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## Unemployment and Income Support: Challenges for the Years Ahead

by  
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# Discussion

# **Unemployment and Income Support: Challenges for the Years Ahead**

Bruce Bradbury

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## **Abstract**

Though labour supply issues are not particularly important during recessions, they impose important constraints upon income support policy in periods of economic growth. How can income support policy for the unemployed best reduce poverty whilst encouraging maximal labour supply? Addressing this question in the light of the major changes occurring in the Australian labour market is the goal of this paper.

The main conclusions are that: policies such as labour market programs will be of great importance in offsetting changes in incentives due to falling wages; targeted (and perhaps generalised) wage subsidies will be an important part of this; greater regional variation in income support payments can be justified on both efficiency and equity grounds; and the growing commodification of female labour will require major changes in the administration of work and income tests for married couple families.

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# 1 Introduction

Income support payments are the primary means by which the Australian Government provides direct assistance to unemployed individuals. Whilst income support can have many goals, it seems clear that its fundamental goal in Australia is the alleviation of poverty among the unemployed.<sup>1</sup> This objective is subject to both fiscal and labour market constraints. The fiscal constraint stems from both the equity/efficiency trade-off over the appropriate magnitude of the taxes required to finance income support expenditure, and the competing demands for public expenditure. The resolution of these issues lies at the core of the political process of government.

The labour market constraint, on the other hand, represents the possible detrimental effect of income support on labour supply. Whilst this constraint is unlikely to be binding when unemployment is high (because there will be enough people to replace those who choose not to search for work), it may be of increasing importance with economic recovery. How can income support policy for the unemployed be best structured to be most effective in reducing poverty, whilst encouraging maximal labour supply as the economy recovers? Addressing this question in the light of the major changes occurring in the Australian labour market is the goal of this paper.

The paper is in four sections. In Section 2 some key transformations occurring in the Australian labour market are introduced. These include: the steady growth in the 'natural' rate of unemployment over the last two decades, the growth in long-term unemployment, the increasing importance of part-time work and the associated increase in married women's labour force participation, and the growth in wage inequality. Section 3 then discusses some of the key policy parameters of the income support system, and their relationship to these labour market changes. Particular issues addressed include: income support replacement rates and their impact upon job search behaviour, long-term unemployment and benefit duration,

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<sup>1</sup> Other objectives which have been suggested (and which in other countries may be more important) include: improving labour market flexibility by encouraging job search; maintaining consumption (both at the individual and aggregate level); and even using unemployment assistance to provide a floor for minimum wages.

poverty traps and the incentives for income support recipients and their spouses to undertake part-time work, and the potential role for regional variations in income support payments. The key policy recommendations raised in this discussion are summarised in Section 4.

## 2 Labour Market Transformations

Australia's structural (as opposed to cyclical) unemployment problem is illustrated in Table 1. This table shows the unemployment and long-term unemployment rates at the peak of the economic cycle prior to the last three major recessions. In 1973, at the end of a long period of economic growth, the unemployment rate was only 1.8 per cent. Unemployment increased significantly in the mid-1970s, and by 1981 at the end of the 'resources boom' was still 5.6 per cent of the labour force. After increasing again in the 1982-83 recession, unemployment was still slightly above this level in 1989 - despite six years of particularly strong economic growth after 1983. Meanwhile, the proportion of the unemployed who were unemployed for over one year (LTU) had risen from less than 5.3 per cent in 1973, to 21 per cent in 1981 to 23 per cent in 1989. The LTU almost made up as large a proportion of the labour force in 1989 as did all the unemployed in 1973.

This 'hysteresis'<sup>2</sup> in the level of unemployment (which has been shared by many other countries) has been ascribed to many causes, but one of the key suspects is income support policy. Similarly, the unlimited duration of unemployment assistance (UA)<sup>3</sup> in Australia and other countries has been described as a key reason for the continuing high rate of LTU (e.g. Layard, Nickell and Jackman, 1991). The strength of these arguments, and the best policy responses to the conflict between poverty alleviation and labour supply that they imply are discussed in Section 3.

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2 The term 'hysteresis' refers to the observation that the relationship of unemployment rates to other economic indicators (such as the rates of economic growth and inflation) tends to depend upon the past (and present) level of unemployment. For example, the level of unemployment consistent with a given level of inflation tends to be higher the greater is the past unemployment rate.

3 Income support for the unemployed has gone under several titles in recent years. Unemployment assistance is used here to encompass Unemployment Benefit, Job Search Allowance and Newstart Allowance.

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**Table 1: Long-term Unemployment Trends**

Year (August)	Unemployed/ Labour Force %	LTU/ Unemployed %	LTU/ Labour Force %
1973	1.8	5.3	0.1
1981	5.6	21.1	1.2
1989	5.7	23.1	1.3

Note: For 1973 LTU defined as 39 or more weeks. Other years 52+ weeks.  
 Sources: ABS, *The Labour Force, Australia*, Cat. Nos 6203.0 and 6204.0 various years.

Whilst unemployment continues to grow, the last two decades have also seen major changes in employment patterns. Part-time employment has grown at a much faster rate than full-time employment - rising from 12 per cent of employment in 1973, to 17 per cent in 1981 to 21 per cent in 1989. Associated with this has been a rapid growth in the labour force participation (both full and part-time) of married women. Their participation rate rose from 39 per cent in 1973, to 42 per cent in 1981 to 51 per cent in 1989. However women with unemployed husbands have largely missed out on this participation increase. By 1989, 62 per cent of married women with employed husbands were employed. Where the husband was unemployed, however, only 20 per cent of wives were working — the same fraction who were working in 1981.<sup>4</sup>

Whilst conclusive evidence on this does not yet exist, the most likely explanation for this low level of participation is the high effective marginal tax rate that applies to the family incomes of unemployment assistance recipients. As part-time employment becomes more important generally, this 'poverty trap' may also prove to be an impediment to the integration of the unemployed themselves back into the workforce.

<sup>4</sup> Source: ABS, *Labour Force Status and Other Characteristics of Families, Australia*, Cat. No. 6224.0, various years. See Bradbury (1992b) and Bradbury and Doyle (1992) for further details and a discussion of the impact of these patterns on income distribution trends. Other possible reasons for this association are also discussed in these papers.

High effective marginal tax and replacement rates are, if anything, likely to become worse due to falling real wages at the lower end of the wage distribution. A trend towards greater wage inequality in Australia since at least the late 1970s is now well established (see King, Rimmer and Rimmer, 1991, Gregory, 1993 and Borland, 1993). Whilst the causes for this are less clear, one potential explanation stems from the growing liberalisation of world trade markets in general, and Australian trade in particular, and the consequent exposure of low-skill workers in the traded goods sectors to competition from workers in newly industrialising countries (Forsyth, 1993). The more this trend continues, the more difficult will become the trade-off between alleviating poverty for the unemployed and providing incentives for the unemployed to enter low-wage employment.

### 3 Policy Responses

How should income support policy respond to these challenges? It is convenient to separate the discussion here in terms of the main parameters available to policy makers. These are: replacement rates, administrative requirements, benefit duration and benefit withdrawal rates (EMTRs). Whilst the focus here is on income support policy, it will become clear that this cannot be considered in isolation from other government policies on unemployment.

#### 3.1 Replacement Rates and Benefit Administration

The rationale for a concern with replacement rates is straightforward enough—if income support payments relative to disposable incomes when employed (**replacement rates**) are too high they might provide excessive incentives for the unemployed to reduce their job search effort. Whilst this is unlikely to be important in periods of very high unemployment (since there will be many people available for each job), when the economy is growing the pursuit of the poverty alleviation goal of income support may actually **cause** unemployment.<sup>5</sup>

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<sup>5</sup> More precisely, the incentive effect may be to increase effective **non-participation** (or reduce the degree of participation of those still maintaining some job search), among those conventionally defined as unemployed.

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To weigh up the importance of incentive effects against the poverty alleviation objective, however, it is necessary to know how strong they are. In this respect there is little consensus. Australian estimates of the effect of benefit levels (or the replacement rate) on aggregate unemployment levels (or durations) have ranged from elasticities of zero (McMahon and Robinson, 1984), to 0.4 (Gregory and Patterson, 1983).<sup>6</sup> The most comprehensive study has probably been that of Trivedi and Kapuscinski (1985) who estimated elasticities of between 0.2 and 0.3, which they considered lower bounds. Recent analysis by the present author has found no apparent behavioural impact of the decrease in replacement rates associated with the introduction of family payments for low wage workers, though this could be due to the unemployed not being fully aware of these changes (Bradbury, 1992a). In a survey of the international literature, Layard et al. (1991) conclude that the elasticity of unemployment duration with respect to benefit levels is probably between 0.2 and 0.9, though as Atkinson (1987) notes, none of the empirical results in this area can be considered particularly robust because it is difficult to find variations in replacement rates that are independent of other supply and demand influences. Thus whilst there is consensus that there are some incentive effects of benefit payments, there is little consensus as to how important these are.

From the policy perspective, however, it is important to recognise that benefit levels are not the only factor that can be altered to encourage the labour supply of the unemployed. Policy options of a more administrative nature include both 'carrots' (expansion in training and job subsidy programs, mobility assistance etc.) as well as 'sticks' (increased supervision, requirements to take on reduced-wage employment or to move to areas of labour demand etc.). The Swedish experience is often held up as an example where large 'carrots' are combined with some 'sticks' and high (short-term) replacement rates to yield low unemployment rates.

**In general, low replacement rates, attractive labour market programs and increased administrative supervision can be seen as alternative (or perhaps complimentary) mechanisms for encouraging labour supply.**

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<sup>6</sup> An elasticity of 0.4, for example, implies that a 10 per cent increase in benefit payments will lead to a 4 per cent increase in the level of unemployment.

Any one of these can be relaxed provided the others are maintained or strengthened. From the point of view of the labour market constraint, therefore, low replacement rates are not essential. The picture is however somewhat different with respect to the fiscal constraint. It is possible (though not necessary) that very low replacement rates combined with minimal labour market programs and low levels of administrative supervision may be the cheapest way of maintaining labour supply.

It is also interesting to note that replacement rates (or the rates of UA payments) do not appear to be the main unemployment policy difference between the current government and opposition. Rather the issue is more one of the appropriate balance between the carrots and sticks mentioned above. Since these disputes are primarily about the appropriate form (and extent) of the labour market programs that should be employed, they are not considered in detail here.

All this notwithstanding, it is true that the higher the replacement rate, the greater will be the demands on administrative and labour market programs in order to maintain labour supply. In this respect the increase in wage inequality, and the fall during the 1980s of the real wages of low wage workers,<sup>7</sup> is of great concern. These changes have led to an increase in replacement rates without any corresponding reduction in poverty. Whilst replacement rates are still well below 100 per cent, and Australian replacement rates tend to fall towards the middle of the distribution for OECD countries, further growth in wage inequality will place increasing stress on the income support system.<sup>8</sup> Indeed falling wages at the lower end of the distribution have already led to significant increases in replacement rates for families without children. In 1979, for example, the (after tax) replacement rate for a married man without children receiving a 10th

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7 See for example Bradbury (1992a) Figure 1.

8 For estimates of Australian replacement rates see Saunders, Bradbury and Whiteford (1989), Bradbury, Ross and Doyle (1991) and Bradbury (1992a). For international comparisons see OECD (1991, Table 7.3). The poverty alleviation orientation of Australian replacement rates means that they are relatively low for single people with short durations of unemployment, and couples with working spouses (who may receive no benefits), but relatively high for couples with long durations of unemployment and many children.

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percentile wage was 61 per cent. By 1990 this had risen to 72 per cent, mainly because of falling real wages.<sup>9</sup>

The only way to decrease replacement rates without increasing poverty is to increase the disposable incomes of people in low wage employment. The Family Allowance Supplement (FAS) already fulfils this role for families with children, and its introduction (along with the earlier Family Income Supplement or FIS scheme) meant that replacement rates for many men with children actually fell between 1979 and 1990.<sup>10</sup> This allowance is equal to the child supplement for pensioners and beneficiaries, and is available to low income families that are not receiving a pension or benefit. As income increases above a threshold, the allowance is withdrawn by 50 cents in the dollar of income (though many complications exist regarding the time period over which income is assessed; see Bradbury, 1992a).

It is possible that increases in wage inequality will eventually require a generalisation of this supplement to all low wage workers. Such a widening of income support would either increase the living standards of low wage workers (and hence increase labour supply), or else be 'shifted' onto employers,<sup>11</sup> leading to an increase in labour demand (some combination of the two is likely).

There are costs associated with such policies however, and in this case they are twofold. First, the increases in marginal tax rates due to the withdrawal of benefit might discourage increases in labour supply or human capital beyond that required for a minimum wage,<sup>12</sup> and second, increases in general tax rates (or reduced expenditure elsewhere) are required to finance

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9 See Bradbury, 1992a, Figure 2.5a. This needs to be seen in the context of the effect of increasing married women's participation on replacement rates (see Section 3.4 below).

10 This is in terms of entitlements. Whether the unemployed are actually aware of the payments available to them is another matter (see Bradbury, 1992a).

11 'Shifting' would occur if wages fell as a result of the introduction of the wage supplement.

12 In this respect an important feature of the FAS scheme is that in many cases the income test is based on incomes received up to a year previously, and so the present value of the income test is less than implied by the combination of the withdrawal rate and income taxation.

the payments.<sup>13</sup> The balance between these two costs is also open to policy manipulation. Thus a simpler alternative to a low-wage supplement is to increase the first tax threshold (people receiving FAS, for example, are usually also paying income tax). Assuming a progressive income tax structure were maintained, this would remove the high marginal tax rates associated with the withdrawal of benefit, but require higher marginal tax rates over the remainder of the income distribution. It is not a simple issue to decide which of these policies is welfare maximising, though we can say that the optimum policy may very well require higher marginal tax rates for lower income earners than for those with higher incomes (though average tax rates will continue to increase with income).

Indeed, low wage supplements have a lot in common with currently existing wage subsidy schemes such as the Jobstart program. Though the legal incidence of payment is different (employers receive the Jobstart subsidy) the effect of the subsidy is likely to be similar in the long run (particularly if low wages continue to fall). The distinguishing features of Jobstart, however, are that assistance is targeted to the most disadvantaged unemployed, and there is a limited duration of assistance. An extension of this type of program might be an appropriate half-way step towards a general low wage subsidy.

In this regard, it may be noted that the Federal opposition has advocated an alternative policy to Jobstart whereby long duration unemployed would be required to accept lower 'training wages' for a period. Whilst this may have the same labour demand outcomes as wage subsidies, the effects on labour supply will obviously be quite different (unless UA is reduced), and such a program would place additional stress on administrative mechanisms compelling the unemployed to search for work.

Finally, on the issue of replacement rates, it is of interest to reflect on the **national** nature of income support policy in Australia. One disadvantage of uniform rates of payment is that income support varies neither with the costs of living in various regions (housing costs are particularly variable), nor with patterns of labour demand. One rationale for keeping policy constant across the nation is to avoid contaminating the geographic price signals of

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13 Unless the labour supply response is so strong (which is unlikely) that UA expenditures decrease by more than the wage supplement expenditure.

the market. The constant rate of age pension, for example, provides an encouragement for pensioners to move to lower cost regions. In the case of the unemployed however, this incentive is perverse as housing costs, in particular, tend to be higher in areas such as the major cities where there is greater demand for labour.

The policy resolution to this issue, it would seem, is relatively straightforward: the variation of income support payments in line with living costs in the local region. One simple way of incorporating this into the present structure of payments would be to increase the proportion of payments paid as rent assistance, and vary the rental test thresholds in line with the average rent in the city (or country region) in which the recipient lives. This implies a higher rate of payment to the unemployed in the major cities, thus assisting both the poverty alleviation and labour market goals of income support. This rare concordance of outcomes assumes that housing costs both vary in line with labour demand and are the main variation in living costs. To the extent to which this is not true<sup>14</sup> the optimal policy will require some degree of trade-off between poverty alleviation and labour supply, but it is hard to believe that a more favourable trade-off could not be found than the present arrangement.

### 3.2 Long-term Unemployment and Benefit Duration

Long-term unemployment (LTU) is of great concern for several reasons. First, given the low level of income support available to the unemployed, this must constitute extreme hardship. Second, LTU may be expected to lead to deterioration in the skills and motivation of the unemployed, to both their own and society's detriment. Third, insider/outsider theories of wage determination suggest that as a result of these sorts of skill deterioration, or because of ranking phenomena,<sup>15</sup> the LTU are seen by employers as poor substitutes for the currently employed. Hence their presence has no influence upon wage bargaining, and hence there may be a higher 'non-accelerating-inflation rate of unemployment' (NAIRU) than if all the

14 For example, people in country areas have higher transport costs.

15 It will usually be the case that workers with the highest skill levels will leave unemployment earlier, implying that the LTU will have relatively low skill levels. Even if this is not the case, it is likely that employers will think that it is.

unemployed were of short duration. All these reasons suggest that for a given level of unemployment it is better to have many people with short durations than a few people with long durations.<sup>16</sup>

As Table 1 showed however, LTU is a continuing problem in the Australian economy. Even in 1989, after six years of strong economic growth, almost a quarter of the unemployed, or 1.3 per cent of the workforce, had been unemployed for a year or more.

A commonly advanced argument is that the unrestricted duration of unemployment assistance in Australia contributes to the current high proportion of long-term unemployment. The federal opposition, for example, proposed in its 'Fightback!' document the exclusion of many of the unemployed from income support after a nine month period of unemployment (though this policy was later amended). It is true that, in the absence of other policy changes, the withdrawal of income support is sure to encourage many unemployed to find some means of support, be it low wage non-award employment in 'peripheral' jobs, marginal self-employment, support from other family members, assistance from charities or crime. However the policy options are really more complicated than this. The best way to illustrate this is in a cross-national context.

Examining a range of OECD countries, Layard, Nickell and Jackman (1991) argue that benefit duration is important in reducing LTU (and indeed unemployment in general), but note that there are two distinct policy regimes under which this can be achieved. As in many social policy areas, the two polar examples are Sweden and the USA. Both of these countries have limited durations of unemployment assistance (though Sweden also has a supplementary assistance program<sup>17</sup>, and in some states of the US there is long-term assistance for families with children) and both have low LTU proportions. However Sweden also has a large commitment to labour

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16 There is a substantial literature on this topic. For Australian and international introductions see Chapman, Junankar and Kapuscinski (1992) and Layard, Nickell and Jackman (1991) respectively.

17 This appears to have been overlooked by Layard et al.

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market programs (LMP). These include mobility assistance, training, and if necessary placement in public sector employment.<sup>18</sup>

Table 2 shows these different policy approaches in the context of a wider range of countries. In 1988, a year of relatively high economic growth, both the level of unemployment and the proportion who were LTU varied widely across OECD countries. As well as these indicators, the table also shows the maximum duration of unemployment insurance (generally paid at a high replacement rate), the maximum duration of all forms of public income support for the unemployed, and an index of 'active' labour market program expenditure per unemployed person.

By the standards of this table, Australia, with its indefinite benefit entitlement, fares relatively well, with a lower LTU rate than most European countries.<sup>19</sup> However of those countries with lower LTU proportions than Australia, all have either short total durations of assistance, high expenditures on LMP, or both. With the exception of Italy, all the countries with higher LTU proportions have relatively long total benefit durations.

Whilst there are clearly many factors influencing the patterns shown in this table (and definitional differences in the variables must be one candidate), it does provide some support for the argument that limited benefit duration restricts unemployment duration. It also emphasises the wide variations in LMP expenditure. Sweden here is clearly an outlier, with LMP expenditure per unemployed over twelve times that of Australia, but there are many other countries with higher levels than Australia. Indeed, only Italy, Spain, the Netherlands and the USA spent less than Australia in 1988 (according to this index). On the other hand, limited durations of benefit entitlement imply increased poverty unless they are so successful in encouraging job search effort that the potential LTU actually find (well paying) work. The example of the US, with its high poverty rate (Smeeding et al., 1990), suggests that this is unlikely.

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18 The last option obviously comes under severe fiscal stress during recessions, but the emphasis here is on policies appropriate to periods of economic growth.

19 This must be qualified by the possibility that in countries with unemployment insurance, many short term unemployed youth may not be included in the unemployment statistics because they are not eligible for income support.

Table 2: Unemployment and LTU, Selected Countries (ranked by LTU %)

	Unemployment Rate % (average 1983 to 1988)	LTU as % of Unemployed, 1988 <sup>(b)</sup>	Duration of Unemployment Insurance (years), 1985	Duration of all forms of Income Support (years) 1985 <sup>(c)</sup>	LMP Expenditure per Unemployed Person, 1987 <sup>(c)</sup>
Belgium	11.3	78	1	indefinite	7.4
Italy	7.0	69	0.5	0.5	0.8
Ireland	16.4	66	1.25	indefinite	5
Spain	19.8	62	0.5	3.5	2.1
Netherlands	10.6	50	2.5	indefinite	2.7
Germany	6.7	47	1	indefinite	10.4
France	9.9	45	3.75	3.75	3.9
UK	10.7	45	1	indefinite	4.6
Denmark	9.0	29	2.5	2.5	7.9
Australia	8.4	28	none	indefinite	2.8
Japan	2.7	21	0.5	0.5	5.6
Finland	5.1	19	indefinite	indefinite	12.9
Austria	3.6	13	0.6	indefinite	11.3
Sweden	2.2	8	1.2	1.2?	34.6
Canada	9.9	7	0.5	0.5?	4.3
USA	7.1	7	0.5	0.5	2.4
Norway	2.7	6	1.5	1.5?	9.8

- Notes:
- a) LTU is 12 months or more.
  - b) 'All forms of income support' includes means tested assistance valued at over \$120 a month (for a single adult). Items have been denoted with a question mark where they appear to conflict with the results in OECD (1991, Table 7.3).
  - c) LMP expenditure is expenditure on 'active' labour market programs per unemployed person, expressed as a percentage of output per person.

Source: Layard, Nickell and Jackman (1991), Table 5 and Table A1.

The conclusion we can draw from all this is simply that, when there is economic growth, restrictive income support policy can be used to get LTU rates down. But the only way to decrease LTU without fundamentally compromising the poverty alleviation goal of income support is via increases in LMP expenditure. This may in turn involve compulsory participation requirements (as in Sweden), but with a sufficient fiscal commitment need not involve abandonment of the poverty alleviation objective.



### 3.3 Poverty Traps

A feature of the Australian income support system that is often noted is the way in which the income test and taxation systems can combine to produce very high effective marginal tax rates (EMTRs). The EMTR is defined as

$$\text{EMTR} = 1 - \partial D / \partial Y$$

where Y is non-transfer income and D is disposable income (= Y + transfers – income taxes). A high EMTR thus implies a small gain (or a loss if  $\text{EMTR} > 1$ ) in disposable income for each dollar increase in market income (such as from part-time or casual employment). Given that workforce decisions are usually made in more discrete units (e.g. an extra day's work or not) a more useful concept may be the effective 'discrete' tax rate, defined as

$$\text{EDTR} = 1 - \Delta D / \Delta Y$$

This describes the change in disposable income when non-transfer income changes by some discrete amount. It can easily be shown that the EDTR will equal the weighted<sup>20</sup> average of the EMTRs over the income range in question. Hence what matters is the presence of high EMTRs over a wide range of incomes. For UA recipients, EMTRs are higher than the top marginal tax rate once private income rises to \$30 per week, and for those with children may reach 120 per cent over the income range where the 20 per cent base income tax rate is combined with the dollar for dollar withdrawal of non-taxed child allowances (Gallagher and Ryan, 1992). This situation is accentuated when the income tests associated with many government services are included.

Since both are a measure of the relative attractiveness of different amounts of non-transfer income, it is not surprising that there is a close relationship between the EDTR and the replacement rate (RR). Letting D(w) equal the disposable income when the person has a wage income of w, the EDTR between a wage of 0 and a wage of w is  $1 - [D(w) - D(0)]/w$ . The replacement rate is  $D(0)/D(w) = 1 - [D(w) - D(0)]/D(w)$ . When the wage is lower than the tax threshold ( $D(w) = w$ ) then the replacement rate will equal

<sup>20</sup> That is the average of the EMTR rates weighted by the income range over which they apply.

the EDTR. If the wage is high enough to attract tax (the usual case in Australia) then  $D(w) < w$  and so the replacement rate will be less than the EDTR.<sup>21</sup> Here the convention of using the EDTR (or EMTR) to describe the disincentives to part-time work is followed.<sup>22</sup>

As well as being of relevance to labour supply concerns, it seems a fairly common perception that having a larger EMTR for low income groups than for those with high incomes is inequitable. Why should the poor face a higher effective tax burden for each additional dollar than the rich? This question, however, is based upon a misleading view of distributional equity. What counts for equity is the distribution of disposable incomes, and these depend not on the marginal, but on the **average** tax rate (which is negative for income support recipients).

If we are to keep total expenditure constant (and assume no change in behaviour), EMTRs can only be reduced by reducing the base rate of payment. Alternatively, if expenditure is to be increased, it is not at all obvious from an equity perspective whether it is best to direct that expenditure to those with the lowest private incomes by increasing the base rate (whilst holding withdrawal rates constant), or to direct it to those with some private incomes by reducing EMTRs.

Equally, it is not obvious that high EMTRs are an inefficient solution to the distributional objective of income support. One rationale for high EMTRs for the unemployed (as opposed to pensioners for example) has been to reinforce the search for full-time rather than part-time work. That is, the goal is to place high marginal tax rates where people would not be expected to locate in the absence of transfers, whilst using optimally redistributive average tax rates at other income points. Indeed from this perspective,

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21 If there are wage subsidies (such as FAS), then  $D(w) > w$  and  $RR > EDTR$ .

22 When we take into account the fact that wage rates can vary between persons (this is not the main focus here) then a case can be made that the replacement rate is a superior analytical tool. Thus the RR describes the financial trade-off between not working and working a given number of hours (which in principle need not be full-time work), whilst the EDTR describes the disposable income effect of a given change in gross income. The working hours required to generate this income will vary from person to person. In the present context however, there is no compelling reason for preferring one measure over the other when measuring incentive effects, though it is more conventional to use the EDTR (or EMTR) to describe the disincentives to part-time work

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Bascand (1987) outlines the welfare advantages in having infinite (or 'sudden death') withdrawal rates, where people lose all their benefit at a given income level. As Bascand notes, however, such an extreme system could discourage employment that might otherwise be undertaken for the development of human capital. In addition, we might note the uncertainty costs associated with 'sudden death' benefit withdrawals.<sup>23</sup>

Whilst the conventional arguments in favour of high marginal tax rates may thus have merit, the problem now is that the assumptions about the incidence of these tax rates are breaking down. In particular, the increase in part-time and low wage work means that the assumption of the non-relevance of the high EMTR bands is no longer applicable. That this transformation suggests a major efficiency burden is most apparent in the case of married women whose husbands are receiving unemployment assistance. Some issues associated with assistance for married couples are considered next, before a more general discussion of alternative income-testing policies.

### 3.4 Married Women's Employment

The growth of married women's employment poses particular challenges for the design of income support. In particular, these changes raise fundamental questions about the appropriate definition of the unit for assessment. The present Australian system is predicated upon the traditional husband breadwinner, plus dependent spouse and children. This has elements of both individual and family entitlement assessment. Thus **eligibility** for income support is assessed on the basis that one individual is looking for work, but the assessment of the amount of income they receive (which is generally termed **entitlement**) depends upon their family composition and income. There is no restriction on both husband and wife looking for work (e.g. they can both seek assistance from the CES) but from the point of view of UA assessment the labour force status of the second member is irrelevant (though their income is not).

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23 These costs are most apparent for pensioner fringe benefits, where there may be uncertainty about the value of the fringe benefit, as well as the question of whether a particular work or savings choice might place the pensioner over the limit.

One implication of the family assessment of entitlement is that the wives of unemployed men share the very high effective marginal tax rates described above. This is particularly important because of the prevalence of part-time work and/or low wage rates among married women. These high marginal tax rates are undoubtedly one reason for the low level of employment among wives of unemployed men. If the expansion of labour demand continues to be in traditionally female areas of work then this pattern could imply a major efficiency burden. Moreover, there are important equity issues associated with this concentration of non-employment. That is, as the two earner family becomes the norm, the income gap between the average family, and the family with neither husband nor wife working increases. This implies a greater economic and social isolation of the unemployed (particularly the long-term unemployed). Similarly, it means a decrease in the main replacement rate facing employed married people (i.e. the ratio of a disposable income based on one wage to an income derived from two full-time wages will usually be less than the corresponding ratio of income support to one wage). Unemployment assistance will be even less effective in maintaining the consumption level of families.

Since the essence of this problem is family-based assessment of entitlement, is an adoption of an individualistic assessment procedure a possible solution? Applying the income and asset tests to the income of the individual might also foster a greater degree of integration with the (primarily) individually-based taxation policy. This change would mean that an unemployed husband could receive full income support irrespective of his wife's income. Similarly the high marginal tax on the earnings of the wives of unemployed men would be removed.

The key problem with such proposals, however, has always been seen to be one of cost. But entitlement is only half the story. Moving towards a fully individual basis of assessment for **eligibility** could lead to fiscal savings. Indeed this seems to be the direction in which policy is heading. Since 1990, eligibility for UA payments for young married recipients has been assessed on an individual basis. Where both husband and wife are aged under 21 (and have no children) both must satisfy the work test to receive full benefits (if only one satisfies the work test they receive half the married rate of assistance). Entitlement, however, is still assessed jointly. This combination of individual and family assessment is of course the one that

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implies least government expenditure, and hence we might expect suggestions in the years ahead to extend this to all UA recipients.

However there are some problems with such a policy shift. The most important is that the pattern of division of labour within the household is still very much in a state of flux, with widely differing expectations held by different parts of the community. However it is likely that the growing commodification of female labour will mean that a shift towards an individual basis for the assessment of income support eligibility is inevitable. Under such a system individuals would be eligible for state income support on the basis of certain specified characteristics such as age (children and the elderly), ill-health, job search or caring responsibilities. If it is desired to maintain the targeted nature of the current income support system, however, (the assumption of) income sharing within the household implies that the assessment of entitlement will still remain family based. This means that for married couples without children, the work test will ultimately be extended to both members of the household, whilst the income test would remain similar to its current structure.

Whilst such a change will remove what will increasingly seem to be an anomaly (that only one member of a couple need look for work), it does not of itself address the question of the high EMTRs for people such as married mothers (or increasingly fathers) for whom part-time work may be the norm. The key to dealing with this problem lies in the structuring of income tests to suit the most likely patterns of labour force participation.<sup>24</sup>

One possible scenario might be for one member of a couple to be designated as a 'primary carer' based on the extent of workforce experience prior to the receipt of UA. The job search requirement would not apply to this person. The base level of income support would be determined with reference to family composition and characteristics as at present. The income test however, would operate as follows. For the non-carer an income test would apply in a similar fashion to the present system. The primary carer would, however, have a much wider free area (or possibly an income range with a low withdrawal rate), followed by a 100 per cent (or higher) withdrawal rate at higher wages. This would be structured to make part-time work

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24 It should be clear that this very 'tailored' approach is thus quite the opposite of the uniform approach suggested by guaranteed minimum income (GMI) proponents.

worthwhile, but to taper out below a low full-time wage.<sup>25</sup> Couples with children could choose to be assessed under either this system or the one applying to couples without children.

Such a revised income support system for married couples will increase the incentives for married women to work part-time, and if the work test is applied to both members of a couple, will increase the job search of married women without children. But should a much more far reaching accommodation with part-time work be made?

### 3.5 Part-time Employment

Part-time work is now by no means confined to students, married women and people near retirement (though these groups continue to form the bulk of part-time workers). Even before the current recession in 1989, and among men aged 25 to 54, some 3.4 per cent of workers were working part-time. This compares with 2.9 per cent in 1981 and 1.5 per cent in 1973. Should unemployment assistance be changed to cater for part-time work in all demographic groups?

This would require the abandonment of income and job search tests predicated upon the search for full-time work. However it is doubtful that things have changed so much, or are likely to change, so as to justify a wholesale reorientation of income support in this way. Irrespective of the increases in firms' demand for casual and part-time labour, part-time work remains to a large extent a supply response. After all (particularly in a tight labour market) people can often combine several part-time jobs to reach full-time earnings (though there are costs in doing this).

More relevant is a partial reorientation of unemployment assistance to allow for part-time employment as a **transition** to full-time employment. This will be particularly relevant if much of the workforce of the future does have to match several part-time jobs to attain an adequate income. For the long-term unemployed in particular, this seems to offer a means of re-integrating such people into the workforce. How can the income test be altered to remove the poverty trap that currently makes such employment

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25 The thresholds might vary with numbers and ages of children.

not worthwhile (or forces the unemployed to attempt to deceive the Department of Social Security)?

The problem of removing high EMTRs has been spelt out above. Unless low wage subsidies are to be significantly expanded, or the base level of assistance reduced, there is only limited scope for a poverty trap alleviation. For example, in August 1990, the after-tax income of a married man (with no children) and with a wage at the 10th percentile<sup>26</sup> was \$326 per week. That is, 10 per cent of married men had disposable incomes below this level. Unemployment benefit for the same man expired when private income reached \$273 per week, or \$293 per week if he was receiving rent assistance. If real wages at the lower end of the distribution continue to fall this gap will close even further.

Whilst some small easing of the income test is possible a more appropriate liberalisation might be to change the **time basis** of the income test rather than the actual thresholds. In 1988 the Social Security Review recommended that an earnings credit be introduced for the long-term unemployed (as currently applies to pensioners) (Cass, 1988). This recommendation was partly taken up by the government in the 1993 election campaign where they proposed a limited earnings credit to be introduced in 1994 (Keating, 1993). Earnings credits permit recipients who have no other income to accumulate their free area allowance up to a maximum of \$500 (the earnings credit for pensioners is twice this amount). When the person does have some part-time or casual employment the income test is applied to the income received after the accumulated credit has been deducted. The objective of the earnings credit is thus to encourage **casual** work rather than permanent part-time work. This is probably more in keeping with the full-time job search goal of unemployment assistance.

This discussion is based on the assumption that we might wish to **encourage** the unemployed (particularly the LTU) to undertake some part-time or casual work. The logical alternative is to leave the income test as it is (or tighten it) but to **require** the unemployed to engage in part-time work, that is, to 'work for the dole'. One important impediment to such schemes is finding the jobs for these people to participate in (and the problems of

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26 That is the 10th percentile of wages for married men working full-time. This estimated is derived from the calculations in Bradbury (1992a).

displacement and substitution implied by any job creation programs). Setting this aside, it is important to be clear of what the element of compulsion implies. Unless the unemployed are manifestly irrational, a compulsion to work for no or little increase in income must mean a decrease in welfare (if it did not they would choose to work). This indeed is seen by some supporters as a positive feature, lessening the attraction of income support and hence encouraging (full-time) job search.

Whilst there are many factors to be taken into account in determining the cost/benefits of this approach, the key issue is distributional. Making income support receipt as unpleasant as possible may lead to efficiency gains, but ultimately it is little different from reducing the level of assistance to the unemployed, and needs to be assessed in terms of the same distributional concerns (and associated negative externalities).

#### **4 Summary and Conclusions**

What suggestions for the future conduct of income support policy can be drawn from this survey? We should start by recognising that in the short-term, with high unemployment and a sluggish economy, the issues of labour supply considered here are not important. The key constraint upon the poverty alleviation goal of income support is fiscal, rather than related to labour supply. It is in the medium and longer term, when we might hope to see a recovery in labour demand, that the labour supply constraint discussed here will be important. Right now, however, is when we should be planning for such an eventuality.

Replacement rates, whilst a potentially important policy variable, must be seen in the wider context of the administration of income support and labour market programs. If the joint goals are the minimisation of poverty and maximisation of labour supply, then high replacement rates combined with extensive labour market programs and strict administrative requirements should be the preferred policy. The main limitations on such a strategy are the economic and political fiscal constraints.

One major concern for the future however, is that falling wages may worsen the trade-off between poverty alleviation and labour supply incentives. Some form of low-wage supplement may ultimately prove to be the only

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way to offset the replacement rate increase due to falling wages without increasing poverty. However such a policy carries efficiency costs, and it will be difficult to judge where best to allocate the increases in marginal tax rates that will be required under such a program. Less costly will be targeted wage subsidies, such as currently exist in the Jobstart program. These will probably be more efficient in reducing unemployment, though not sufficient to address the general problem of a more divided society.

More immediately, there do seem to exist opportunities for 'fine-tuning' income support policy to achieve a better trade-off between poverty alleviation and labour supply. Greater regional variation in income support payments, in particular, has the potential to simultaneously address variations in needs, whilst providing some encouragement for the unemployed to move to areas of greater labour demand. Options also exist for minor easing of the income tests to assist gradual re-entry to paid work. The proposed introduction of an earnings credit is an important step in this direction, and there does not seem to be any reason why these cannot be made as generous as currently applies to pensioners (at least for the long-term unemployed).

Whilst these are relatively minor changes, many commentators have argued for a much more far-reaching transformation of income support. It has been suggested that the problem of long-term unemployment can be reduced by limiting the duration of income support receipt. Similarly it has been proposed that the long-term unemployed should 'work for the dole' or be compelled to accept below-award wages. The key objection to these policies is distributional, together with the negative social externalities that can follow from excluding people from socially recognised forms of subsistence. Moreover, the stigmatised status of the LTU may mean that very low wages indeed will be required to ensure adequate demand for their labour. This will make the enforcement of their labour supply more difficult

One feature that is often described as an unintended consequence of a focus on poverty alleviation is the high effective marginal tax rate facing UA recipients. There are, however, sound grounds for maintaining high EMTRs, so long as full-time work is the norm. The area where this assumption is most strongly challenged is with respect to the employment of mothers of young children (eventually fathers also). There is good reason to believe that the low rate of employment of the wives of income support

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recipients is due to the high EMTRs on part-time and low wage work. It has been argued here that this implies a more targeted approach to income testing may be effective in increasing labour supply. This could involve offering a lower marginal tax rate for part-time work to the principal child carer in married couple income units.

More generally, the growing commodification of female labour means that the 'dependent spouse' assumption of income support cannot be retained for much longer. Job search requirements have already been introduced for non-adult spouses of UA recipients (with no children). Finding a way to extend this to older age groups, whilst recognising the wide variations in the social norms concerning women's labour market participation, will be a major challenge for income support administration.

Finally, whilst the focus of this paper is quite deliberately on the system of **income support** for the unemployed rather than the whole system of government unemployment assistance, this does not imply a disregard for other components of that assistance, nor a rejection of the central role of labour market programs in providing assistance to the unemployed. Indeed, one of the key points made above is that labour market programs are of great importance and may indeed be required to lift (or maintain) replacement rates without undesired behavioural responses. Nonetheless, income support remains a key element in government policy to assist the unemployed, and careful design is needed to ensure that it can achieve its competing objectives most successfully.

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