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DOES THE SOCIAL SECURITY INCOME SUPPORT SYSTEM REMOVE THE INCENTIVE TO WORK?

Barbara Whitlock

DISCUSSION PAPER NO. 303

January 1994
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ISBN: 0 7315 1630 3
ISSN: 0725 430X

* This paper was originally written as a thesis for the Graduate Diploma in Economic History, Australian National University. The author completed the Diploma in 1993. The views expressed are those of the author and do not necessarily reflect those of the Department of Social Security.
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SUMMARY

This paper discusses the incentive to work provided by the income support system, focusing particularly on the level of unemployment benefits relative to wages. This relativity is technically known as the replacement rate. Section 2 provides a brief history of the level of unemployment payments and other features of the income support and taxation system. Section 3 provides a history on the number of people unemployed and changes in the labour market, such as the growth in the number of low-paid jobs, which have increased the focus on the relativity between wages and unemployment benefits.

Using data from the Income Distribution Survey, Section 4 examines the difference between unemployment payments and income from work, for the population as a whole. It shows that replacement rates depend on a variety of factors including whether people are currently employed or unemployed, their marital status, age, number of dependents, and the wages they currently earn or could potentially earn. The section finds that the value of unemployment benefits does not generally seem to be sufficiently high to discourage people from working. This is true for people who are currently unemployed, when their "exit" replacement rates are examined, and it is true for people who are employed, when their "entry" replacement rates are examined. The average person leaving unemployment benefit for full-time employment in 1991 could expect a more than doubling in the disposable income of their income unit. For employed people, nearly 95 per cent of all families would experience a decline in their disposable income of at least 20 per cent if they were to lose their jobs and become unemployed.

After this aggregated analysis, Section 5 provides a more disaggregated analysis of replacement rates. It examines hypothetical family types such as single people, married people and people with one or two children, and the value of unemployment payments available to them compared to minimum award wages. These calculations are done for 1973, 1983 and 1993 to show how replacement rates have changed over time. The section shows that replacement rates for both single people and couples have risen slowly over time, being higher in 1993 than in 1973. For single people and sole parents, replacement rates in 1973, 1983 and 1993 were not sufficiently high to encourage people to take unemployment payments rather than accept low-paid full-time work. This was true regardless of whether or not they combined unemployment payments and part-time work.

For couples who have no income, other than unemployment payments, replacement rates have also never been high enough to encourage them to stay on unemployment benefits rather than accept low-paid work. Where couples have been able to combine part-time work and unemployment payments, they would have had some financial incentive to remain on income support rather than accept low-paid full-time work. In 1973 and 1983, the amount a couple could receive on unemployment payments combined with part-time work earnings was only $2 or $3 less than a couple's income, where one partner had low-paid work. By 1993, a couple combining unemployment payments and part-time work could be substantially better off than a couple where only one partner had a low-paid job. So the income support system has always had the potential to encourage couples, who are combining unemployment payments and part-time work, to remain unemployed if the alternative is for only one of them to get a full-time low-paid job.

Section 6 takes a narrower focus again, looking at not just the decision to work or not to work, but whether to work an additional hour. This is done by examining effective marginal tax rates (EMTRs) which are defined as how much money people do not get of each additional dollar of private income. The income is reduced through taxation and through the withdrawal of income support payments. In cases where EMTRs are 100 per cent, there is no financial gain from earning an additional $1 of income. These calculations have also been done for 1973, 1983 and 1993. The
section shows that EMTRs have improved significantly since 1973. In 1973, EMTRs of 100 per cent and more existed over wide income ranges and began at very low levels of private income. By 1983, EMTRs had improved significantly with EMTRs of 100 per cent starting at higher levels of income, however, they still continued over wide income ranges. In 1983, there were also no EMTRs of more than 100 per cent. By 1993, EMTRs faced by unemployed people had got worse again, with 100 per cent EMTRs starting at lower levels of private income and continuing over broader income ranges than in 1983. EMTRs are still too high to always produce an incentive for people to earn an additional dollar of income.

This descriptive analysis is then put into context in Section 7 by examining the findings of Australian and overseas literature about how people actually respond to changes in replacement rates. This discussion does not find that increases in the level of unemployment payments encourage more people to become unemployed and take up unemployment payments. The evidence does show, however, that changes in payment levels have a reasonably large impact on the length of time people spend drawing unemployment benefits when these people are unemployed for a short time. Changes in unemployment payments have little impact on the length of time people spend unemployed when they are long-term unemployed. Where unemployment payments are available for a long or indefinite period, it is likely to increase the number of people who are long-term unemployed. Where eligibility tests applying to unemployment payments are stringently administered, the number of people drawing unemployment payments will fall. Finally, the income support system is not the only factor which has an impact on the number of people unemployed. Expenditure on labour market programs appears to reduce the unemployment rate.

Although the previous section showed that, on the whole, the income support system is working efficiently to support people when they are unemployed, Section 8 suggests some possible policy options which respond to the three major problems raised. The first set of policy options is aimed at reducing high EMTRs through, for example, not having 100 per cent withdrawal of unemployment payments. The second is aimed at reducing replacement rates for couples by changes to the unemployment payments system. Under this proposal, the eligibility for couples to unemployment payments, and the income tests applying to unemployment payments, would be assessed individually, not jointly. The third set of options suggests reductions in the length of time for which unemployment payments are available through increasing expenditure on labour market programs. Section 9 concludes the essay.

DOES THE SOCIAL SECURITY INCOME SUPPORT SYSTEM REMOVE THE INCENTIVE TO WORK?

1. Introduction

Australia has experienced high and sustained unemployment since the mid 1970s. Debate on why unemployment is high has tended to be split: it is because people can not get jobs or it is because people do not want jobs. Unemployment is the result of a number of factors. This essay examines one of the factors which may add to unemployment, namely the relationship between the income support system, wages and taxation.

In discussions about the incentive to work provided by the income support system, the feature which receives most attention is the level of unemployment benefits relative to wages. The relativity between the value of unemployment payments compared with wages is known technically as the replacement rate. There are a number of other features of the income support system which also impact on the level of disposable income available from unemployment payments, such as the amount which can be earned while still retaining unemployment payments. Section 2 provides a brief history of the level of unemployment payments and other features of the income support and taxation systems. Section 3 provides a history on the number of people unemployed. It also points to changes in the labour market, such as the growth in the number of low-paid jobs, which have increased the focus on the relativity between unemployment benefits and wages.

Using data from the Income Distribution Survey, for both the employed and the unemployed populations, Section 4 examines the difference between unemployment payments and income from work, for the population as a whole. Section 4 shows that replacement rates depend on a variety of factors including whether people are currently employed or unemployed, their marital status, age, number of dependants, and the wages they currently earn or could potentially earn.

After this aggregated analysis, Section 5 provides a more disaggregated analysis of replacement rates. It examines hypothetical family types such as single people, married people and people with one or two children, and the value of unemployment payments available to them compared to minimum award wages. These calculations are done for 1973, 1983 and 1993 to show how replacement rates have changed over time. Section 6 takes a narrower focus again, looking at not just the decision to work or not to work, but whether to work an additional hour. These calculations have also been done for 1973, 1983 and 1993.

This descriptive analysis is then put into context in Section 7 by examining the findings of Australian and overseas literature about how people actually respond to changes in replacement rates. Finally, Section 8 suggests some possible policy responses and Section 9 concludes this essay. Appendix 1
2. Features of the Income Support and Taxation Systems

There are a number of reasons why unemployment is high and why it has remained so. It is difficult to pinpoint these reasons and even more difficult to apportion their contribution to unemployment. The reasons that unemployment is high may include that economic growth has been too low to create a sufficient number of new jobs to keep up with a rapidly growing labour force; award wage rates are higher than the marginal product of employees so labour demand is reduced; or the skills of unemployed people are not suitable for the jobs which are available, resulting in mismatching.

Certain factors relating specifically to the income support system may also impact on the decision to work. These factors include the level of unemployment payments compared with the level of wages; income tests on unemployment payments and the interaction of taxation (both of which are implicit in the discussion on replacement rates); the length of time for which unemployment payments are available; the value of fringe benefits available to the unemployed compared to those available to employed people; unemployment payment eligibility criteria such as activity testing and waiting periods; and the ability to transfer off unemployment payments and onto other forms of income support (such as disability support payments). In this essay I will focus on the relationship between unemployment payments, wages and taxation and their possible contribution to unemployment.

At this stage it will be helpful to outline, in general terms, how the income support system works and how it interacts with the taxation system. Unemployment benefit is paid by the Department of Social Security. Since unemployment benefits became administered by the Commonwealth Government, the basic structure of the unemployment payments system has remained intact. When applying for benefit people are required to register as looking for work with the Commonwealth Employment Service (CES). They must also actively search for work or be involved in training and this is called the activity test. People may have to wait a short length of time before being eligible for benefit and this period is known as the waiting period.

The amount of benefit unemployed people are paid will depend on whether they are single, married, have dependent children and if they are renting. For example, currently an unemployed married couple who are renting and have a child will receive a married rate of unemployment benefit, rent assistance paid at the rate for people with children, basic family payment and additional family payment.

The level of unemployment payments received also depends on the assets people own and how much they earn, known as the assets and income tests respectively. It is possible to earn a small amount of income while still retaining total or partial entitlement to unemployment payments, i.e. receiving maximum or part unemployment payments. Even though a person may still be receiving full or part rate unemployment payments, they can incur tax on the income they earn. They may also have to pay tax on their unemployment payments. If, for example, a person is only on benefit for a short period of time within a year but they are employed full time for the rest of the year, their tax liability will be worked out on the sum of the unemployment payments and their earned income.

I will give a brief description of these features of the income support system and describe how they have changed and evolved over time since the Commonwealth began to administer unemployment payments in 1945. I will begin by examining the value of unemployment benefit and other payments available to unemployed people and then I will examine changes in income and assets tests and activity tests. Finally, I will briefly look at the income tax system.

Firstly, looking at the value of unemployment benefits, Charts 2.1 to 2.3 show that they were quite low until early 1972. (DSS, 1983; DSS, 1992) Chart 2.1 shows the real value of unemployment payments, for the period 1948-49 to the present, for both single people and couples, deflated by the Consumer Price Index. All figures are in 1992-93 dollars.
Chart 2.2 compares unemployment payments for a single person and a couple to average weekly earnings for all person employees for the period from 1945-46 to the present.

Chart 2.2: Unemployment Payments as a percentage of Average Weekly Earnings

Chart 2.3 compares unemployment payments for single people to household disposable income per person for the period from 1959-60 to the present.

Chart 2.3: Unemployment Payments as a percentage of Household Disposable Income per person

All three charts tell a similar story. Over the period from 1948-49 to 1971-72, benefits were maintained at a fairly stable level and they were increased on an ad hoc basis, with long intervals between each increase. Over the period from 1972 to 1975, benefits increased dramatically and in broad terms, they have been maintained at this new, higher level. Specifically, unemployment benefits for single people and couples averaged 18 per cent and 31 per cent of average weekly earnings respectively over the period 1945-46 to 1971-72. In 1972-73, unemployment payment for singles and couples jumped to 26 per cent and 45 per cent respectively of average weekly earnings. In 1992-93, unemployment benefits are now 28 per cent and 51 per cent of average weekly earnings for single people and couples respectively.

Given the fairly low level of inflation over most of the period from the post war until 1972-73, regular adjustments to unemployment benefits were not necessary for unemployment benefits to maintain their real value. In early 1972, the McMahon Government increased unemployment payments by $7 (or a massive $40 in 1992-93 dollars). The Whitlam Government, in early 1973, gave an increase in the payment for singles of $4.50 ($24 in 1993 dollars) and gave couples an increase of $12.50 ($66 in today's dollars). When inflation became a regular feature of the Australian economy, there was a perceived need to maintain the real value of unemployment payments. Over the period of the Whitlam Government, benefits were increased on a fairly regular basis. During the Fraser Government, provision was made for automatic increases in benefit based on movements in the consumer price index and this arrangement was not varied substantially. The main exception was that the annual indexation increase for single unemployment payment recipients due in November 1978 was not paid. Indexation of, and additional ad hoc increases to, unemployment payments have also been a feature of the Labor Government post 1983.

To sum up, the value of unemployment benefits was low until 1972, compared to average weekly earning and household disposable income per person. From 1972 through to 1975, the value of unemployment payments rose dramatically and this value has been roughly maintained into 1993.

A number of other payments are available to unemployed people, including Basic Family Payment, Additional Family Payment, Rent Assistance and Guardian's Allowance. (Although the names of payments have changed over time I will use the current name of each payment to save confusion.) As the Table 2.1 shows, not all these payments have always been available to unemployed people and the value of the payments which have been available has risen over time. (DSS, 1983; DSS Annual Reports, various; DSS Budget Information Kits, various)
Table 2.1

OTHER SOCIAL SECURITY PAYMENTS
Real Value (in 1992-93 dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Family Payment</td>
<td>n.a</td>
<td>3.84</td>
<td>2.65</td>
<td>9.35</td>
<td>10.45</td>
</tr>
<tr>
<td>Additional Family Payment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;13 years</td>
<td>4.75</td>
<td>11.53</td>
<td>23.88</td>
<td>17.81</td>
<td>30.95</td>
</tr>
<tr>
<td>13-15 years</td>
<td>4.75</td>
<td>11.53</td>
<td>23.88</td>
<td>17.81</td>
<td>43.70</td>
</tr>
<tr>
<td>Rent Assistance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single: no children</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>32.00</td>
</tr>
<tr>
<td>Couple: no children</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>34.00</td>
</tr>
<tr>
<td>1-2 children</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>37.40</td>
</tr>
<tr>
<td>3+ children</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>42.60</td>
</tr>
<tr>
<td>Guardian’s Allowance</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>14.50</td>
</tr>
</tbody>
</table>

Turning firstly to Basic Family Payment, it has been available to all families since 1945 for the second child and for all subsequent children. In 1950, Basic Family Payment also became payable for the first child within a family. The value of Basic Family Payment varied depending on the position of the child in the family. For example, the value of Basic Family Payment is currently higher for the fourth child in a family than it is for the first child. Basic Family Payment was free of a means test until October 1987 when it became subject to an income test. In January 1992, Basic Family Payment became subject to an assets test.

Additional Family Payment was introduced in 1945 and was subject to a means test. It was originally an add-on to unemployment benefits for the first child and was payable where a person had custody, care and control of a child who was under the age of 16. From 1962, Additional Family Payment became payable for second and subsequent children, in addition to Basic Family Payment. From 1962 until 1971, the rate for the second child was higher. In May 1983, Additional Family Payment also became available to low income working families, not just people primarily reliant on unemployment benefits, and in 1989 its rates were substantially increased. In January 1993, Additional Family Payment was no longer paid as part of unemployment benefits and instead it became a separate child payment paid to the principal carer. Additional Family Payment is now usually paid to the mother, along with Basic Family Payment and Rent Assistance (where applicable).

Rent Assistance is a payment available to unemployed people who are renting, and low-income people with children who are renting, where the cost of their rent is above a set threshold value. Until 1986, Rent Assistance was not available to unemployed people, although it was available to Pensioners and Sickness Beneficiaries. In 1986, it became available to longer-term unemployed people (people who had been drawing payments for 6 months). In 1987, Rent Assistance became available to working families with children. In July 1989, Rent Assistance became payable immediately to all unemployed people with children, with a six month wait still applying to people without children. In March 1992, Rent Assistance became payable immediately to all unemployed people, except those under the age of 18.

Guardian’s Allowance was introduced in 1965 to help sole parents support children who were under 16 years. Eligibility for Guardian’s Allowance was extended to unemployment beneficiaries in May 1984.

Income tests are another important feature of the income support system. In 1945, the amount of income which could be received while still getting maximum rate benefit was one pound and this was increased to two pounds in 1957 ($33 in 1992-93 dollars). This amount is known as the “free area” and it applied at the same level for both single people and couples. (This was based on the assumption that there would only be one breadwinner per family.) For income in excess of the free area, benefit was withdrawn on a pound for pound basis, so one pound of private income reduced benefit by one pound (i.e. a 100 per cent withdrawal rate). In September 1969, the free area was increased to $6 per week ($38 in 1992-93 dollars) and a 100 per cent withdrawal rate still applied to income in excess of the free area. In November 1980, the income test was liberalised again so that while the free area of $6 remained ($13 in 1992-93 dollars), benefit was only withdrawn at 50 per cent of private income in excess of the free area, up to a maximum of $50. Unemployment benefits were withdrawn on a dollar for dollar basis for all private income above $50.

In October 1982, the income test was again liberalised. All beneficiaries could now receive other income of up to $10 per week without reduction in benefit ($18 in 1992-93 dollars). Thereafter benefit was reduced by half the amount of other income between $10 and $60 per week, and by the full amount of other income over $60 per week. (DSS, 1983) In March 1984, the free area increased to $20 ($33 in 1992-93 dollars) and the 50 per cent withdrawal rate applied up to $70, with dollar for dollar reduction occurring thereafter. In May 1986 the free area was raised to $30 ($44 in 1992-93 dollars).

In September 1990, an additional free area for earned income (called the earnings disregard) was introduced. It allowed an additional $15 a week to be earned by both a married beneficiary and spouse without reducing maximum benefit entitlement. The maximum combined free area and maximum earnings disregard was $60 per week ($62 in 1992-93 dollars). This earnings disregard was increased in September 1993 to $25 per week for each of a married beneficiary and spouse and the disregard was introduced for single people at the rate of $15 per week. The combined free area and maximum earnings disregard for couples was $80 per week and for single unemployed people was $45 per week.
In March 1994, an earnings credit will be introduced where beneficiaries can accrue their free areas up to $500 which can be offset against income from employment. This will provide an incentive for allowance recipients and their spouses to earn moderate casual or part-time income without automatically affecting their income support payments. (DSS Budget Information Kits, various)

As can be seen from these changes, the income test has been liberalised over time. For single people, the free area is about 20 per cent higher in 1993 than it was in 1969. For couples, the free area has more than doubled in real terms over this time, rising by 111 per cent. This is primarily due to couples being recognised as individuals, where both partners may get part-time work. The rise in the real value of the free area increases the monetary gain from combining part-time work with income from unemployment payments and the rise in the free area for couples encourages both members of a couple to seek work.

Unlike the income test, the assets test has not always applied to unemployment payments. The assets test is a new feature of the unemployment benefit system, only being introduced in December 1987 for those aged 25 years and over and in September 1990 for those aged less than 25 years.

Activity tests have always been a feature of the Australian Social Security system. In 1945, applicants were required to show that they were capable of undertaking, and willing to undertake, 'suitable' work and had taken reasonable steps to obtain such work. The Director-General of Social Services was empowered to determine what was suitable work and could also deny benefit to a person who became voluntarily unemployed without good reason, became unemployed through misconduct as a worker or who refused to accept other suitable employment. Benefits were not payable to unemployed persons whose unemployment was due to direct participation in a strike. Where a couple was drawing unemployment payments, only one partner in the couple had to meet the activity test. So, for example, a husband had to be seeking work but his wife did not. The activity test for couples has not changed.

It was not until 1976 that activity-testing eligibility provisions were tightened. On 23 March 1976, the Government announced that the definition of suitable work would be extended, people would be required to lodge their income statements personally each fortnight with the Commonwealth Employment Service (CES), more selective reviews were to be conducted by DSS field officers, benefits were not payable to school leavers during the long holidays, and people who voluntarily gave up their jobs had to wait six weeks before being granted unemployment payments. In 1979, provisions were tightened for workers involved in industrial action and for people leaving work voluntarily. Where a person left work or would not take up a suitable job offer, it was required by law that postponement of payment was to be for at least six weeks and up to 12 weeks. (DSS, 1983)

In September 1986, additional staff resources were allocated to establish regional unemployment benefit review teams to verify efforts by beneficiaries to find work. In November, unemployment benefit forms had to be lodged personally and continued registration with the CES was made compulsory for unemployment benefit recipients. In March 1987, automatic reviews were established for people receiving benefit for more than two years. In July, the minimum postponement periods for benefit applying to voluntary job leavers were made standard and cumulative. A work intention questionnaire for benefit eligibility was also introduced in July 1987. In September, the deferment period for unemployment beneficiaries aged under 21 years increased from six to 13 weeks and CES registration was imposed on them.

In July 1988, additional mobile review teams were set up and in September, an enhanced work intention form was introduced on a targeted basis. In November 1989, work test procedures were toughened for itinerants and beneficiaries moving to low employment areas and interviews at one year of unemployment were intensified. In December 1989, ten more review teams were set up. In September 1990, there was an increase in the non-payment period for unemployment benefit recipients who failed the work test and a non-payment period was introduced for recipients who failed to attend interviews or respond to correspondence. In January 1992, mobile review teams were again extended. (DSS Budget Information Kits, various)

On the whole, activity testing becomes much tougher as economic growth picks up and this is appropriate. Where new jobs are being created, the administration of Social Security payments should help to ensure that unemployed people are pushed to search for jobs. When economic growth falls, some of the toughened administrative procedures can be reduced, such as reducing the number of mobile review teams. However, many of the tightened criteria stay in place even when growth does dip again. In periods where the number of applicants for jobs far outweighs the number of jobs, it would appear to be wasting administrative resources to impose tough work tests.

It is possible for Social Security clients to appeal decisions taken by the Department. The Social Security Appeals Tribunal was established in each State and Territory in 1975 by the Minister for Social Security to consider appeals by people not satisfied with departmental decisions. Appellants dissatisfied with a Tribunal decision have a further right of appeal to the Administrative Appeals Tribunal. In 1992-93, nearly 10,000 appeals were lodged with the Tribunal, with 2,900 being lodged by unemployed people. Of all appeals decided by the Tribunal in 1992-93, about 40 per cent were lost by the Department. Although the number of appeals is very low compared to the total number of DSS clients, a very high proportion of appeals are lost by the Department, indicating the stringency of access to unemployment payments.

General waiting periods are another feature of the Social Security system. When unemployment benefits were first established in 1945, provision was made for a seven-day waiting period during which unemployment benefit was not payable. Unemployment benefit was payable from and
including the seventh day after the day on which the claimant became unemployed or lodged their claim, whichever was the later. Benefit was then payable for an indefinite period of time unless the unemployed person’s circumstances changed. Unemployment benefit is still payable for an indefinite period. Apart from general waiting periods, there are other types of waiting periods which depend on the circumstances of the unemployed person. For example, if a person has left work voluntarily or has access to moderately high cash reserves, they may have a longer waiting period. The following deals only with general waiting periods.

In 1969, the seven-day waiting period for unemployment benefit was required only once in every 13 weeks, in respect of more than one period of unemployment. In 1977, it became possible for the waiting period to be waived by the Director-General of Social Services. (DSS, 1983) In 1987, the seven-day waiting period was re-introduced. In February 1991, the seven-day waiting period for claimants in hardship was waived. In July 1991, it became possible for the seven-day waiting period to be waived where a claimant was receiving Social Security income support within the previous 6 weeks (for short-term unemployed people) and 13 weeks (for long-term unemployed people). In September 1993, the seven-day waiting period could be waived for all unemployment beneficiaries who had been claimants within the previous 13 weeks. (DSS Budget Information Kits, various) While there have not been many changes to general waiting periods, liberalisation has tended to occur when economic growth is low and waiting periods have been re-introduced when economic growth accelerates.

To sum up, changes to the income support system seem to be triggered by changes to economic growth. While the economy is buoyant, tough activity tests are implemented to encourage job search. As economic growth falters, activity tests become less stringent, waiting periods are waived and the value of unemployment payments rise. Income tests have progressively become more liberal and are now set so as to encourage the combination of part-time work while still receiving unemployment payments for single people and both partners in a couple.

**Income Taxation**

Over the period 1950-51 to 1993-94, the Australian Income Taxation system has gone through a number of changes, although the system still has three primary elements. First, there are income thresholds and marginal tax rates where progressively higher income thresholds are associated with progressively higher marginal tax rates. Second, there are deductions which are amounts of expenditure on particular items (such as donations to charities) which can be offset against taxable income, thus reducing the amount of tax which has to be paid. Third, rebates are set amounts which can be subtracted from personal income tax liability. An example of a rebate is the dependent spouse rebate. I will discuss briefly the structure of the taxation system at three points in time, namely 1972-73, 1982-83 and 1993-94. (ATO, 1992)

In 1972-73, there were 29 different marginal tax rates, with the first marginal tax rate of 0.2 cents applying up to $200. No tax was payable, however, unless income was more than $1040 per annum ($5524 in 1992-93 dollars). For income between $1041 and $1121, a shade-in rate of tax of 67 per cent applied, so for income in this range, each dollar was taxed at 67 per cent. After $1121, the marginal tax rate fell to 10 per cent, but rose thereafter. Tax deductions were available for a dependent spouse and up to two children up to age 16. Income support payments were not taxable so only additional private income was subject to tax.

In 1982-83, there were four marginal tax rates with the tax free threshold up to $4195 ($7471 in 1992-93 dollars). Rebates were available for a dependent spouse and for a sole parent. The dependent spouse rebate replaced tax deductions for children in 1975-76 and the sole parent rebate was introduced in 1975-76. Rebates provide greater assistance to lower income earners than tax deductions. The higher a person’s marginal tax rate, the higher is the value of the tax deduction they receive, so someone on a higher income gets a larger tax deduction. Rebates are of equal value to both high and low income earning taxpayers. However, a person must have a sufficiently high level of income to incur a tax liability in the first place, for either a deduction or rebate to provide any assistance. Social security payments, by contrast, provide assistance to those with insufficient income to incur an income tax liability. Income support payments, except Basic Family Payment, were taxable (income support payments became taxable in 1976). So unemployment payments and private income were both subject to tax.

In 1993-94, there are five marginal tax rates with a tax free threshold applying up to $5400. (Dawkins and Willis, 1993) A Medicare Levy on family, rather than individual, taxable income is also payable (being introduced in February 1984). A threshold level of income must be earned before the Medicare Levy applies and unemployment payment recipients are below this threshold. The Medicare Levy is subject to a shade-in rate of 20 per cent for income above the threshold, with the rate then falling to 1.4 per cent. Rebates are available for low-income people (for income up to $750) and a dependent spouse rebate applies, with the amount higher for couples with children than without children. A sole parent rebate also applies. Income support payments, except family payments and Rent Assistance, are subject to tax. (Tax stopped being applied to Additional Family Payment in March 1984.)

Beneficiary rebates also apply in 1993-94, being introduced in 1984-85. Beneficiary rebates ensure that a person reliant solely on income support for the full year, and not receiving any other private income, will not have to pay tax on income support payments. The value of the lowest income threshold has tended to be fallen over time in real terms. This is largely as a result of Governments reducing marginal tax rates, rather than fully indexing income thresholds in line with inflation. At the same time, the value of unemployment payments has risen. This combination has resulted in the Government putting in place a system of rebates for income support recipients to ensure that no tax is paid on unemployment payments where this is the only income received by an unemployed person.
3. Why did Replacement Rates become a Concern?

In this section, I provide time series data on the number of people unemployed. I begin by showing that the number of people who were unemployed was quite low until 1975, but after the mid 1970s the number of people unemployed rose sharply. The combination of the rise in the number of people unemployed and the rise in the value of unemployment payments around the same time created concern about replacement rates. A number of related labour market factors, some of which began in the mid 1970s, have also contributed to the concern about the relativities between unemployment payments and low wages.

First I begin by examining the number of people unemployed. Charts 3.1 and 3.2 provide data on the number of people unemployed although the data for the years prior to 1966 are indicative only. Prior to 1966, the most reliable time series data collected on the number of people unemployed comes from two sources.

The first is the number of people drawing unemployment payments. Prior to the introduction of the Commonwealth unemployment benefits scheme in 1945, the relief of the able-bodied unemployed was undertaken by the States. Except in Queensland, where an unemployment insurance scheme was introduced in 1923, the customary methods of assisting the unemployed were through rations or sustenance to the unemployed in need or paying for food or wages in return for relief work provided by local authorities. (DSS, 1983) Reliable time series data are available on the number of people drawing unemployment payments from 1946 from the Director-General of Social Services (now the Department of Social Security). The second source of data is the number of people registered with the Commonwealth Employment Service (CES) as looking for full-time work. CES data are available from 1950. (Foster and Stewart, 1991; DSS Annual Reports, various)

Both data sources are likely to be an underestimate of the number of people unemployed. It is likely that many unemployed people found work without the help of the CES and so they did not register with the CES. Also, the CES only registered those looking for full-time work, thus excluding those looking for part-time work. (In 1964, about 10 per cent of the workforce was employed part time.)

The number of unemployment beneficiaries is also an underestimate of the total number of people unemployed since many people were excluded from drawing benefits and many who were eligible probably did not draw them anyway. Not everyone was automatically eligible for unemployment payments including married women (unless it was not reasonably possible for her husband to maintain her), Aborigines (unless the Director-General was satisfied that, having regard to his character, standard of intelligence and social development, it was reasonable that he should receive them) and people who had not resided continuously in Australia for 12 months. (DSS, 1983: pp. 88-89) It is likely that drawing unemployment payments has always had some degree of stigma attached to it so that many people were unwilling to draw payments. In addition, the average length of time that people were unemployed prior to 1974 was quite low, although it did fluctuate.(1) For example, in 1945-46 the average length of time that people drew unemployment payments for was 3 weeks; and in 1968-69 it was 6 weeks for males and 7 weeks for females. People may have used personal savings to tide themselves over during such short periods of unemployment rather than claiming unemployment benefit.

In 1964, the Australian Bureau of Statistics (ABS) began a quarterly survey of labour supply on a national basis. Estimates for August 1966 and subsequent periods are not strictly comparable with those for earlier periods. The main factors causing the discontinuity included that, from August 1966, the estimates included Aboriginals and the coding of industry was based on a more comprehensive place of work index. In 1978, the labour force survey started to be done on a monthly basis and it has been ongoing ever since. It provides reliable time series data on the number of people unemployed.(2)

![Chart 3.1 Full-time Unemployed and Recipients of Unemployment Payments](chart.png)

Note: Unemployed looking for full-time work is a combination of two data sources. Data from 1950 to 1965 are from the CES and data from 1966 onwards are from the ABS.
As can be noted from Charts 3.1 and 3.2, the number of unemployment beneficiaries and the number of people unemployed were very low until 1975. From the post-war period until this time, Australia recorded very low or negative growth on only a few occasions including in 1952-53, 1956-57 and in 1961-62. Apart from these anomalies, Australia experienced strong economic growth and with it strong employment growth and low unemployment. The only times when unemployment rose to more than 100,000 were associated with these declines in aggregate economic growth. After each recession, unemployment fell away quickly.

When the unemployment rate rose to 4.6 per cent in 1975, it was the first time this had happened in Australia's post-war history. In the early 1970s, the unemployment rate stood at around 1 to 2 per cent. With a brief exception during the 1961-62 recession, it had never exceeded 3 per cent although it rose to 2.9 per cent in the aftermath of the collapse of the Korean War wool boom in the early 1950s. Since 1974 the number of unemployed people and the number of unemployment beneficiaries has varied enormously. However, neither have fallen back to the levels experienced in the 1950s and 1960s. The high level of unemployment was a concern to the community in the mid 1970s and into the early 1980s. Rapid economic growth over the period of the mid to the late 1980s reduced the attention paid to unemployment. Despite the economic and employment growth over this time, a high level of unemployment persisted. When the Australian economy went into recession in 1990-91 the concern with high unemployment returned.

In addition to the number of people in receipt of benefits increasing, there have been a number of other changes in the labour market and the income support system which have increased the focus on relativities between low wages and unemployment payments. While some of these changes began some time ago, not all these trends were discernible until recently.

Focusing firstly on the labour market, it is apparent that wages for many people have fallen. As Professor Gregory's "Disappearing Middle" study (1992) has shown, the share of low-paid work has increased. In Australia, since 1976, 71 per cent of all new jobs have been created in the bottom 20 per cent of the male full-time weekly earnings distribution. In addition, research by McGuire (1993) shows that the amount earned in low-paid jobs, for full-time adult non-managerial employees, has fallen over the period 1985 to 1992, with men's and women's earnings at the first decile declining by 7.1 per cent and 4 per cent respectively. From 1975 to 1992, men's earnings at the first decile from full-time work have fallen by 5.1 per cent, however, women's earnings have increased by 5.3 per cent.

Another change which has occurred in the labour market is that wages no longer explicitly take the circumstances of the earner into account. Over the period from 1907 (Harvester Case) to 1973, wages did take into account the circumstances of the earner. In 1974, however, the Conciliation and Arbitration Commission determined that one minimum wage for adults should apply rather than separate male and female rates based on family needs. (DIR, no date given) In contrast, the income support system has always recognised the needs of a family by including payments for a spouse and children, where applicable.

Within the income support system, it is now possible to earn more private income while retaining benefits than used to be the case. As noted in Section 2, the amount of private income which can be earned while still receiving unemployment payment has been liberalised on a number of occasions. Liberalising the income test by itself does not ensure that beneficiaries can access more private income. An associated change in the labour market, that of an increase in the number of part-time jobs, has contributed to the likelihood that people drawing unemployment payments will be able to get some private income from part-time work. In 1993 (year-to-date), 23 per cent of the workforce is employed part time, whereas in 1964, only 10 per cent of the workforce was employed part time. Given the greater number of part-time jobs available and the liberalisation of income tests on private income, the income gain from combining part-time work with unemployment payments has increased relative to low-paid full-time work.

In summary, from the post-war period until 1974, there was little need for concern about replacement rates. Strong economic growth occurred for most of the period after the war. Associated with this was rapid employment growth, and the number of people drawing unemployment benefits was low. In 1974-75, unemployment rose dramatically and, unlike previous rises in unemployment, high unemployment persisted and has become a permanent feature of the Australian economy.

The high and sustained level of unemployment, the large number of people drawing unemployment benefits, the increased value of unemployment benefits and the increase in the amount of private income which can be earned while retaining unemployment payments have all provoked concern that
the income support system may be a factor contributing to high unemployment. In addition, changes in the labour market which have seen the number of low-wage jobs increase and the pay in these jobs fall, have also resulted in a sharp focus on the relationship between unemployment payments and low wages.

4. Replacement Rates Examined at the Aggregate Level

Two types of replacement rates can be distinguished - exit replacement rates and entry replacement rates. Exit replacement rates relate to people who are currently unemployed while entry replacement rates relate to people who are employed. Exit replacement rates are defined as the ratio of current income while on unemployment payment to prospective disposable income from employment. Entry replacement rates are defined as the ratio of imputed total after-tax income while out of work, and in receipt of unemployment payment, to current total after-tax income while employed.

The concepts of entry and exit replacement rates were not developed until the late 1980s. It was not really until this time that there was explicit recognition by researchers that people exiting the unemployment pool were likely, on average, to be offered lower wages than those received by people who were already working. (This is discussed further in Section 5.) Prior to 1989, the replacement rate was usually measured as the rate of unemployment payments at both the single and couple level compared to average weekly earnings (as in Chart 2.2). So at a point in time there were two replacement rates.

Exit and entry replacement rates will differ for family units, because the potential or actual earnings of those currently unemployed or employed vary across the population, and because unemployment payments received will vary according to age, marital status and number of dependants. What results, therefore, is not a single replacement rate, but a distribution of replacement rates at any one point in time. (Replacement rates in countries with unemployment insurance schemes do not vary in this manner. Under these schemes, income while unemployed tends to be a set proportion of the earnings received while working. Thus, in countries which have unemployment insurance, replacement rates do not vary according to the circumstances of the unemployed persons.)

While entry and exit replacement rates cover mutually exclusive groups of people (either working or not working), they can both cover people facing exactly the same financial incentives. The most likely group who could appear in either category are people for whom there is little financial incentive to work or not to work, that is, a person for whom wages are about equal with unemployment payments. Faced with little financial incentive to work, some people will choose to work and some will not.

Research by Bradbury, Ross and Doyle (1991) examines the exit replacement rates of hypothetical family units receiving unemployment payments. Replacement rates are calculated for current beneficiaries (for whom wages are estimated) and ex-beneficiaries (for whom unemployment payments are estimated). This population provides useful information on exit replacement rates since it examines the group who are, or have recently been, unemployed.

The numerator in calculating these replacement rates is the sum of unemployment benefits, family and educational transfers to dependent children and other non-wage, non-transfer income. The denominator is the sum of wages (either actual or estimated) and family and educational transfers and non-wage incomes, from which PAYE taxation is deducted. The wages for ex-beneficiaries are from the 1986 Income Distribution Survey (IDS). For current beneficiaries, IDS data and multiple regression techniques are used to estimate the likely weekly wages that beneficiaries would receive if they accepted full-time wage or salaried employment. The IDS data from 1986 are updated to January 1991 in order to examine changes in replacement rates between 1986 and 1991. Updated or aged data uses existing data and then takes account of movements in earnings and other income components over the intervening period.

The caveat which Bradbury, et al make to their study is that it only looks at direct monetary benefits received while employed or unemployed, and ignores any fringe benefits, employment costs and non-financial benefits from either employment or leisure which may influence a person's decision to seek employment.

The main finding of the research by Bradbury, et al was that the average person leaving unemployment benefit for full-time employment could expect more than a doubling in the disposable income of their income unit. This applied in both 1986 and 1991. As expected, Bradbury, et al found different results for groups with different characteristics.

For older single persons and older couples without children, the increase in the base rate of unemployment benefit relative to wages between 1986 and 1991 means that replacement rates have increased. Single people generally had the lowest average replacement rates. For single persons aged over 30, the median replacement rate was between 35 and 39 per cent. Median replacement rates for young people aged under 18 were very low (under 30 per cent), and at least 90 per cent of these young people had replacement rates below one half. Replacement rates for couples without children were estimated at between 61 and 72 per cent in 1991, depending on the age of the couple and the estimation assumptions used.

In both 1986 and 1991, the family types with the largest median replacement rates were those with children, particularly those with three or more. This reflects the higher levels of unemployment benefits paid to larger families. In 1991, for such families receiving Additional Family Payment based on their current income, the median replacement rate was 77 per cent and 9 in 10 of such families had replacement rates below 80 per cent. Additional Family Payment (which is paid to low-income earning families with children) has been successful in reducing the very high replacement rates facing large families since it increases disposable income when employed.
For married people, replacement rates can be calculated by assuming either that one or both partners of the couple find work. In the future, an increasing prevalence of married women's employment may lead to a lowering of replacement rates.

The analysis which follows examines entry replacement rates which compare income from unemployment payments with after-tax income received from employment for people who are currently employed. Saunders, Bradbury and Whiteford (1989) examined the entry replacement rates faced by families who had full-time workers in them. They artificially aged the ABS 1981-82 Income and Housing Survey to January 1988, taking account of movements in earnings and other income components over this time period. They found that for the vast majority of families, the replacement rates lie between 25 per cent and 75 per cent. Almost 92 per cent of all families in the sample face replacement rates in this range. For the sample as a whole, just over one half of one per cent face an estimated replacement rate in excess of 100 per cent implying that they would be financially better off unemployed than in work.

I have used a similar methodology to Saunders, et al. I have not had to age the Income Distribution Survey data I used since recent survey data is available from the 1989-90 Income Distribution Survey. The other main difference between Saunders, et al and the methodology used here is that I have tested whether all employed workers are better off employed, not just full-time workers. It is important to examine replacement rates for part-time workers, since in 1990, part-time workers represented 21 per cent of the employed workforce. I have, therefore, included both part-time and full-time workers in my analysis.

I have calculated each working family unit's total weekly disposable income using the Department of Social Security's Policy Effects Model and unit record data from the Income Distribution Survey. This income while working comprises three types of income, namely wage income from full-time and part-time work, non-wage income such as earnings from rent and dividends, and income from DSS including family payments and unemployment payments where applicable. (Unemployment payments may be available where a person does not earn sufficient income from a job to eliminate their entitlement to these payments.) I have then calculated each family unit's income if they were not working which is the sum of their entitlement to unemployment payments, Rent Assistance and family payments. I have assumed that while unemployed, they have no other wage or non-wage income.

Where DSS payments are available, families are assumed to be drawing them. All children and students are assumed to be less than 13 years, thus the lower rate of Additional Family Payment applies. People who were self employed have been excluded from the analysis given their reported earnings tend to be unreliable. Population benchmarks are applied to the sample data from the IDS, expanding it to approximate the total family types within the current Australian population.

Chart 4.1 shows the distribution of the replacement rates resulting from the comparison of income received by the currently employed population with the income they could receive from income support payments. For all families, the median replacement rate is 30 per cent. This means that for the average working family, unemployment payments are equal to only 30 per cent of the current income they receive from employment. For the vast majority of families, the replacement rate lies between 20 per cent and 80 per cent. More than 94 per cent of employed families face replacement rates in this range.

Table 4.1 (p. 20) provides a range of summary information on the replacement rates faced by different family types. The table is disaggregated by marital status, age, families with and without children and families according to the number of children they contain. In general, these results show that replacement rates are lower for younger people, single people and people without children than for couples with children and sole parents. They also show that replacement rates increase with the number of dependent children.

For single people aged 21 years or more without children, the median replacement rate is 30 per cent, and 85 per cent of them lie in the range 20 per cent to 50 per cent. For couples with children, the median replacement rate is 40 per cent, and 88 per cent lie in the range 30 per cent to 80 per cent. For sole parents, the median replacement rate is 60 per cent, and 90 per cent lie within the range 40 to 80 per cent. It is only for families with three or more children, that a large number face replacement rates of 90 per cent or higher.

For the sample as a whole, only 2.5 per cent of families face replacement rates of 100 per cent or more, implying that they would be financially better off unemployed than in work (once the costs of work and the concessions available to unemployed people, such as cheap pharmaceuticals, are taken into account). Of course, there will be people who face the same financial incentive who are not working and so are not captured in these entry replacement rate calculations. For people to have
such high replacement rates implies they are working part time or have very low full-time wages. (Low full-time wages apply to youth, trainees and people working for below award wages.)

If people are motivated by income concerns, it does not appear rational that 2.5 per cent of the working population choose to work when they would be better off not doing so. Why are people choosing to work then? A number of explanations are possible.

The decision to work could be based on longer-term considerations. For example, it could be that the employed person has an expectation that part-time work will become full-time or the number of hours will increase; that the training wage associated with a traineeship will be replaced by a higher wage for a qualified worker; that the employed person expects to be promoted; or that, in a couple where only one person is employed part time, there is an expectation that the unemployed spouse will find work.

Alternatively, people may not realise that they are worse off working rather than being unemployed since the interaction of the taxation and income support systems operates in a complex way. People may not be motivated by income or there may be a great deal of psychic income attached to working which outweighs the income loss. At such low income levels, this is unlikely to be true. It could be that the data are not reliable, however, this is difficult to test. There may be some non-wage income, such as superannuation or subsidised home loans, which is not captured in disposable income. There is no way of knowing which of these reasons explains why people might financially disadvantage themselves by working.

There are two main points which can be made from this analysis on entry replacement rates. First, there is a small proportion of workers actually choosing to work who would be financially better off unemployed. Second, for the working population as a whole, both part time and full time, unemployment payments are not sufficiently high to encourage them to leave employment. Nearly 95 per cent of all families would experience a decline in their disposable income of at least 20 per cent if they were to lose their jobs and become unemployed.

To sum up, based on aggregate data from the Income Distribution Survey, the value of unemployment benefits does not generally seem to be sufficiently high to discourage people from working. This is true for people who are currently unemployed when we examine their exit replacement rates and it is true for people who are employed when their entry replacement rates are examined. The average person leaving unemployment benefit for full-time employment in 1991 could expect a more than doubling in the disposable income of their income unit. For the average working family, nearly 70 per cent of them would have their disposable incomes decline by at least one half (in December 1990) if they were to lose their jobs and become unemployed.
5. Replacement Rates for Individual Family Types

The following section compares the income support payments which various family types could have received when they were unemployed compared to their likely wages when employed in 1973, 1983 and 1993. Unemployment payments and supplementary payments are affected by a number of factors. These include age, the presence of dependent children, marital status and whether both partners are seeking to participate in the labour market (and whether on a full-time or part-time basis). Minimum award wages are used to compare with unemployment payments. This is based on recent research from three sources which shows that people seeking employment from the unemployment pool are likely to initially receive low wages if they find jobs.

Research by Saunders, et al (1989), based on the ABS 1981-82 Income Distribution Surveys, and by Saunders (1992), based on the ABS 1990 Survey of Income and Housing Costs and Amenities, has indicated a substantial relationship between unemployment and low income while in work. This research found that people experiencing a period of unemployment were more likely to have been low-income earners while in work, when compared with those who had not been unemployed.

Unemployed people were also more likely to receive a lower wage offer when going for a new job than people who were already employed. Bradbury, et al (1991) found that wage offers to unemployed people were about 12 per cent lower than offers to employed, but otherwise equal, individuals. This phenomenon is known as "wage scarring".

Using minimum award rates to compare to unemployment payment poses a problem because there is no single minimum wage rate. Minimum award rates of pay vary between awards and between classifications within awards. The awards which have been chosen here are the lowest full-time award wages payable to adults based on three out of the eight awards which covered the largest number of employees in 1990. (ABS, 1991) The awards are the Metal Industry Award, the Shop Employees (NSW) Award and the Australian Government Employees Award, thus covering both the private and public sectors; manufacturing, retail and clerical industries and both State and Federal awards. In Federal awards, the lowest minima are generally in line with the classification used here for the Metal Industry award.

It is not clear how representative such wages are of wages actually paid. In May 1990, 20 per cent of all employees were not covered by an award. In August 1992, 70,000 full-time employees (4 per cent) earned less than $190 a week (ABS Weekly Earnings of Employees Distribution, 1992). It is likely that employees earning such low wages were either in receipt of junior rates of pay or were employed outside the regulated wage sector.

On the other hand, the award wages applying to a particular job may not be an accurate reflection of average or expected earnings in that job. Many employees receive over-award payments, bonuses and overtime payments. In May 1992, such payment boosted the award wages of the average full-time non-managerial adult male employee by 14 per cent. Women and juniors, however, tend not to receive such significant increments to award wages. For the Metals industry, the lowest award classification had average over-award earnings of $44 per week in 1990. (MTU,MTIA&ACM, 1990)

Table 5.1 examines replacement rates for single adults, sole parents and couples, with and without children in 1973. Looking at the numerator, Social Security payments are maximum rate payments, including family payments where applicable. The denominator is income from employment, specifically being the sum of the award rates of pay in June 1973 (for three major awards) after tax and DSS family payments where applicable.

Table 5.1 - June 1973

<table>
<thead>
<tr>
<th></th>
<th>Single Adult, 21+</th>
<th>Couple Adults, 21+</th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>none 1 2 Children none 1 2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Metal Industry</td>
<td>42% 51% 60% 71% 79% 88%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shop Employees</td>
<td>32% 39% 46% 55% 61% 68%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australian Govt Employees</td>
<td>38% 45% 54% 64% 71% 79%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Rates applying June 1973. All income is after tax.

Table 5.1 shows that replacement rates across various family types were fairly low. A family with two children and one breadwinner on minimum award rates would have been 12 per cent worse off on unemployment payments ($8.50 per week, or $34.50 in 1992-93 dollars). It is unlikely that these replacement rates would provide any incentive for people to choose not to work. High replacement rates are most likely to apply to unemployed married women in low-wage jobs (and, less frequently, women) whose partners are neither employed nor actively seeking paid work. Because the rate of income support in these cases includes a component for the support of the dependent partner, the wage required to replace that income support is necessarily higher than it would be for a single person.

It is also possible to examine the replacement rates of people who are receiving unemployment payments but are working part time. In 1973, it was possible to earn up to $6 per week and still be in receipt of maximum unemployment payments. Each dollar of private income over $4 reduced unemployment payments on a dollar for dollar basis. If we compare a family with two children on full unemployment payments, plus the allowable private income of $6, to a sole wage earning family, the wage earning family would have been only about 1 per cent better off than being on
unemployment payments. In today’s dollars, they would have been $3 worse off unemployed. (Of the family types shown in the above table, a family with two children will have the highest replacement rates.) Such high replacement rates had the potential to encourage people to remain on unemployment payments and work part-time.

Table 5.2 examines replacement rates for various family types in 1983.

<table>
<thead>
<tr>
<th>Table 5.2 - June 1983</th>
<th>UNEMPLOYMENT PAYMENTS COMPARED WITH FULL-TIME WAGES FOR ADULTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Adult, 21+</td>
<td>Couple Adults, 21+</td>
</tr>
<tr>
<td>Children</td>
<td>none</td>
</tr>
<tr>
<td>Metal Industry</td>
<td>40%</td>
</tr>
<tr>
<td>Shop Employees</td>
<td>38%</td>
</tr>
<tr>
<td>Australian Govt Employee</td>
<td>39%</td>
</tr>
</tbody>
</table>

Note: Rates applying June 1983. All income is after tax.

Table 5.2 also shows that in 1983 replacement rates were also fairly low. A family with two children and one breadwinner on minimum award rates would have been at least 11 per cent worse off on unemployment payments ($22 per week, or $39 in 1992-93 dollars). Such low replacement rates would also have been unlikely to induce people not to work.

The replacement rates for people who were receiving unemployment payments, but working part-time, were higher than for people only receiving unemployment payments. In 1983, it was possible to earn up to $10 per week and still receive maximum unemployment payments. Each dollar of private income over $10 and up to $60 reduced unemployment payments by 50 cents for each additional dollar. After $60, a 100 per cent withdrawal rate applied. A family with two children and a sole breadwinner on minimum wages was only about 1 per cent better off than a family on unemployment payments with the $60 of private income. In today’s dollar terms, they would have been $2 better off in paid employment. Such a small differential between unemployment payments and low-wage earnings may have encouraged some people to stay on benefits and work part-time.

Table 5.3 examines replacement rates for single adults, sole parents and couples, with and without children. Looking at the numerator, DSS payments are maximum rate payments, including Rent Assistance and family payments where applicable. The denominator is after-tax income from employment plus DSS family payments where applicable and unemployment payments to the unemployed spouse if they are looking for work. In some cases, award rates of pay are sufficiently low that an unemployed partner will still be eligible for part-time unemployment payment. This was not the case in 1973 or 1983.)

It is likely that many couples are unaware that they would be entitled to unemployment payments when one member has a full-time job. In addition, sometimes the partner who is not working will not be looking for work and so they would not be eligible for unemployment payments. The table, therefore, includes two sets of calculations for couples. In the first, the denominator refers to couples in which the partner, who is not working, does not draw unemployment payments. In the second set of calculations, the denominator assumes that the partner not working is receiving unemployment payments.

Table 5.3 - 1993-94 | UNEMPLOYMENT PAYMENTS COMPARED WITH FULL-TIME WAGES FOR ADULTS |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Adult, 21+</td>
<td>Couple Adult, 21+</td>
</tr>
<tr>
<td>Children</td>
<td>none</td>
</tr>
<tr>
<td>Metal Industry</td>
<td>61%</td>
</tr>
<tr>
<td>Shop Employees</td>
<td>55%</td>
</tr>
<tr>
<td>Australian Govt Employee</td>
<td>52%</td>
</tr>
</tbody>
</table>

Note: Rates applying 1993-94. All income is after tax.

Table 5.3 shows that replacement rates are not high for single people or sole parents. They are also not usually high for couples with only one partner earning a low full-time wage, even where the partner, who is not in paid employment, does not draw part-time unemployment payments. The highest replacement rate is 92 per cent and it applies in the metal industry. This replacement rate equates to a couple with one person in work being $24 per week better off than a couple where neither partner has work. It does not seem likely that this income differential would be sufficient to encourage an employed person to take unemployment payments instead.

Replacement rates for single adults are highest when compared to the minimum rate in the Metal Industry Award and lowest when compared to the minimum rate in the Australian Government Employees (AGE) Award. This is because, of the three award rates considered, the minimum award rate is highest in the AGE Award and lowest in the Metal Industry Award. Interestingly, however, when compared to couples with one partner in full-time employment and the other partner unemployed, replacement rates are highest when the employed partner is employed under the AGE Award. This is because for such couples, the higher award wage under the AGE Award, as compared to the Metal Industry Award, is more than offset by the reduction in unemployment benefits payable to the unemployed partner. Over the relevant income range, a one dollar increase in wages of the employed partner leads to a one dollar decrease in unemployment benefits payable to the unemployed partner. However, after-tax income falls as private income increases, because the employed partner faces a marginal tax rate of 20 per cent while the unemployed partner’s income is
below the tax threshold. Hence as the wages of the employed partner increase, taxed income increases and untaxed income falls.

Again, replacement rates are higher in 1993–94 for people who are combining part-time work with unemployment payments than those who only get unemployment payments. For single people and sole parents combining part-time work and unemployment payments, replacement rates are not particularly high, but for couples they are high. At this stage it is worth reminding the reader that an activity test only applies to one partner of an unemployed couple, so only one person has to be participating in the labour market.

There are three situations which can be examined here. (In these three sets of calculations, the level of income from part-time work is set equal to the maximum amount which can be earned within the combined free area, earnings disregard and the earned income range which reduces unemployment payments by 50 cents for each additional dollar of private income.) The first situation is where both partners are drawing unemployment payments and one partner also has part-time work, compared to where one partner has a full-time low-paid job and the other partner is unemployed. In this situation, the replacement rate is 99 per cent for a couple with no children when compared to only one partner working in a low paid government job.

The second situation is the same as the first, except that in the numerator both partners are combining part-time work with unemployment payments. In this case, where both partners are drawing unemployment payments and working part-time, compared to where only one member of the couple has a low-paid government job, the replacement rate is 104 per cent. So the couple drawing benefits are $13 per week better off than the couple with the low-paid full-time job.

The third situation is where one member of the couple is combining unemployment payment and part-time work compared to a couple with one partner in a low-paid full-time job where the other partner is not looking for work, and is thus not eligible for unemployment payments. For a couple in this situation where the full-time employed person is in the metal industry, the replacement rate is 114 per cent! So, the couple drawing unemployment payments and where one person has part-time work is $45 per week better off, than the couple where one person has a low-paid job in the metal industry and the other member is not looking for work.

In all these three cases, such high replacement rates may provide little incentive to accept an offer of employment. This is especially true when the costs of work and the benefits available to people on income support (such as low-cost pharmaceuticals) are taken into account.

A number of caveats need to made about these high replacement rates. They assume recipients of unemployment payments are eligible for maximum income support payments. Many recipients will not be eligible for maximum payments or they will not be eligible for certain payments such as full Rent Assistance. Further, it is not particularly realistic to assume that both partners drawing unemployment payments are able to find part-time work at levels which would maximise their total income. As noted in Section 4, there are a number of reasons why people may choose to work when they would be financially better off not doing so (for example, they do not realise they are worse off working or their decision to work is based on longer-term considerations). Finally, as noted earlier, adverse comparisons of unemployment payments and wages occur for couples because the unemployment payments for two people are compared with the wage for one person. However, this comparison rests on an assumption that the single earner couple remains the norm. In July 1992, 51 per cent of married couple families had both partners participating in the labour force, so this assumption is outdated.

I will briefly turn to examining the influences on replacement rates between 1973, 1983 and 1993. Quickly recapping on the replacement rate calculation, the numerator is the sum of unemployment payments, taxation and the private income which can be earned while retaining unemployment payments; while the denominator is the sum of wages, taxation and income support payments available to working people. So what changes have occurred to each of these elements and how has this impacted on replacement rates?

Between 1973 and 1983, replacement rates rose slightly. While real unemployment payments rose and the free area increased significantly to push up the numerator, the denominator also rose due to a large increase in real wages although this was offset by increases in the average tax paid by low-income earners. Between 1983 and 1993, replacement rates rose again, especially for couples. The numerator rose because of increases in real unemployment benefits, and additional income support payments (like rent assistance and guardian's allowance) now being available to unemployed people. There was also a large rise in the amount of private income, for couples where both were working, which could be earned while retaining some unemployment payments. The main factor which pushed the denominator down was a fall in real minimum award wages, however, this was offset by an increase in income support payments available for working families (through Additional Family Payment) and large falls in the average tax paid by low-income people.

To sum up, replacement rates for both single people and couples have risen slowly over time, being higher in 1993 than in 1973. For single people and sole parents, replacement rates in 1973, 1983 and 1993 were not sufficiently high to encourage people to take unemployment payments rather than accept low-paid full-time work. This was true regardless of whether or not they combined unemployment payments and part-time work.

For couples who have no income, other than unemployment payments, replacement rates have also never been high enough to encourage them to stay on unemployment benefits rather than accept low-paid work. Where couples have been able to combine part-time work and unemployment payments, they would have had some financial incentive to remain on income support rather than accept low-
paid full-time work. In 1973 and 1983, the amount a couple could receive on unemployment payments combined with part-time work earnings was only $2 or $3 less than a couples’ income where one partner had low-paid work. By 1993, a couple combining unemployment payments and part-time work could be substantially better off than a couple where only one partner had a low-paid job. So the income support system has always had the potential to encourage couples, who are combining unemployment payments and part-time work, to remain unemployed if the alternative is for only one of them to get a full-time low-paid job.

Given that unemployment was not high in 1973 but replacement rates for couples were, it does not appear that high replacement rates were enough, in themselves, to encourage couples out of work and onto unemployment payments. Further, in 1973 it was more likely that only one partner in a couple would be in the labour force. So if a high replacement rate were to encourage a working partner in a couple out of a job, it would have been more likely to do this in 1973 than in 1993. It would also have been easier for a person in 1973 not to accept a job because the work test was not applied as stringently then as it is in 1993. Finally, the unemployment rate for couples is lower than that for singles, despite the higher replacement rates facing couples. It would therefore appear that fluctuations in unemployment since 1973 and the secular increase in unemployment over that time mainly reflect factors other than increases in replacement rates.

6. Effective Marginal Taxation Rates

Replacement rates, as a measure of the incentive to work, tend to focus on ‘binary’ decisions - whether a person would be financially better off in a full-time job or not, compared to being on unemployment payments. Of course, this will not be the only option open to an unemployed person. An unemployed person may be offered a part-time job and, in theory at least, a particular number of hours to work in the part-time job. The decision to work may then be approached in a more ‘cumulative’ way, that is, whether to work an additional hour in a part-time job, or not.

When a full-time wage earner is making the decision about whether to work an extra hour or not, they will focus on how much disposable income they will receive from the additional hour of work. This will be an hourly wage rate minus the marginal rate of tax to be paid on this additional income. (For example, where a person’s income goes from $50,000 to $50,001, their additional disposable income will be $1 minus 47 cents tax and minus 1.4 cents Medicare levy.)

The story is slightly more complex for an unemployed person. Not only will they have to consider the tax paid, but they will need to focus on how much their unemployment payments will reduce by, since unemployment payments are subject to income tests and withdrawal rates. This concept is known as the effective marginal tax rate or EMTR and can be defined as how much money people do not get of each additional dollar of private income.

In terms of providing incentive to work, where effective marginal tax rates are high and high rates are sustained over wide income ranges, they will reduce the incentive to work since people get to keep only a small amount of the additional income they earn. In cases where EMTRs are 100 per cent, there is no gain from earning additional income over the range where EMTRs of 100 per cent apply. Where EMTRs are more than 100 per cent, people will actually lose money from working more hours.

Charts 6.1 and 6.2 show the effective marginal tax rates in 1973, 1983 and 1993 faced by both singles and couples respectively, as their private income changes. Strictly speaking, EMTRs can only be calculated for annual earnings, however, the points at which EMTRs change have been converted to weekly figures.


Source: Distributional Modelling and Taxation Section

Looking firstly at Chart 6.1 for single people renting privately, in June 1973, we find that they faced EMTRs of 100 per cent at a low level of private income and across a wide income range. EMTRs of more than 100 per cent also existed over a wide income range.

Specifically, the 100 per cent withdrawal rate began at $6 of weekly private income ($31 in today’s dollars). The 100 per cent EMTR occurs when unemployment payments are being withdrawn at 100 per cent for each additional dollar of private income. The interaction of 100 per cent withdrawal of benefit, combined with a 67 per cent shade-in marginal tax rate produced a 167 per cent EMTR over an income range of $8 in today’s dollars, beginning at $20 of private income which is $103 in 1993 dollars. (Where a dollar of untaxable unemployment payments is replaced by a dollar of taxable private income, taxable income increases so tax is levied.) After the income range over which the shade-in tax rate applied was passed, the EMTR fell to 110 and 111 per cent as people passed over
the ninth and tenth ordinary tax brackets, while at the same time having their benefits withdrawn at 100 per cent. (In 1973, there were 29 marginal tax rates!) At $27.50 ($142 in 1993 dollars), the EMTRs fell to 13 per cent as the last dollar of unemployment payment was withdrawn.

By June 1983, effective marginal tax rates had improved significantly. While an EMTR of 100 per cent existed, it started at a higher private income level and was over a smaller income range than in 1973. The 100 per cent EMTR began at $60 of private income ($104 in 1993 dollars) and continued over an income range of $44 ($76 in 1993 dollars) as benefit is withdrawn on a dollar for dollar basis. The EMTR fell to 31 per cent when the last dollar of unemployment payment was withdrawn at $104 ($180 in 1993 dollars). Part of the reason that EMTRs of more than 100 per cent had been eliminated by 1983 was because all unemployment payments became taxable. Where a dollar of taxable unemployment payments is replaced by a dollar of taxable private income, taxable income does not change so no additional tax is liable to be paid.

By September 1993, however, EMTRs are worse than 1983, but still significantly better than in 1973. This is partly because some unemployment payments are no longer taxable, such as Additional Family Payment and Rent Assistance. The 100 per cent withdrawal of benefit occurs at $85 and continues for an income range of $123, as benefit is withdrawn on a dollar for dollar basis. An EMTR of 120 per cent begins at $208 and continues for $34 due to the combination of non-taxable rent assistance being withdrawn at 100 per cent for each dollar of private income earned and taxation of 20 per cent being applied to each dollar of private income. (In this case, non-taxable income falls by $1 but taxable income rises by $1 and the marginal tax rate at this level of income is 20 per cent.) At $242 of private income, the EMTR falls to 20 per cent as the last dollar of unemployment payment is withdrawn.

The reason effective marginal tax rates are so high, for people earning private income and receiving unemployment payments, is that in Australia we have a targeted welfare system. As private income rises, welfare payments fall. Under such a system, in practice, it is difficult to avoid high EMTRs since the community generally does not support people on high private incomes also receiving welfare payments. It would be possible to avoid such a high EMTR by increasing the tax rebate for people receiving unemployment payments, or by creating a higher tax rebate for people who are renting privately.

![Chart 5.2: Comparison of Effective Marginal Tax Rates of Unemployed Couple (with 2 children, renting privately)](chart)

Source: Distributional Modelling and Taxation Section. (One child is assumed to be less than 13 years and the other between 13 and 15 years.)

Chart 6.2 examines the EMTRs faced by couples renting privately in June 1973, June 1983 and September 1993. In 1973, we find that couples faced EMTRs of 100 per cent at a low level of private income and that they faced EMTRs of 100 per cent and more over fairly broad income ranges. Specifically, the 100 per cent withdrawal rate began at $6 of private income ($31 in 1993 dollars). The interaction of 100 per cent withdrawal of benefit, combined with various marginal tax rates, produced EMTRs of between 106 to 113 per cent. EMTRs of 100 per cent and more continued over an income range of $47 or $240 in today's dollars. The EMTR fell from 108 per cent to 15 per cent when the last dollar of Additional Family Payment was withdrawn.

By June 1983, effective marginal tax rates had improved somewhat. While an EMTR of 100 per cent existed, it was at a higher private income level than in 1973, but still over a wide range of private income. The 100 per cent withdrawal rate began at $60 of private income ($104 in 1993 dollars) and continued over an income range of $132, or $230 in 1993 dollars. The EMTR fell from 100 per cent to 31 per cent when the last dollar of Additional Family Payment was withdrawn.

In September 1993, however, EMTRs were worse than in 1983, but still better than in 1973. The 100 per cent withdrawal of benefit occurs at $95 and continues for an income range of $244. At $339, the last dollar of unemployment payments is withdrawn and EMTRs fall to 20 per cent. Because Additional Family Payment is also available to low income earners, and because the Medicare Levy is shaded-in at 20 per cent, high EMTRs persist for people who are not recipients of unemployment payments.
An EMTR of 88 per cent is maintained over a private income range of $76 beginning at $415, due to Additional Family Allowance phasing out at 50 per cent and a 38 per cent marginal tax rate applying at this level of income. This is followed by an EMTR of 108 per cent which begins at $491 and continues up to $528 of private income, due to the Medicare levy shading in at 20 per cent. If the Medicare levy shaded in at a lower rate than 20 per cent, or if the Medicare Levy was not payable on the first $5,400 (for example) of private income, such high EMTRs would be avoided. The EMTR falls to 89 per cent at $528 and continues for $110 as the income range over which the Medicare Levy is shaded-in is passed. The EMTR falls to 94.4 per cent as the last dollar of Additional Family Payment is withdrawn at 50 per cent (38 per cent marginal tax rate plus 14.4 per cent Medicare Levy).

To sum up, Charts 6.1 and 6.2 show that EMTRs have improved significantly since 1973. In 1973, EMTRs of 100 per cent and more existed over wide income ranges and began at very low levels of private income. By 1983, EMTRs had improved significantly with EMTRs of 100 per cent starting at higher levels of income, however, they still continued over wide income ranges. In 1983, there were also no EMTRs of more than 100 per cent. By 1993, EMTRs faced by unemployed people had got worse again, with 100 per cent EMTRs starting at lower levels of private income and continuing over broader income ranges than in 1983. Further, single unemployed people also faced EMTRs of 120 per cent, while for employed couples, EMTRs of 108 per cent now existed. At levels of private income where EMTRs are 100 per cent or more, there is no incentive to earn a small amount of additional income. So from the point of view of providing an incentive to earn additional income, the income support system was made worse between 1983 and 1993 although it has improved significantly compared to 1973.

EMTRs are still too high to always produce an incentive for people to earn an additional dollar of income. Of course, in practice, people will rarely be offered the choice of earning just an additional $1 of income. Moreover, people will probably be unaware of the EMTRs they are facing, so EMTRs may not affect their decision to work additional hours. Despite these qualifications, it is preferable for the Social Security and taxation systems to interact in such a way that they do not have the potential to reduce people’s incentive to work.

7. Behavioural Responses to Changes in Unemployment Payments

High replacement rates and high effective marginal tax rates are of little consequence unless they actually affect the behaviour of the unemployed. There are a number of possible ways in which the level of unemployment payments may affect behaviour, and consequently the number of unemployed people. An increase in unemployment payments may increase unemployment levels and/or the take-up rate of unemployment payments, or may lead to a longer average duration on unemployment payments. Long or indefinite provision of payments may also increase average unemployment duration. Strict eligibility criteria may reduce the number of people on unemployment payments. A range of studies examining these propositions is discussed below.

Level Of Benefits

A proposition which has been frequently tested is that an increase in unemployment payments leads to an increase in the number of people unemployed or in the inflow into unemployment (as measured by the Australian Bureau of Statistics). A number of analysts in the late 1970s and early 1980s examined the impact of unemployment payments on unemployment in Australia. They included Gregory and Paterson (1980), Gregory and Duncan (1980), Johnston, Campbell and Simons (1978), McMahon and Robinson (1984), Pitchford (1983) and Trivedi and Baker (1982). Broadly, their conclusion was that the rate of real unemployment payments was not a significant determinant of the aggregate unemployment rate as measured by the ABS Labour Force Survey. Estimates of the effect of benefit levels on aggregate unemployment levels ranged from elasticities of zero (McMahon and Robinson) to 0.4 (Gregory and Paterson). Trivedi and Kapuscinski (1985) found only weak evidence that inflows into unemployment increased markedly due to an increase in unemployment payments. Their results suggested that the elasticity of entry into unemployment with respect to the replacement ratio was between 0.2 and 0.3.

A slightly different proposition which has been tested, both in Australia and overseas, is that an increase in unemployment payments leads to an increase in the number of unemployment beneficiaries (that is, the take-up rate of unemployment payments). Gregory and Paterson (1980) found that the level of payments significantly affected the number of recipients of unemployment payment in Australia. Trivedi and Kapuscinski (1985) found weaker and more fragile evidence than Gregory and Paterson's results. Looking at the converse, Bradbury (1993c) did not find an apparent flow of people off unemployment payments into low-wage jobs associated with the introduction of Additional Family Payment for low-wage workers.

Two UK studies by Nickell (1982) and Stern (1986) also found that there was no strong evidence that unemployment payments have much effect on inflows. Results from the US indicate that unemployment insurance may have important effects on inflows into unemployment but that the impact may be from the demand side and not the supply side of the market. This means employers are more likely to lay off workers who have access to unemployment insurance payments (Atkinson and Micklewright, 1991).

Another proposition which has been tested is how long people spend drawing unemployment benefits. Specifically, the hypothesis which is tested is whether or not an increase in unemployment payments results in people being on unemployment payments for a longer duration (that is, a reduced outflow of unemployment payments). Some authors of the 1970s and 1980s found that the level of payments had a robust, but reasonably small impact on the period spent receiving unemployment
payments. More recent Australian and overseas studies reinforce these earlier findings where they examine unemployment rates relating to people who are unemployed for short periods. Where people are long-term unemployed, the studies find that a very weak relationship between the increase in the time people spend in receipt of unemployment payments in response to an increase in these payments.

Bradbury and Vigond (1986) estimated that, in 1981-82, a 14 per cent increase in payments would lead to a 3 per cent rise in the average duration of unemployment of 24 weeks (equivalent to about three days). Trivedi and Kapuscinski (1985) found that, for people with unemployment spells of less than 26 weeks, an increase in unemployment payments of $10 a week (10 per cent) would lengthen an unemployment spell by between 1.5 and 3 weeks (between 10 to 15 per cent). This is quite a sizeable effect. For the long-term unemployed, Trivedi and Kapuscinski find that the level of real unemployment payments is a 'marginal' variable. Fahrer and Pease (1993) found that replacement rates were not a significant factor influencing outflows from unemployment.

Danziger, Haveman and Plotnick (1981), in the US, found a positive relationship between unemployment insurance and duration of unemployment which "appears robust". Nickell (1979) in the UK found that the effect of payments on the probability of returning to work was not constant across all durations. For the first 20 weeks or so, there was a significant impact on individual outflow probabilities, but for the long-term unemployed, the effect was negligible. Thus, the level of income support payments do not exert a strong influence on exits from long-term unemployment. Atkinson and Micklewright (1991: pp. 1713) reflect on this UK study and state that "in the case of the UK, income support for most of the long-term unemployed may be increased to a higher level without concern for incentives".

In a survey of international literature, Layard, Nickell and Jackman (1991) found that there were large variations in the influence that replacement rates had on the likelihood of people leaving unemployment. The results typically suggest that the elasticity of exit rates from unemployment with respect to the replacement ratio are of the order of 0.2 to 0.9. Their own work suggested that replacement rates were highly statistically significant but that a large change in replacement rates was necessary to have an impact on the number of people leaving unemployment. Their equation shows, for example, that a 10 percentage point fall in the replacement rate will lead to a fall in the unemployment rate of 1.7 percentage points. To achieve a 10 percentage point cut through reducing DSS payments (and not changing wages or taxes), DSS payments for singles and couples without children would need to fall by about $30, and for couples with two children, by around $45.

These estimates imply that only quite a large cut in payments could be expected to raise outflows from unemployment significantly. Furthermore, a fall in the unemployment rate does not necessarily imply that all the people who stop drawing payments find jobs. They may withdraw from the labour market.

A caveat to the above discussion is that a rapid rise in unemployment can result in unemployment payments being made more generous given more people have to survive on them. To some degree, therefore, unemployment and payment levels may be simultaneously determined at the aggregate level. This would imply that econometric estimates may overstate this relationship.

**Duration of Benefits**

A different proposition to that tested above also relates to the length of time people spend drawing unemployment payments. The hypothesis tested is that long or indefinite payment duration increases the time spent unemployed, and thus, the number of long-term unemployed.

Fahrer and Pease (1993) note that it is possible that job search may depend on the maximum length of time that unemployment benefits are available. In Australia, this hypothesis cannot be tested since unemployment benefits have always been able to be received for an unlimited duration of time. Econometric estimates in the US by Moffitt and Nicholson (1982) and Moffitt (1985) suggest that an increase in potential unemployment insurance of one week increases the mean length of time unemployed by between 0.1 and 0.15 weeks. The estimates of Katz and Meyer (1988) suggest that a one week increase in unemployment insurance would increase the length of time spent unemployed by up to 0.2 weeks.

Jackman, Pisarsides and Savouri (1990) found that an increase in the length of duration for which unemployment benefits are available, increases unemployment at given levels of vacancies. Countries where benefits run out after say six or twelve months experience a more favourable vacancy-unemployment relationship than countries which pay benefits indefinitely.

The OECD Working Party on Employment sought to identify the causes of long-term unemployment. It conducted a regression analysis of 19 OECD countries for the period 1979 to 1991 and compared these findings with other statistical studies (OECD Employment Outlook 1993). It found that the main general causes of long-term unemployment overall were job security arrangements (such as severance pay), the duration for which unemployment benefits were available and the degree of active labour market policy. The factor which was found to have the greatest influence on the Australian level of unemployment during this period was the duration of unemployment payment.

Layard, Nickell and Jackman (1991) found that there was a positive correlation between unemployment and payment duration in a number of countries. They found that long-term unemployment was generally higher in countries where unemployment payments were available for a long period than in countries where unemployment payments had limited duration. However, a closer examination of these data reveal that the relationship was not particularly strong. For the
period examined by Layard, et al (from 1983 to 1989), Australia’s long-term unemployment rate was lower than the rate in 10 out of 18 OECD countries. Their equation estimated that a one year fall in unemployment payment duration would lead to a fall in the unemployment rate by 0.92 percentage points.

Two points can be made here. First, this is a relatively small fall in the unemployment rate for a very large fall in the duration (and thus adequacy) of payments. Second, and as noted above, a fall in the unemployment rate does not necessarily imply that all the people who stop drawing payments find jobs.

Nickell (1993) states that effective systems to place and train unemployed people reduce unemployment to a significant degree. Jackman, et al (1990) and Layard, et al (1991) note that unemployment can be lowered by reducing duration of unemployment payments or by increasing expenditure on labour market programs. In the Layard, et al study, those countries with lower proportions of long-term unemployment than Australia, have either short total durations of assistance, high expenditures on labour market programs or both. Jackman, et al found that unemployment in Sweden was lower than the US because Sweden spent more on labour market programs. These studies show that other factors also have a large influence on unemployment levels.

**Stringency of Activity Tests**

The last proposition which econometricians have tested is to do with the activity testing associated with drawing unemployment payments. The hypothesis is that an increase in the stringency of activity tests applying to unemployment payments will reduce the number of people claiming unemployment payments.

Gregory and Paterson (1980) obtained results which showed that the introduction of tougher eligibility criteria in 1976 in Australia markedly reduced the inflow into unemployment. For these same eligibility criteria, Trivedi and Kapuscinski’s (1985) results indicated a strong negative and statistically significant effect for adult males, but not for any other group. Layard, Nickell and Jackman (1991) found that tight administration of unemployment benefits appeared to have a marked influence on rates of outflow from unemployment.

Weatherley’s report into compliance policies in the Australian Social Security in 1993 found that ‘a policy of total client compliance was not realistically achievable and would require an assault on civil liberties inconsistent with the values of a democratic society’. (Weatherley, 1993: p. 6) He concluded that the compliance measures implemented by the Department of Social Security have been effective in reinforcing voluntary compliance and deterring non-compliance. Further, additional compliance measures would be unlikely to be cost effective.

It should be noted that, in Australia, eligibility criteria attached to receiving unemployment benefits are relatively strict compared to many OECD countries. The type of unemployment benefit system which exists in Australia and New Zealand means that in order to receive benefits, recipients are required to search for work. In many other OECD countries, job search activity is not a requirement of receiving unemployment insurance. Bradbury (1993b) shows that, in Australia from 1983-84 to 1992-93, reduced eligibility and assets tests were estimated to save about $3 billion.

To sum up the previous discussion of research on behavioural effects, it does not find that increases in the level of unemployment payments encourage more people to become unemployed and take up unemployment payments. The evidence does show, however, that changes in payment levels have a reasonably large impact on the length of time people spend drawing unemployment benefits when these people are unemployed for a short time. Changes in unemployment payments have little impact on the length of time people spend unemployed when they are long-term unemployed. Where unemployment payments are available for a long or indefinite period, it is likely to increase the number of people who are long-term unemployed. Where eligibility tests applying to unemployment payments are stringently administered, the number of people drawing unemployment payments will fall. Finally, the income support system is not the only factor which has an impact on the number of people unemployed. Expenditure on labour market programs appears to reduce the unemployment rate.

**8. Possible Policy Responses**

The previous sections showed that, on the whole, the income support system is working efficiently to support people when they are unemployed without creating incentives for people not to want to work. The research does point to three potential problems. The first is that EMTRs could reduce the incentive to work since there can sometimes be little or no monetary gain from working additional hours while still receiving unemployment payments. The second problem is that replacement rates for couples can be very high when the alternative is only one person in the couple earning a low wage from full-time employment. The third problem is that the long length of time for which unemployment benefits are available may increase the number of people who are long-term unemployed.

At the moment, some people who want to work are better off not doing so, thus the income support system is constraining their choice. When employment growth picks up, it is important that the income support system does not create barriers to becoming employed or working more hours. The main focus of the policy discussion below is to lower effective marginal tax rates and replacement rates so that people are encouraged to earn income to get off unemployment payments or to reduce the amount of unemployment payments they claim. These options also focus on low-income earners. The other policy focus is to reduce the length of time for which unemployment benefits are available.
There are a number of policy options which could be designed to reduce high replacement rates and reduce high effective marginal tax rates. They include extending fringe benefits to low-wage earners and attaching wage supplements to low-paid jobs. These options are not aimed at the source of the replacement rates problem which is the current structure of the income support system and how it interacts with the taxation system. The policy options which follow are aimed at changing the sources of the problems.

It is possible to avoid high effective marginal tax rates and this should be done where possible to maximise people’s incentive to work. Low EMTRs can be achieved through a number of mechanisms, including, for example, through not having 100 per cent or more than 100 per cent withdrawal rates of benefits and by not having ‘sudden death’ withdrawal of benefits, where below some threshold private income all benefit is received, but after the threshold is reached, total benefit is withdrawn at once, e.g. Basic Family Allowance. High EMTRs can also be avoided by ensuring that high withdrawal rates do not occur at very low levels of private income; ensuring that the threshold level where tax begins to be paid is not set too low so that benefits are not being withdrawn rapidly while imposing tax on the private income earned; increasing tax rebates for people drawing unemployment payments; having a lower phase-in rate for the Medicare Levy; reducing the level of unemployment payments to ensure that the tax threshold is higher than annual unemployment payments; and ensuring that the lowest marginal tax rates are not set too high.

The budgetary cost of significantly reducing EMTRs can, of course, be quite high since it means that welfare payments will be withdrawn more slowly and will become available to people on higher incomes than is currently the case. As an initial step to reducing EMTRs, it would be desirable to ensure that no EMTR existed which was greater than, say, 90 per cent. Thus, there would always be an incentive to work an extra hour since a minimum of 10 cents per extra dollar earned would accrue to the worker. The budgetary cost of reducing EMTRs to a maximum 90 cents would not be particularly high and may be offset by people choosing to work more hours. Certainly, such a measure would be desirable from an equity viewpoint, although it would slightly reduce the targeting of payments to people with very low incomes.

It is not surprising that EMTRs of 100 per cent and more exist since there is no formal mechanism for the consideration of the interaction of Social Security and taxation policy. Taxation policy tends to be made in isolation from Social Security policy. It is imperative that a joint body with officers from the Department of Social Security, the Treasury and welfare groups be established to consider and improve the interaction of tax and the income support system.

Reducing high EMTRs will help to reduce high replacement rates, other things being equal, because welfare payments will still be available to people on higher private incomes. So someone earning a low income from work will still be eligible for a small amount of income support since the income tests applying to unemployment payments will be more generous. The differential between the income of a person on full unemployment payment compared to someone on a low earned income will be greater.

While lower withdrawal rates of payment will help to reduce replacement rates for both single people and couples, it is clear from the above tables that replacement rates for couples are very high in some cases. It is also clear that replacement rates for single people are not nearly so high. High replacement rates occur for couples because the income support for two people is being compared with the wage for one person and because the joint income test on couples results in their benefits being withdrawn at low levels of private income.

Bradbury (1993b) notes that the high EMTRs applying to married women are probably one reason for the low level of employment among wives of unemployed men. In 1989, 59 per cent of married women with children and with employed husbands were employed while only 17 per cent of wives were working where the husband was unemployed. Bradbury suggested two primary changes to the income support system which would help to address the problem of high replacement rates for couples. These changes are that eligibility for unemployment payments be individually assessed, and that the income tests applying to unemployment payments also be assessed individually.

Currently, the Social Security system allows a couple to jointly qualify for unemployment payments, even if only one of them is looking for work. This is based on the assumption of one breadwinner per family. (Given more than half of married couples have both partners in the labour force this assumption is clearly outdated.) Bradbury suggests that individuals within a couple qualify individually for income support payments. Factors which would qualify someone for income support in their own right would include caring for a young child or aged adult, being sick or disabled, being old or looking for work. To qualify for income support, where both partners were unemployed and had no other responsibilities, they would both have to look for work. This type of activity test, thus, encourages dual labour force participation.

The income test would be individually rather than jointly based as at present. Thus, the free area and the withdrawal rates would apply to individual earnings rather than combined earnings. The income test would be structured so as to make working worthwhile but so as to fully taper out income support at low full-time wages. The thresholds where the taper stops could vary with the number and ages of children. Under such an income test, where only one person in a couple is earning a low wage, the other partner would still be receiving some income support. Such a system would provide more incentive for a partner in a couple to accept low-paid work.

Another response to reducing replacement rates is to reduce the length of time for which unemployment payments are available, thus reducing the numerator of the replacement rate calculation for the longer-term unemployed. It would also be possible to cut the level of unemployment payments and so reduce the numerator of the replacement rate calculation for all
unemployed people. The econometric evidence showed that limiting the duration of payments, by itself, was not a particularly effective means by which to reduce the length of time spent on unemployment payments or the unemployment rate. The study by Layard, et al (1991) showed that reducing the duration of unemployment payments by one year would lead to less than a one percentage point fall in the unemployment rate. This is a very large fall in duration, and thus adequacy of payment, for a fairly small result. Studies by Layard, et al and Jackman, et al (1993) did show that the combination of limited duration of unemployment payments and high levels of expenditure on labour market programs were effective in reducing the number of people who are long-term unemployed. The amount spent on labour market programs is not high in Australia compared to many other OECD countries (OECD, 1993). Given this evidence, an appropriate policy response would seem to be to limit the duration of unemployment payments and dramatically increase labour market program expenditure on the long-term unemployed.

An alternative to limiting the duration of unemployment payments is to reduce overall rates. Econometric evidence quoted earlier, however, shows that this is also an ineffective means by which to reduce the inflow of unemployed people. Changing unemployment payments at the margin did not have a large effect on the number of people unemployed or the number of people drawing unemployment payment. There was some evidence that, for people who are currently drawing unemployment payments, reducing the payments may reduce duration of unemployment. However, for long-term unemployed people, cuts in payments had little effect on the likelihood of them exiting the unemployment pool.

Limiting the duration of unemployment payments without other policy measures aimed at reducing unemployment, or slashing the level of unemployment payments, are not measures which are likely to greatly increase flows into employment, particularly in the present environment of few employment opportunities. Stopping or severely cutting income support might increase the participation of some of the unemployed in the informal, non-award labour market (for example, providing lawn mowing and other services at very low rates of pay). Such employment would be unlikely to provide sufficient income to keep people out of poverty, even where they work extremely long hours. Further, some of the services provided by workers in the informal sector have little value, such as people washing car windshields at traffic lights. It is unlikely that all unemployed people would be able to find jobs in the informal sector. Those who could not would be thrown into poverty and they would survive as best they could. Unemployed people without any financial support would have to resort to begging, crime, and other forms of marginal existence. Cutting unemployment payments or limiting their duration without doing anything else will not be very effective in dramatically reducing unemployment and the social cost of implementing these measures would be very high.

9. Conclusion

This essay has examined whether features of the income support system, and in particular, whether the level of replacement rates has increased unemployment. From 1946 to 1973, the number of people unemployed was low and the level of replacement rates was also low. From 1972-73, replacement rates rose and unemployment became high shortly thereafter. A number of other labour market factors, such as the decline in the pay received in low-paid jobs, resulted in the relativities between unemployment payments and low wages being compressed.

Despite these changes, there is still a strong financial incentive at the aggregate level to remain employed or to get a paid job. Using exit replacement rates, Bradby et al (1991) showed that the average person leaving unemployment benefit for full-time employment in 1991 could expect more than doubling in the disposable income of their income unit. Using entry replacement rates, I showed that for the average working family, nearly 70 per cent of them would have their disposable incomes decline by at least one half (in December 1990) if they were to lose their jobs and become unemployed.

Examining replacement rates at a more disaggregated level showed that replacement rates have risen over time, being higher in 1993 than in 1973. Between 1973 and 1983, replacement rates rose slightly. While the real value of unemployment payments rose and the free area increased significantly to push up the numerator, the denominator also rose due to a large increase in real wages, although this was offset by increases in the average tax paid by low-income earners. Between 1983 and 1993, replacement rates rose again, especially for couples. The numerator rose because of increases in real unemployment benefits and because additional income support payments (like rent assistance and guardian's allowance) are now available to unemployed people. There was also a large rise in the real value of private income, for couples where both were working, which could be earned while retaining some unemployment payments. The main factor which pushed the denominator down was a fall in real minimum award wages, however, this was offset by an increase in income support payments available for working families through Additional Family Payment and large falls in the average tax paid by low-income people.

For single people and young people replacement rates were not high in 1973, 1983 or 1993. For couples who have no income, other than unemployment payments, replacement rates have also never been high enough to encourage them to stay on unemployment benefits rather than accept low-paid work. For all these years, however, replacement rates were high for couples combining unemployment payments and part-time work. Given that unemployment was not high in 1973 but replacement rates for couples were, it does not appear that high replacement rates were enough, in themselves, to encourage couples out of work and onto unemployment payments. It would therefore appear that fluctuations in unemployment since 1973, and the secular increase in unemployment over that time, mainly reflect factors other than increases in replacement rates.
Adverse comparisons of the incomes of social security recipients and low-wage earning couples rest on an assumption that the single earner couple remains the norm. In actual fact, more than half of married couple families now have both partners participating in the labour force.

The discussion on EMTRs focused not on the decision to work or not to work, but whether to work an additional hour. In the main, EMTRs have improved since 1973 but they are worse in 1993 than they were in 1983. Some EMTRs in 1993 are still too high to produce an incentive for people to earn an additional dollar of income.

Despite high replacement rates and high EMTRs, the econometric evidence on behavioural responses was mostly very positive. The econometric evidence did not find that increases in the level of unemployment payments encouraged more people to become unemployed and take up unemployment payments. The evidence did show, however, that changes in payment levels have a reasonably large impact on the length of time people spend drawing unemployment benefits when these people are unemployed for a short time. Changes in unemployment payments have little impact on the length of time people spend unemployed when they are long-term unemployed. Where unemployment payments are available for a long or indefinite period, however, they are likely to increase the number of people who are long-term unemployed. Where eligibility tests applying to unemployment payments are stringently administered, the number of people drawing unemployment payments will fall. The income support system is not the only factor which has an impact on the number of people unemployed. Expenditure on labour market programs appears to reduce the unemployment rate.

The main problems identified in the discussion were high EMTRs, high replacement rates for couples and the length of duration of unemployment payments combined with inadequate expenditure on labour market programs. To address high EMTRs, potential policy responses could include lowering withdrawal rates for benefit, reducing marginal tax rates, increasing tax thresholds and increasing rebates for income support recipients. High replacement rates for couples would be partly addressed through reducing high EMTRs. In addition, eliminating joint entitlement to benefits and joint income tests and replacing these with individual entitlement and individual income tests would provide greater incentive for couples to undertake work. Finally, the long duration for which unemployment benefit is available could increase the number of long-term unemployed people. Reducing the duration of benefit while increasing expenditure on labour market programs available to long-term unemployed people would seem to be an effective way to reduce the number of long-term unemployed people. When employment growth picks up it will be important to ensure that income support provisions do not create barriers to couples accepting job offers. Adopting these policies will help to ensure that the income support system does provide an incentive to work.

Endnotes

(1) As the number of unemployed people rose, so too did the duration of unemployment. In November 1963, about 22 per cent of all unemployed people had durations of more than 3 months. In 1973, it was 10 per cent but it rose to 33 per cent by November 1983. In August 1993, 70 per cent of all unemployed people had durations of greater than 3 months.

(2) For a detailed explanation of the difference between ABS and DSS statistics, see Appendix 2.
Glossary of Terms

Earnings Disregard

For the purposes of social security income tests, this refers to the amount of non-transfer income which is earned from wages which a pensioner or beneficiary may receive before reductions in pension or benefit occur. This type of non-transfer income does not include non-wage income such as rental income, dividends, etc.

Effective Marginal Tax Rate (EMTR)

A measure of the tax paid and/or withdrawal of pension, benefit or other government payment or service through income testing which results from receiving an extra dollar of private income.

Free Area

For the purposes of social security income tests, this refers to the amount of non-transfer income (for instance, earnings or rental income) which a pensioner or beneficiary may receive before reductions in pension or benefit occur. This type of non-transfer income can include both wage and non-wage income.

Indexation

This is a measure to guard against the effects of inflation in reducing the real value of benefits. Some rates of benefit are indexed against the Consumer Price Index (CPI) and automatically increased every six months according to the increase in prices reflected by the CPI in the previous two quarters.

Take-up

The take-up rate of a payment is the proportion of people eligible for the payment who in fact receive it.

Taper

The rate at which social security payments are withdrawn or 'tapered away' over the range of non-transfer income between the benefit free area plus the earnings disregard and the final cut-off point.

Tax Threshold

This is the level above which income begins to be taxed. No tax is paid on income at or below this level. Beneficiaries, as well as other groups which receive tax rebates, have higher effective tax thresholds, this is, the level of income at which they begin to pay tax is higher.

Work Test

This refers to measure taken by the Department of Social Security to verify that a claimant for, or recipient of, unemployment benefit is performing set activities (such as job search or training) in order to find employment.

Appendix 2

Differences Between ABS and DSS Unemployment Numbers

It is commonly acknowledged that not everyone covered by the Australian Bureau of Statistics (ABS) definition of unemployment is eligible to receive DSS payments of job search (JSA) or newstart allowances (NSA). On the other hand, not all persons eligible for JSA/NSA would be considered unemployed by the ABS. Methodological differences and varying definitions of unemployment may account for the discrepancy between ABS and DSS unemployment numbers. ABS unemployment data are derived from a monthly survey of households and are thus subject to normal statistical error. DSS data are a by-product of the administrative process which essentially provides a complete count of those receiving full or partial payment of JSA/NSA.

The official measure of unemployment in Australia is the monthly estimate of the number of persons classified as unemployed by the ABS. In accordance with the International Labour Organisation definition, the ABS classifies a person as unemployed if he or she is 15 years and over, was not employed during the week prior to the survey for more than one hour and has actively looked for full-time or part-time work at any time in the four weeks prior to the survey.

Job Search and Newstart Allowances are paid to persons who satisfy the Department of Social Security that they are unemployed, capable of undertaking, available for and actively seeking work, that they are registered with the CES as unemployed, are between the ages of 16 and 59 for women and 16 and 64 for men. Eligibility for JSA/NSA payments is also subject to a claimant meeting a test on assets and a fortnightly test on income.

Persons receiving DSS unemployment allowances but not considered unemployed by the ABS include:

- persons whose earnings from part-time or casual employment are not sufficient to preclude them from receiving a partial allowance;
- persons attending training courses;
- persons who are incapacitated for work in the short-term;
- discouraged jobseekers (that is those who want a job and are available to start work but are not actively looking for work);
- persons who are employed but not declaring their income to DSS.

Persons who are included in the ABS definition of unemployment but not paid JSA/NSA include:

- most 15 year olds, women aged 60 or older and men aged 65 or older;
- married women (and some men) whose spouses are in full-time employment or are also unemployed and in receipt of the married rate of income support;
- people with an entitlement to another form of income support (eg: sole parents, wife pensioners);
- persons whose unearned income or assets are above the relevant cut-out point for allowance entitlement;
- persons with less than one week unemployment and others serving DSS waiting periods.
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