

Employment and welfare reform in the EU

Barry Watts

The Lisbon summit in 2000 set the ambitious target of making the EU “the most competitive and dynamic knowledge based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion.”¹

One of the main goals of the Lisbon Agenda was to increase employment throughout the EU in an attempt to address the impact of an ageing population on the supply of labour, sustain public finances and improve the EU’s competitiveness.

EU leaders agreed to set a target for the EU to have 70% of the working age population employed and to increase the number of women in employment to 60% by 2010. A year later, at the Stockholm European Council in March 2001, an intermediate employment target was set to increase the employment rate to 67% by 2005. Today these ambitious targets are far from being met.

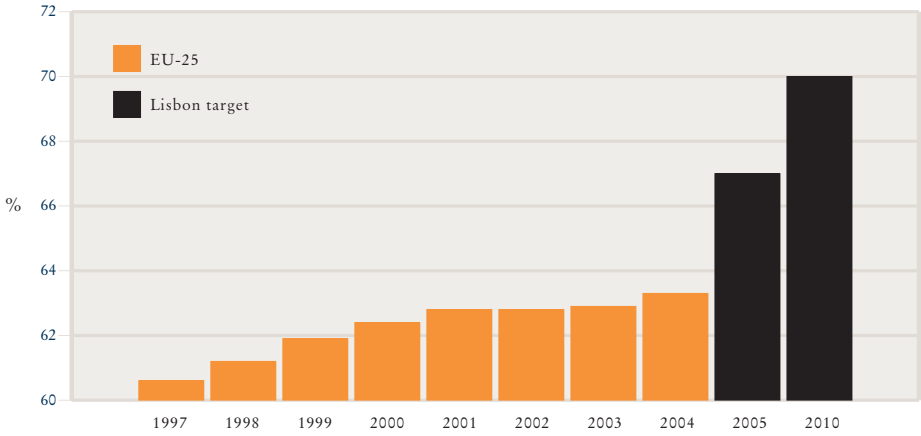
The state of play

The European Commission carried out a mid term review of the Lisbon Agenda in 2004 conducted by the former Dutch Prime Minister Wim Kok. The report - Facing the Challenge, The Lisbon Strategy for growth and employment - found that little progress had been made over the first four years.² Indeed progress seems to have slowed, rather than accelerated, since the Lisbon summit.

As Figure 1 below shows, from 2000-2004 EU employment levels rose less than 1% from 62.4% in 2000 to 63.3% in 2004, far below even the intermediate target of 67%. There are substantial differences in the employment levels in the EU. Figure 2 shows that employment levels vary from less than 52% in Poland and 65% in Germany to nearly 76% in Denmark. In 2004 only 4 member states³ had over 70% employment rate and only 8 out of 25 member states were meeting the 2005 67% target⁴.

Figure 1

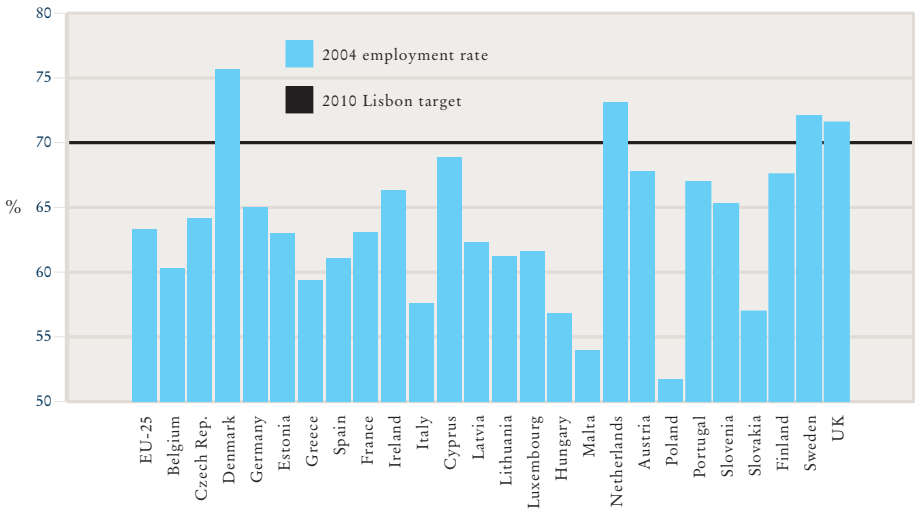
Overall EU employment rate 1997-2004



Source: Eurostat

Figure 2

Employment rates by country



Source: Eurostat

Welfare reform to increase employment

Governments can call upon a range of policies to increase employment. The macro-management of the economy plays a big role, and the use of the tax system affects employment levels. For example, employers' social contributions are often seen as a tax on jobs. Several member states have "active" labour market policies aimed at reequipping the unemployed with new skills, such as the New Deal in the UK.

Others have tried to introduce job subsidies for employers - i.e. payments to employers for creating jobs, such as Italy's recently introduced IRAP scheme. Employment is also affected by regulation on hiring and firing workers, such as the French government's current attempt to reduce employment protection legislation on young workers to reduce youth unemployment.

Any attempt to increase employment in the economy faces two challenges: getting people who are either inactive or on welfare benefits into work and encouraging people already in the labour market to work longer hours. The combination of the way that benefits are paid and means tested, plus the effects of the tax system, can give individuals little incentive to come off welfare or work harder, trapping people into welfare dependency. There are three specific problems that governments face: unemployment, inactivity and the low wage traps.

UNEMPLOYMENT TRAP

The unemployment trap exists where the market wage is too low to offer an incentive to take up work compared with the welfare benefits individuals receive. This is a result of the effect of benefit withdrawals and higher tax rates as they move into work. This can be solved by either cutting or time limiting welfare benefits or offering in-work benefits to encourage the transition into work.

INACTIVITY TRAP

There is also a challenge to get those who are out of work but not claiming benefits into employment. The so called inactivity trap exists where employment is judged not to pay because income related benefits may be lost with the uptake of paid work. For example partners or spouses of working individuals may not take up work if pay is jointly taxed, or if the couple may lose family benefits if household income is raised.

LOW WAGE TRAP

A low wage trap, sometimes referred to as the poverty trap, can also exist where there are no financial incentives to work longer hours or for higher salaries. This can be caused by both taxes and benefits, when an increase in gross income does not translate into a sufficient increase in net income to incentivise the extra hours of work.

European economies face many of these problems to increasing employment, but what is key to achieving the Lisbon Agenda is getting people into employment. This means that adopting effective measures to address the unemployment and inactivity traps are important. European countries have high levels of means tested benefits which are a major cause of the unemployment trap. Table 1 below outlines the different unemployment benefit schemes in each of the 25 EU member states.

The majority of member states have a two layered welfare regime, consisting of unemployment insurance and assistance. Insurance is paid immediately after becoming unemployed and assistance is for those who have used up their insurance contributions.

Table 1: Different welfare regimes in each member state

Country	Unemployment Insurance	Unemployment Assistance
Austria	55% of daily net income, lasts 5-18 months depending on insurance duration and age	Income based assistance of 92% of previous insurance benefits, with no time limit
Belgium	55-60% of earnings depending on circumstances, for first year unemployed. Decreases in second year. Has no time limit	None
Czech Republic	For the first 3 months get 50% of average net monthly earnings, reduces to 45% thereafter, max 6 months	None
Cyprus	60% of weekly wage, increases depending on circumstances	None
Denmark	90% of earnings, for up to 48 months	None
Estonia	50% of average daily earnings for up to 100 days then 40%	Flat rate per month
Finland	Basic and earnings related allowances (basic + 42% of difference between wage and basic allowance). 16 month duration	Labour market support amount per day
France	57% of daily wage, 4-60 months	Provision for older workers
Germany	60-67% depending on circumstances for up to 18 months	53-57% of net earnings, no time limit

Table 1 continued: Different welfare regimes in each member state

Country	Unemployment Insurance	Unemployment Assistance
Greece	40% of daily wage for manual workers, 50% of monthly wage for white collar workers, up to 15 months	17-20% depending on reason for losing job
Hungary	65% of average salary for 6 months	None
Italy	40% of average pay over last 3 months or 80% of previous earnings for up to 9 months for those in the building trade	None
Lithuania	Fixed and variable parts, paid in full for 3 months then reduced by 50%	None
Ireland	Flat weekly rate for up to 13 months	Unlimited fixed amount per week
Latvia	Amount depends on insurance contributions (from 50-65% of average wage) and amount declines over 9 months	None
Luxembourg	80% of earnings for 24 months	None
Malta	Fixed amount per day depending on circumstances, maximum of 156 days	Fixed amount per day
Netherlands	70% of last salary or 70% of minimum wage for short term benefits lasting from 6-60 months	70% of minimum wage for up to 24 months
Poland	Flat rate benefit depending on length of economic activity	None
Portugal	65% of wage, 12-30 month duration	80-100% of minimum wage, lasts 12-30 months
Slovakia	50% of average gross earnings over last 3 years, for up to 6 months	None
Slovenia	70% of average monthly earnings for first 3 months, falls to 60%. Length depends on insurance payments, up to 24 months	80% of employment benefit up to 15 months

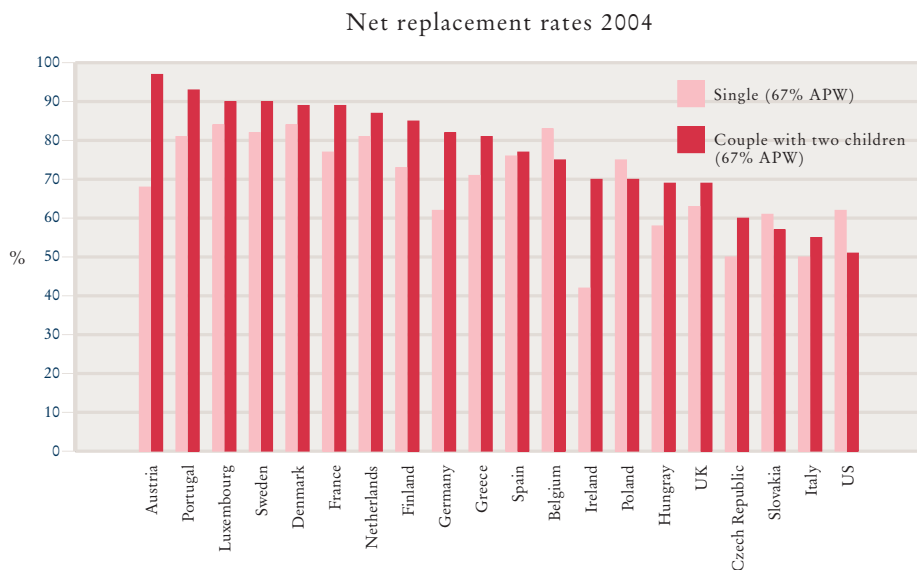
Table 1 continued: Different welfare regimes in each member state

Country	Unemployment Insurance	Unemployment Assistance
Spain	70% of earnings for 6 months, reduced to 60% for 18 months	75% of minimum wage up to 18 months
Sweden	80% of earnings, usually 300 days but can be extended to 600	Basic daily allowance with no time limit
United Kingdom	Contributions-based Job Seekers Allowance, flat rate with a 6 month limit	Income based Job Seekers Allowance, varies according to family and income, no limit
US	26 weeks maximum receipt, level of benefit varies by state	None

Source: Based on MISSOC 2005 data

Figure 3 shows the net replacement rates for each member state. This is a comparison of in-work incomes and out-of-work incomes showing the loss of income when losing a job and getting unemployment benefits.

Figure 3



Source: OECD, Tax Benefit Model: www.oecd.org/els/social/workincenives

Overall Denmark has the most generous unemployment insurance system providing 90% of earnings that can last for up to 48 months. Luxembourg and Sweden have 80% of earnings, whereas the Netherlands, Slovenia and Spain have 70% of employment benefits. These countries also have high net replacement rates. As we can see some countries, such as Sweden (90%), France (89%) and Luxembourg (90%) have very high levels of net replacement rates for couples with two children. This means there is little or no incentive to come off benefits in these countries as moving into work would not result in any financial gain. For the single person the net replacement rate is usually lower but still very high in Denmark (84%), Belgium (83%), Sweden (82%), Portugal (81%) and Luxembourg (84%). In comparison the UK, Greece, Italy and Ireland have low unemployment benefits and net replacement rates.

Another way to measure the unemployment trap is to look at the marginal effective tax rate (METR). It is the rate at which benefits decrease and taxes increase as an individual starts employment and it measures the short-term financial incentives to move from unemployment into paid employment. In the following graphs the net income line shows the METR. The flatter the net income line the larger is the part of any additional earnings that gets taxed away. We can see that for Sweden and Germany the line is horizontal at low wage levels meaning that any increase in gross income is completely taxed away. In comparison, for the US the line is upward sloping, creating an incentive to move into employment.

Figure 4

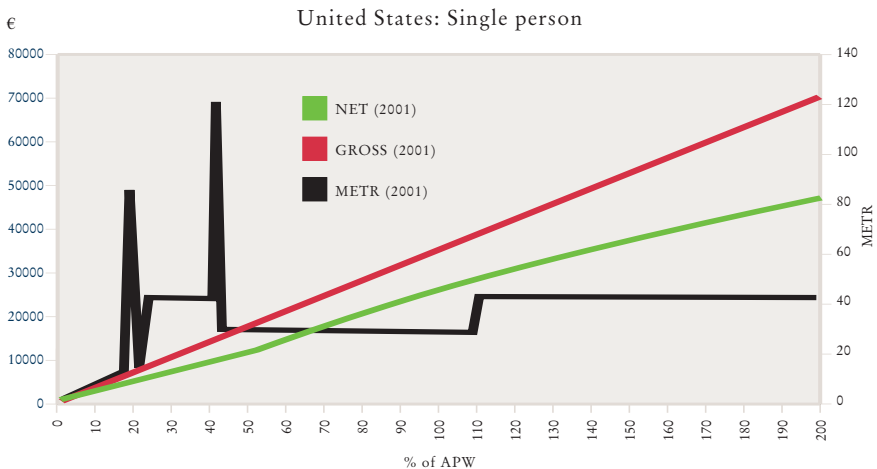


Figure 4

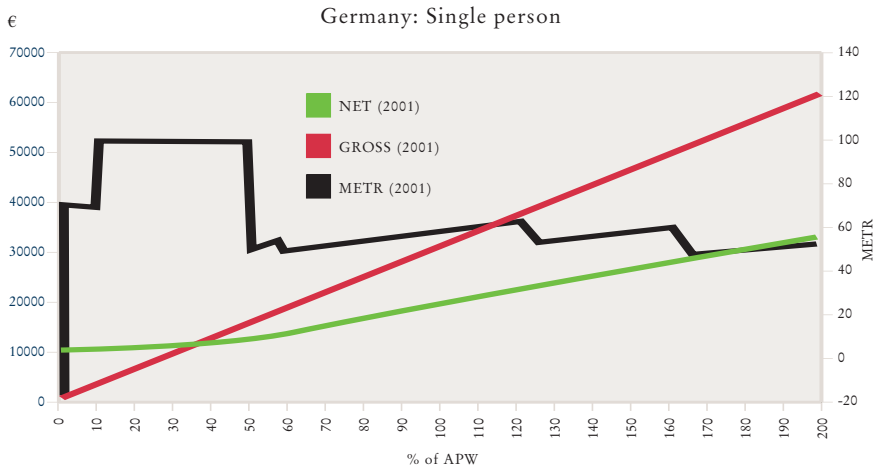
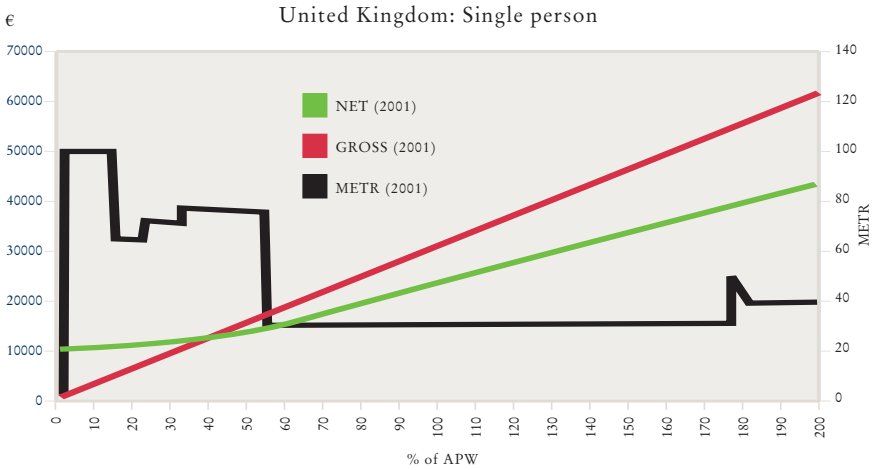
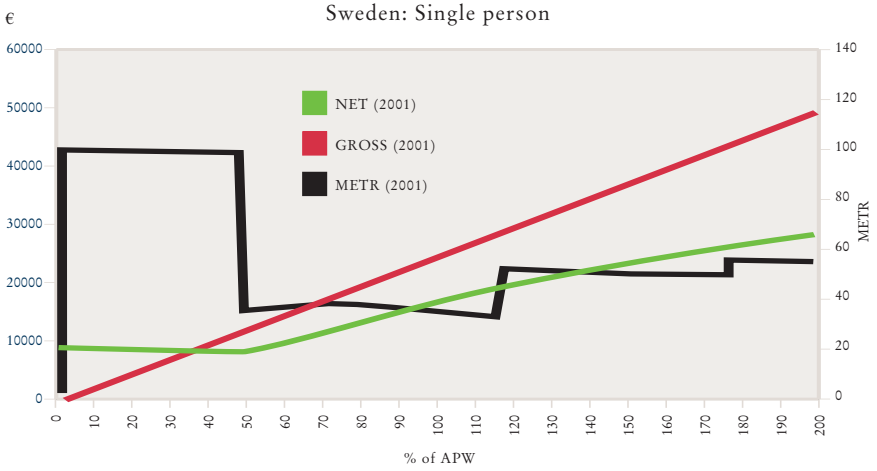


Figure 5:

Prevalence of marginal tax rates of over 100% and over 80% - by wage earned by welfare leaver and family type (2003)

Family type	Wage as % average	Country																		
		BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI	SE	UK	CZ	HU	PL	SK
Single	50%	100	106	100	97	97	78	88	65	104	92	87	110	90	105	79	80	74	87	88
	67%	90	93	89	77	78	83	73	58	87	86	75	87	81	87	71	66	64	74	73
	100%	79	78	78	57	63	68	59	53	69	73	64	66	69	70	58	53	56	61	56
	150%	72	73	71	49	52	58	55	49	61	60	57	55	62	61	50	46	57	52	48
1 earner couple No children	50%	90	75	100	100	96	60	100	66	102	96	100	73	92	100	84	91	72	76	105
	67%	81	85	89	79	74	84	90	55	104	92	87	69	89	98	82	78	63	74	95
	100%	71	78	75	58	59	65	69	53	84	79	72	64	76	77	67	64	55	61	72
	150%	65	72	66	50	49	54	57	50	65	64	63	51	67	66	55	53	57	52	57
2 earners couple No children	50%	96	106	99	70	97	101	53	75	104	88	79	112	83	105	44	76	72	75	85
	67%	88	90	87	56	78	84	47	65	84	77	69	90	72	87	41	63	63	65	69
	100%	77	77	76	43	63	69	41	57	65	67	60	68	62	70	38	51	55	55	53
	150%	71	72	68	39	52	57	38	52	55	56	55	53	58	61	37	44	57	48	46
Lone parent 2 children	50%	91	106	100	110	96	67	48	73	101	90	100	73	94	103	57	93	86	79	92
	67%	81	90	93	86	78	90	24	51	94	86	84	69	87	91	65	79	68	67	79
	100%	73	82	80	63	60	74	37	52	68	77	71	71	78	79	68	67	54	66	64
	150%	68	76	70	50	49	58	38	52	58	63	62	58	68	68	59	56	56	56	54
1 earner couple 2 children	50%	85	76	100	110	96	53	96	77	101	93	100	74	92	100	63	100	86	100	106
	67%	77	82	85	86	78	90	88	52	104	89	99	69	94	100	70	95	68	87	111
	100%	68	80	75	63	58	74	73	53	90	80	80	65	87	83	73	76	54	73	86
	150%	64	74	66	50	48	58	59	52	67	64	68	62	74	70	63	62	56	64	68
2 earners couple with children	50%	96	106	116	72	99	101	69	83	115	86	85	110	91	105	68	77	72	95	92
	67%	88	90	100	58	79	83	59	73	89	76	73	85	78	87	59	64	63	79	74
	100%	77	77	84	44	63	66	49	64	66	67	63	64	66	70	50	55	55	64	57
	150%	71	72	73	37	52	54	43	57	55	56	57	51	61	61	45	46	57	54	51

Source: European Commission, European Economy 2/2005

As figure 5 above shows, the marginal tax rate faced by people leaving welfare is often above 80% or even 100% in many member states, particularly for those taking up low paid jobs. Italy and the UK have relatively few ultra-high marginal tax rates. Germany has a large number – for example the spouse of someone who is already working and has children would face an 84% tax rate even if he or she got a job at the average wage.

Are Tax Credits the way forward?

One labour market policy that has been successful in increasing employment in the US and the UK are Tax Credits, which supplement the income of low wage earners and create a financial incentive to enter the labour force. The US Earned Income Tax Credit (EITC) system originally set up in 1975⁵ has been credited with lifting more than 5 million people out of poverty.⁶ Approximately 19 million Americans⁷ take part

in the scheme which is designed to offset the burden of social security taxes, supplement earnings and complement efforts to help families make the transition from welfare to work.⁸

The UK's Working Tax Credits (WTC) and Child Tax Credits (CTC) introduced in April 2003 replaced the Working Families Tax Credit. The WTC is available to everyone over 25 years olds working more than 16 hours a week. The amount of credit depends upon hours worked, number of children and earnings. The CTC is paid to people on low incomes to help with the costs of bringing up children. Both the UK and US schemes are examples of refundable Tax Credits which means if the credit amount is larger than the family tax bill, the family receives a refund.⁹ This allows families to take advantage of the Tax Credit even if they owe little or no income tax.¹⁰

The Tax Credit system is a so-called "in-work benefit" that encourages those who are economically inactive or unemployed to enter the labour market by offering financial incentives which increase as earnings increase. In the case of the US' EITC the incentives increase until they reach a plateau approximately at the poverty level. They remain consistent and then phase out at high levels of income.

The WTC is slightly different, with a working condition of 16 hours and more generous benefits and a longer "drop out" at the end (i.e. it is phased out more slowly, and is available to higher earners). The disadvantage of the hours criteria is it creates a spike at the threshold level, as figure 6 below shows. This reduces the incentive to increase work efforts after the threshold.

The WTC encourages someone to get a job that consists of at least 16 hours of work, but there is little or no incentive to get a full time job because the marginal loss of benefits and leisure time outweighs the gains from higher wages. The WTC has a much larger phase out rate and income distribution. Although a longer phase out means there is a lower substitution effect, it increases the cost of the programme and the number of recipients with relatively high income.

Figure 6

A comparison of the EITC and WTC according to number of children



In the UK system, Tax Credits count as income in means tested benefits. This can outweigh the benefits that Tax Credits provide. Richard Blundell (2004) argues that this is “deliberate and ensures that there are no implicit tax rates on earnings exceeding 100%.”¹¹

The EITC can push up incomes by 40-60% depending on conditions. Someone earning \$6.25 per hour in the US would make \$12,500 per year. With the EITC and other benefits this gets pushed up to \$8-9 per hour or \$16-18,000 per year. In the UK a single mother who is earning £15,000 per year and works more than 30 hours can get £6,131 in tax credits, pushing her income up to £21,131 per year.¹² The WTC is reduced by 37p for every £1 of gross earnings in excess of the first income threshold of £5,220 per year.

In-work benefits in the EU

Several European countries have introduced Tax Credits systems, as shown in table 2 below, but they are modest in size and relative to the UK and US’ systems they have been of limited use in attracting people back to work.¹³

For example, Belgium has been operating an in-work benefit scheme called Credit d’impot. When it was introduced in 2002 it was subject to a maximum payout of €90 per year. This rose to just €496 in 2004. Belgium’s in-work credit is meant for individuals earning around the minimum wage.

Similarly an evaluation of France’s “Prime pour l’emploi” programme showed financial support to be very low, “accounting at most for 4.7% of declared income.” This compares to 40% on average for the US EITC.¹⁴

The French scheme also excluded those with the lowest earned income, the group that would have benefited the most from a Tax Credit system that reduced the unemployment trap.

Table 2: In-work benefits in each member state

Country	In-work benefits
Austria	Single-earners' Tax Credit Wage Earners' Commuting Tax Credit Children's Tax Credit Increased amounts in 2004 and 2005
Belgium	Limited Tax Credit introduced 2002
Denmark	Tax Credit 2004- where taxpayer can deduct 2.5% of earned income in calculation of taxable income
Finland	Earned Income allowance- calculated on basis of taxpayer's income from work
France	Prime pour l'emploi 2001- at least one person must work in a tax household. 2 parts to credit; variable part depends on number of hours worked, amount of lump sum depends on family situation, additional for child and spouse
Germany	Small benefit for those taking seasonal work Non-Income Family Tax Credit
Greece	Refundable Tax Credit- for low income families with children and in rural areas
Hungary	Employment Tax Credit- 18% of wage income earned Child Tax Credit
Italy	Tax Credits for employees Child Tax Credit Tax allowances which have introduced a "no tax area", leading to tax savings for low/middle income earners
Ireland	Back to Work Allowance- receive 75% of unemployment benefit for 3 years Enterprise Allowance- receives 75% of unemployment benefit for 4 years Part Time Job Incentive Scheme- Long term unemployed receive a weekly allowance Family Income Supplement- weekly payment for families at work on low pay

Table 2 continued: In-work benefits in each member state

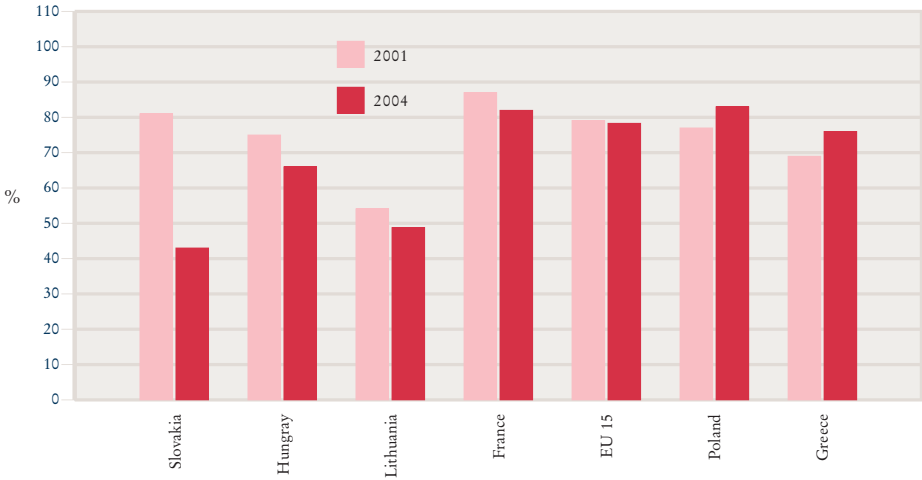
Country	In-work benefits
Luxembourg	Child Tax Credit
Netherlands	Combination Tax Credit for parents with children under 12 Supplementary Tax Credit for single parent families Tax Credit for organised child care, long term unemployed, job acceptance and old age
Poland	Non-refundable Tax Credit for all workers
Portugal	Limited Tax Credits which vary according to circumstances
Slovakia	Non-Wastable Child Tax Credit
Spain	Non-Wastable Tax Credit for workable women, and with children under 3. Women who work and contribute to a social security scheme get rebate of €100 per month for each child under 3
Sweden	Refundable Tax Credit- where 75% of social security contribution is returned to payer Non-standard relief Tax Credit- equal to 25% of the trade union dues and 40% of the unemployment insurance fee Special Tax Credit- for statutory minimum local income tax
United Kingdom	Working Tax Credit Child Tax Credit

Source: OECD 2006

Very few of the attempts to introduce Tax Credits so far have made a significant difference to the marginal rate of tax faced by welfare leavers. As Chart 7 below shows, only the reforms in Hungary and Slovakia seem to have made a significant impact. The majority of EU member states and the EU average are unchanged. The unemployment trap seems to have worsened in Poland and Greece.

Figure 7

Changing unemployment trap rates 2001-2004



Source: European Commission New Chronos database

Advantages of Tax Credits

There are several advantages to the Tax Credit system over traditional welfare provisions. Traditional welfare systems often provide high, means tested unemployment benefits that offer a disincentive to find work, creating an unemployment trap, as was outlined above.

Tax Credits have a positive participation effect, encouraging people with the promise of higher wages, to come off benefits and take up employment. The OECD estimated in 1995 that in the US the net replacement rate with EITC in a 2 children family was 63%. Without the EITC it would have been 97%.¹⁵

Tax Credits have also been useful in encouraging single parents back into work, a key target for the EU. The Lisbon Agenda set a target for a 60% employment rate for women and the challenges faced by an ageing population and declining birth rates means that it is important to encourage more women in to work. Tax Credits could help to achieve this. Evidence from the US suggests that the EITC has been responsible for increasing the labour market participation of single women with children from 62-81%.¹⁶

Tax Credits ensure people receive an income that is sufficient to avoid poverty whilst avoiding imposing high labour costs on employers. As the OECD argues “high non-wage labour costs can reduce demand for low-skilled workers...employment subsidies can be an important link between work that pays and is affordable for the low skilled.”¹⁷

They are also cost effective compared to traditional welfare programmes. The OECD in its 2005 report found that traditional welfare systems, which redistribute to non-working poor, meant that redistributing one additional euro to low income individuals required a reduction in welfare of the high income people by 2-4 euros¹⁸. In comparison the OECD found that the economic loss of redistributing to the working poor with Tax Credits is substantially lower. They argued that if Tax Credits were introduced in Denmark, Ireland, France, Portugal and Spain there could be an aggregate welfare gain, where one euro redistributed could lead to an increase in the income of higher earners.¹⁹

Tax Credits are not means tested, thus avoiding some of the stigma related to seeking benefits, and ensuring everyone that is eligible receives them. The EITC has a positive image and Scholz estimates the take-up is very high at around 80-85% of those who are eligible.²⁰

Some European countries have opted to introduce tax cuts instead at the lower end of the income threshold. The disadvantage with this is that it benefits the rich as equally as the poorest people and is fiscally “expensive”. As Raymond Gradus (2001) argues, “if the main objective of the tax reform is to reduce the unemployment among low skilled, an in-work Tax Credit is more effective than reducing the basic rate of income.”²¹

Conclusion

Although efforts have been made to make work pay and reform EU members’ benefit systems, the EU has a long way to go to achieve its objectives on employment and looks likely to miss the Lisbon target. Unemployment traps are still very high. Means tested benefits need to be lowered and Tax Credits such as the US’ EITC need to be adopted across the EU to tackle rampant unemployment.

Tax Credits offer a number of advantages over other in-work benefits and are preferable and more effective than tax cuts. They should not be viewed as a panacea for Europe’s employment problems, for they are good at encouraging people to enter the labour market but not so efficient at stimulating additional supplies of labour. In combination with improved education and other policies, Tax Credits can help the EU begin to approach the Lisbon Agenda targets.

- 1 Kok, W, Facing the Challenges, The Lisbon strategy for growth and employment, 2004, p7
- 2 “Over the last four years, the overall performance of the European economy has been disappointing. The economic upturn in Europe has been weaker than in the US and Asia over the past two years,” Kok, W, 2004, p11
- 3 Denmark, Netherlands, Sweden and the UK
- 4 Austria, Cyprus, Denmark, Finland, Netherlands, Portugal, Sweden and the UK
- 5 The EITC originally provided modest income tax rebates and has gone through a number of changes (1986, 1990, 1993, 2001)
- 6 Johnson, N et al, 2001, Center on Budget and Policy priorities, A Hand Up-how state earned income tax credits help working families escape poverty, p2
- 7 Beamer, G, 2005, State Tax Credits and making work pay in post-welfare reform era, The Policy Studies Organisation, Review of Policy Research, volume 22, no 3, p2
- 8 Johnson, N et al, 2001, p13
- 9 This is in comparison to a non-refundable tax credit which does not refund any excess credit to the taxpayer.
- 10 Johnson, N et al, 2001, p14
- 11 Blundell, R, 2004, Labour Market Policy and Welfare Reform: Meeting Distribution and Efficiency Objectives, De Economist 152, No 2, p241
- 12 HMRC, 2005, Child Tax Credit and Working Tax Credit a guide, p37
- 13 OECD, 2005, Welfare Reform in European Countries: A Micro simulation Analysis, paper number 28, p21
- 14 OCD, 2003, Making Work Pay Making Work Possible, p121
- 15 Doudeujns et al, 1999, Arbeitsanreize fur einkommenschwache Familien mit Kingdern, infor MISEP 66, p99

- 16 Ellwood, R.T., 2001, The Impact of the Earned Income Tax Credit and Social policy reforms on work, marriage and living arrangements, *National Tax Journal*, 53(4). Also see Meyer, B.D., and Rosenbaum, D.T., 2001, Welfare, the Earned Income Tax Credit, and the labour supply of single mothers, *Quarterly Journal of Economics*, 116(3)
- 17 OECD, 2003, Making Work Pay Making Work Possible, *Employment Outlook 2003*, chapter 3, p114
- 18 OECD, 2005, Welfare Reform in European Countries: A micro-simulation analysis, Paper no 28, p8
- 19 Ibid, p26
- 20 Scholz, J, 1994, The earned income tax credit: Participation, compliance and anti-poverty effectiveness, *National Tax Journal*, vol. 47, p 70-71
- 21 Gradus, R, 2001, Comparing Different European Tax's Policies Making Work Pay, *Info Studien 3/2001*

Barry Watts is a researcher at Open Europe and previously worked at the Centre for Economic and Social Inclusion, analysing recent welfare reforms in the UK.

