EMCO/21/091003/EN

Making work pay

Facts, figures and policy options

Report to the Employment Committee

Group of Experts on Making Work Pay

1 October 2003

Employment Guideline 8:

Make work pay
through incentives to enhance work attractiveness

Member states will reform financial incentives with a view to making work attractive and encouraging men and women to seek, take up and remain in work. In this context, Member States should develop appropriate policies with a view to reducing the number of working poor. They will review and, where appropriate, reform tax and benefit systems and their interaction with a view to eliminating unemployment, poverty and inactivity traps, and encouraging the participation of women, low skilled workers, older workers, people with disabilities and those furthest from the labour market in employment.

Whilst preserving an adequate level of social protection, they will in particular review replacement rates and benefit duration; ensure effective benefit management, notably with respect to the link with effective job search, including access to activation measures to support employability, taking into account individual situations; consider the provision of in work benefits, where appropriate; and work with a view to eliminating inactivity traps.

In particular, policies will aim at achieving by 2010 a significant reduction in high marginal effective tax rates and, where appropriate, in the tax burden on low paid workers, reflecting national circumstances.

1. Introduction

'Making work pay' (MWP) is a key issue for enhancing employment opportunities, reducing benefit dependency and increasing participation. Accepting and keeping a job is the most important route to escape poverty and to ensure social inclusion. The importance of these goals and of MWP policies is underlined by the specific Guideline 8 of the Employment Guidelines, which is dedicated to making work pay through incentives to enhance work attractiveness. The decision to accept a job is influenced by financial as well as non-financial factors; eligibility conditions of social benefits are another important aspect. So while the focus of this report is on financial attractiveness, it is important to remind that the non-financial factors have to be also considered in order to design an internally coherent and comprehensive policy package.

Non-financial factors
Work attractiveness includes a broad spectrum of aspects, such as the quality of work, career prospects, the extent to which work and family life can be reconciled, the availability of child care, whether jobs are temporary or permanent, the extent to which people are enabled to use and maintain their qualifications, etc. as well as financial incentives. The quality of work directly influences job satisfaction. Arrangements for reconciling work and family life make it easier for people (often women) to accept a job or to remain active on the labour market. Temporary jobs can be a useful steppingstone to better paid, permanent jobs. In the mean time it should be realised that these jobs have the risk of offering a dead-end perspective when such a transition is not easy to make. Opportunities for education and on-the-job training can stimulate people to take up work. All these aspects may help to increase job satisfaction and to improve earnings potential and career prospects.

The factors mentioned here have a different impact on the employment status of different groups and the interaction with welfare provisions is complex. While too generous welfare transfers may weaken work incentives, well designed welfare systems may further help. Provisions for childcare and maternity leave can keep women in work, helping to reconcile work-career and family duties. Lone parents experience specific difficulties. Family responsibilities and health problems explain a significant share of outflows from the labour market. Part-time employment and improvement of working conditions might help these groups to take up a job or remain employed. Age is also an important determinant of participation in many countries. Investment in training, especially at the workplace is important for upgrading the skills and keeping older workers longer at work.

Financial incentives
Non-financial factors and the design of social security systems are important to make work attractive. Yet they are a necessary but not a sufficient condition. An additional condition is that accepting a job should be financially attractive. Studies show that people want to increase their net income when accepting a job. The financial aspects of work attractiveness are the prime subject of this paper. As defined in Guideline 8, 'making work pay' mainly addresses financial incentives to encourage men and women to seek, take up and remain in work. Some of the broader issues concerning work attractiveness that are outside the scope of this report will be the subject of the European Commission Communication on "More employment through better social protection", to be adopted by the end of 2003. This report has benefited from extensive recent research by the OECD in this field, especially where it concerns the analysis of instruments and possible solutions.[1]

Policies for MWP increase financial rewards from (accepting) a job. The increased financial incentive may induce people to continue or resume labour participation and improve their income situation. While financial rewards matter in all situations in which people are contemplating whether to accept a new job and/or increase their work effort, the issue appears quite central for those people whose individual and household income situation allow to get welfare transfers, have low earnings capacity in low paid jobs or have to take into particular account non-financial factors, e.g. family care duties. In these situations accepting a job, given the existing market wages and welfare provisions, may not

[1] OECD, *Employment Outlook 2003*, chapter 3: Making work pay and facilitating participation for under-employed groups, Paris, 2003 (forthcoming).

increase their income. The market wage offered sometimes is too low to encourage labour supply and to accept a job and too high for employers to offer such a job. Given the level of unemployment benefits and high effective tax rates, accepting a job or moving to a better paid job hardly results in a gain in net disposable income (or may even result in a loss). Individuals/household members are captured in a trap that prevents them working or increasing their work efforts, which may lead to household incomes under the poverty line. MWP therefore is not only an important instrument to stimulate an increase in work acceptance and work effort. It is also an important redistributive tool as it may lift households above the poverty line.

Aim and content

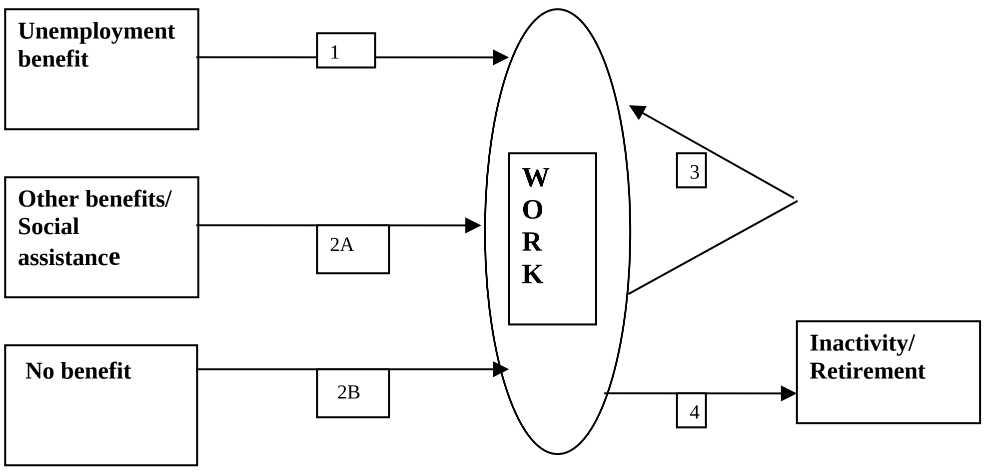
This report aims to identify the main factors underlying the (lack of) financial incentives to seek, take up and remain in work (section 2). Section 3 analyses possible instruments for enhancing financial benefits from accepting (better paid) work. Examples from Member States are used to illustrate policy options. Finally, section 4 identifies guiding principles for designing policies to MWP.

2. Does work pay?

Labour market transitions

The labour market takes a central place in analysing conditions for MWP. Especially in the case of (possible) labour market transitions, people have to evaluate whether to accept a (better paid) job. Financial incentives determine to a large extent, whether these transitions take place or not and therefore they constitute an important allocation mechanism. Labour market dynamics can be seriously hampered and employment can be much lower by lack of the right incentives. Figure 1 provides an overview of possible labour market transitions.

Figure 1 Transitions on the labour market



For MWP, it is important to study the financial consequences of each transition. In order to measure the income change of every transition, indicators must be constructed. Table 1 relates the various transitions shown in figure 1 with the accompanying possible indicators and terminology.[2] These transitions concentrate on employees. The primary focus of MWP-policies is to improve financial incentives for accepting a (better paid) job and is therefore on the supply side. Lack of incentives for employers to hire workers for low paid jobs is about reconciling productivity and total wage costs. We turn to this second issue at the end of next section 3. Another important route to increase access to better paid jobs is by raising productivity. These policies, however, are outside the scope of this report.

[2] Annex 1 (the technical annex) provides an explanation of the terms and indicators used.

Table 1 Transitions and indicators

Transition	Labour market situation	Indicator
1: Benefit to work	Unemployment trap	marginal effective tax rate-UT
2A: Other benefit/social assistance to work	Inactivity trap	marginal effective tax rate-IT
2B: No benefit to work	Inactivity trap	marginal effective tax rate-IT
3: Work to work	Poverty trap	marginal effective tax rate-PT
4: Work to retirement	Retirement trap	replacement rate

Table 1 distinguishes the following transitions:

- *Transition 1* is concerned with the move from an unemployment benefit to a job (full-time or part-time).[3] Because there may be little difference between benefit income (possibly supplemented by income dependent subsidies) and the income from work, people may find it financially unattractive to accept a job and can be trapped in unemployment. Hence the term unemployment trap is used to describe this situation.
- *Transition 2A* concerns someone who previously was on (means-tested) social assistance, a benefit other than unemployment benefit or a subsidised job, and who accepts a job. Though coming from a different labour market situation, people covered by unemployment benefits being more attached to the labour market and the (potential) duration of unemployment benefits being usually more limited than that of the other schemes (often having no time limitation at all), the effects are to a large extent similar to transition 1. People may also move from one government scheme to another. For practical reasons we omit these possible transitions here.
- *Transition 2B* concerns the income effects of moving from no benefit to a job. This involves a non-working person accepting a job. On practical grounds such a situation very often refers to people living in a household where there is a breadwinner who already holds a job.[4] The term 'inactivity trap' then refers to the previously inactive secondary earner. The consequences of this job acceptance for total household income can make participation for secondary earners financially unattractive. This is because total household income may hardly increase as a result of taxes and the loss of income dependent benefits (or tax allowances). The secondary earner may be discouraged from participation and trapped in inactivity, hence the term inactivity trap.
- *Transition 3* is about the consequences from moving from a job to a better-paid job or getting a salary raise in the present job. The earnings increase may relate to more effort (per unit of time), the financial returns to additional human capital investment or also an increased number of working hours in a part-time job (like the transition from a part time to a full time job). The poverty trap means that workers are caught in low paid jobs and have limited financial incentives for improving their situation, for example through training, due to taxation, loss of benefits etc. This can hamper job mobility and contribute to suboptimal allocation and labour market frictions.
- *Transition 4* from work to retirement means leaving the labour market altogether at the end of a career. Although financial incentives play an important role in the retirement decision, this is mainly the subject of Guideline 5 which is concerned with 'active ageing'. Moreover, the European Commission will present a Communication on "Strategies for raising the effective age on the labour market", to be submitted to the Spring European Council 2004. This Communication will examine Member States employment policies and reforms of their social protection systems to achieve the goal of raising the effective age on the labour market by 5 years and identify main orientations for action. Therefore, these issues will not be dealt with in this report (see also Box Pension reform).

[3] The transition from work to unemployment is the reverse of transition 1 and the analysis is similar. For reasons of simplification, this transition will not be analysed here separately.
[4] For Member States where policies distinct between married and unmarried couples, any reference to households with two partners refers to married couples.

BOX 1 Pension reform
Many EU-Member States have undertaken or are currently envisaging undertaking pension reforms. An important aim is to increase the financial attractiveness of continued participation. Other measures try to keep older workers attached to the labour market by introducing possibilities for gradual or part time retirement and to strengthen the financial fundamentals of pension schemes. *Austria* for example reduces the annual accrual rate so that the full (pre)pension rate of 80 per cent of past real wages will be reached after an insurance period of 45 (in stead of 40) years. Early retirement because of unemployment will be abolished. The premium for later retirement is increased, reinforcing measures to increase the (effective) retirement age to 65. Also individual pension accounts will be introduced. In *Sweden* since January 2003 pension payments are based on lifetime earnings. Before the reform, the 15 best years in terms of income level were the base for future pension payments.

In this report, MWP is in particular concerned with four situations:

1. the unemployment trap;
2. the inactivity trap for people living on social assistance;
3. the inactivity trap for a potential secondary earner;
4. the poverty trap for a low-income worker.

Table 2 identifies the (cumulative) factors behind the calculated income change after a transition on the labour market.

Table 2 Factors behind the various traps

		Unemployment Trap	Inactivity Trap (social assistance)	Inactivity Trap (secondary earner)	Poverty Trap
O.	Gross income	X	X	X	X
A.	Tax rates and/or employee social security contributions rates	(X)	(X)	X	X
B.	Social Security benefits	X	X		
C.	Income dependent schemes	X	X	X	X
D.	In-work benefits	X	X	X	X

The part of the gross income gain that is lost (component O minus A, B, C and D) is the *marginal effective tax rate*. Marginal effective tax rates measure the degree to which any gross income gain would not be received by the employee (or 'taxed away'). They can be used to evaluate the financial incentives and identify whether or not a household member is at risk of the unemployment trap, the inactivity trap or the poverty trap (for details see annex 1: technical annex).

Some of the underlying factors influence one trap more than the other. The change in gross income (O) and the effect of income dependent benefit schemes (C) and in-work benefits (D) are relevant for all traps. Tax rates (A) however only influence the unemployment trap or the inactivity trap for people living on social assistance if social benefits are not taxed in the same way as labour income. For if so, tax rates or social security contribution rates will not influence the difference between net income from social security or from work. Social security benefits only influence traps for people who hold such a benefit, which is the case for those in an unemployment trap (unemployment benefits) or in an inactivity trap (social assistance). The unemployment trap is particularly influenced by the (potential) duration of unemployment benefits, as in most Member States the incentive to leave the unemployment rolls clearly increases over time as benefits decline over time.

Calculations
The figures presented below for the various indicators cover four different typical households at various income levels.[5] The results used in this report are based on stylised models for typical households. The households included are: a single person, a single parent with two children, a one earner married couple with two children and a two-earner married couple without children. In most countries single persons make out a large part of the benefit population. Lone parents are a group of

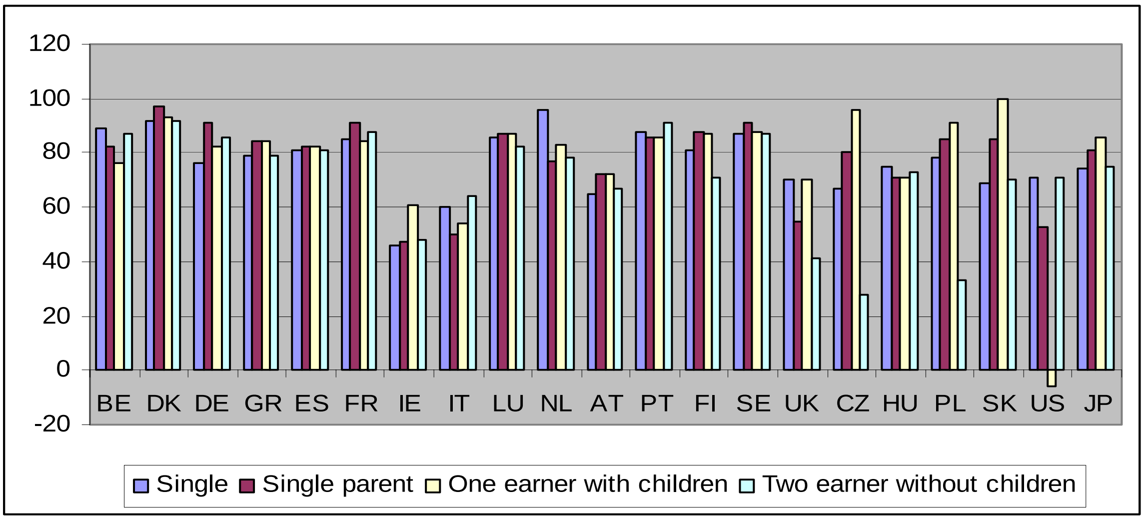
[5] The data used are based on the results of Commission/OECD Project on calculating effective tax rates on labour, 2003.

particular interest, since labour participation is often low and, especially long term, benefit dependency is much higher than for other categories. For couples the question whether to participate is often the result of a joint decision process, in which financial incentives with regard to the effects for total household income play a vital part. Since most Member States have income dependent benefit schemes for children, couples with and without children are included. Given that the lack of financial rewards from work is potentially more relevant for low income groups, we will focus here on situations of workers earning wages below the Average Production Worker (APW).

Annex 1 (the technical) annex provides an overview of the wages, benefits and tax components included in the calculations. Related issues, such as coverage of benefit schemes, work related costs and internationally comparability, are also dealt with there.

The unemployment trap
The unemployment trap is measured by comparing the net income from a job to the net income while out-of-work. Figure 2 shows how much of additional gross earnings is lost when moving from unemployment benefit to a job earning 67 per cent of the APW. Figure 2 gives results for four different household types and for all EU-Member States, four countries that will join the EU in 2004 (Czech Republic, Hungary, Poland and Slovakia; only for these new Member States data are available in the Commission/OECD project), the United States and Japan. The results indicate that for all four household types a proportion of gross income increase close to or higher than 80 per cent is taxed away in most countries. This means that from every gross Euro earned by moving from a benefit to a job, only €0.20 remains as a net increase. Ireland and Italy are the exceptions with much lower unemployment traps. This holds for all jobs paying 67 per cent APW or less and stretches out to even higher income levels. This means that in most countries for all household types there is quite a substantial income range where there is hardly any financial incentive to take up a job and leave the unemployment benefit situation. In almost all EU-Member States the unemployment trap is therefore a matter of concern.

Figure 2 Unemployment trap, indicators on 67 per cent of the APW (2001)



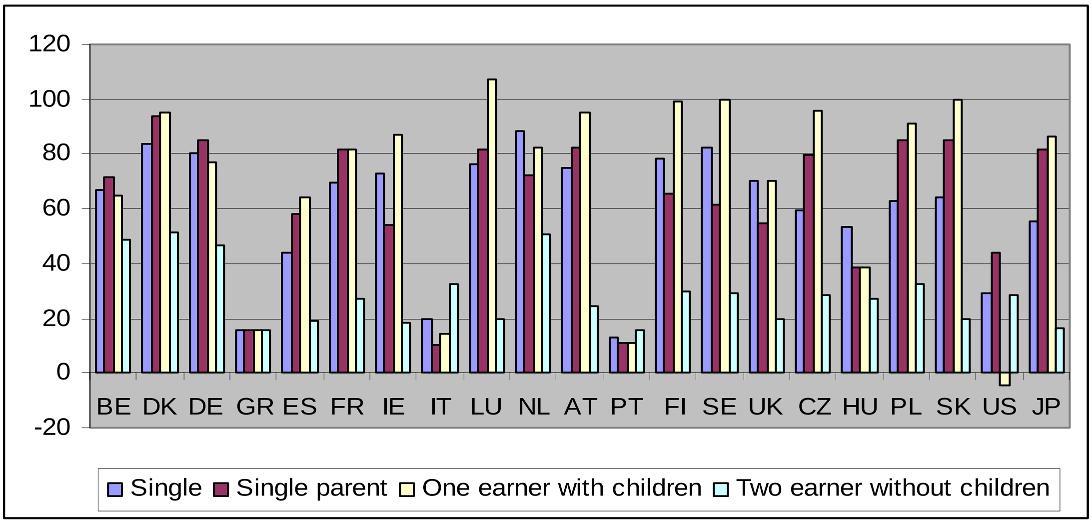
Source: Commission/OECD (2003).

Denmark has the highest unemployment traps for all household categories. The unemployment trap for singles is also large in Belgium and Netherlands. Unemployment traps for single parents are high in Germany, France and Sweden. For two earner couples the unemployment trap is high in Portugal. In all these countries more than 90 per cent of the gross income gain is not received by the employee. In-work tax credits lower marginal effective tax rates significantly for some household categories in the UK and the US. The unemployment trap is largely caused by unemployment benefits which are almost completely phased out at 67 per cent of the APW. The new Member States do on average not have greater or smaller unemployment traps than most current EU-Member States. The Czech Republic and Poland do sometimes perform worse, but show much lower rates for two earner families without children. Rates in the US are much lower than for most EU-Member States, while Japan performs conform the EU average.

The inactivity trap

The inactivity trap is measured here as moving from inactivity, receiving social assistance (where applicable), to a job. As far as the inactivity trap for secondary earners is concerned, the inactivity trap for a two-earner household can be interpreted as such, though data availability makes a clear distinction difficult. These traps lay somewhat below the levels for unemployment traps (figure 3). For two earner families with children, there is practically no inactivity trap in most countries. For this group the highest levels of around 50 per cent are reached in Denmark and Netherlands. This is due to the fact that these households at this income level do not qualify for social assistance. In most EU-Member States, for the remaining household types on average between 60 and 70 per cent of an income gain is lost when moving from inactivity to work at a wage level of 67 per cent APW. Differences between countries are large, however, as Greece, Italy and Portugal have no problems relating to the inactivity trap. This is due to the fact that these countries don't have fully covering social assistance schemes. The disincentive to take up a job by inactive people remains serious in several Member States. High inactivity traps for more than one household category particularly appear in Denmark, Sweden, Luxembourg, Finland, France, Netherlands, Germany and Austria. For the new Member States presented here there seems to be an inactivity trap for single parents and one earner families (except for Hungary). This is also the case in Japan. Especially due to the effect of in-work tax credits and no fully covering social assistance scheme, the inactivity trap in the US is almost absent. A one earner family receives a net payment on its total tax bill.

Figure 3 Inactivity trap, indicators on 67 per cent of the APW (2001)

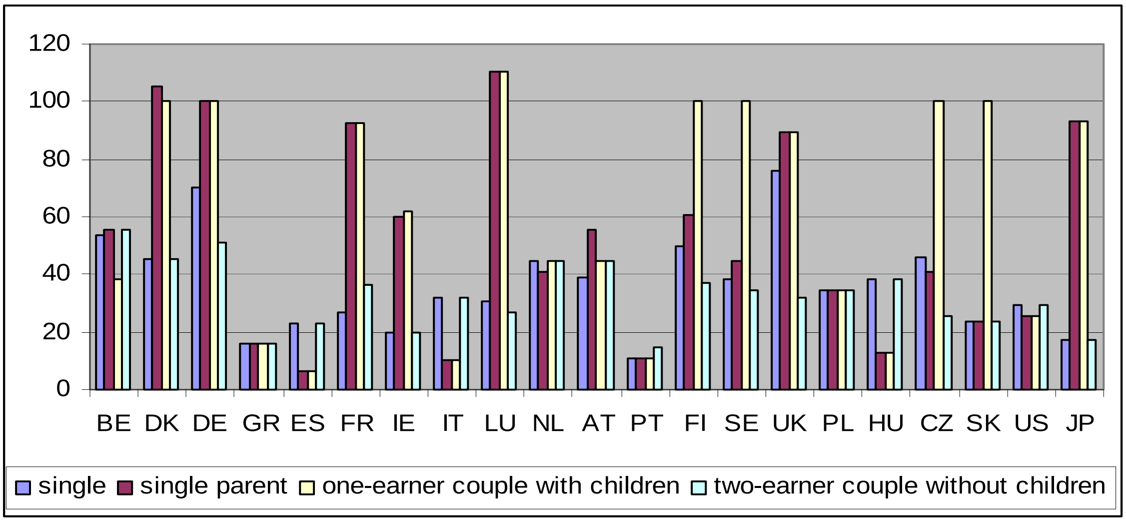


Source: Commission/OECD (2003).

The poverty trap

The poverty trap is calculated as the change in net income resulting from a small increase in gross earnings. Here steps of income changes of 1 percent of the APW were calculated over a certain income range and the median was taken to represent the marginal effective tax rate for each income range. Figure 4 shows the results of these calculations for the various household types and for the income range 33 to 67 per cent of the APW. The poverty trap is especially high for single parents and one earner couples and much lower for both other types. In some countries the marginal rates are close to or higher than 100 per cent. This means that for a household the acceptance of a better paid job may even result in a net loss. Single parents and one earner families face high poverty traps in Denmark, Germany, France, Luxembourg and United Kingdom. Finland and Sweden have a large poverty trap for one earner families, which is however a household type that hardly exists in these countries. For single persons and two earner families, Germany and Belgium show the largest poverty traps with marginal effective tax rates above 50 per cent. Some countries show on average small poverty traps well below 50 per cent. In Greece, Spain, Italy, Portugal and Ireland (for a single person and a two earner family) gross income gains lead to relatively high increases in net disposable income. In most of these countries this is due to the fact that there is no social assistance as an alternative for these households. The new Member States show on average much smaller poverty traps for all household types, except for the one earner couple in Czech Republic and Slovakia. Japan also has a significant poverty trap for this group and also for single persons. In the US marginal effective tax rates are low and sometimes negative, because of high in-work tax credits.

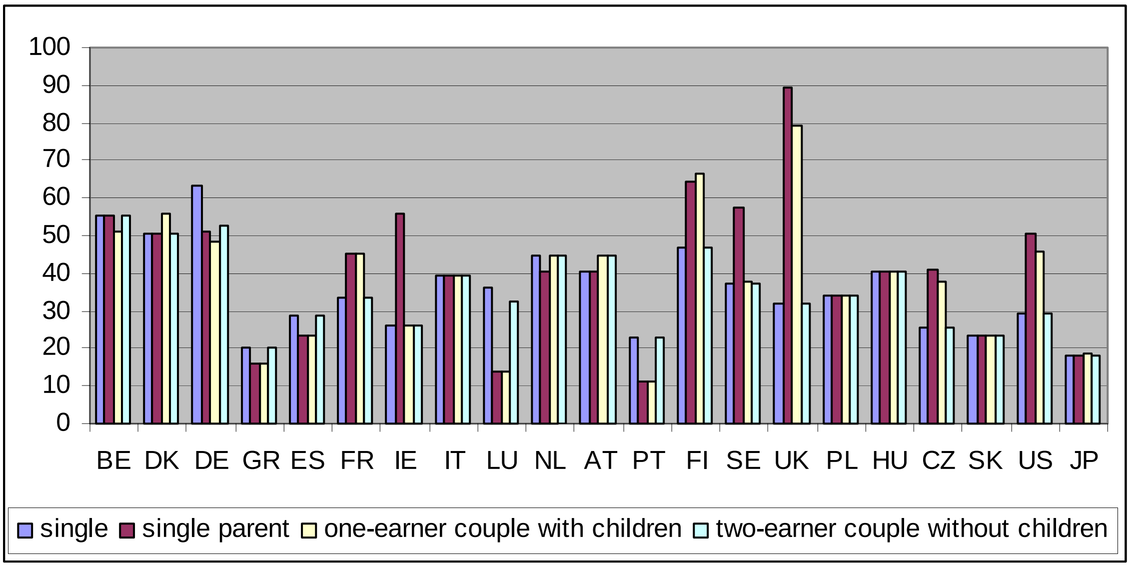
Figure 4 Poverty trap indicators (income range 33 to 67 per cent of the APW, 2001)



Note: The income loss resulting from a 1 percentage point gross income increase is calculated as the median marginal effective tax rate over the income range 33 to 67 per cent APW. Source: Commission/OECD (2003).

Figure 5 shows the results of similar calculations for the income range between 67 and 100 percent of the APW. In general income losses resulting from small marginal gross increases are much lower, reflecting the fact that most income dependent schemes are already phased out in these higher ranges and only taxes and social security contributions are paid. These are relatively high in countries like Belgium, Denmark, Germany and Finland for every household category, but hardly exceed 50 per cent. Because tax credits are phased out in this income range, the UK and the US show relative high marginal effective tax rates for single parents (also in Ireland) and one earner families with children. Japan and the new Member States show on average lower marginal effective tax rates than current EU-Member States.

Figure 5 "Poverty" trap indicators (income range 67 to 100 per cent of the APW, 2001)



Note: The income loss resulting from a 1 percentage point gross income increase is calculated as the median marginal effective tax rate over the income range 67 to 100 per cent APW. Source: Commission/OECD (2003).

Conclusion
Member States differ more where it concerns the poverty trap and the inactivity trap than the unemployment trap. When moving from an unemployment benefit situation to a job, around 80 per cent of the increase of gross income is not received by the employee in almost all Member States. There are some exceptions, where nevertheless still more than half of the gross gain is lost. Thus the unemployment trap is a serious problem in most Member States, as net income changes from leaving the benefit situation are low. With regard to the inactivity trap and the poverty trap the evidence is mixed. In some countries gross income gains do not result in net gains at all and thus are financially not attractive. In other countries more than half of a gross income increase is translated into a net increase. In a number of Member States poverty traps in the income range 33 to 67 per cent of the APW are on average much higher for single parents and one earner couples with children than for single persons and two earner couples. Traps decrease for all household types in higher income ranges, because of the absence of interaction between tax and benefit systems. For most Member States above 67 per cent of the APW, the trap relates entirely to the progressivity of the tax system.

3. How to make work pay?

This section will address possible options for Member States to increase the financial incentives to make work attractive. The focus here is on instruments Member States can use to make work pay. An increase in wages is therefore not taken into account as a policy option. In general, one could argue that there is no single instrument to make work pay for everyone in every situation. Country specific circumstances largely determine the size and nature of the problem and the effectiveness of possible solutions. MWP-policies should be firmly embedded in labour market policies (as discussed in section 1). Other policy instruments aimed at increasing participation and reducing benefit dependency, may also increase the incentives for people to find a job, such as improving the availability and access to childcare facilities

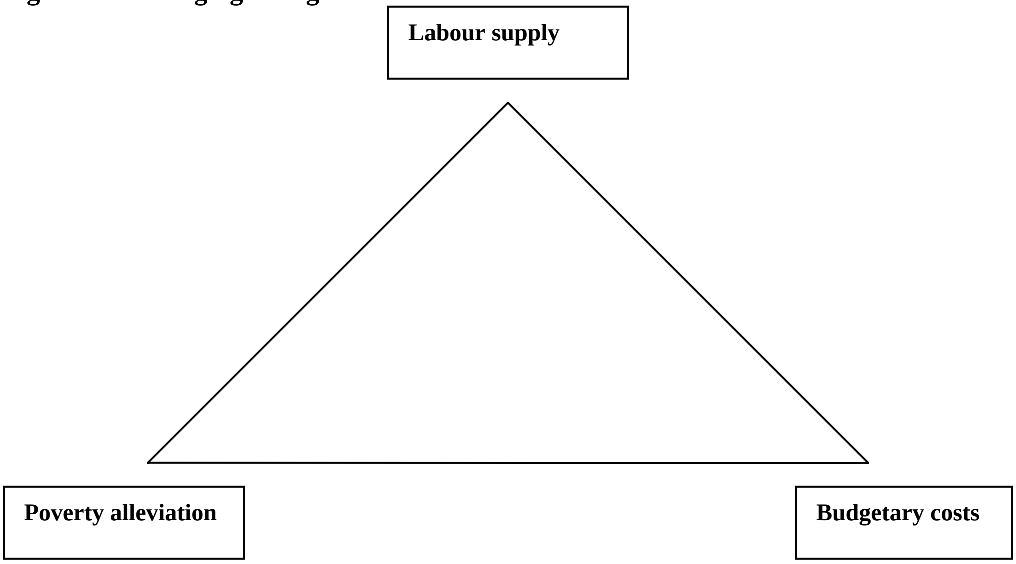
While having the same basic problems and/or policy objectives, Member States may follow different routes in their policy interventions. Policies to make work pay operate either through the supply side (by raising disposable income of workers with low earnings in absolute terms and/or relative to benefit income) or the demand side (by reducing non-wage employers’ cost of employing low-wage labour).

In the supply-side approach at least two motives play a role. Policies try to stimulate inactive or unemployed people to accept (low-paid) jobs and, sometimes at the same time to increase net disposable income for workers by redistributing income in favour of those on low pay (the “working poor”). The resulting increase of the effective labour supply will keep labour costs, at least at the lower end of the labour market, in check. The demand-side approach stresses a concern with high unemployment and a lack of jobs at the lower end of the labour market. It focuses on increasing labour demand through reducing labour costs, without lowering wages. Here we will analyse the supply-side approach in more detail than the demand-side approach, as we focus on improving financial incentives for workers to make work pay. The end of this section briefly reviews a reduction of labour costs as an instrument.

Challenging triangle
In designing policies to increase incentives for MWP, three aspects should be taken into account:
1. Increasing labour supply: Unemployment traps, inactivity traps and poverty traps have an adverse influence on total labour supply and should be diminished in order to increase labour participation and employment growth and reduce benefit dependency.
2. Poverty alleviation: Social security systems and income dependent schemes play an important role in the alleviation of poverty, by supporting low income families and people with high costs, for example for housing, health care, childcare etc and insufficient means.
3. Budgetary cost: Measures to improve incentives for MWP should be cost effective and consistent with a broader budgetary framework.

These aspects form what is sometimes called a ‘challenging triangle’, because of the occurrence of trade-offs (figure 2). Measures to reduce unemployment traps can stimulate people to accept a job (increase labour supply) but at the same time they may also imply high budgetary costs. For example, reducing the number of people benefiting from certain income dependent subsidies may positively influence the attractiveness of work and thus labour supply and the budget, but may decrease the level of the necessary income protection. In addition, in the medium-term, the budgetary expenses in temporal income support for people in unemployment, invalidity or in poor financial situation could also be considered not just as a budgetary 'cost' but also as an investment as it increases the human capital stock of the economy. Successful policies for Member States to make work pay have to find a proper balance within this challenging triangle.

Figure 2 Challenging triangle



3.1 Policy design: Increase net benefits from work

Section 2 has already identified the main factors causing the various traps. In order to address these factors, the net rewards from work can be increased by four types of policy-measures:

A. reduce tax rates and/or social security contribution rates for employees;
B. reform social security systems;
C. reform income dependent benefit schemes;
D. strengthening financial incentives through in-work benefits (IWBs).

Types A, B and C aim to reduce the adverse consequences of high tax rates, high levels of social security contributions and high income dependent benefits on the attractiveness of work. Type D, the in-work benefits, seeks to reduce these adverse effects by compensating them for certain groups and/or income ranges.

In this section, each policy-measure will be examined in more detail. In describing the measures, a distinction will be made between:

1. change the level of benefit or contribution rates;
2. change the duration of benefits or measures, i.e. whether they should be temporary or permanent;
3. change the coverage, i.e. whether measures or schemes should be targeted or not.

In the analysis examples provided by Member States are used as an illustration and should not necessarily be considered ‘best practices’. Table 3 gives an overview in linking these examples to the four routes as well as to options to reduce employers’ non-wage cost for low-wage employment.

Table 3 Overview relating examples to possible measures

		Labour supply				**Labour demand**
Country	**Measure**	**A. Tax rates and social security contributions**	**B. Reform social security systems**	**C. Reform income dependent schemes**	**D. In-work benefits**	
Austria	1. pension reform	X				
	2. Kindergeld				X	
	3. tax reform	X				
Denmark	1. More people into employment		X			
	2. Tax package	X			X	
France	1. lower labour costs at the bottom					X
	2. tax credit prime pour l'emploi				X	
	3. incentives benefit claimants		X			
	4. housing allowance reform					
	5. changes of the housing tax	X		X		
Germany	1. marginal employment (mini-jobs)	X				
	2. midi-jobs	X				
	3. worker subsidy (Mainz model)				X	
Ireland	1. taxation and social welfare system	X			X	
	2. tightening conditionality		X			
	3. active labour market programmes		X			
Italy	1. employment incentives new hires					X
	2. temporary labour cost rebate					X
	3. lowering taxes	X				
Netherlands	1. employment tax credit				X	
	2. income policy municipalities			X		
Portugal	1. social integration income		X			
	2. partial unemployment insurance		X			
Spain	1. help mothers with children < 3				X	
	2. criteria unemployment benefit		X			
Sweden	1. maximum fee for child care			X		
	2. pension reform		X			

A. Reduce tax rates and/or social security contribution rates

The need to finance public spending through taxation and/or social security contributions inevitable has distortionary effects on the labour market. The size of this effect depends on the elasticity of labour supply and labour demand. Relative elasticities also determine by whom, i.e. workers or employers, taxes are borne. This topic will not be further discussed here. The greater the responsiveness to tax-induced changes in relative prices, the greater the efficiency loss to the economy. Efficiency losses increase more than proportionally with the tax rate.[6] As a result, high tax rates and social security contribution rates can contribute to an increase in the unemployment rate.[7] High tax rates are not the only cause for inadequate financial incentives. Tax rates in EU-countries nowhere exceed 50 per cent in lower income brackets (and also the highest rates remain below or close to this threshold). As the various traps appear well below the wage level of an average production worker, the appearance of income dependent schemes (and social security contributions) can also be an important factor for not having sufficient financial incentives in several Member States.

In the past years many Member States have either reformed their tax system or announced plans to do so (Box 2). Although considerations to make work pay have often been one of the motives, more general broad economic objectives were usually the main drive to do so.

[6] G. Carone and A. Salomäki, Reforms in tax-benefit systems in order to increase employment incentives in the EU, *European Economy economic papers*, nr. 160, September 2001.
[7] C. Planas, W. Röger and A. Rossi, "How much has labour taxation contributed to European structural unemployment?", *European Economy economic papers*, May 2003.

BOX 2 Tax reform

Austria: A tax reform amounting to a net relief of €3 billion (1.3 per cent of GDP) will be implemented in 2004-2005. Tax measures are targeted at low income families, by increasing the sum that is free of taxation. This will lower the marginal tax rate for an average production worker by about 1.5 per cent points. In 2005 tax brackets will be redesigned to increase work incentives.

Denmark: In Spring 2003 a new tax agreement was reached, aimed at reducing taxes on income from work. The main elements of this package are an increase of the medium tax limit and the introduction of an (in-work) employment deduction of the work income, which is not phased out.

Germany: Workers earning between €0 and €400 (mini-jobs) are not subject to paying either social security contributions or income tax. Instead, employers pay a 25 per cent lump sum tax. Workers have health insurance, are covered by the pension scheme and are fully protected under labour law. Workers with earnings between €400 and €800 (midi jobs) only pay lower social insurance rates, with earnings subject to normal taxations. Both schemes are aimed at increasing labour supply.

Ireland: In recent years structural changes have been implemented in both the tax and social welfare systems which seek to incentivise employment and to make work pay. Since 1997, both the standard and top rates of tax have been reduced by 6 percentage points each. The introduction of a system of tax credits was completed in April 2001. Tax credits are more equitable in that they have the same value for all those who pay tax regardless of their level of income. The value of the main personal credits has increased significantly in recent years which has had the effect of moving significant numbers of income earners out of the tax net altogether.

Italy: Last year's budget included a reduction of taxes, targeted at low to medium incomes. These measures are implemented in 2003 as a first step towards a broad based simplification and lowering of taxes on personal incomes.

Level: Across the board reductions of tax rates and employee social security contribution rates are a direct way to increase the net gain of gross income increases and to increase labour supply. When people are contemplating whether to participate, income and substitution effects of tax cuts on labour supply operate in the same positive direction. But for people already at work, tax cuts have ambiguous effects on labour supply. This ambiguity holds for marginal effective tax rates well below 100 per cent. However, as demonstrated in the previous section, marginal effective tax rates are sometimes so high than there is clearly a sizeable trap and thus a negative impact. Lower tax rates and social security contribution rates contribute to alleviating poverty, the extent of which depending on the groups benefiting from it. In any case, however, the option of reducing tax rates or social security contribution rates across the board often is a budgetary very costly instrument, because it is not very well targeted. As a result, dead-weight losses are substantial. If social security benefits are not taxed and subject to social security contributions, only workers will benefit from lower rates, resulting in a reduction of all traps. In case social security benefits are taxed and pay social security contributions, everybody benefits from lower rates. This option would therefore not contribute to a reduction of unemployment traps, but it can contribute to lower inactivity traps and poverty traps.

Duration: Within the framework of general tax policies on labour, temporary measures can only take the form of specific tax credits or in-work benefits. These are discussed in section 3D.

Coverage: Reductions of tax rates and social security contributions can be targeted at specific groups as some groups, such as new recruits, low-paid labour, women and older workers, appear to be more responsive for these measures than others. For them, lowering tax rates might be a preferred option as it may limit budgetary costs. Specific tax measures often take the form of IWBs and are discussed in section 3D. By limiting the coverage, poverty alleviation for certain groups can be easier accomplished and budgetary costs reduced.

Conclusion: Lower tax rates and social security contributions can contribute to reducing the various traps discussed. Both will increase incentives for labour supply and could, especially if targeted, also alleviate poverty. In general, tax cuts are hard to target and therefore usually have high budgetary costs.

B. Reform social security systems

The way in which social security systems are designed directly affects the unemployment trap and the inactivity trap and has a big influence on the financial incentives for taking up work.

Level: Social security systems guarantee income protection for those who cannot (find) work within a reasonable period of time. Too generous benefit levels may, however, weaken the financial incentives to work. By reducing benefit levels, financial incentives for accepting a job can be increased, but poverty alleviation may be hampered. Balancing the two goals of increasing labour supply incentives and at the same time alleviating poverty will not be simple. It's a challenge for policy-makers to find a proper design of benefit systems, in order to meet both ends.

Duration: Rigorous eligibility and duration criteria of social benefits are important mechanisms in order to avoid disincentives to accepting a job. Most schemes provide lower benefits the longer the benefit duration. Research shows that most people leave the benefit situation during the first and last months of their entitlement.[8] Duration of benefits is therefore an important design parameter. A time limit can balance on the one hand the need for sufficient time to find a suitable job and in the mean time have a sufficient income with on the other hand strong incentives to seek and accept work in order to prevent long term benefit dependency and the deterioration of skills.

Coverage: Eligibility and conditionality provisions of unemployment benefit and social assistance schemes determine the extent to which there is an alternative to taking up a job. The administration as well as the enforcement of schemes influences the incentives for people to take up a job. For example, strict rules for monitoring job search efforts will limit the degree of choice for refusing a job offer, thereby increasing incentives for work acceptance. If future unemployment benefits or pensions are based on past income, it will be more attractive to accept a (better paid) job, as a job will increase current as well as entitlements for future income. This way, the income insurance role of social security systems is strengthened, thus providing a work-based safety net.

Conclusion: A design of social security systems based on past contributions rather than broad based benefit systems without eligibility requirements may positively influence labour supply. The level and the duration of benefits should be sufficient to provide income support and avoid poverty. Too generous social security systems in level and duration decrease incentives for taking up work and create a risk for long run benefit dependency.

C. Reforming income dependent schemes

Income dependent schemes aim to accomplish different goals. In general, poverty alleviation has been the main goal in designing these schemes. Although income dependent schemes can be part of the tax system, in many Member States these schemes are subsidies. The effects of both types are similar. Income dependent schemes are in general considered a cost-effective instrument to target income support at specific households with a low income. Often these households are unable to pay certain costs out of their regular income. In these cases income dependent schemes are supplements, tackling costs in areas such as housing (rent subsidies) or raising children (childcare and/or cost for child education). In some Member States, these schemes are targeted to special groups, such as disabled or elderly people. Belgium, France and Netherlands have more income dependent schemes than other Member States.[9] The impact of income dependent schemes is mostly determined by the level, the income range to which they apply and the marginal deduction rate. These parameters will be discussed below more in depth.

Level: Incentives for labour supply can be raised by reducing the benefit level (holding all other parameters constant). As a result, the budget of income dependent schemes is reduced. This runs counter, however, to the prime goal of these schemes, because poverty alleviation is reduced.

Duration: Income dependent schemes play an important role in providing poverty alleviation by covering specific costs for low-income groups. It could be considered to phase payments out gradually in time, making them temporary available for a short period after taking up work. This softens the

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[8] See for an overview P. Fredriksson and B. Holmlund, Improving incentives in unemployment insurance: A review of recent research, *Institute for Labour Market Policy Evaluation (IFAU)*, 11 February 2003.

[9] M. Buurman and S. Desczka, *International Income Statistics*, Elsevier, September 2001.

income consequences of such a transition. In France, the housing tax is designed in such a way that after leaving the benefit situation for a job the tax exemption continues for another year. Such a temporary measure will increase labour supply incentives less than permanent measures. It will, however, not reduce the role of income dependent schemes in alleviating poverty. More budget is needed for this time limited supplement, but additional budgetary means would be relatively efficiently targeted at those people accepting a job.

Coverage: The total number of people benefiting from income dependent schemes is determined either by the income range to which they apply, or by the specific target group, or by both. The way a benefit is phased out (the marginal deduction rate), is important in determining the group benefiting from income dependent schemes. A simple reduction of the marginal deduction rate is similar to reducing tax rates.[10] The speed with which people lose benefits is reduced and therefore incentives for better paid jobs are increased. The additional budgetary costs will be smaller than in case of a tax cut, because only those who use the scheme will benefit. This higher budget implies that more money is paid to (low-income) families using income dependent schemes. In Sweden the maximum fee on childcare is an example of a reduction of marginal rates within an income dependent benefit scheme.

The marginal deduction rate can also be reduced while simultaneously extending the income range to which an income dependent scheme applies. The consequence of this is that more people will be entitled to income dependent schemes on the basis of their income. This has an important disadvantage. It means that more people will (potentially) lose the benefit when their income increases and thus will face larger traps. People currently in the scheme, for whom the marginal deduction rate is reduced, will increase their (hours of) participation. The overall net result of both these reactions is a priori inconclusive.

Another important aspect is the household categories to which income dependent schemes apply. If benefits are only available for unemployed or inactive people, accepting a job involves losing a subsidy completely, which implies higher unemployment and inactivity traps. If benefits would be available to all low income households this effect would not occur. If targeting is considered, it is preferable to relate benefits to labour market-neutral parameters such as household status or age (demographic characteristics) and better not to employment status. Equally, dependence on income should be avoided, because of the increase of the poverty trap in the income range where benefits will be phased out. The 2000 Housing allowance reform in France was implemented to remove differences in treatment between income sources, thereby eliminating a high implicit tax for people leaving social assistance. Also the scope of subsidies could be reconsidered. For example, in the Netherlands the possibilities for municipalities for providing income support are limited to payments on an individual basis.

Conclusion: Poverty alleviation is the most important goal of income dependent schemes. Changing the level, the income range and the marginal deduction rate can influence incentives for labour supply. There are offsetting effects. In general, increasing supply incentives for one category should not reduce incentives for (too many) others.

D. In-work benefits

In order to make work pay, many use in-work benefits (IWB). IWBs aim (1) to increase financial incentives towards work as well as (2) to improve the income position of those with low paid jobs. These play a role in all Member States using IWBs, although there are differences regarding the importance of each objective.

Level: The level of IWBs differs substantially between countries. International comparison shows that the maximum amount of in-work benefits is in general higher if it is household-based, in which case the main focus of IWBs is poverty alleviation. Dead-weight losses are higher in case of individual-based benefits, as part of these individuals will live in households which are not considered poor.

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[10] The effects of reducing the income range to which these schemes apply, are similar to reducing the level and will not be discussed here as a separate option.

However, individual-based schemes provide a stronger financial incentive for non-participating partners and thereby decrease the inactivity trap. Empirical evidence shows that IWBs have encouraged more people to take up work. In the UK and the US tax credits appear to be an effective instrument to encourage lone-parent families and jobless households to return to work (see Box 3). The relatively generous earning's supplements under Canada's SSP and the US's EITC explain the scale of the employment effects.

BOX 3 Evidence on MWP-policies from US, UK and Canada

United States: The Earned Income Tax Credit (EITC) is the most prominent example of MWP policies in the United States. Total costs amount to $32 billion (0.33 per cent of GDP); the number of recipients is 20 million (1 household in 5). It is available from the very first dollar earned and thus encourages any work attachment. Its amount is differentiated according to whether taxpayers are without dependent children, with one child, or with more than one qualifying child. The expansion of the EITC in the 1990's has been found to promote employment, especially among single parents. The increase in overall employment has not been substantial, due to offsetting decreases in participation by spouses.

United Kingdom: The Working Family Tax Credit (WFTC) is a 5 billion (0.6 per cent of GDP) in-work benefit reaching 1.3 million households. Blundell and Hoynes[1] report significant increases of employment rates for lone parents, which are partially offset by less participation by married women. Overall effects on employment are positive.

Canada: The Canadian Self-Sufficiency Project (SSP) pays an earnings supplement targeted at single parents who have been welfare recipients for at least a year. The supplement is paid for three years, provided that the recipient works for at least 30 hours per week. The supplement roughly doubles the gross earnings of many low-wage workers. The scheme has brought a large number of people back into work, thereby increasing their incomes and reducing poverty. The major drawback is that the employment effects of SSP gradually wore off once payment of the earnings supplement ceased.

[1] R. Blundell and H. Hoynes, "Has in-work benefit reform helped the labour market?", *NBER Working Paper*, 8546, 2001.

The prime goal of the American EITC is poverty alleviation.[11] Reducing poverty, especially among children, is also an important objective of the British WFTC. The Dutch employment tax credit and the French tax credit "prime pour l'emploi" primarily focus on making (the acceptance of a) job more attractive and therefore try to stimulate labour supply. The American EITC is much more expensive, since European countries try to establish the goal of income redistribution and poverty reduction through different ways. Most countries try to increase economic self-support by phasing in the IWB. As the amount of hours worked is stimulated, benefit dependency is reduced. The UK and Ireland try to achieve the same goal by requiring a minimum amount of hours worked. In most countries, career development and wage progression are often better for people working full time. It may, however, discourage those with young children to accept a job that involves too many hours. It may also induce potential recipients to cut down or manipulate hours to the minimum requirement to become eligible for the payment. For example, the UK specifies classes of hours. The result of this is that participation peaks at 16 hours per week, with virtually nobody working 14 or 15 hours.

In designing IWBs, policy makers face a dilemma. As only those in-work qualify for the take-up of IWBs, unemployment and inactivity traps can be reduced in a direct way. But since the problem of MWP is especially concentrated at lower income levels, IWBs could be even more targeted (at the same budgetary costs) by phasing them out at higher income levels. Almost all countries using IWBs are phasing out. By doing so, however, this may contribute to already high poverty traps for higher income ranges. This is the reason why the employment tax credit is not phased out in the Netherlands. A positive effect of this may be that recipients are encouraged to develop their occupational skills, as studies in the US show that EITC-recipients may have cut down on their training efforts (OECD, 2003). Phasing out may balance the trade-offs of the challenging triangle, however, if the number of people in the phase out range is relatively small or the elasticity of labour supply is low. In that case the increase in the poverty trap will apply only to a limited number of people and negative effects on labour supply will be limited as well.

[11] R. Blank, Evaluating welfare reform in the United States, *Journal of Economic Literature*, December 2002.

Duration: Some IWBs are temporary, focusing on increasing incentives for accepting work rather than on income support. Whether a temporary measure is effective or not depends on the possibilities to enter or stay on the labour market and on wage mobility. The shorter it takes before someone will find a better paid job, the better temporary measures be considered as an effective alternative instrument in comparison to phasing out IWBs. The longitude of the period within a recipient will achieve real economic self-sufficiency depends crucially on national (labour market) circumstances. Sustained support reflects the fact that difficulties in finding and holding a job are structural. Budgetary costs are therefore necessarily higher. Canadian experiences with the SSP show that positive effects wither away if measures are not in effect for a sufficiently long amount of time.

Coverage: Apart from temporary measures, income rises are generally responsible for a gradual reduction of IWBs as these are phased out in most countries. Eligibility may also depend on the recipient's prior status. For example, the Canadian SSP only gives access to IWBs if someone leaves a welfare scheme or was long term unemployed. Targeting IWBs to specific groups can be highly effective, as experiences with the EITC show that groups such as lone parents are highly receptive when it concerns financial incentives. For example in Spain a non-wasteable tax credit of €100 per month for each child is paid out to working women with children under 3 years. Targeting may have undesirable implications, however, for example if lone parents are withheld from family formation. Also, it may increase stigma for specific groups and change job search behaviour if, for example, IWBs are confined to former welfare claimants.

Countries have undertaken different measures to increase take-up of IWBs. By using the tax system administration costs are generally low, while those who qualify can easily be reached. As a result, non-use can be limited. In many countries, measures for low paid workers have considerably reduced the amount of taxes due, relative to the amount of IWBs they qualify for. Therefore IWBs often are refundable or non-wasteable, meaning beneficiaries whose tax liabilities are insufficient receive a net cash payment from the tax service on their total tax bill. If IWBs are not refundable, getting the benefit depends on individual circumstances like the amount of tax deductions a person has.

Table 4 summarises the main characteristics of IWBs in various countries.

Table 4 Characteristics of in-work benefits (2001)

Country	Individual or Household	Refundable/non-wasteable	Phasing in	Phasing out	Minimum hours worked
Belgium	Individual	Yes	Yes	Yes	No
Canada	Household	Yes	Yes	Yes	No
Finland	Individual	No	Yes	Yes	No
France	Individual	Yes	Yes	Yes	No
Netherlands	Individual	No	Yes	No	No
United Kingdom	Household	Yes	No	Yes	Yes
United States	Household	Yes	Yes	Yes	No

Source: OECD, *Employment Outlook 2003*.

Conclusion: The effects of IWBs on labour supply crucially depend on three factors:

1. If IWBs are targeted to certain income ranges, there is an offsetting effect on the initial increase of participation and employment, due to the increase in the poverty trap in the phase out range. Not phasing out IWBs involves high budgetary costs, but can influence training and work efforts positively without the negative effects on labour supply, which accompany phasing out.
2. Phasing out may be sensible if there are relatively few workers in the phase out range and if wage mobility is high.
3. Targeting IWBs to certain groups, especially lone parents and jobless households, may be highly effective.

3.2 The minimum wage and employers' non-wage costs

Minimum wages and/or lowest pay scales in collective labour agreements provide a floor for the reward of low paid jobs. Also in many Member States benefit schemes are to some extent linked to the minimum wage level. Evidence has shown that the proportion of working poor is relatively lower in countries with a relatively generous minimum wage (OECD, 2003). At the same time unemployment problems among low skilled workers are related to relatively high minimum wages and/or relatively high social security contributions and payroll taxes imposed on low wages.[12] High employer costs prevent workers with (perceived) low productivity from being hired and stimulate substitution through capital. If policies are successful in reducing the unemployment and inactivity trap thereby increasing labour supply, these people can only find jobs if their total labour costs can be afforded by employers. In this subsection we will focus on measures to increase labour demand by reducing *total* labour costs.

Minimum wages influence the incentive structure for low paid jobs for employers. Total labour costs are important for the hiring decision. To a certain level, incentive structures for both labour supply and labour demand can be improved simultaneously. Net take-home pay can be increased by reducing taxes, social security contributions or increasing IWBs, while at the same time total labour costs can be reduced by lower employer taxes and lower employer social security contributions. Thereby the dilemma between lowering labour costs and increasing net wages is attenuated.

According to OECD (2003) evaluations of employment subsidies in Belgium, France and The Netherlands show positive impacts on low skilled employment. There are substantial dead-weight costs, however, because also existing jobs which are not under threat and jobs that would have been created anyway are subsidised. Low-wage subsidies may hamper upward wage mobility as it gets more expensive for employers to award wage increases if at the same time the subsidy is reduced. According to the OECD (2003) employer surveys report major windfall effects, although these seem to differ between the short run and the long run. Research focusing on the effects for low-skilled workers is more optimistic. This means that at least some redistribution of employment opportunities in favour of this group takes place. Effectiveness is raised if wage subsidies are closely targeted on the groups for whom employment is promoted. For lasting effects it is important for workers involved to develop their human capital, leading to mobility to more stable and higher quality jobs. This would strengthen the case for making these subsidies temporary.

With relatively high minimum wages it is hard to justify IWBs, since employment is already demand-constrained and the high minimum wage in itself could make work pay. The OECD (2003) argues that the effectiveness of instruments like IWBs is enhanced if they are backed up with a moderate minimum wage. Wages then cannot decrease below the minimum wage. In this way it is secured that IWBs reach the target population and do not result in lower wages because of a more effective labour supply.

BOX 4 Examples of labour demand policies

France: A scheme reducing employer's social security contributions has been in place since 1993. Rates differ according to the length of the working week. For firms which are on a 39 hours basis, the maximum of the reduction is 18.2 per cent of the gross minimum wage and phased out to 0 at 1.3 of the minimum wage.

Italy: Several employment incentives for new hires exist, covering youths and also people over 25 years who have not been employed in the previous 24 months and who were hired by a firm increasing its number of permanent employees. Temporary labour cost rebates are in place for workers covered by the most generous unemployment benefit schemes.

4. Guiding principles: towards making work pay

As stated in Guideline 8, making work pay is an important instrument to make it more attractive for people to seek, accept and remain in work. Financial incentives are often lacking for people on unemployment benefit (unemployment trap), for people on social assistance or spouses of a single earner (inactivity trap) and for those in low paid jobs to accept a better paid job (poverty trap).

In designing fiscal policies there is a trade off between the effects of such policies on the attractiveness of work and therefore labour supply, on poverty alleviation and on the government budget. The challenge for Member States in implementing these objectives is to find a balance within this

[12] OECD, *Employment Outlook 1999*.

‘challenging triangle’. There is no single instrument to make work pay for every country and every person in every situation. To increase financial incentives to make work pay appropriate policy measures are in the field of a reducing of tax rates or social contributions rates paid by employees, reforming social security systems and income dependent benefit schemes and the introduction of in-work benefits. Elements in the design of these policies concern the level, the duration and the coverage of the financial incentives.

Five guiding principles to make work pay can be identified. These principles can help Member States in implementing the main objectives of Guideline 8, being part of the European Employment Strategy.

1. Develop a comprehensive strategy
There is no single instrument to make work pay. To increase financial incentives in order to make work pay, means in any case examining the interaction of policy objectives in several policy areas, such as tax policy, social security systems and income dependent schemes. At the same time, non-financial factors play a vital role, and are sometimes even more important. Examples are the provision of adequate child care facilities, flexible working hours, part time contracts, training to upgrade skills etc. In addition, high minimum wages and high employer costs may affect labour demand negatively and thus reduce the number of jobs. Hence, financial incentives to make work pay should be part of the right comprehensive policy mix to make work pay, taking into account all these different aspects and national circumstances.

2. Aim for mainstreaming of policies
The lack of financial incentives to make work pay generally derives from (the interaction of) schemes primarily designed for other purposes, mainly poverty alleviation (with budgetary constraints). The phasing out of housing allowances, while limiting budgetary costs, may reduce financial incentives to accept a (better paid) job. Equally, too generous unemployment benefit systems (level and/or duration) may reduce incentives to take up work. Therefore it is important that policies with an impact on making work pay are mainstreamed and reformed, as to reduce their adverse effects on labour supply. This under the condition of taking into account the aim to alleviate poverty and the cost-effectiveness of policies.

3. Pursue reforms by taking into account specific labour market situations
In finding a proper balance within the challenging triangle, specific situations on the labour market should always be taken into account:

- In general high poverty traps can be reduced through a reduction of tax rates and social contribution rates paid by employees, as it can help to improve the acceptance of a better paid job and thus stimulate dynamics on the labour market and productivity.
- When the unemployment trap or the poverty trap is high due to income dependent benefits, a reform of these benefits should be considered, without disregarding the importance of poverty alleviation. If a reform would harm poverty alleviation too much, such a reform can be combined with a reduction of tax rates and social security contributions for employees, or the introduction of in-work benefits.
- In reforming income dependent schemes an extension of the phasing out range, thus reducing the poverty trap, will be effective if the number of people in the extended income range is limited. If the number of people in the phasing out range is large, an extension of the phasing out range could reduce labour supply in this income range too strongly and should not be considered
- If social security systems keep people trapped in unemployment or inactivity, a reform of these systems can be considered, for example a reduction in benefits or duration, or a strengthening of eligibility criteria and sanctions. Any reform should not contradict with the role social security systems play in poverty alleviation.
- A work-based system that provides entitlement rights to future benefits through past contributions while in-work can positively influence labour supply incentives. It will be more attractive to accept a (better paid) job, if future unemployment benefits or pensions are based on past income. Then a job will increase the current as well as the entitlements for future income.

- If minimum wages are relatively high it can be cost-effective to focus on a reduction of employer costs either by a reduction of minimum wage or by a subsidy for employer's cost of low-wage labour.
- If minimum wages are relatively low, in-work benefits can be an effective instrument to make the acceptance of work by unemployed or inactive people financially more attractive and to reduce the number of working poor. The alternative of increasing minimum wage levels can harm labour demand.

4. *Target policies on groups*

In order to limit dead-weight losses, policy measures can be targeted on specific groups.

- In targeting, it is preferable to relate benefits to labour market-neutral parameters such as household status or age (demographic characteristics). They should better not depend on employment status, as benefits would be lost immediately after taking up a job. Equally, dependence on income should be avoided, because of the increase of the poverty trap in the income range where benefits will be phased out.
- In-work benefits can be especially effective for raising labour participation of secondary earners (often women) or lone parents. To make work financially attractive, they could be focused on secondary earners or lone parents, thus reducing inactivity and unemployment traps. As this conditionality would be based on demographic factors, such a targeted measure would not harm other groups. In this respect the provision of child care is equally important.
- If only a small proportion of jobs is in the lower end of the labour market, in-work benefits can be focused on the low paid, by phasing the benefits out above a certain income level. In order to avoid a large reduction of labour supply in the phasing out range – due to an increase in the poverty trap in this range – it is required that the number of people in this income range is relatively small or the elasticity of labour supply is low.
- In work benefits should better not be phased out however if elasticity of labour supply is high and the number of people in the phasing out range is large.

5. Consider temporary measures and time limits

It can be cost effective to focus on measures that are temporary available for its recipients and on time limits.

- Too generous social security systems directly decrease incentives for taking up work and create a risk for long run benefit dependency. In order to increase financial incentives for unemployed and inactive people, the duration can be reduced while providing supportive measures, for example active labour market policies, to help the unemployed to find a job.
- Income dependent benefits play an important role in poverty alleviation, for example in covering costs for health care or housing. Here, the introduction of time limits does not seem to be an option.
- If it is difficult for low-paid workers to find a better-paid job, in-work benefits should be permanent. If in-work benefits are phased out, employees may grow out of the income range of in work benefits through training and promotion. If they stay in the income range of the in-work benefit, this may prevent them from becoming a working poor.

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