

Work Incentives

Introduction

A key aim of public policy is to ensure that work pays while achieving adequate income protection for the unemployed. This is particularly important in the case of young people in order to avoid locking them into long-term unemployment which has very negative economic and social consequences in the longer-term.

What does the data tell us about how we reconcile the need to provide adequate social protection with that of ensuring that disincentives to enter or rejoin the labour market are minimised? The EU Commission has published very useful data on this question¹.

Labour Market Performance

The employment rate of low-skilled workers² in 2013 was as follows

Ireland 49.1%

EU 28 61.1 %

Ireland ranking 22

We are one of the poorer performing EU Members states on this measure. So we have a problem in that about half of our low-skilled workers are unemployed.

Definitions

Economically inactive people are those who are not in work, but who do not satisfy all the criteria for unemployment under the International Labour Organisation (ILO) convention (wanting a job, seeking a job in the last four weeks and available to start work in the next two), such as those in retirement and those who are not actively seeking work. Unemployed people are those who meet the ILO criteria.

Work Incentives

The EU report uses two measures to assess work incentives. These are the inactivity trap³ and the unemployment trap⁴. The data is as follows

¹ Tax Reforms in EU Member States 2014, European Economy 6/2014

http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee6_en.pdf

² Low-Skilled workers are those aged 25-54, with only pre-primary, primary or lower secondary education.

³ **Inactivity trap** refers to the disincentive to return to employment after inactivity. The inactivity trap is also often referred to as the participation tax rate and refers to the part of the additional

Inactivity Trap for Single People 2012

	50% Average Wage	67% Average Wage
Ireland	87.8%	74.9%
EU 28	61.5 %	56.6 %
Ireland's Ranking (of 27)	25	25

Only Denmark and Netherlands are worse

Unemployment Trap for Single People 2012

	50% Average Wage	67% Average Wage
Ireland	86.7%	74.1%
EU 28	79.2%	75.2 %
Ireland's Ranking (of 25)	20	11

At the 50 % level only Belgium, Latvia, Netherlands, Denmark and Poland are worse.

The contribution of the tax system to these implicit marginal tax rates is less than 3% in the case of the inactivity trap and less than about 2 % for the unemployment trap at the 50% level and about 12% for the inactivity trap and 11 % for the unemployment trap at the 67 % level; this suggests that the problem seems to be arising mainly from the loss of benefits.

Such high effective marginal tax rates are at levels that would be unconscionable if applied to those at the top of the income distribution; why is this not the case at the other end of the income distribution ?

gross wage that is taxed away in the form of increased taxes (personal income tax, employee social insurance contributions) and withdrawn benefits such as unemployment benefits, social assistance and housing benefits in the event of an inactive person taking up a job.

⁴ **Unemployment trap** refers to the disincentive to return to employment from unemployment. It measures the part of the additional gross wage that is taxed away when a person returns to work from unemployment. It takes into account the reduction in benefit payments following the return to the labour market, as well as higher taxes and social insurance contributions.

Second Earners

Second earners sometimes face specific disincentives to returning to work from inactivity or to increasing the number of hours worked. Such disincentives usually arise from the tax system but loss of benefits can also play a role.

The employment rate and average hours worked for women (used as a proxy for second earners) is as follows

Employment of Women 2013

	Employment Rate	Average Working Hours
Ireland	65.6%	31.4
EU 28	72.7%	32.7
Ireland ranking of 28	23	25

Note : Employment rate is for age group 25-54. Female working hours refers to average number of usual weekly hours of employed persons in main job.

Disincentives to Work 2012

	Inactivity Trap	Low-Wage Trap
Ireland	46.6%	39.6
EU 28	39.7%	37.7
Ireland ranking of 26	3	8

Note : The inactivity trap is for second earner in a two earner couple with two children; principal earner with 67 % of average wage , second earner with 67 % of average wage.

The low-wage trap is for second earner in a two earner couple with two children; principal earner with 67 % of average wage, second earner moving from 33% to 67 % of average wage.

In Ireland less than one-third of the disincentive is due to the tax system.

Conclusion

Based on this data the disincentives to work for young people with low skills are high and need to be reduced. While the issue is clear, it is less obvious what to do about it. One route, not likely to be acceptable is to reduce benefits. Another is to extend the earnings taper. This looks more attractive but it pushes the traps further up the earnings distribution and is more costly. Another option is to make an in-work benefit like Family Income Supplement more generous and increase the take-up rate.