tax reductions are generally quite expensive insofar as they do not target specific groups but are available to all those with earnings below a given threshold. The costs of in-work benefit schemes in the United States and the United Kingdom (the EITC and the WFTC, respectively) are contained by a close targeting of beneficiaries. In-work schemes are aimed only at a part of the low-skilled population – families with children (other than a small tax credit for single people in the United States). Because authorities are reluctant to see children grow up in poverty, out-of-work benefits are usually higher for families with children. Targeting in-work benefits at families with children therefore both directly increases the well-being of children in some low-income households and ensures that their parents have an incentive to work which otherwise would be lacking. In addition, as with other MWP policies, both the EITC and WFTC are withdrawn as earnings rise.

Such targeting is effective in keeping overall costs down, permitting large subsidies to be focused on those who do benefit from the programmes. But there are unfortunate consequences: as stressed above (see also Dilnot and McCrae; Hotz and Scholz), some of those already working face an incentive to reduce their hours worked or even (if they are in a couple where both partners are working and are earning relatively little) for one member of a couple to withdraw completely from the labour market. In the United States, Hotz and Scholz argue that initial tax rates are low enough for the additional marginal effective tax rate (METR) increase of the EITC to be imposed on earned income without major damaging effects. In the United Kingdom, the issue of high METRs has greater prominence, reflecting the fact that several benefits other than the employment-conditional benefit are withdrawn as earnings rise (see Box 4.2). However, Dilnot and McCrae argue that high METRs do not reduce labour supply of those in work to such an extent as to offset the increase in hours worked from those entering employment, a conclusion with which Hotz and Scholz concur from studying the US experience.

Hence, the overall message from these studies is fairly optimistic. 'Make work pay' policies promote employment of the target group of those who might otherwise be trapped in joblessness. As a result of MWP policies, there is some reduction in hours worked or employment by those already working, even though such negative effects can be mitigated by judicious design of the schemes. More generally, however, the effects on employment and income distribution strongly depend on the initial wage distribution and the tax and benefit system. In countries with a narrow distribution of earnings and high levels of taxes and out-of-work benefits, the financing of 'make work pay' policies are likely to lead to strong negative effects on hours worked of those who finance the schemes (see below).

Does making work pay improve the distribution of income?

The other main objective of MWP policies is to redistribute income towards low-income individuals or households. Indeed, some experts at the Workshop argued that the primary objective of MWP policies is to increase the incomes of those near the bottom of the income distribution. Their view was that the greater the proportion of expenditure that goes to households in the bottom deciles of the income distribution, the better. Expenditure which goes to supporting those with low earnings but who are in households with high incomes is not well spent.

In this respect, the papers by Hotz and Scholz, Dilnot and McCrae and Gregg show that MWP policies of the United States and the United Kingdom significantly increase the income of poor households. Relatively little goes to high-income households. Of course, the very poorest in society do not usually have any earnings. Hence, if they are not able to take advantage of the expanded job opportunities provided by MWP policies, they do not see a rise in their resources. Moreover, the EITC scheme in the United States is phased in as earnings rise up to a threshold – so, those with a higher wage rate may benefit *more* from the programme than those with a lower wage rate. The group which benefits most from existing schemes is lone-parent households for whom the rewards to working have been low in the past and who form a significant subset of those in poverty.[7]

However, the focus of in-work benefits on household income is inefficient to the extent that it does not distinguish between those who have low income because of low effort in the labour market rather than disadvantage. In the United Kingdom, beneficiaries have to work a minimum of 16 hours per week in order to qualify for the benefit, but this still leaves the possibility of those who have higher wage rates but who choose to work less receiving a greater tax credit than those with lower skills and wage rates who put in greater work effort. In contrast, employment subsidy programmes, e.g. the payroll tax reductions in France and the Netherlands, are tailored to the wage *rate,* not total earnings. Those who work more do not receive reduced subsidies. Furthermore, such measures are aimed at *individual* disadvantage, rather than low family income (see Fitoussi in this volume). Whether the fact that the subsidies support low-skilled members of high-income households should be viewed as a problem with the policy or not depends on the underlying objective of policy.

In summary, the Workshop identified a trade-off. Whilst all MWP policies seek both to promote low-paid employment and to increase the incomes of those near the bottom of the income distribution, they vary in the stress they give to each of these two objectives. The fact that different objectives are being pursued implies that the assessment and comparison of such schemes should be made on a number of criteria. For example, it is inappropriate to judge in-work benefits that have a strongly redistributive element solely in terms of their impact on the labour market through criteria such as changes in participation rates or aggregate hours worked; instead, one needs to augment these criteria by adding others such as the effects of the measures on household income and poverty.

Framework conditions

If, on balance, it is possible to assess positively the experiences of some countries in using MWP policies, it is reasonable that other countries should seek to emulate them by adopting similar strategies. The papers in this issue suggest that the effectiveness of MWP policies strongly depends upon a number of framework conditions that in turn affect labour demand and supply responses to policy (see the paper by Bertola for an overview). Most obviously, favourable macroeconomic conditions make it easier to find jobs for those drawn into looking for work by MWP policies. Aside from the general condition of the economy, the eventual success of MWP policies depends on their interaction with a number of social, tax and labour market policies and institutions.

The minimum wage and the tax/benefit system

Statutory and negotiated minimum wages are often considered as surrogates or complements for MWP policies. A minimum wage raises the wage rates of some, so increasing the returns to work in the same manner as an earnings supplement. But the downside is that a too-high minimum wage will harm employment prospects for low-productivity workers. The paper by Gregg summarises evidence on whether minimum wages affect employment, and looks at the distributional effects of such policies. It concludes that, if set at a reasonably low level, there are unlikely to be large negative effects on aggregate employment. However, the effects of the policy will almost certainly be different for different labour market groups: established workers may benefit, but the employment prospects of young people are likely to be harmed, especially if minimum wages are not graduated by age. Increased minimum wages may also have unfocused distributional effects: insofar as young people living with their parents or second earners with wealthy spouses benefit from a boost to their wage income, the increases in household income arising from an increase in minimum wages are scattered across the income distribution, and are not tightly targeted on low-income households. The empirical evidence reveals that the minimum wage is a relatively ineffective anti-poverty tool compared with in-work benefits.

Minimum wages also closely interact with other MWP policies. As noted by Bertola, minimum wages and non-employment benefits set a floor to wages that compresses the distribution of wages. The extent to which this occurs is very important in determining the viability of MWP schemes. The higher the wage floor, the greater the proportion of workers who will be covered by a subsidy of a given size and thus the higher the cost of such a subsidy. A relatively high level of the minimum wage also means that any increase in METRs occurring in the withdrawal region of an in-work benefit (or a targeted wage subsidy) affects a large proportion of workers. Hence, the trade-off between promoting the labour supply of those who are without work and damaging labour market incentives of those already working becomes more stark in the presence of a minimum wage set at an inappropriately high level.

The overall level of taxation is similarly important for MWP policies. The higher existing marginal tax rates are, the more difficult it becomes to withdraw in-work benefits or targeted wage subsidies rapidly. Tax rates accumulate, sometimes leading to METRs approaching 100 per cent or more, at which point there is no financial incentive to increase hours worked or human capital.

As Hotz and Scholz note, the United States has relatively low minimum wages, low social benefits and low tax rates. Also, the earnings distribution is relatively wide. This makes it possible to have large employment-conditional tax credits, which can be withdrawn gradually. METRs can be kept low, yet the credit does not penetrate a particularly dense part of the earnings distribution. Trade-offs in the United Kingdom are rather more difficult. Although low in comparison to many countries, transfer levels are higher than in the United States. In order to avoid the Family Credit benefits being paid to an inappropriately large part of the population, the withdrawal rate was historically set at a high rate – 70 per cent of net income which, combined with other taxes and in-work benefits, meant that METRs could exceed 90 per cent for a small number of families. In introducing the WFTC, the United Kingdom has reduced the withdrawal rate to 55 per cent. But, as Dilnot and McCrae note, although very high METRs are reduced for a few, this means that quite high METRs are extended to many, as workers with earnings close to the median level become eligible for the new, more generous, benefit.

Taxes and wage floors may also have a combined effect that influences the effectiveness of MWP policies. For example, minimum wages might limit the possibility that employers ‘capture’ part of in-work benefits by reducing wage rates. Indeed, in the presence of high METRs, reductions in wage rates no longer result in much change in net household income. Potentially, this could create a situation whereby public funds designed to support low-wage workers are instead passed through to employers in the form of reductions in wage rates and without inducing them to hire more labour.

To sum up, a number of framework conditions influence the relative merits of in-work benefits over wage subsidies and vice versa. Assuming that the MWP scheme aims to meet both inclusion and redistributive objectives, it seems that countries perhaps fall into two camps. In those with a low tax-benefit environment and relatively low minimum wages, the essential problem is to encourage labour supply and to provide higher incomes for those in poorly paid jobs. In these circumstances, it seems preferable to place greater stress on in-work benefits. By contrast, in countries with high levels of taxes and benefits and relatively high wage floors, making work pay schemes are likely to have high fiscal costs and risk reinforcing disincentive effects related to higher METRs. As a result, policy interventions in the second group of countries should probably focus on wage subsidies, as the essential problem is one of increasing labour demand for the low-skilled or inexperienced workers. There may also be advantages to a sequencing of policy reforms, with a reduction in labour costs via exemptions from payroll taxes for the low paid in order to stimulate growth of a part of the economy based on low-skilled employment, followed by reforms to increase incentives to take up such jobs. Finally, in some countries, it is possible that earnings distributions are so narrow, or initial tax rates are so high, or other framework conditions are such that policies to make work pay cannot be introduced without having overall adverse effects.

Mobilising labour supply

Only if people are actively searching for work and are able to accept work if they do find it, will policies that increase the return to work be effective. This was emphasised particularly in the paper by Greenwood and Voyer, which shows that the greatest labour market impact of the Self-sufficiency Project (SSP) in Canada was when the earnings supplement was combined with other services designed to promote effective labour supply. Help with job-search and family-care arrangements on the one hand, and increasing the returns to work on the other, turn out to be mutually reinforcing approaches to help people to find a job (although evidence suggested that such services did not significantly increase the proportion of the target population which *keep* a job once found – see below).

The paper by Grubb examines one neglected area of policy that may contribute to ‘making work pay’ – the requirements put on those receiving unemployment benefits to search for work and accept suitable job offers, and how tightly such conditions are enforced. As he notes, these requirements tend to offset the disincentive effects of unemployment benefits and if job search or related requirements associated with benefit receipt are very strong (so that the disutility of unemployment with benefits is almost as great as the disutility of unemployment without benefits), the result could be more intensive job search (and lower unemployment durations) than if there were no benefit system at all. Strict availability conditions can both put those who are without jobs into contact with work subsidised through MWP policies more often, and can push them to accept lower-paid jobs (which attract the MWP subsidy).

As Grubb describes, there are substantial differences across countries. Relative strictness in one area of eligibility conditions is often balanced by relative laxity in another. Furthermore, very strict eligibility requirements and sanction provisions in some countries run the risk of discouraging officials from seeking to apply them fully, whereas somewhat milder provisions may provide a better framework for systematic application. Although the relationships between benefit eligibility conditions, enforcement mechanisms and strategies aiming more broadly at ‘activation’ of the unemployed are complex, Grubb cites some evidence that differences in eligibility criteria and their enforcement can have a real impact on work incentives and employment outcomes.

A second aspect of mobilising labour supply is emphasised in the paper by Dilnot and McCrae. Finding appropriate and affordable child care is often identified as a big barrier to work, particularly for lone parents who are, as noted above, one of the major target groups of existing employment-conditional tax credits or benefits. The WFTC in the United Kingdom now has a very substantial supplement to cover (most) child-care costs for those eligible for the credit. The risk is that existing informal care provision (by friends or relatives) will be brought into the market in order to qualify for the subsidy, implying large dead-weight costs. Although there might be gains from a formalisation of care arrangements (for example, making it easier to monitor and improve the quality of care), Dilnot and McCrae argue that targeting the funds directly to suppliers might have been more effective in expanding child-care provision.

Policy design

However elegant and desirable MWP policies may look in outline, their effectiveness depends crucially on their detailed administration. Many pitfalls have been encountered in countries that have already introduced these policies.[8] Paying the in-work supplement as a benefit, as in the United Kingdom (and several other countries), has the problem, as with many means-tested benefits, that take-up is often low. Ignorance, stigma and heavy application procedures all discourage workers from applying for benefit. Many years of intensive publicity campaigns in the United Kingdom have been necessary to reach the point where take-up covers around 70 per cent of all those eligible.

The alternative approach, followed in the United States and to which the new WFTC scheme in the United Kingdom now adheres, is to pay the supplement as a refundable tax credit. The tax unit needs to be similar to the income unit used for targeting. In the United States, the tax unit is the married couple, so targeting the tax credit on family income should be straightforward. Even so, there has been a problem with payments being made to ineligible households. Countries where the tax unit is the individual face a more complex task if they wish to use the tax system to pay benefits based on family income.

The period of assessment for benefit must match that used in the tax return. Income tax is calculated on annual income. Although, in principle, people may claim the EITC in the United States on the basis of a short period of earned income, final entitlement depends on annual earned income. Hence, most people claim on an annual basis. This means that the supplement is received as an end-of-year ‘lump sum’, rather than as an ongoing supplement clearly linked to work. Evidence is lacking, but it would not be surprising if this restricts the labour supply impact of the programme.

If the income tax system is to be used to deliver an earnings supplement, it must cover a large proportion of the eligible population. This is the case in the United States, for a variety of reasons. In contrast, until recently, the policy of the United Kingdom was to limit the number of people who had to complete annual tax-assessment forms. As the United Kingdom has found, attempting to use the tax system to deliver MWP schemes in such circumstances is administratively cumbersome and costly.

Administrative difficulties in applying payroll tax reductions for all those with low earnings are often of a lesser order than those arising from the application of in-work benefits.[9] Other administrative issues are general to tax credits, employment-conditional benefits, employment subsidies and payroll tax reductions. For example, schemes are sometimes designed to limit the in-work benefit or wage subsidy to full-time workers (such as the Canadian Self-sufficiency Project and Earnings Supplement Project) in order to prevent workers with high hourly earnings from becoming eligible if they work only a few hours per week or on a part-year basis. Such criteria can be difficult to administer. Nevertheless, some countries have succeeded in collecting detailed information on actual hours worked to assess eligibility and levels of employment subsidies.

Finally, several papers stress that the 'marketing' of the scheme seems important for its success. The Canadian SSP experiment reported by Greenwood and Voyer found the very phrase 'making work pay' to be effective in selling the programme. The introduction of the WFTC in the United Kingdom has been accompanied by an extensive marketing campaign.

Limitations of policies to make work pay

There is some evidence that workers who re-enter employment after a period of joblessness with the aid of a tax credit or in-work benefit do so at a wage below that which they had prior to losing their job. This is to be expected: prior job-specific human capital may be lost, as are any rents attached to a prior job. But some governments stress that MWP policies are not supposed to be *permanent* supports to individuals. Instead, the belief is that, once employed, workers will acquire skills and move up the earnings' ladder, and will no longer require public support. Yet, in practice, very little is known about how workers acquire skills on the job. Furthermore, as the Canadian evidence shows, some of those who re-enter employment do so only *temporarily*, being trapped in a cycle of joblessness and low-paid work.

Unfortunately, one inevitable consequence of increasing support for those with low skills is that the incentive to increase those skills is reduced. There is a risk that human capital investment might be reduced. The underlying policy objective of permanently promoting the self-sufficiency of low-skilled workers can therefore be met only partially by MWP policies. Complementary policies that help the low skilled to retain jobs once they find them and to promote skill acquisition so as to find better jobs are also required.

Drawing attention to such limitations of policy to make work pay is important. However, the existence of policy trade-offs and the practical difficulties of implementing the schemes should not be allowed to obscure a rather positive message arising from analysis of MWP policies. The studies presented in this issue do not suggest that policies to make work pay ‘solve’ the problem of low employment and low wages of those with low skills. Indeed, unless certain framework conditions are met (for example, including the earnings distribution, the tax system and the minimum wage), it is even possible for MWP policies to be counterproductive. Furthermore, there is growing evidence that there is no single measure that, of itself, will have a major impact on employment. Hence, MWP policies have to be seen as an element of a comprehensive policy strategy, e.g. the ten broad policy guidelines of the OECD Jobs Strategy. But any policy that has empirical evidence supporting claims that, in certain circumstances, it could promote *both* efficiency *and* equity by fostering employment and decent levels of family income deserves to be considered in countries facing such problems.

Notes

1 This paper is an extract from OECD *Economic Studies,* Vol. 31, No. 2, 2000 (copyright OECD, 2000). The full publication can be purchased from OECD’s bookshop, in electronic or paper form, via www.oecd.org. Here, we reproduce the introductory overview chapter and (in Box 4.1) summaries of the other chapters from the table of contents.

2 The authors are grateful for helpful comments and suggestions from Jørgen Elmeskov, Michael Feiner, Philip Hemmings, John P. Martin and Ignazio Visco. They are also indebted to Lyn Louichaoui for her assistance. The views

expressed are those of the authors and do not represent those of the OECD or its Member countries.

3 The evaluations of these programmes are particularly significant, as the design of the experiment allows for the effects of the programmes to be determined with far greater accuracy than with the simulation exercises upon which evaluations in other countries must rely.

4 Austria and the United Kingdom, and especially Belgium and the Netherlands, have also lowered payroll taxes for low-paid workers. See OECD (1999).

5 OECD (1997) makes an attempt to simulate the effects of different types of MWP policies. A more recent paper (Bassanini *et al.*, 1999) simulates the potential overall employment effects of a simple EITC-type scheme in four OECD countries (United States, Germany, United Kingdom and Sweden) using a Computable General Equilibrium (CGE) model.

6 When wages in any particular firm are increased, labour costs are raised and, potentially, employment reduced. Higher marginal tax rates mean that the after-tax gain to employees from a wage increase is reduced. Hence, a more progressive tax system alters the balance between risk and return in wage negotiations, possibly promoting wage moderation.

7 Available estimates suggest that lone parents form a third to a half of those benefiting from the WFTC in the United Kingdom and the EITC in the United States.

8 In this respect, Hotz and Scholz consider difficulties in administering the EITC to be its greatest drawback.

9 However, attempts to impose conditionality (for example, requiring employers to have a net increase in employment in order to qualify for the tax reduction) or using an hourly definition for the rebates sharply increase administrative difficulties of payroll tax reductions.

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