

In-work policies in Europe: Killing two birds with one stone?

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Abstract

Generous social assistance has been held responsible for inactivity traps and social exclusion in several European countries, hence the recent trend of promoting employment through in-work transfers. Yet, the relative consensus on the need for ‘making work pay’ policies is muddled by a number of concerns relative to the design of the reforms and the treatment of the family dimension. Relying on EUROMOD, a EU-15 integrated tax-benefit microsimulation software, we simulate two types of in-work benefits. The first one is means-tested on family income, in the fashion of the British *Working Family Tax Credit*, while the second is a purely individualized policy. Both reforms are built on the same cost basis (after behavioral responses) and simulated in three European countries suspected to experience large poverty traps, namely Finland, France and Germany. The potential labor supply responses to the reforms and the subsequent redistributive impacts are assessed for each country using a structural discrete-choice model. We compare how both reforms achieve poverty reduction and social inclusion (measured as the number of transitions into activity). All three countries present different initial conditions, including existing tax-benefit systems and distribution of incomes and wages. These sources of heterogeneity are exploited together with different labor supply elasticities to explain the cross-country differences in the impact of the reforms.

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1. Introduction

Poverty has been reduced in many industrialized countries by the development of large-scale welfare systems which include generous social assistance schemes for the poorest. However, there is a well-known risk that the instruments used for this purpose generate social exclusion by making work financially unattractive, especially to less productive workers. Consequently, benefit schemes must be designed in a way which preserves sufficient income while ‘making work pay’. In this respect, pioneering in-work transfers have been introduced for many years in the US and the UK, with the Earned Income Tax Credit (EITC) and the Working Family Tax Credit (WFTC) respectively. Several European countries have recently experienced the implementation of similar reforms or actively debated about doing so.

Yet, the relative consensus on the need for this type of policy is muddled by concerns about efficient design, given the framework conditions and the general objectives pursued. In particular, the treatment of the family dimension is a crucial issue which deserves specific attention. EITC/WFTC-type of policies, means-tested on household income, are suspected to increase work incentives for single workers but to discourage married women with working partner. It is typically argued that this efficiency loss is outweighed by the equity gains from targeting families in need. In contrast, individualized schemes appear to combine clearer incentive effects with less efficient targeting, since resources may be transferred to workers in well-off families. Overall, whether redistributive and efficiency objectives can be reconciled in a single policy measure remains an open question.

This paper provides the first comprehensive comparison of these two alternative policies and their implications on labor force participation. To do so, we simulate the labor supply effects of a purely individualized in-work transfer and of an extended version of the WFTC. We conduct these simulations for three European countries which experience inactivity traps, namely Finland, France and Germany. Despite numerous debates (esp. in France) on the appropriateness of in-work transfers, none of these countries has implemented policies as generous as the EITC/WFTC. More generally, we tackle the issue of the design of in-work policies by exploring for each country the role of initial conditions, e.g. the institutional framework, the distribution of income, etc. These conditions are key to the success of a reform, as stressed in previous studies (e.g. Bertola, 2000), but have not received systematic attention in large-scale analyses.

To analyse the potential effects of each reform on incentives and redistribution, we estimate a structural labor supply model for single and married women, using micro data for the three countries and a tax-benefit microsimulation program. To perform meaningful comparisons, the reform scenarios are calibrated to reach the same budgetary cost after potential behavioral responses.

To clarify policy analysis, we compare the reforms in the light of two clear-cut policy goals, namely *poverty reduction* and *social inclusion* (measured as the number of transitions into work). Specifically, we question which of the suggested in-work benefits succeeds best on each account and whether the incentive effect of in-work transfers is significant in poverty reduction. Firstly, results show large efficiency gains from moving from family to individually based policies. While the impact on poverty is quite similar between the two policies, the individual wage subsidy increases women’s employment. At the same time, the negative employment effect of the WFTC on married women offset by far the positive effect on single women. This result comes in contrast to those in the US and the UK. Secondly, it turns out that the WFTC can be particularly effective when priority is assigned to lone mothers, a group showing the highest risk of poverty and social exclusion. We also discuss what can be achieved given each country’s social policy agenda.

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