Replacement Rates 2012

Introduction

1. This paper updates TSG paper 11/14. Findings from an analysis of current hypothetical replacement rates (for a number of household types at a variety of income levels) are presented and related issues discussed.

2. Replacement rates, or replacement ratios, are typically used to measure unemployment traps. Such traps occur when a person's net income when unemployed compares favourably with his/her net income when employed thereby resulting in a disincentive to work. The higher the ratio, the greater the disincentive to work.

$$\text{Replacement Rate:} \quad \frac{\text{Net Income when unemployed}}{\text{Net Income when employed}}$$

3. For this paper, hypothetical cases are used and a number of replacement rates produced for various household types and at a range of in-work income levels.

Replacement rates matter

4. General labour market economic theories support the view that high replacement rates act as disincentives to work while evidence from empirical studies is mixed but on balance shows a link between replacement rates and duration of unemployment.

Replacement rates should be interpreted with caution.

5. Financial incentive effects vary with individual circumstances and characteristics e.g. sex, age, presence of dependents, household makeup and location. Replacement rates depend entirely on what is included in their calculation e.g. the particular social welfare payments, the timing of the claim or in-work income comparators. Non-quantitative factors such as a person's location and the existence of individual job opportunities are also important. Some caution is required therefore in interpreting replacement rate results and their use in changing policy proposals.

What is a high replacement rate?

6. Given the individual nature of the decision to work there is no specific cut-off level of replacement rate that constitutes a disincentive. It is generally prudent to pay particular attention to replacement rates of 70% or more given the basis of the calculations in this analysis. Changing trends in replacement rates should also be monitored.

Current Context

7. Since 2008 we have experienced a sudden acceleration in unemployment with levels now at 14.8%[1]. The experience of previous high unemployment rates raises

[1] Seasonally adjusted Standardised Unemployment Rate (SUR) July 2012.

concerns particularly in terms of the lagged rates of recovery in employment relative to economic recovery. High unemployment rates of between 13% and 17% were seen in Ireland from the early 1980s right through to the mid-1990s. Even with GNP growing annually by generally more than 5% between 1987 and 1992 a sustained fall in unemployment was not seen to begin until 1994. One of the factors which contributed to this was weak employment incentives due to the tax/benefits system.

8. Jobseeker rates of Social Welfare payments almost doubled over the period 2001 to 2009 from €106.66 to €204.30. The rates are now €188 weekly. The level of Social Welfare payments to those of working age still needs to be monitored particularly in the medium term given the disincentive effects associated with high replacement rates. This is particularly relevant in the context of high unemployment and particularly rising long-term unemployment in terms of striving to avoid a repeat of the lagged response seen in the 1980s.

9. High replacement rates are often cited as contributing to the persistence of unemployment. Current unemployment policy needs to keep people close to the labour market so that when employment opportunities arise they are in a position to take them up. It needs to pay particular attention to the risks of long-term unemployment. Replacement rates represent just one strand in labour market activation policy. Measures such as increased interventions in a period of unemployment, training and education, targeting of those at risk of long-term unemployment, improved anti-fraud initiatives and stronger enforcement of conditions attached to entitlements all contribute to labour market activation.

10. The Government published its 'Pathways to Work' statement on labour market in February 2012. Pathways to Work" is based on five strands:

- more regular and ongoing engagement with the unemployed
- more targeted activation places and opportunities
- incentivising the take-up of opportunities
- incentivising employers to provide more jobs for people who are unemployed, and
- reforming institutions to deliver better services to the unemployed.

Approach to compilation of 2012 replacement rates[2]

11. In-work income levels used are National Minimum Wage (NMW), 67% of Average Wage (AW), Average Wage[3], 150% Average Wage, and 200% Average Wage. The figures used in determining replacement rates are based on the latest available CSO AW data at the time the replacement rates were compiled. Last year's paper used Average Industrial Earnings (AIE), however the CSO no longer publish figures for AIE. This is in line with the OECD approach where Average Wage is used. Due to the change in estimation, we have reproduced 2011 replacement rate

[2] Full details of the calculations are available separately.

[3] The Average Wage is calculated by the CSO using all sectors of the economy except agriculture. It includes all grade levels from Management to Manual Labour. Self-Employed people are not included in the calculations.

calculations using an AW figure so that a comparison between 2011 and 2012 can be made. Further detail on this is in paragraphs 25 and 26.

12. The family structures used relate to Jobseekers (one-earners in the case of couples) and One Parent Families. For Jobseeker households replacement rates are produced for a single person, a couple with no children and couples with one, two, three and four children while for One Parent Family households replacement rates are produced for those with one, two and three children. The Child Benefit data for 2011 shows that 41% of families had one eligible child, 36% had two, 17% had three and 5% had four eligible children. Jobseekers data relating to 2011 increases for qualified children (IQCs) shows that Jobseekers with between 1 and 4 children account for almost 99% of cases while 95% of OFP recipients have 3 or fewer children.

13. Included in the calculation of in-work income are income from employment, taxation (couples treated as married), Pay Related Social Insurance (PRSI), Universal Social Charge (USC), Spouse's entitlement to Jobseekers Allowance (Spousal JA[4]) for a couple with no children, Family Income Supplement (FIS) or Spousal JA for a couple with children, depending on which payment is more beneficial, One-Parent Family Payment and FIS (for a one-parent family) if applicable and Child Benefit. Fuel allowance is not incorporated in these figures though in certain instances it may be payable with Spousal JA or when OFP supplements in-work income – its inclusion would have the effect of reducing replacement rates in those cases.

14. Out-of-work income includes the main Social Welfare payment (maximum rate payable of Jobseeker's Allowance or One-Parent Family Payment), Fuel Allowance, Child Benefit.

15. A variety of replacement rates were produced in addition to the standard replacement rates, to consider (i) maximum disincentive effects relating to rent supplement (ii) CE Scheme income for One Parent Family Payment recipients, and (iii) two-earner household disincentives. (iv)This year we have also looked at the disincentives to joining the regular workforce associated with participation in the Tús and CE Schemes operated under the aegis of DSP.

Main Findings

(a) Impact of Budget 2012 Changes

Main Budget 2012 changes

16. There were no reductions in the primary rates of payments such as Jobseeker's Benefit and Allowance.

[4] Spousal JA is the spouse/partner's residual entitlement to Jobseekers Allowance (JA). If an unemployed person who is claiming for an adult dependent takes up low paid work, his/her spouse may be entitled to a JA payment in his/her own right. The amount of this payment will depend on the working spouse's income. For families with children the more beneficial of either FIS or Spousal JA is included in the replacement rate calculation.

17. Child Benefit for the third and subsequent children was reduced. For the third child there is a new rate of €148 per month which is down from €167 in 2011, a €19 reduction. Child Benefit for the fourth and subsequent children is now €160, down from 2011 rate of €177, therefore a reduction of €17. There will be further reductions in the rates for third and subsequent children in 2013 when Child Benefit rates will be aligned at €140 for all children. (Note that Child Benefit as a universal payment is included on both sides of the RR calculation. The impact of reductions will affect out-of-work income more as Child Benefit will typically be a bigger proportion of out-of-work income than in-work income).

18. The USC entry point changed. From January 2012, people who earn less than €10,036 are exempt from paying USC, up from €4,004 in the previous year. The rates have remained the same.

19. The season for fuel allowance of €20 per week was reduced to 26 weeks in 2012 from 32 weeks in 2011.

20. There were changes made to the Rent Supplement minimum contributions. The minimum contribution for a single person increased from €24 to €30 per week. There was also a new minimum contribution rate brought in for couples set at €35 per week up from €24 per week in 2011.

21. The means test for the One-Parent Family Payment (OFP) was amended in January 2012. The amount of earnings disregarded in the means test was reduced from €146.50 to €130.00 per week in 2012 for new and existing recipients. This will be further reduced to €110 in 2013.

22. New entrants on the Community Employment Scheme are no longer entitled to another Department of Social Protection payment. Existing scheme members can continue to claim other welfare payments until their current community employment placement ends.

Impact of Budget 2012 changes on Replacement Rates

23. For jobseekers the effect of Budget 2012 measures has been to reduce basic replacement rates in most cases by between 0.1 and 0.7 percentage points. The replacement rate reductions were greatest for single persons at NMW and 67% AW. This was due to the reduction of the fuel allowance season from 32 weeks to 26 weeks. Couples with 3 and 4 children at earnings between NMW and 200% AW also experienced larger replacement rate reductions due to the reduction of the fuel allowance season and Child Benefit reductions.

24. For one-parent family payment (OFP) recipients, the basic replacement rates were reduced by around 1.7 percentage points for in-work income levels up to AW while smaller reductions applied above these earnings levels. This was due to the fuel allowance season reduction and changes to the means test for OFP.

Budget 2012 measures have generally resulted in reduced replacement rates.

Change in Nominal Wages – potential impact on replacement rates

25. The AW figures[5] used for this analysis are on a different basis to the AIE figures that were used in last year's paper. The earnings figure used in last year's paper was €33,296 (AIE) while the AW figure in this year's paper is €35,959. However, we have recalculated the 2011 replacement rates using the 2011 AW to allow for a proper comparison between the two years.

26. The AW used for 2011 is c. €693.80 per week or €36,077 per annum, while the AW used for 2012 is c. €691.50 per week or €35,959 per annum. This is a 0.33% decrease on 2011. For all replacement rates except the NMW calculations, this reduction in the AW would and would have a slight upward effect.

(b) <u>Jobseekers</u>

Jobseeker One-earner families (One earning compared with no-one earning)

27. Prior year earnings data relating to Jobseeker Assistance and Jobseeker Benefit claimants previously pointed to the significance of the two lower in-work income levels i.e. 67% AW and NMW. Of the six Jobseeker one-earner households examined at these income levels, seven of the twelve basic replacement rates calculated are over 70% as illustrated in the table below. However, the Replacements Rates for those seven households have reduced by an average of 0.45 percentage points on 2011 levels, mainly due to the fuel allowance reduction from 32 weeks to 26 weeks and the reduction in Child Benefit for families with 3 or more children.

<u>Jobseeker One Earner - Basic Replacement Rates 2012</u>

	NMW	**67% AW**	**AW**	**150% AW**	**200% AW**
	€17,542	***€24,093***	***€35,959***	***€53,939***	***€71,918***
Single	61%	49%	36%	28%	23%
Couple	68%	63%	55%	41%	34%
Couple + 1Child	72%	67%	60%	46%	39%
Couple + 2 Children	75%	71%	66%	52%	44%
Couple + 3 Children	77%	73%	67%	57%	48%
Couple + 4 Children	76%	72%	66%	61%	53%

28. The table also illustrates that replacement rates can be expected to fall as in-work income levels rise and that they typically rise as household size increases (due mainly to the fact that social welfare payments take dependents into account while direct income from employment does not).

[5] The figures used in determining replacement rates are based on the latest available CSO AW data at the time the replacement rates were compiled. Due to the change in estimation, we have recalculated 2011 replacement rates using the AW figure for 2011 so that a comparison between 2011 and 2012 can be made.

2012 RR figures for couples with children show disincentives to take up employment at low income levels even where in-work income at these levels is supplemented by social welfare payments in the form of FIS or Spousal JA.

Impact of Inclusion of Rent Supplement

29. When rent supplement[6] was included in out-of-work income figures, replacement rates were shown to rise significantly across all categories of Jobseeker (by approx. 25 percentage points in many cases using Dublin rent levels and 15 percentage points using rural rent levels). The impact on replacement rates for one parent families was similar.

30. Data from the Department of Social Protection indicates that the proportion of Jobseekers Allowance/Benefit recipients in receipt of rent supplement was approx 11.7% in 2011[7]. It is important to note that in calculating these rates, we have assumed that each household receives the maximum amount allowable of rent supplement in both Dublin and in the rural areas.

31. Replacement Rates including Rent Supplement for 2012 have fallen by an average of 5 percentage points for Jobseekers and One-Parent Family payment recipients compared with 2011. This is mainly due to the Budget 2012 measure and the lowering of maximum rent levels between 2011 and 2012.

Two-Earner Replacement Rates (One spouse earning compared with both earning)

32. Replacement rates for two-earner households in these examples are shown in the table below to be notably high across all categories in terms of the disincentives for the second spouse to take up employment at NMW. It should be noted that households where Spouse 1 is earning the AW (c. €35,959) and has none or one child, then there is no entitlement to FIS or to Spousal JA[8] for Spouse 2. For most households spousal JA is payable at reducing rates up to where Spouse 1 is earning at AW (€35,959). FIS is more beneficial than Spousal JA for couples with 3 children where the spouse is working at AW and for couples with 4 children.

[6] Rent supplement is included to show the maximum disincentive effect using maximum rent levels in place from January 2012. Unless unemployed for more than a year and subject to a means test, many unemployed would completely lose their entitlement to rent supplement if they took up work at greater than 30 hours per week. This has implications in terms of discouraging a return to full-time work. Maximum disincentive effects however will not apply to a significant number of recipients.

[7] Social Welfare Statistical Report 2011 pages 39 and 89.

[8] Spousal JA in the two-earner examples refers to the potential entitlement to Jobseeker's Allowance for the spouse who is not in work. The amount of this payment will depend on the working spouse's income.

Two-Earner Basic Replacement Rates 2012 -

*(The financial disincentive for second earner to take up a National Minimum Wage job)

	NMW €17,542	67% AW €24,092	AW €35,959	150% AW €53,939	200% AW €71,918
Couple	**73%**	**70%**	**67%**	**73%**	**76%**
Couple + 1Child	**79%**	**76%**	**70%**	**75%**	**78%**
Couple + 2 Children	**84%**	**80%**	**72%**	**76%**	**79%**
Couple + 3 Children	**85%**	**85%**	**78%**	**76%**	**79%**
Couple + 4 Children	**86%**	**87%**	**86%**	**79%**	**80%**

All Replacement Rate values above 70% are shaded. The darker shade indicates family groups that would receive a social welfare payment (either Spousal JA or FIS) when the second earner is not working.

33. The impact of Budget 2012 measures on two-earner replacement rates has been very small reductions of between 0.04 and 0.17 percentage points with small increases for couples with two children between NMW and AW. Couples with four children have tended to have biggest reductions in their replacement rates due to Child Benefit reductions for three or more children.

34. Even couples without children have high replacement rates at NMW and at 67% AW.

The figures indicate potentially quite strong disincentives for the Spousal JA claimant to take up work at NMW (even without considering additional in-work costs such as childcare).

35. For example a couple with 2 children where one spouse works at 67% AW and the other spouse claims Spousal JA has a net weekly income of €633.63 compared with €788.77 were the second spouse working at NMW (RR of 80%). The Spousal JA payment of €138.48 is no longer payable and additional tax/PRSI/USC of approx. €43.72 become payable upon taking up employment. Conditionality attached to Spousal JA is also an issue that needs to be considered (see more under (c) below).

36. Department of Social Protection data suggests that a significant number of Jobseeker couple claimants have one person in receipt of a JA/JB payment, while the other has income from employment[9]. This points to the relevance of examining replacement rates for two-earner households and also the relevance of issues relating to Spousal Jobseeker entitlements. It is very difficult to generalise given the heterogeneity of cases. Nonetheless the replacement rates calculated are useful indicators of potential disincentives.

37. It is important to note in the Two-Earner case, as for all cases in this analysis, that the cost of childcare and other additional working costs has not been factored into the Replacement Rates calculations. Some analysis has been done this year by the ESRI with regard to the costs of working – see appendix.

[9] The rules which apply where a spouse is working are different on Jobseeker Allowance (JA) and Jobseeker Benefit (JB). The replacement rate calculations in this document are based on JA.

(c) Spousal JA and FIS

38. For Jobseeker families with children the more beneficial of FIS or Spousal JA is included in the calculation. A claim for the more beneficial payment is typically what would result where a spouse in receipt of JA and claiming an increase for an adult dependent and child dependent(s) takes up employment. FIS and Spousal JA are therefore serving a similar purpose by contributing to low income households with children even though these payments are devised for very different purposes.

39. For larger families FIS is more beneficial while Spousal JA is generally more beneficial for families with up to three children. The calculations point to inequities between alternative benefits which are in effect achieving the same purpose but at different costs. The Spousal JA means test was reviewed approx four years ago in order to encourage activation of the second spouse. However given the differences between FIS and Spousal JA it may now result in Social Welfare payments which are too high.

The Spousal JA means test should be re-examined, possibly with a view to aligning the payment level more closely with FIS. Reductions to Spousal JA payments will however have the effect of increasing replacement rates and this should be considered in any review. Enforcement of conditionality relating to Spousal JA should be strengthened as this may result in establishing more appropriate entitlements for households as well as possible Exchequer savings.

(d) One Parent Families

40. For one-parent families the basic replacement rates are low. The highest replacement rates for one-parent families occur at 67% AW where replacement rates are 51%, 54% and 56% respectively for a one, two and three child family. These replacement rates are reduced on previous years due mainly to the One-Parent Family Payment (OFP) means disregard reduction introduced in Budget 2012 (the further reduction in January 2013 will have a downward impact on replacement rates next year). The fact that the highest replacement rates occur at the second income level is evidence of a poverty trap which is discussed in the next section. Similar to Jobseekers, when maximum rates of rent supplement are included in the calculations, replacement rates are seen to rise significantly. Data from the Department of Social Protection indicates that the proportion of one-parent families who are in receipt of rent supplement is approx 16%[10].

41. As mentioned in paragraph 22 regarding Budget 2012 changes, new entrants on the Community Employment Scheme can no longer retain the OFP. OFP recipients who are new to CE Schemes now face much lower replacement rates than before. The largest reduction occurred at 67% of AW, the replacement rate for a One-Parent Family with 1 child joining a CE scheme in 2011 reduced from 90% to 55% for those joining in 2012. In 2012 approximately 3,300 OFP recipients are on the CE scheme, which makes up approximately 15% of all CE scheme participants. The Budget 2012 measure has reduced the incentive for lone parents to join a CE scheme. Of the 3,300, only 220 are on the new rate of payment since Budget 2012 changes.

[10] Social Welfare Statistical Report 2011, pages 39 and 89.

The Budget 2012 measures ending concurrent payments to new entrants on CE Schemes mean that there is no longer a financial incentive for recipients of OFP to join the Community Employment scheme instead of joining the regular workforce.

(e) Community Employment and Tús Schemes

42. Considering progression from the Live Register to the workforce via schemes such as CE or TUS highlights issues arising from the level of payments to participants on those schemes. The following table shows replacement rates for CE Scheme participation versus employment at NMW, 67% AW and AW for a one-earner couple with 2 children. This indicates that some people on these schemes may face disincentives to move from CE Scheme employment (which is on average 39 hours per fortnight) to full-time employment in particular at the two lower income levels.

Couple + 2CD (one earner)	NMW	67% AW	AW
In-work	€597.44	€633.63	€677.75
Working on CE scheme	€456.40	€456.40	€456.40
Difference	***€141.04***	***€177.23***	***€221.35***
R/R	**76%**	**72%**	**67%**

43. CE is an expensive employment support programme which is not time-limited to the same extent as schemes such as TUS or JobBridge and where participants self-select. There are anomalies in how payments on the scheme operate in particular where reduced JA entitlements are "maxed up" on joining a CE Scheme.

44. The following table illustrates the effect of "maxing up" in calculating CE Scheme income. The example used is that of a two-earner family where Spouse 1 is in work at NMW, 67% AW and AW. We compare the situation where Spouse 2 takes up a NMW job with Spouse 2 participating in a CE Scheme. Firstly, a clear financial incentive is shown for Spouse 2 to remain on CE rather than move to fulltime NMW work.

Couple + 2 children (Two-Earner) (Spouse 1 on various incomes)	NMW	67% AW	AW c.€36,000
Spouse 2 works at NMW	€710.27	€788.77	€946.23
Spouse 2 accepts CE scheme	€646.95	€695.81	€853.27
Difference	**€63.32**	**€92.97**	**€92.97**
RR	**91%**	**88%**	**90%**

45. The example also illustrates anomalies in the system when we consider how much these families would receive in JA payments versus taking a CE placement as illustrated in the table below. Families with smaller JA entitlements due to higher means from earnings actually do better out of CE Schemes as their payments are maxed up to €188 plus they receive an additional €20 top-up. Families whose JA entitlement is greater than €188 retain their entitlement and receive a €20 top-up.

Spouse 2 Jobseeker Allowance entitlement vs. CE Scheme entitlement where Spouse 1 is earning either NMW, 67% AW or AW			
Spouse 1 earning level	**NMW**	**67% AW**	**AW**
Spouse 2 JA Entitlement	€205.99	€138.48	€7.04
Spouse 2 CE Earnings	€225.99	€208.00	€208.00

46. Recent changes introduced for new entrants to the Rural Social Scheme and TUS bring their entitlements in line with CE (and will achieve expenditure savings). Further changes to entitlements for participation in all three schemes should be considered in order to address disincentive effects and anomalies as illustrated above.

Financial incentives relating to CE Scheme participation should be further examined along with stricter time-limiting of scheme participation, with a view to reducing the incentive to remain on the scheme or to move from one supported employment scheme to another. The focus must be on progression to forms of employment in the regular workforce.

(f) Poverty Traps and High Marginal Effective Tax Rates

47. The detailed replacement rate calculations illustrate that poverty traps[11] exist for one parent families between earnings at NMW and 67% AW. For example, a one-child one-parent family working at NMW (€17,542) would have a net weekly income of €514.76 while their net weekly income would fall to €508.12 if working at 67% AW (€24,092). An annual gross increase of €6,550 translates to a €345 net loss. This is due mainly to the loss of OFP payable.

48. Related issues in the form of high Marginal Effective Tax Rates[12] (METRs) exist for one parent families and couples with and without children at the three lower income levels. For example, the difference between net in-work income at 67% AW (gross c. €24,092) and at AW (gross c. €35,959) is significantly less than the difference in gross pay. For a couple with one earner and no children, net weekly in-work income is €510 on 67% AW and €591 on AW, a difference of just €81 per week or €4,218 per annum net versus almost €11,900 gross increase in income. In 2011 examples, the METR is very similar to the 2012 figures due to very few changes to Tax, PRSI and USC in Budget 2012.

49. Couples with children see similar effects between 67% AW and AW with c. €67 difference in weekly income where there is one child or c. €3,500 p.a. For a couple with 4 children the effect is a difference of c. €70 weekly or c. €3,600 p.a. which still illustrates a disincentive to earn more income, representing just 30% of the extra €11,900 in gross earnings. To put it another way the household is losing 70% of the additional gross earnings due to tax/benefit interactions.

[11] A Poverty Trap occurs when an increase in gross income, which may be due to working increased hours or for increased wages, results in a decrease in net income.

[12] Marginal Effective Tax Rates (METRs) or Effective Marginal Tax Rates measure the proportion of additional earned income which is lost by way of the combined effect of increased taxes and other charges and decreased benefits

50. In the case of one parent families, 2011 data suggested that those on low-incomes (earning less that €425 per week) were a significant proportion of OFP recipients (35%). Even though they do not appear to face high replacement rates (due to OFP retention when working, their particular tax status and possible entitlement to FIS) they face significant financial disincentives in terms of increasing their earnings from employment at certain levels.

The tax/welfare factors which contribute to poverty trap/high METR issues for one parent families and couples at income levels at or below AW need to be reviewed. The high taper rate of 60% associated with FIS would be a factor in this.

Replacement rate interactions with the National Minimum Wage, Taxation and Activation Measures

National Minimum Wage (NMW)

51. The NMW has remained at the same level since July 2007. Replacement rates at NMW level were shown in the analysis to be high for most categories of jobseeker couples (72% or more for couples with children, 68% for couples without children and 61% for single persons). However it is important to note that all categories of Jobseeker or OFP recipient who face replacement rates at NMW have seen reductions in those replacement rates due to Budget 2012 changes especially those in receipt of Rent Supplement due to the minimum contribution increase and the lowering of the maximum rent levels.

52. Persons on reduced rates of Jobseeker payments, be they spouses with working partners, those under 25, or those on penalty rates of payment, will face lower replacement rates at NMW than those shown in this analysis.

Taxation

53. Replacement rates also have implications for tax policy. To put it simply, increases in income tax (whether achieved by reducing tax credits or standard tax bands or by increasing tax rates) will cause replacement rates to rise. Any policy changes toward further broadening of the tax base using tax on incomes need to be cognisant of this. The same is true of PRSI and USC changes[13].

54. It is important to note that at low income levels there are low levels of tax payable e.g. at NMW no PRSI is payable, tax of €4 weekly applies to single persons only and the USC payable is €10.51 for all example cases. At AW (€691.52 gross weekly) total tax, PRSI and USC varies from €145.49 for a single person to €85.42 for a family with children. Many jobseeker households at the lower income levels are shown to face high replacement rates despite low levels of tax paid.

[13] Note that replacement rates for the self-employed are not part of this analysis.

Achieving the right balance between the level of the NMW, labour legislation, social welfare rates, taxation and levels of activation is crucial to avoiding work disincentives.

Activation

55. As regards when income support can act as a disincentive to work there are two key aspects - the level of payments and the conditionality attached. Replacement rates relate to the former, though they are not entirely confined to it. Activation relates to the latter - Activation policies address the passivity associated with social welfare transfers by encouraging people into employment, training and education. They can take the form of job search assistance, personal development or skills training, formal educational qualifications, work schemes etc. Generally the higher the level of conditionality of payment imposed, the stronger the activation policy.

High replacement rates and low unemployment can coexist if activation is strong

56. It is generally accepted that where countries have high replacement rates and low levels of unemployment they have implemented strong activation measures. Such systems however, bring with them costs in terms of higher unemployment payments and higher activation costs. In the Irish system there are high replacement rates for some but not all cohorts of the unemployed.

57. As regards the impact of high replacement rates on the labour market Grubb (2007) has pointed out that there can be benefits to high replacement rates. These arise in the form of an improved earnings distribution (in terms of the low-paid) as well as, when combined with strong activation measures, increased productivity and increased labour force participation.

Co-ordinated approach to Labour Market Policy

58. The Programme for Government identified a range of measures to support employment and to assist unemployed people. The *Jobs Initiative* provided for a range of additional labour market supports for unemployed people. Furthermore, a fundamental restructuring of the institutional framework for labour market activation is being put in place through the establishment of the National Employment and Entitlements Service (NEES) and the new further education and training authority (SOLAS). Deeper and more regular engagement with unemployed people through these new structures will bring our labour market activation strategy into line with best international practice and address criticisms of our previous passive strategies by organisations such as the OECD (2009) and the ESRI and NESC (2011).

59. The Department of Social Protection are committed to having in place by end-2012 a case management labour market engagement process deployed nationwide so that systematic interventions are made with people on the Live Register which is informed by a profiling system developed in conjunction with the ESRI.

60. In terms of looking to the longer term, there is much consensus that improved activation is a key element in a strong labour market policy. Ultimately strong activation strategies help to establish if people are involuntarily unemployed.

> It is essential that job opportunities, as the economy recovers, are taken up by those on the live register. To achieve this it is essential that we have a strong activation framework in place, and that the balance between unemployed income supports and in-work income does not discourage people from taking up jobs.

OECD and IMF comments regarding Irish Replacement Rates.

OECD - Long term unemployed face high replacement rates

61. The OECD has been critical of Ireland in terms of having weak activation measures and has referred to Ireland having relatively high replacement rates which encourage high benefit dependency ratios.

62. The latest published OECD figures relate to 2010 and show net replacement rates at two stages of unemployment (initial phase and long-term), for three different earnings levels – 67%, 100% and 150% Average Worker earnings, with two children and without children for three family types – a single person, one-earner married couple (i.e. dependant spouse) and a two-earner married couple (spouse in work). These are hypothetical replacement rates – they do not attempt to quantify the numbers to which the replacement rates apply.

63. The OECD's initial phase of unemployment replacement rates are produced to show replacement rates if the family groups are (a) not in receipt of housing assistance and (b) in receipt of housing assistance. The OECD figures show that one-earner couple replacement rates are consistently above the average for the 32 OECD countries for both (a) and (b). They find that single people/lone parents in receipt of housing assistance have replacement rates that are either average or above average. Conversely, the OECD figures show that Two-Earner replacement rates are consistently below average when factoring in all income levels and whether they have children or not.

64. The OECD also produces replacement rates for the long-term unemployment phase, which automatically assumes that the family groups listed above, are in receipt of housing assistance. The OECD finds that the replacement rates for single people/lone parents and one-earner couples are consistently above the OECD average. The OECD calculations show that for most other member states the benefits to the long-term unemployed reduce with time. Ireland's welfare payments stay at the same level as in the initial phase however (comparing with initial phase including housing assistance).

65. In comparing the initial phase replacement rates with housing assistance to the long term replacement rates with housing assistance, we can see that Ireland's replacement rates stay the same as welfare payments don't reduce with time. We see

that this is not the case for the majority of the other OECD countries, where their welfare payments do reduce with time. This causes Ireland's long-term replacement rates to rise significantly up the rankings. The most noticeable are the replacement rates for single people/lone parents, which are around or slightly above average in the initial phase, but are amongst the highest in the long-term (this group has the highest replacement rates at the AW and 150% AW levels in the long-term). While we acknowledge that those on housing assistance are not in the majority in Ireland, they still represent a significant number of people.

IMF

66. The IMF have commented in a recent release, 'Ireland: Selected Issues'[14] published in September 2012 that:

"In contrast to most countries in Europe, unemployment benefits in Ireland do not vary with duration of the unemployment spell. This structure can create work disincentives for a minority of job seekers. *Replacement rates for most of the newly unemployed on the Live Register fall below the OECD average, as around three-quarters of job seekers do not receive additional benefits. However, with time, the replacement rates rise substantially for those entitled to additional benefits. For instance, replacement rates in a one-earner married couple that receives child, adult dependent, and housing assistance benefits amount to 90 percent after 5 years of unemployment, far above the OECD average. Although at present less than 5 percent of the unemployed receive all benefits, this ratio may rise given rising unemployment durations."*

ESRI view on Irish Replacement Rates

67. The ESRI last week published a paper entitled "Work Incentives: New Evidence for Ireland", authored by Tim Callan. In the paper they aim to calculate incentives to work in Ireland by using replacement rates. Initially the paper addresses international comparisons, firstly by looking at the OECD's calculations and then by doing their own comparisons of Irish and British replacement rates. Finally they estimate Irish replacement rates while also factoring in the extra costs of childcare and travel when working. The paper addresses the OECD net replacement rates for Ireland and its use in terms of international comparisons. They highlight the problems with the OECD's long-term replacement rate calculations which automatically assume the groups are receiving housing assistance, whereas only 12% of the unemployed receive rent or mortgage supplement in Ireland.

68. Secondly, the paper highlights that when comparing Irish replacement rates with British replacement rates the two are very similar when looking at actual family cases. In fact, the British have more of their population with replacement rates higher than 70% (26.1% versus 23.5%). In Britain 1 in 2 unemployed people receive housing assistance as opposed to 1 in 8 in Ireland. However, Ireland has more of the population with replacement rates over 100%, which includes mostly those groups that receive rent supplement.

[14] Ireland: Selected Issues; IMF Country Report 12/265;(note all policy recommendations in this paper are staff views in the context of the 2012 Article IV consultation with Ireland).

69. The final part of this paper addresses the costs of working in Ireland, by factoring in the extra costs of travel and childcare (see appendix for more detail). The paper finds that 34.6% of the unemployed population faces replacement rates above 70% when factoring in transport costs and full-time childcare costs. The paper also finds that 12-13% of the population would earn more money on welfare than in work, when factoring in additional costs of working (i.e. have replacement rates greater than 100%).

Composition of the Live Register

Numbers in long term unemployment continue to increase

70. The number of persons in long-term unemployment has increased greatly over the last few years. The long-term unemployment rate is now 8.8% according to the latest CSO Quarterly National Household Survey release[15]. Long-term unemployment accounted for 60.6% of total unemployment in quarter one of 2012 compared with 55.1% a year earlier and 40.9% in the first quarter of 2010.

Part-time mix

71. A significant cohort on the Live Register work part-time. At the end of July 2012 there were more than 74,000 casuals/part-time workers (paid for part of the week) representing 16% of the total compared with c. 71,000 (15% of the register) in July 2011. In addition there were almost 14,000 casuals/part-time workers who were on the register but not receiving a payment. This is a significant increase in percentages on August 2007, where only 11% (19,509 of 176,414 people on the live register) were in the same category.

72. Relatively high income/means disregards which apply to Jobseekers Allowance and One Parent Family Payment are intended to actively encourage part-time work. There is a danger however that these may act as a barrier to the take up of full time employment and encourage long-term welfare dependency. Stricter enforcement of conditions for payment of jobseeker benefits for part-time work may be necessary to ensure that recipients only receive benefits where they are involuntarily unemployed.

73. Budget 2012 measures have improved incentives for taking up full time employment due to changing the payment week from a six to a five day week for Jobseeker's Benefit recipients. Also Sunday earnings will be taken into account when calculating the amount of Jobseeker's Benefit or Jobseeker's Allowance to be paid; this measure coming into effect in 2013.

Budget 2012 measures should help encourage individuals into full time work opportunities. Enforcement of the conditions on those in part time work to seek full time work opportunities may also need to be strengthened.

[15] CSO Quarterly National Household Survey; 2012-Quarter 1

Conclusion

Need for increased awareness of the impact of policy changes on replacement rates.

74. Given that replacement rates do matter and can act as disincentives to work there needs to be an increased awareness by policy makers of the impact of policy changes on replacement rates so that problems relating to high replacement rates are not exacerbated. Income tax, USC and PRSI increases, social welfare increases and falling average in-work incomes would all cause replacement rates to rise. Combine these with theories relating to job-search costs and falling reservation wages[16] during a spell of unemployment and the effect is compounded.

75. Replacement rates of the type produced in this analysis are most useful in terms of identifying trends in net incomes vs. wages. It is not an exact science even in terms of when high replacement rates act as disincentives. While replacement rates do matter and high replacement rates need to be addressed, it is crucial to recognise how replacement rates link with conditionality of payments and activation measures and this may need to be the overriding issue.

76. In terms of the level of replacement rates, the monitoring of trends is very important but the level of replacement rates may have more to do with affordability by the State than with avoiding a particular threshold. High replacement rates don't absolutely have to be avoided – they can co-exist with low unemployment but only where activation is strong. Improvements are being made in terms of activation in Ireland. We should aim to avoid any worsening of replacement rates and move toward increased activation so that there will be improvements in factors along with financial incentives which promote, ease and encourage take up of employment, particularly when economic circumstances improve.

77. The TSG is invited to discuss this paper.

Sectoral Policy Division
Department of Public Expenditure and Reform
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[16] Falling reservation wage - while a person remains out of work searching for employment their employability (as perceived by an employer) reduces and so the wage they can command in the labour market is seen to fall (falling reservation wage). Thus the replacement rate they face rises.

Appendix

"Work Incentives: New Evidence for Ireland" by Callan, Keane, Savage, Walsh and Timoney

In this paper, Callan et al. estimate the costs of working in Ireland in order to see if people face disincentives to work. To do this they factor in the extra costs of travel and childcare due to working. They use the 2010 SILC data as the main dataset in the paper, but also use information from the National Travel Survey 2009, Household Budget Survey 2009/10 and the Quarterly National Household Survey to estimate the costs of travel and childcare.

They found using three methods that the reasonable range of extra transport costs due to working is between €15 and €25. They highlighted that they considered €15, €20 and €25 as low, medium and high travel costs respectively.

They found for childcare costs firstly that 1-earner families generally pay somewhere between €100 and €150 per week on childcare whereas 2-earner families pay around €200 per week for childcare. They highlight in the paper that these childcare costs are actually higher than those quoted in the Crilly, Pentecost and Tol paper.

Finally the paper uses the 2010 SILC data and the SWITCH tax/benefit model to estimate the amount of the population that would face disincentives to work. The authors find that 12-13% of families with a young child are better off unemployed. They also find that 4% of families without a young child would be better off unemployed.

They find that 12.2% of the unemployed population would earn more income on welfare than in work when factoring in the extra costs of working. They also find that 34.6% of the unemployed population face replacement rates higher than 70%, when factoring in the extra costs of working.

"The Cost of Working in Ireland" by Crilly, Pentecost and Tol.
In this paper, earlier this year, the authors aimed to estimate the costs of working in Ireland. They estimated the additional household costs that are incurred when moving from unemployment into the workforce. The paper looked at five household costs that could potentially increase and they are:

1) Childcare
2) Transport
3) Heat and Light
4) Take-Away Food
5) Clothing

The data they used was a combination of the 2004/2005 Household Budget Survey (HBS) and the 2005 EU-Survey of Income and Living Condition (SILC). They used these data sources to estimate the likelihood of extra expenditure on the five areas above.

They found that for a person who is paying for childcare for two children, then the in-work cost is €227.48 and the out-of-work cost is €39.37, which gives extra expenditure of €188.11 per week for those in work.

They then used the SILC data to estimate the income levels of particular groups, in particular those with no childcare costs and those with one child under 5 years of age. They found that 15% of those individuals with no childcare costs would be better off if out-of-work due to the extra costs of Transport, Food and Clothing as opposed to 4% in Callan et al.'s paper. They found that 44% of those individuals with one child under 5 years of age would be better off out-of-work when factoring in all the extra costs as opposed to 12/13% in Callan et al.'s paper.

The results of these papers differ substantially. Callan et al.'s paper uses more up to date datasets than used in the Crilly, Pentecost and Tol paper.