MINISTRY OF SOCIAL DEVELOPMENT
TE MANATŪ WHAKAHIATO ORA

Future Focus Evidence Brief

The effectiveness of financial incentives

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FUTURE FOCUS EVIDENCE BRIEF: THE EFFECTIVENESS OF FINANCIAL INCENTIVES

Key points

- Financial incentives are mechanisms that address both low employment rates and in-work poverty.
- Financial incentives can be effective at ‘making work pay’ by creating an appreciable income gap between benefit and paid employment, taking into account the costs of working (eg childcare, transport to work).
- In-work benefits (eg in-work tax credit) are employment-conditional payments made to people or families that face labour market challenges. When targeting groups with low employment rates, such as sole parents, they can be a cost effective way of increasing employment rates.
- Wage subsidies are payments made to employers to top up the wages of low-productivity workers. They increase the likelihood of a low-skilled worker gaining employment. Wage subsidies are most effective when targeted at groups who have labour market challenges, such as the long-term unemployed.
- Minimum wages are not an effective method of increasing employment rates. Increases in minimum wages lead to small employment losses. Minimum wages improve the targeting of in-work benefits by preventing employers of low-skilled workers dropping wages and “pocketing” the value of the in-work benefit

Key documents

OECD (2008). *In-work benefits and making work pay in OECD countries: An update* Reference: DLSE/ELSA/WR1(2008).

Financial incentives, such as in-work benefits, minimum wages and wage subsidies, are mechanisms that address both low employment rates and in-work poverty. Financial incentives ‘make work pay’ by creating an appreciable income gap between benefit and paid employment, after taking into account costs of working (eg childcare, transport to work).

Situation in 2009

Prior to the introduction of the in-work tax credit in April 2006 many New Zealand families were little or no better off in low-paid employment once work-related costs, benefit abatement, other entitlement abatements (eg Accommodation Supplement, tax credits and Childcare Assistance) and tax were taken into account. In particular, those with low earnings potential who needed to use paid childcare were often worse off in paid work than on benefit. Qualitative interviews with sole parents consistently found that a lack of financial incentives to take up paid work meant that some sole parents stayed on benefit (Department of Labour & Ministry of Social Development, 2002).

What works, for whom and under what circumstances? What are the unintended consequences?

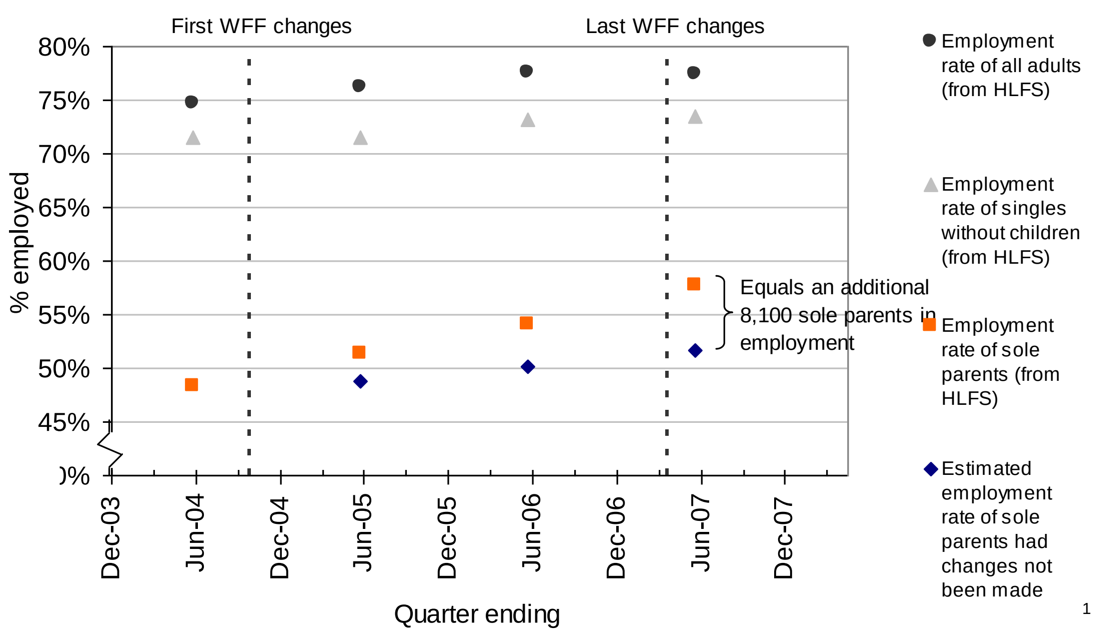
In-work benefits are employment-conditional payments made to individuals or families that face labour market challenges. In-work benefits can be a cost-effective mechanism to 'make work pay' as they also reduce in-work poverty (OECD, 2008).

In-work benefits are most effective when targeted at groups with labour market challenges.

- In New Zealand, an additional 8,100 sole parents moved into paid employment as a result of policy changes which included the introduction of the in-work tax credit. (Figure 1). The percentage of sole parents working 20 hours or more (as required by the in-work tax credit) increased from 36 percent in June 2004 to 48 percent in June 2007. Around three-quarters of this increase was due to the policy changes in financial incentives and support (MSD & IR, 2009).

- The Earned Income Tax Credit (US) and Working Tax Credit (UK), which have some similar characteristics to the New Zealand in-work tax credit, have resulted in an increase of sole parents' employment rates of around five percentage points (OECD, 2008).

Figure 1: Percentage of adults aged 18-64 who are working at least one hour a week



Source: Calculations based on unpublished Household Labour Force Survey data, June quarters.
[1] Calculated as employment rate less Difference-in-Differences estimate.
The estimated employment rates have confidence intervals of ± 4 pp. The only statistically significant effect is that seen in the June 2007 quarter when all the policy changes were implemented.

Targeting in-work benefits to families can lead to decreased employment rates of second earners in couple families. Targeting the individual rather than the family unit removes the adverse effects on second earners, but is less cost-effective and does not result in the same effect on sole parents' employment rates.

- In the US second earner employment rates dropped as a result of the EITC, though this was offset by an increase in the primary earner employment rate (OECD, 2008).

- The Mini-jobs reform (Germany), which was a rebate in social security contributions for all workers in low-income jobs, only resulted in a small employment rate effect. The employment effect was outweighed by a reduction in hours of those already in work.

Wage subsidies are payments made to employers to top up the wages of low-productivity workers. They do not increase the income gap between benefit and work, but increase the likelihood of a low-skilled worker gaining employment.

Wage subsidies are most effective when targeted at groups who have labour market challenges, such as the long-term unemployed. Non-targeted wage subsidies can lead to government subsidising wages of individuals who would have gained employment without the subsidy and subsidised workers taking the jobs of non-subsidised workers.

- Wage subsidies that are broadly targeted have employment gains of around 10 percent (Lee,2003)

- More targeted programmes, such as that in the Netherlands for those who have been out of work for more than two years, have larger employment gains of 20-30 percent (Lee, 2003).

- Targeted wage subsidies can have a negative signalling effect, with employers in the US using wage subsidy receipt as evidence of a low-productivity worker (Lee, 2003)

- Risks include cases where employers receive a subsidy to hire a worker they would have hired anyway (deadweight), and workers in firms without subsidies lose work to firms with subsidies (displacement). These unintended effects mean that the net effects of hiring subsidies on overall employment levels are often less than the impact of the subsidy on the individual who receives it (Boone & Van Ours, 2004)

What doesn't work and why?

Time-limited **in-work benefits** have little impact on employment once payments cease.

- The impact of the Self-Sufficiency Payment (Canada) on sole parents' employment rate was strong in the payment phase, but dropped once payments stopped (Ford et al., 2003).

Minimum wages are an ineffective method of increasing employment rates. Although minimum wages act as a financial incentive to work by raising earnings, increases in minimum wages lead to small employment losses:

- Increasing minimum wages leads to increased labour costs to employers. As a consequence employers may reduce staff numbers or hours of work to keep labour costs low.

- Most recent international studies find employment losses as a result of minimum wage increases, especially among low-productivity workers. There is comparatively little evidence of positive employment effects (Neumark and Washer, 2007).

- Historical increases in the New Zealand real minimum wage have had a minimal negative impact on employment (Chappell, 1997).

Minimum wages improve the targeting of in-work benefits by preventing employers of low-skilled workers dropping wages and "pocketing" the value of the in-work benefit (OECD, 2008).

What don't we know

The impact of **in-work benefits** in an economic downturn is unclear. When there is involuntary unemployment not all individuals who want to work will find a job, or they may not be able to find the hours required.

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