

Replacement Rates 2010

Introduction

1. This paper follows on from “Replacement Rates and Unemployment” which was published on the Department of Finance website prior to Budget 2010. The main 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 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.

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

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 replacement rates act as disincentives to work while evidence from empirical studies is mixed but on balance shows a small but significant link between replacement rates and duration of unemployment.

Replacement rates should be interpreted with caution.

5. Clearly the replacement rate calculated will vary greatly depending on what is included in the income elements. 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, the in-work income comparators etc. There are also issues that cannot be incorporated into quantitative analysis such as a person’s location and the existence of individual job opportunities. Some caution is required therefore in interpreting replacement rate results and their application to potential policy changes.

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. The Nevin Group (1993) referred to replacement rates often being of particular concern when they are over 80% - this threshold represents a potential increase in disposable income to an unemployed person of 25% or less. It would be 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 13.8%¹. The experience of previous high unemployment rates raises 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 in the last ten years – the 2001 personal rate of €106.66 rose as high as €204.30 in 2009 and now amounts to €196 weekly. The level of Social Welfare payments to those of working age 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 and rising 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.

Approach to compilation of 2010 replacement rates²

10. In-work income levels used are National Minimum Wage, 67% of Average Industrial Earnings (AIE), Average Industrial Earnings, 150% Average Industrial Earnings, and 200% Average Industrial Earnings.

11. The family structures³ 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.

¹ Seasonally adjusted Standardised Unemployment Rate (SUR) August 2010.

² Full details of the calculations and related assumptions (including items not factored into the calculations) are available separately.

³ Relevance of family size: Child Benefit data for 2008 shows that 41% of families had one eligible child, 35% had two, 17% had three and 5% had four eligible children. Jobseeker data relating to increases for qualified children (IQCs) shows that Jobseekers with between 1 and 4 children account for almost 97% of cases while 95% of OFP recipients have 3 or fewer children.

12. Included in the calculation of in-work income are income from employment, taxation (couples treated as married), PRSI (including Health Levy), Income Levy, Spouse's entitlement to Jobseekers Allowance (Spousal JA) 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.

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

14. 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) the impact of differential rent inclusion, (iii) CE Scheme income for One Parent Family Payment recipients, and (iv) two-earner household disincentives.

Main Findings

(a) Jobseekers

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

15. In 2009 analysis, prior year earnings data relating to Jobseeker Assistance and Jobseeker Benefit claimants pointed to the significance of the three lower in-work income levels i.e. AIE and below. Of the six Jobseeker one-earner households examined at these income levels, half of the basic replacement rates calculated are over 70% as illustrated in the table below⁴.

Jobseeker One-Earner Basic Replacement Rate 2010					
	NMW	67% AIE	AIE	150% AIE	200% AIE
Gross:	€17,542	€22,415	€33,455	€50,183	€66,910
Single	64%	53%	40%	30%	25%
Couple	70%	65%	60%	44%	37%
Couple + 1Child	73%	69%	63%	49%	42%
Couple + 2 Children	76%	72%	66%	55%	46%
Couple + 3 Children	78%	75%	69%	61%	51%
Couple + 4 Children	79%	76%	70%	64%	56%

16. 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).

2010 RR figures show disincentives to take up employment at low income levels even where in-work income at these levels may be supplemented by social welfare payments in the form of FIS or Spousal JA.

⁴ Spousal JA is the spouse/partner's residual entitlement to Jobseekers Allowance. For families with children the more beneficial of either FIS or Spousal JA is included in the replacement rate calculation

Impact of Inclusion of Rent Supplement/Differential Rent

17. When rent supplement was included in out-of-work income figures, replacement rates were shown to rise significantly across all categories of Jobseeker (by approx. 30 percentage points in many cases) while the inclusion of differential rent had a far less distortionary effect⁵. Differential rent is calculated based on the level of household income be it income from Social Welfare or employment. Recently there has been a shift towards local authority rental accommodation schemes where, like for differential rent, accommodation is long-term and when a person gets work they remain in the scheme but pay more.

The rules underpinning differential rent schemes are clearly preferable to rent supplement from a work incentive perspective.

Jobseeker Two-Earner Replacement Rates

18. 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. Spousal JA is payable at reducing rates up to Spouse 1 income at AIE (€33,455) for all except the couple with 4 children where FIS is the more beneficial payment.

Jobseeker Two-Earner Basic Replacement Rate 2010					
(Based on Spouse 1 earning at various levels and Spouse 2 potentially taking up NMW job).					
	NMW	67% AIE	AIE	150% AIE	200% AIE
Couple	74%	72%	66%	72%	76%
Couple + 1Child	80%	77%	72%	74%	78%
Couple + 2 Children	85%	82%	77%	75%	78%
Couple + 3 Children	87%	85%	81%	76%	79%
Couple + 4 Children	86%	86%	87%	79%	80%

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

19. For example a couple with 2 children where one spouse works at 67% AIE and the other spouse claims Spousal JA has a net weekly income of €649.87 compared with €797.20 were the second spouse working at NMW (RR of 82%). The Spousal JA payment of €170.36 is no longer payable and additional tax/PRSI/levies of approx. €20 become payable on taking up employment. Conditionality attached to Spousal JA is also an issue that needs to be considered (see more under (b) below).

20. Department of Social Protection claims data from September 2009 suggested that a significant number of Jobseeker couple claimants (up to 68,444 or 58%) had one person in receipt of a JA/JP payment, while the other had income from employment.

⁵ Rent supplement is included to show the maximum disincentive effect. 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 many recipients and a relatively small proportion of those on the live register are in receipt of rent supplement (12% of Jobseekers per Sept 2009 data).

This points to the relevance of examining replacement rates for two-earner households and also the relevance of issues relating to Spousal Jobseeker entitlements. The data also points to the heterogeneity of cases and so highlights that it is very difficult to generalise for many cases. Nonetheless the replacement rates calculated are useful indicators of potential disincentives.

(b) Spousal JA and FIS

21.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.

22.For larger families FIS is more beneficial while Spousal JA was 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 two years ago in order to encourage activation of the second spouse. However given the inequities 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.

(c) One Parent Families

23.For one-parent families the basic replacement rates are low. The highest replacement rates for one-parent families occur at 67% AIE where replacement rates are 55%, 57% and 59% respectively for a one, two and three child family. 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.

24.While one-parent families in general face low replacement rates, those participating in CE scheme employment face particularly high replacement rates even compared with earnings at AIE level (where, for example, the replacement rate is 85% for a one parent family with two children). While this category of one-parent family is significant in terms of their replacement rates, at approximately 5,000 they are not a huge proportion of One-Parent Family Payment (OFP) recipients. They do however make up approximately a quarter of all CE scheme participants.

One-parent families on CE schemes therefore face a particularly strong incentive to favour CE scheme employment over other forms of employment and this should be examined with a view to encouraging OFP recipients into more general forms of employment (i.e. those not subsidised by the State).

(d) Poverty Traps and High Marginal Effective Tax Rates

25. The detailed replacement rate calculations illustrate that poverty traps⁶ exist for one parent families between earnings at NMW and 67% AIE. For example, a one-child one-parent family working at NMW (€17,542) would have a net weekly income of €524.78 while their net weekly income would fall to €502.33 if working at 67% AIE (€22,415). This is due mainly to the loss of OFP payable.

26. Related issues in the form of high Marginal Effective Tax Rates⁷ (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% AIE (gross c. €22,400) and at AIE (gross c. €33,500) is significantly less than the difference in gross pay. For a couple with one earner and no children, net weekly in-work income is €521 on 67% AIE and €565 on AIE, a difference of just €44 per week or €2,282 per annum net versus €11,000 gross increase in income.

27. Couples with children see similar effects with c. €60 difference in weekly income where there are one, two or three children or c. €3,200 p.a. For a couple with 4 children the effect is a difference of c. €67 weekly or c. €3,500 p.a. yet this still illustrates a disincentive to earn more income, representing just 32% of the extra €11,000 in gross earnings. To put it another way the household is losing 68% of the additional gross earnings due to tax/benefit interactions.

28. In the case of one parent families, 2009 data suggested that those on low-incomes (earning less than €425 per week) were a significant proportion of OFP recipients (38%). 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, and this is evidence of distortion in the tax/social welfare system.

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

(e) Impact of Budget 2010 Changes

Main Budget 2010 changes

⁶ 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.

⁷ 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

29.Reductions of at least 4.1% were applied to payments to those of working age. Child Benefit was reduced by €16 per child to €150 per month for the first two children and €187 for the third and subsequent children (cuts of 10 and 8% respectively). Compensating measures were applied to negate the impact of this reduction on families for whom increases for qualified children (IQCs) were in payment with another social welfare payment. The IQC was increased by €3.80 to compensate fully for the reduction in Child Benefit. The FIS earnings thresholds were also increased by €6 per week per child to compensate families with children on low pay.

Impact of changes on Replacement Rates

30.For jobseekers the effect of Budget 2010 measures has been to reduce basic replacement rates by 1 or 2 percentage points. The replacement rate reductions were greater for single persons and couples without children while replacement rates for families with children were affected to a lesser extent the greater the number of children. This is because Personal Rates and Adult Dependent Rates were reduced for all categories while overall payments relating to children were maintained for low income families. This means disincentive effects for these categories (many of which were already high), although reduced, have worsened relative to other households.

31.For one-parent families, the basic replacement rates were reduced by around 1 percentage point for most of the hypothetical cases⁸.

Budget 2010 measures have generally resulted in reduced replacement rates.

Other Budget 2010 Measures

32.New Jobseeker Allowance claimants under age 25 and without child dependents are now only entitled to reduced maximum personal rates of payment – a maximum rate of €100 per week was introduced for those aged 20 to 21 and €150 per week for those aged 22 to 24⁹. The Qualified Adult rates applicable are also reduced. These rate reductions would clearly have a significant downward impact on replacement rates for such claimants.

33.Reducing the personal rate of Jobseeker's Allowance and basic Supplementary Welfare Allowance to €150 per week where job offers or activation measures have been refused will translate into lower replacement rates for such individuals and so a stronger financial incentive to work.

34.Regarding the proposal to develop a universal social charge to replace Employee PRSI, the Health levy and the Income Levy, it will be of interest to see how these potential changes would impact on replacement rates given that PRSI and the levies are an important element of how the tax/welfare systems interact. Both headline

⁸ Some figures for 2009 One Parent Family Replacement Rates shown in "Replacement Rates and Unemployment" were understated by a few percentage points. The comment regarding the impact of 2010 Budget changes is based on revised calculations.

⁹ Note certain exceptions apply e.g. while participating in a course of education or training.

replacement rates and especially detailed replacement rate calculations could be useful in such policy work, in assessing PRSI changes in terms of progressiveness and in looking for poverty traps and related issues.

Falling Nominal Wages – potential upward impact on replacement rates

35. The AIE figures¹⁰ used for this analysis show very small reductions in wages compared with what many commentators suggest will be shown for nominal wages in 2009 and 2010. For example, the ESRI estimate that average earnings may have fallen by 2% in 2009 and will fall by 3% in 2010. A 3% fall in AIE would, all other things held constant, translate into an increase in basic replacement rates of on average 0.7% for the various Jobseekers households (excluding those at NMW).

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

National Minimum Wage

36. Replacement rates at NMW level were shown in the analysis to be high for most categories of jobseeker (70% or more for couples with/without children and 64% for single persons). Social welfare rates were generally reduced in Budget 2010 but the NMW has remained at the same level since July 2007.

37. There has been some debate regarding the level of the NMW (including the different rates in place for young people and certain trainees). Some have argued for the retention of existing rates. The OECD¹¹ has called for it to be reduced noting it to be high by international standards and that it should also be adjusted downwards as market wages fall.

38. The reduced rates of Jobseeker Allowance now payable to new claimants under 25 could be seen as another argument for reducing the NMW as replacement rates for these categories would still be low enough to incentivise the take up of employment. The NMW represents a wage floor below which employment cannot occur – a reduction in the wage floor should in theory increase demand for employees by removing limitations to downward wage flexibility. Forfás (2009) however refer to the unpredictability of a change in the NMW on employment and inconsistent international economic evidence. If a reduction in the NMW resulted in increased supply of lower-paid jobs, incentives to take up such employment would exist for certain categories of jobseeker e.g. young jobseekers without dependents.

39. In the context of youth unemployment, the level of the NMW and its use as a marker for minimum rates of pay in certain sectors (e.g. through Employment Regulation Orders (EROs) and Registered Employment Agreements (REAs)) may limit job opportunities for younger people, whose level of productivity may not

¹⁰ The figures used in determining replacement rates for 2009 and 2010 are based on the latest available CSO AIE data at the time the replacement rates were compiled. For 2009, the four quarters to quarter 1 2009 were used (average €646.80 weekly) and for 2010 calculations the four quarters to quarter 2 2009 (€643.37 weekly). Latest available calculations are to quarter 3 2009 and give an average figure of €641.24.

¹¹ OECD 2009 Economic Survey - Ireland

initially justify the payment of such minimum rates (even where these are reduced for younger/less skilled staff).

40.By reducing the NMW however, already high replacement rates would be worsened for many categories unless social welfare rates were also reduced. The Commission on Taxation (2009) attached importance to preserving incentives to work for those on low earnings. A decrease in the NMW, without an off-setting reduction in social welfare, would have the same disincentive effect as a tax increase.

41.**See separate paper on the NMW for further discussion.** This includes details of the formal IR process involved in changes to the NMW and wider issues relating to Employment Regulation Orders and Registered Employment Agreements.

Taxation

42.Replacement rates also have implications for tax policy. To put it simply, increases in 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 broadening of the tax base using tax on incomes need to be cognisant of this.

43.It is important to note that at low income levels there are low levels of tax payable e.g. at NMW no income tax or PRSI is payable while at AIE (€643.37 gross weekly) tax varies from €58.29 for a single person to €5.79 for a family with children and PRSI of €46.39 is payable in all cases. Many jobseeker households at the lower income levels are shown to face high replacement rates despite low levels of tax paid.

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

44.As regards when income support can act as a disincentive to work there are two key aspects - the level of payments and the contingency of payments. Replacement rates relate to the former, though they are not entirely confined to it. Activation relates to the latter - Activation policies attempt to 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

45. It is generally accepted that the distinguishing factor regarding countries which have high replacement rates and low levels of unemployment is strong activation

measures. Grubb (2007) points out that there can be benefits to high replacement rates 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. Such systems however, bring with them costs in terms of higher unemployment payments and higher activation costs.

46. Stronger activation measures can help overcome the disincentive effects associated with higher replacement rates. Improvements in activation measures are being made for example in the form of increased education/training places and reforms which incentivise young people to avail of same, reduced Jobseeker Allowance rates for those under 25 and the penalty rate for those who refuse to participate in training/education. The DSP (DSFA 2009) announced the development of a profiling system which can be used to identify those at risk of long-term unemployment and facilitate the targetting of this group – thus activation spend could be more efficiently used. Recent changes to FAS¹² should mean a move toward more streamlined and efficient Public Employment Service with better integration between the DSP and FAS strands of that service.

47. The least costly methods to progress activation policy may well be stricter enforcement of conditions attached to payments and changes to payment rates or duration of payments. Consideration should also be given to activation measures in other countries. While it may not be possible to replicate other more expensive activation systems in full in Ireland it should be possible to adopt some of their features e.g. part-time work or training, compulsory participation in employment/training schemes and time limitations to benefits.

48. 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. It could be argued that disincentives may be irrelevant at times of high unemployment due to the prevalence of involuntary unemployment. Ultimately the only way to establish if people are involuntarily unemployed is through activation and conditionality so these must be at the heart of policy in the future especially when economic recovery results in improved supply of jobs.

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. The measures the Government has taken in previous Budgets in restructuring income supports for young people, increasing opportunities for education and training, and clarifying the conditionality for income supports for the unemployed should be built upon in this context.

Conclusion

¹² As part of the March 2009 Transfer of Functions, it was announced that elements of FAS, the National Training Authority, would move to the Department of Social and Family Affairs renamed the Department of Social Protection, and to the Department of Education and Science now the Department of Education and Skills.

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

49. 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. Tax 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 during a spell of unemployment and the effect is compounded.

50. 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.

51. 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 and well implemented. 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.

52. The TSG is invited to discuss this paper.

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