Comparing Different European Income Tax Policies Making Work Pay

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Abstract

Raising the participation at the lower end of the labour market abstract is hindered by the high burden of taxation. Therefore, recently, in some European countries serious efforts have been made to make work pay. In this paper an overview of these current efforts is given. With the exception of Germany there seems to be a consistent policy of making work pay through the introduction of a substantial in-work tax credit and a decrease of the basic rate. In some countries due to distributing aspects the in-work tax credit is targeted to families with children. Moreover, two countries have a back to work allowance or premium for benefit claimants. Given the limited resources for future tax reforms, increase of in-work credits seem appropriate for further progress in making work pay.

Keywords : tax reforms, income tax, make work pay, tax credit

1. Introduction

One of the most severe problems in Europe is the low rate of employment at the 'lower end' of the labour market. In most European countries it seems that the high burden of taxation and income dependent benefits do not stimulate labour market participation. An interesting debate about this issue is taking place and important measures to reform tax and benefit systems to tackle this problem have already been taken. Tax and benefits reforms with as objective stimulation of employment opportunities have been announced. It is well-known that the US and Canada have incorporated in-work credits in their tax system (cf. Haveman and Wolfe (2000), Duncan and Gilles (1996)). Recently, as will be shown in this paper, some European countries have introduced these credits as well. In the Netherlands as from January 2001, a new income tax act has been implemented. Working is made more attractive by the introduction of an employment tax credit. In Belgium a tax reform with the introduction of in-work credit has been proposed and will be discussed by Parliament. Moreover, in the UK from October 1999 the replacement of the Family Credit by a Working Families Tax Credit (WFTC) has increased in-work benefits. Ireland has already put measures in place to make work pay and discusses a move to a system of tax credits. In Finland there has been an increase of the so-called municipal earned income allowance. In Germany a different route has been taken. Here, a large tax reform has been announced in which the basic personal allowance is significantly raised and tax rates are significantly lowered.

In order to improve the situation at the lower end of the labour market, there are various alternative policies. In this paper the possible reductions in income taxes are analysed. Hereby, the incentives of unemployed persons or partners to accept jobs are strengthened. It should be noticed that besides weak financial incentives, a shortage of productivity for low-skilled workers can be a reason for high unemployment. Raising the productivity of low-skilled by enhancing their skills is a solution for this problem. Bridging the gap between productivity and wage cost by an employment subsidy can be an effective policy as well. In Europe, we see a development towards more targeted approaches, both on the productivity gap and incentives (cf. Lönnroth (2000)). Our contribution is focused on incentives.

Before presenting the different policies, in section 2 of the paper a brief assessment of Europe's labour market and income-distributional policies is given. Special attention will be paid to an outline of the situation concerning replacement rates. It is shown that the replacement rates in some countries come close to 100% so that for a benefit-claimant the acceptance of a job may result in hardly any income gain at all.

In section 3 of the paper an overview of the policy measures is presented that have already been taken to make work pay. Hereby, an overview of six countries is given: the Netherlands, UK, Finland, Ireland, Germany and Belgium. Recently, in all countries measures have been taken to make work more attractive. In section 4 we compare the different policies of these countries. Although serious steps have been taken, the replacement rates are still very high and further measures are needed. The potential for further efforts will be discussed in section 5.

2. The current situation of the European labour market

2.1 Labour market conditions

The European economy seems to be in good shape. According to recent OECD-figures real GDP-growth is projected to increase to about 3% in 2000 and slowing slightly in 2001. Especially, in the Euro region figures reflect a sharp decline in joblessness. For example in Germany even with cuts being made in public programmes, a reduction in the unemployment rate by almost one percent since summer 1999 is noticed. Other countries face a decline in the unemployment rate as well. For some countries, like the Netherlands and Ireland, there seems a risk of overheating. The number of vacancies is growing and is above the peak of the previous cycle, at the beginning of the last decade. Although unemployment is decreasing rapidly, participation rates at the ‘lower end’ of the market are still very low. This is especially the case for low-skilled persons (see table 1).

Table 1. Participation rates by educational attainment

	Less than upper secondary education	Upper secondary Education	Tertiary Education
Belgium	47.3	72.1	83.7
Finland	54.1	71.0	82.1
Germany	49.2	71.0	84.2
Ireland	48.6	66.6	83.0
United Kingdom	54.3	76.0	85.5
Netherlands	52.1	74.0	82.8

Source: OECD (1998)

This table shows that the labour market position of low skilled is a matter of concern in all considered countries.

Furthermore, research by the OECD has shown that the unemployed households make out a large share of the poor population (individuals living in households with incomes below 50% of the median adjusted disposable income of the entire population, table 2). In Finland and Belgium the share of unemployed households in the poor population seems relatively low. The reason for this is that in these countries the level of social assistance is not means-tested by the family income. In this case getting a small job while your partner receives social assistance does not lead to a cut in the amount of social assistance. Furthermore, the level of social assistance is high in the Scandinavian countries and Belgium. This seems to be the explanation for the large share of households with one worker in the poor population of these countries.

Table 2: Individuals of working-age in the poor population by the labour force status of their household (as a % of total households in poor population)

	Non-employed households	Households with one worker	Households with two workers
Belgium (1995)	35.7	60.8	3.5
Finland (1995)	32.9	39.8	27.2
Germany (1994)	54.7	42.3	3.0
Ireland	-	-	-
Netherlands (1995)	54.4	38.5	7.1
United Kingdom (1995)	44.9	41.8	13.3

Source: OECD (2000b)

Individuals in a jobless household have a higher risk of being poor. This is in particular the case for households with children.

In tax reforms income distributional goals are important as well. Table 3 shows the level and trend in income equality from the mid 80s to the mid 90s in the different countries.

Table 3: Gini coefficients in the mid 80s and mid 90s

	Gini coefficient mid 80s	Gini coefficient mid 90s	Difference
Belgium	26%	27.2%	1.2%
Finland	20.7%	22.8%	2.1%
Germany	26.5%	28.2%	1.7%
Ireland	33%	32.4%	- 0.6%
Netherlands	23.4%	25.5%	2.1%
United Kingdom	31.9%	34.4%	2.5%

Source: OECD Database.

These results show that the level in inequality is highest in the Anglo-Saxon countries. In Ireland the Gini coefficient has decreased, whereas the Gini coefficient in the UK is still increasing. A special concern in the UK is that a third of all children live in households with incomes below half the national average (Treasury, 1999). The level of inequality in Scandinavian and Rhine-land countries is less than in the UK, but nevertheless growing. For the Netherlands and Finland the Gini coefficient between 1985 and 1995 rose by 2.1%.

2.2 The replacement rates

The issue that taxation and income dependent benefits may lead to the appearance of a poverty trap has been an object of studies for some years now. A possible way to describe the burden of taxation and income dependent benefits on a central and local level is to calculate the net replacement rates. Not only in the Netherlands, but also in other European countries do high marginal deduction rates and net replacement rates lead to poor incentives for people who live on social assistance to accept a low paid job. Table 4 gives an overview of the net replacement rates for long-term unemployed at the level of earnings of the average production worker (APW) and at the level of earnings of 2/3 of the APW-level. The net replacement rate shows what the loss of income is when losing a job and getting social assistance.

Table 4: Net replacement rates at APW and 2/3 of APW

	2/3 APW earnings	*APW earnings*
Belgium	90%	63%
Finland	97%	97%
Germany	61%	52%
Ireland	73%	62%
Netherlands	94%	79%
United Kingdom	89%	74%

Source: OECD (2000a). Figures used from the 1997 OECD Database on taxation and benefit entitlements. It is assumed that the worker is 40 years old, has a dependent spouse and 2 children, and started to work at 18. Housing costs are assumed to be 20% of gross APW earnings.

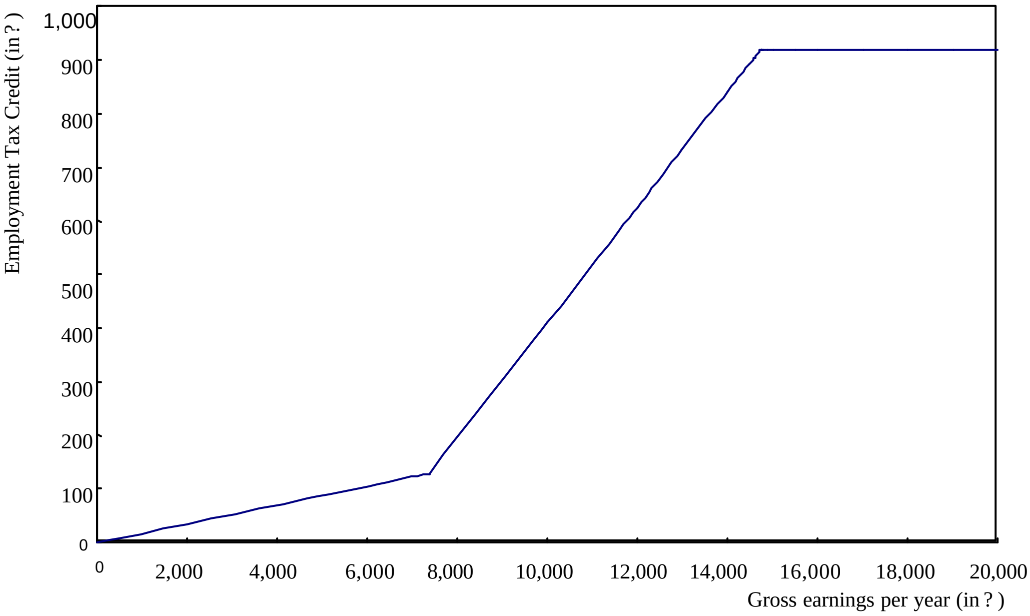
As table 4 shows, the net replacement rate lies between 60% and almost 100% at low wage levels. Especially the net replacement rates for Finland and the Netherlands are high. In Finland the net replacement rate is very high due to many cumulating social security schemes and income taxation. Also for the Netherlands the net replacement rate is relatively high. Only in Germany the net replacement rate is lower. A possible explanation is that there is little support for housing costs. Table 4 does not show the impact of local income dependent benefits. In the Netherlands, municipalities were given means to support low income families to fight poverty. This development has a large impact on the poverty trap. The marginal deduction rates in the Netherlands can go up to or over 100% for low incomes. This means that there is no or hardly any income gain when accepting a low paid job or improvement of the income-position. Therefore, some economists point out that the local government role in providing social assistance should be limited (Oers (2000)). Table 4 gives an average of net replacement rates in different countries for one type of household. The effects differ per type of household. In a recent report by the Ministry of Social Affairs and Employment (2000a) different household types are considered. Results show that for all groups the marginal deduction rates reach levels of over 100%, but are the highest for low-income households with children.

3. The policy measures in different countries

3.1 The Netherlands

The Dutch government has already taken some measures to reduce the poverty trap (Ministry of Social Affairs (2000b), Ministry of Finance (1999)). In the last years the Earned Income Tax Allowance has been raised. In 2000 this allowance is a tax deduction of 12% of the taxable income with a maximum of € 1,465.[1] However, one of the disadvantages of such an allowance is that high wage earners get more support than low wage earners. Therefore, due to the new 2001 Income Tax Act the Earned Income Tax Allowance is going to be converted into an Employment Tax Credit. Furthermore, the Employment Tax Credit is higher than the Earned Income Tax Allowance. Figure 1 gives an overview of the amount of Employment Tax Credit by certain levels of earnings.[2]

Figure 1 The Employment Tax



1 The exchange rates used in this article are the fixed rates for Belgium, Germany, Finland, Ireland and the Netherlands and the exchange rate of 8 December 2000 of € 1.64 for 1 English pound.

The maximum amount of the Employment Tax Credit is € 920, which will be reached at the minimum wage level (€ 15,117 gross income per year). The Employment Tax Credit is paid to workers and self-employed people up to the amount of tax paid.

Furthermore, in 2001 premiums were introduced to reduce the poverty trap for benefit claimants, who accept a full-time job and did have income support for at least one year. This premium can be granted only once during a lifetime. The total amount of premium is € 1,815. A quarter of the premium is paid every six months to somebody who holds a job for a period of two years. Municipalities are responsible for paying these premiums. It should be noticed that the granting of premiums anticipates on a future income increase. This may occur not in all cases if one considers the low earning capacity of some benefit claimants. Nevertheless, granting premiums can be a useful additional instrument to stimulate a benefit claimant to accept a job and reduce the poverty trap for some groups.

Furthermore, under the Income tax the basic personal allowance (that part of income, which is not taxable) is converted into a General Tax Credit.[3] Because the tax credit is independent of the incremental tax rate, non-working partners will find it more attractive to seek a paid job. With the tax reform 2001 the income tax rates on workers' income are decreased. The basic tax rate is decreased by 1.55% to 32.35% and the top rate is decreased by 8% to 52%.

In the new Income tax act some new instruments are introduced for (working) families with children. First, a Combination Tax Credit is introduced aimed at making childcare more affordable to working parents. The Combination Tax Credit is given to parents with annual earnings exceeding € 3,938. The amount paid is € 103 per year for each working parent. Second, a Child Tax Credit is introduced for families with an annual income of less than € 54,501. The Child Tax Credit is € 38 and if income is less than € 27,251 it will be doubled.

Moreover, the Dutch government has announced that for childcare the current system of income dependent benefits will be replaced by a tax credit.[4] The introduction of a Childcare Tax Credit will be combined with a change in the financing system. Currently, parents pay a contribution depending on their household income. The rest is financed by the government or by employers. A substantial part of the childcare places

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2 The amount of Employment Tax credit is calculated as follows: 1.748% of the earnings with a maximum of € 129 and 10.732% of the earnings exceeding € 7,371.

3 The Personal Allowance is deductible from the taxable income and in general a fixed amount of maximally € 4,061. This amount can be transferred between partners. The General Tax credit is deductible from the tax that has to be paid and in general a fixed amount of maximally € 1,507 for each taxpayer.

4 Source: Tweede Kamer, vergaderjaar 1999-2000, *Kamerstukken 26587 nr. 9.* (House of Commons, 1999-2000, *House of Commons 26587 no. 9*)

are financed by the government on a restricted budget. This causes shortages of day-care centres and long waiting lists for parents. In 2003, when the childcare facilities are supposed to meet the actual demand, the childcare system will become fully demand driven. Parents will receive an income dependent tax credit. Employers are supposed to pay their share of the actual costs and the government pays the rest. The present role of municipalities for regulating day-care centres will become less dominant.

3.2 United Kingdom

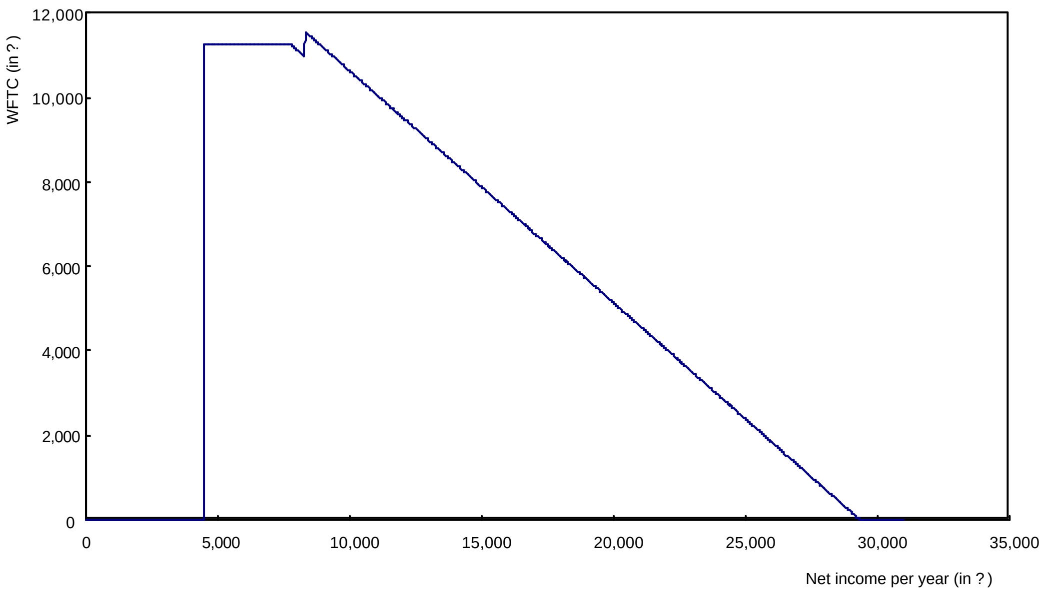
The UK government has taken several measures to reduce the poverty trap. The most important UK-reform to make work pay is the replacement in October 1999 of the Family Credit (FC) by the Working Families Tax Credit (WFTC) and the introduction of the Childcare Tax Credit. There seem to be three important differences between WFTC and FC:

- The WFTC is more generous than FC. According to Blundell and Brewer (2000) the average award of the credit per year has risen from € 5,405 to € 6,520 (an increase of 20%).
- The marginal pressure or the taper rate has been decreased from 70% for the FC to 55% for the WFTC.
- FC is an in-work means-tested benefit for working parents with low income, while the WFTC is an in-work means-tested tax credit for the same target-group.

As a consequence of the increase in generosity of the WFTC the number of working families receiving a credit has increased from around 800,000 to around 1 million and the number of children receiving WFTC has increased with more than 30%. The introduction of the WFTC seems an important explanation for the recent drop in poverty figures given by the Treasury. According to Treasury (1999, p.24) about 580,000 adults will be lifted out of poverty.

The WFTC is a refundable tax credit available to families working more than 16 hours a week. The amount of the credit depends upon earnings, hours worked and the number of children. The WFTC is paid through the wage packet. The WFTC for a couple with one child and an average hourly wage of € 5.33 is given in figure 2. This average hourly wage leads to an extra credit for working more than 30 hours with an annual income at a level of € 8,500.

Figure 2: The working Families Tax Credit



Furthermore, the income tax rates on low income will be decreased. Per 1 January 2001 the basic tax rate will be decreased from 20% to 10%. The general personal allowance will be raised by € 313 to € 7,235 in 2001.

Also the childcare system has changed dramatically. Under the old system up to € 1,902 per year of the registered childcare costs can be offset against net income. Under the new system a childcare credit is given of up to 70% of eligible childcare costs, up to maximum costs of € 3,152 per year for one child and € 4,627 per year for two or more children. Due to this measure there has been a 156% increase of families receiving childcare credit.

3.3 Germany

In 2000 the German Parliament has adopted the Tax Reform 2000 (Ministry of Finance (2000)). The tax reform consists of three phases. The first phase takes place 1 January 2001, the second 1 January 2003 and the third phase 1 January 2005. For the income tax the tax reform measures are increasing the basic personal allowance and decreasing the tax rates.

The first phase of the tax reform increases the basic personal allowance to € 7,158. At the same time the basic tax rate will fall to 19.9% (from 25.9% in 1998) and the top rate to 48.5%. As from 1 January 2003 the basic personal allowance will be further increased up to € 7,414. At the same time the basic tax rate will be decreased to 17% and the top rate to 47%. Per 1 January 2005 the basic personal allowance will be increased up to € 7,669. At the same time the basic tax rate will fall to 15% while the top rate will be cut to 42%.

The objective of this tax reform is to decrease the overall tax burden, especially for low paid workers. Results show that sole earners with a low income profit most from this tax reform. Over a period of 5 years they experience a decrease in their average tax burden of almost 50%. By cutting the basic tax rate the German government's goal is to stimulate growth and create new jobs. The tax reform also has an important impact on the social policy. The cut in the basic tax rate will mainly benefit small and medium incomes, but also small unincorporated companies. The objective of cutting the top rate is to achieve an internationally appropriate top rate level.

So, in Germany there are no plans to introduce in-work benefits or credits. Nevertheless, in Germany a debate about such an instrument takes place. For example the Future Commission of the Friedrich Ebert Stiftung has proposed to exempt a certain monthly income from National Insurance and to phase out this exemption.

The tax reform does not have any specific measures to enhance childcare facilities. However, the German tax system does have a monthly child grant in the form of a tax credit. The credit is € 138 for the first and second child € 153 for the third child and € 179 for the fourth and any further child. The tax credit is granted as a refund if not enough tax is paid.

3.4 Belgium

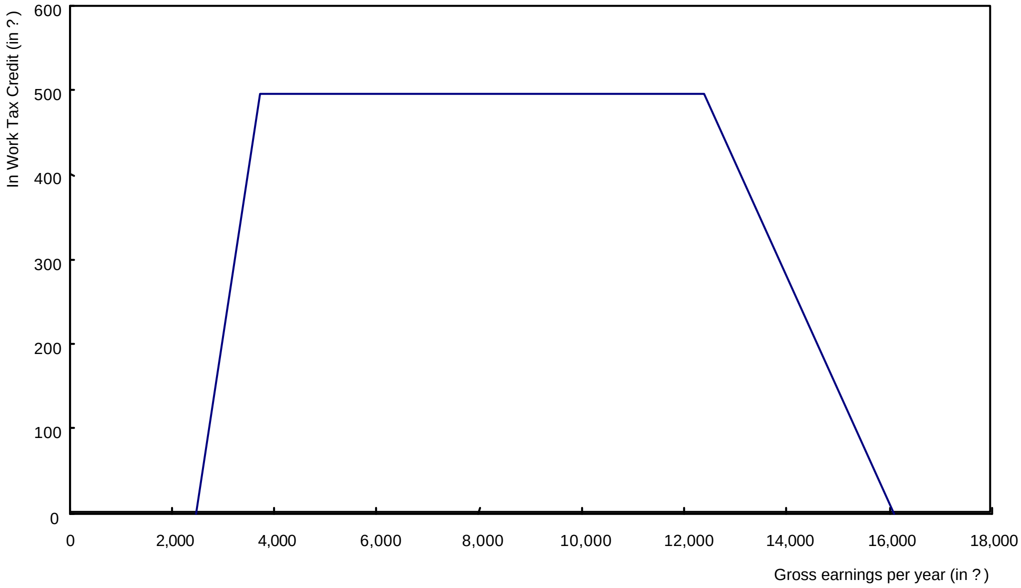
In 2000 the Belgian government has proposed a tax reform for the years 2001 to 2003 (cf. Reijnders (2000), Plasman (2000)). The outline of this tax reform has been approved by the Belgian parliament; the actual law is still waiting to be passed by the Belgian parliament. The tax reform is imposed in two separate phases; the actual implementation dates have yet to be set.

The first phase of the tax reform is focused at the reduction of the tax burden on labour-income and consists of two measures:

- The introduction of an in-work tax credit of € 496 per year;
- The reduction of the tax burden for average incomes by means of adjusting the tax brackets and reducing the number of tax rates by abolishing the two highest rates.

The in-work tax credit is meant for working individuals with an income around the minimum wage. Every individual with an income out of work is eligible for this tax credit. This tax credit consists of a fixed amount of € 496 for individuals with a taxable income between € 3,718 and € 12,395. The tax credit is phased in between € 2,479 and € 3,718 and phased out between € 12,395 and € 16,113. The tax credit is granted as a refund if not enough tax is paid. Figure 3 gives an overview of the in-work tax credit.

Figure 3: In Work Tax Credit



The Belgian government decided to adjust the second and third tax brackets in order to decrease the tax burden on or around the average income. In the second phase of the tax reform the personal allowance for married couples will be raised to double the level of a single person. In order to reduce the marginal deduction rates and to keep the Belgian economic position competitive in relation to the surrounding countries, the Belgian government has proposed to abolish the highest tax rates. The top rate will be lowered from 55% to 50% after tax reform.

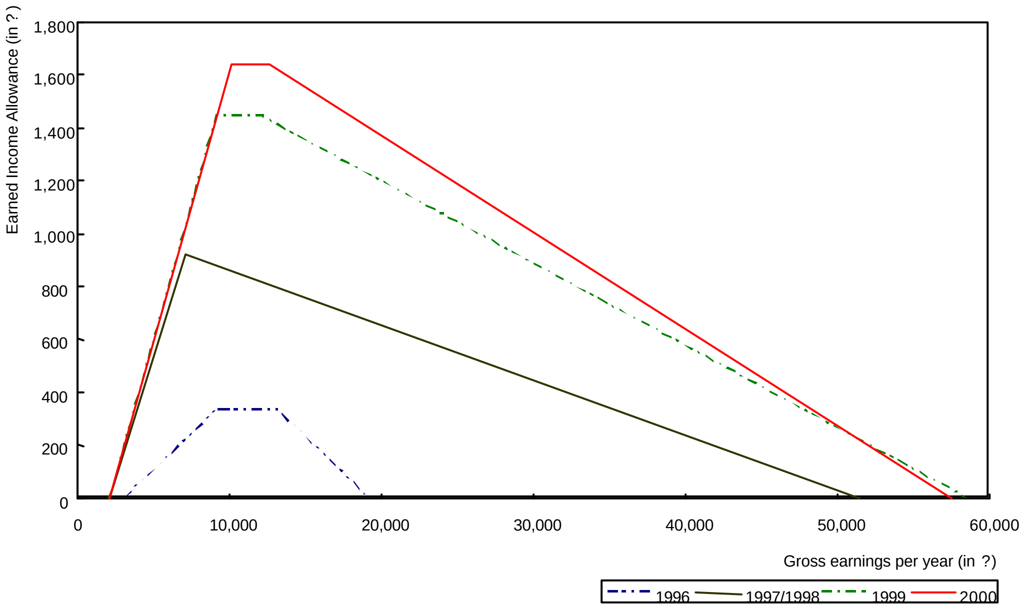
The second phase of the tax reform is focused on treating single persons, married and not married couples equally. The second phase of the tax reform individualises the tax system in Belgium. It abolishes the most visible differences between single and married persons.

This tax reform does not have any specific measures to enhance childcare in Belgium. In an earlier stage several measures have been taken to extend the number of childcare facilities. Firstly, the number of available places has been extended by new possibilities with subsidised jobs and by allocating more budget to childcare. Secondly, childcare facilities have been extended by forming organisations, for example an organisation in the Brussels region has been started which offers childcare facilities to unemployed people when participating in training and searching for employment.

3.5 Finland

In Finland the recession of the early 1990s led to a dramatic rise of the unemployment rate. In order to stimulate employment, changes have been made in Finland's tax system since the mid 1990s (cf. Ilmakunnas (2000)). The most important policy measure is the introduction of the so-called earned income allowance in municipal taxation in order to encourage low-paid and temporary work. The structure of this in-work allowance is given in figure 4.

Figure 4: Earned Income Allowance 1996-2000



The role of the earned income allowance has been intensified in recent years (Figure 4). The current maximum amount of the allowance is nearly the average monthly wage for women, and since 1997 the earned income allowance has been deducted only from wage and entrepreneurial income. It is going to be raised to € 2,079 in 2002. The effect of the allowance is obviously lower than the effect of a credit, because the relief is the deduction from the tax allowance times the marginal tax rate. In Finland the income tax rate for municipalities is on average 18%. The earned income allowance is in municipal taxation since state income tax is only paid when the yearly income exceeds € 8,006.

The entitlement to this allowance is based on the income of the individual. The allowance is not granted if one pays no local taxes. Furthermore, the basic rate in the state tax system has decreased from 6% to 5% between 1997 and 2001.
The Finnish system of childcare has much in common with the current Dutch system. Childcare is subsidised through public provision and there is a tax relief to reduce the work-related costs. In Finland the right to publicly provided child day-care has been extended to cover all children under school age. The fees for public day care cover, on average, 10-14 % of the total costs of these services. The fees are means-tested against the family income. Accordingly, in Finland the government is strongly subsidising the use of childcare services. Childcare services are mainly publicly provided and they are relatively cheap to the families needing these services. There is also a means-tested allowance for private childcare which is paid to the provider of the service (not to the family directly). Due to a long tradition of public child care there seems to be no need for large-scale changes in this respect.

Furthermore, the family support system includes also the child home care allowance (amount depends on the number of children and the amount of the means-tested supplement). Families in which one partner cares for children under the age of 3 at home are entitled to it. This scheme was launched in the late 1980s.

3.6 Ireland

In many ways Ireland’s policy to increase incentives to work is similar to the UK (cf. Daly (2000)). In recent years efforts have been made to make Ireland’s in-work benefit - the Family Income Supplement (FIS)- more generous. The multiplier has been increased from 50% to 60%, the maximum earning ceiling has been increased and the basis for assessment of the supplement has been changed from gross earnings to earnings after taxes and social contributions. As a consequence the number of working families receiving a benefit has increased.

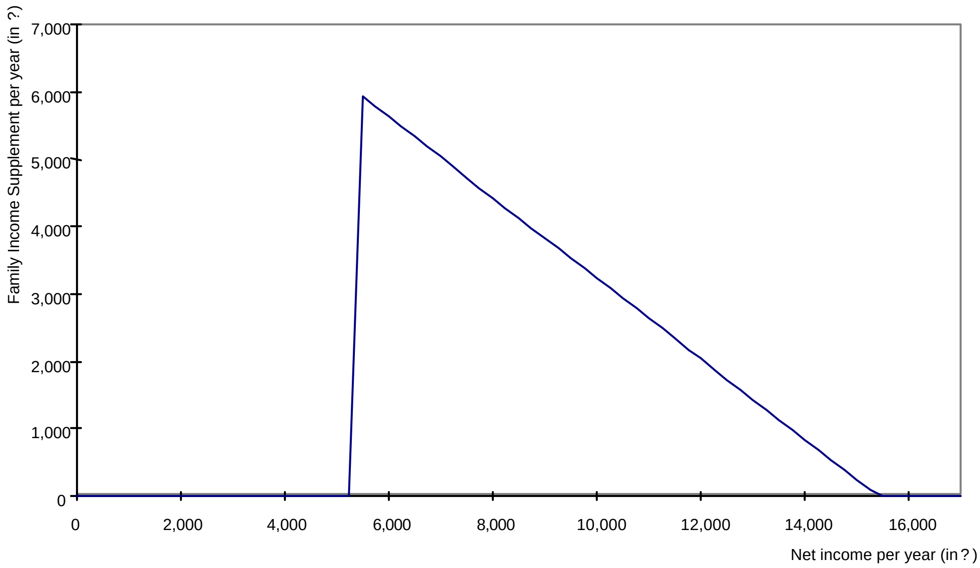
The Irish’s FIS is a weekly payment for families at work on low pay. Families qualify for the FIS if they are in full-time employment which is expected to last for at least 3 months and if they have at least one qualified child who is normally living with and being supported by the claimant. Full-time employment is defined as employment for at least 19 hours per week (or 38 hours every fortnight). The third means-test is an income-test. A family qualifies for the FIS if the family income after taxes and social contributions is less than the amount given in table 5.

Table 5: Income Limits of the FIS (2000-2001)

Number of children	Income Limit (in € per year)
1	15,387
2	16,708
3	18,029
4	19,350
5	21,000
6	22,322
7	23,444
8 or more	24,567

The amount of FIS is calculated as 60% of the difference between the weekly income and the weekly income limit. The FIS is paid by a book of payable orders, which can be cashed weekly at a Post Office, and it is refundable. In figure 5 the FIS for a family with one child is given.

Figure 6: Family Income Supplement



Furthermore, there are plans to replace this in-work benefit by an in-work tax credit, which is fully refundable for the same target-group. One of the reasons for this policy change is that the non-take is estimated to be significant. The government has stated to complete this policy by April 2001.
Moreover, there is a Back to Work Allowance (BWA) programme, which reduces the poverty trap for benefit claimants (see Ifo (2000)). To qualify for the BWA an

individual has to be getting Lone Parent's Allowance or should have been unemployed for the last 12 months and got a job for at least 20 hours per week. Participants in the scheme will receive support for 3 years. They will receive 75% of their weekly social welfare payment in the first year, 50% in the second year and 25% in the third year. The allowance is deposited weekly on the participant's bank account.

Also marginal tax rates for those with low earnings have been reduced. The basic rate has been decreased by 2% for 2000/2001 to 22%. Contrary to the UK there are no plans to introduce a tax credit for childcare. In Ireland the measures taken to enhance childcare consist of various different benefits granted to providers of childcare. The tax-system provides relief for those providing childcare by means of a capital allowance for the costs of constructing, refurbishing or extending the premises used for childcare. Furthermore, the childcare provided by the employer is exempted from the Income Tax.

4. Overview

In this section a comparison of the measures taken by the different countries to make work pay will be given. Table 6 shows the differences in the in-work credit of the six countries that are described in this paper. Only Germany does not have an in-work credit or benefit.

Table 6: In-work credits in 2001

	Target group	Refundable	Maximum	Phase in	Phase out	Hour criterion
Belgium (2001)	Individuals	Yes	€ 496	Yes	Yes	No
Finland (1996)	Individuals	No	€ 263[a]	Yes	Yes	No
Netherlands (2001)	Individuals	No	€ 920	Yes	No	No
Ireland	Families	Yes	€ 6,000[b]	No	Yes	Yes
UK (1999)	Families	Yes	€ 11,924[b]	No	Yes	Yes

[a] Taxes saved reach a maximum of €263 when using a (overage) marginal rate of 18%.
[b] The maximum of the FIS and WFTC depends on the number of children and the weekly income. The figure shown is the maximum amount received by family with one child and an hourly wage of € 5.33. The maximum of the FIS is reached at low income levels and phases out quickly.

The target group of first three countries are individuals. For Ireland and UK the in-work credit is targeted towards families with children. Due to the smaller target group the credit can be higher and, therefore, this credit has important distributional aspects as well. It should be noticed the shown maximum of the OFTC and the FIS is reached at low income levels and phases out quickly. Moreover, the credit in Ireland and the UK have an hour criterion, so that parents have to work a certain amount of time to qualify for the credit. The distribution of working hours shows a spike at this threshold, indicating that the incentive to increase work efforts after this threshold is poorer

(Brewer and Blundell (2000)). In most countries the in-work credit is phased out. For persons who will be confronted with these phase out there can be negative incentive effects. Moreover, two countries (the Netherlands and Ireland) have a back to work allowance or premium for benefit claimants.

Table 7 shows the changes in basic and top rates and the basic tax allowance or credit in the different countries after the various tax reforms.

Table 7: Changes in basic and top rates and the amount of basic personal allowance or basic tax credit after tax reforms

	Basic rate	Top rate	Type of zero tax rate	Amount	Maximum first tax bracket
Belgium (per 2002)	0%	- 5%	Allowance	€ 5,280	€ 6,495
Finland (1997-2000)	- 1%	- 0.5%	Allowance	€ 7,568	€10,697
Germany (2000-2005)	- 10.9%	- 8%	Allowance	€ 7,206	€ 9,249
Ireland (2000-2001)	- 2%	- 2%	Allowance	€ 5,969	€21,590[a]
Netherlands (2001)	-1.55%	- 8%	Tax Credit	€ 1,507	€14,870
UK (2001)	-10%	0%	Allowance	€ 7,235	€ 9,743

[a] The tax brackets are different for single persons and married couples with or without dependent children. The figure shown in this table is the maximum amount for a single person without dependent children.

As shown in table 7 Germany makes work pay by lowering the basic rate. Therefore, the budgetary relief of the German tax reform is rather large (1.8% of GDP). In the Netherlands and Belgium the budgetary relief of the described tax reforms is less than 1% of GDP. As a consequence, for other countries the decrease in the basic rate is much lower than in Germany. Only the UK decreases the basic rate with 10%. With the exception of the UK, more emphasis is put on lowering the top rate in the countries surveyed in this paper. Furthermore, table 7 shows the amount for the basic allowance or basic tax credit and the maximum for the first tax bracket after the reform. Especially, in German tax reform the basic allowance will be raised substantially.

In order to stimulate participation of women with children there has been an accompanying tax policy in childcare. The most provoking is the one in the UK with the introduction of a childcare tax credit. The Netherlands introduced a small childcare tax credit, which is available for all forms of childcare as well. Furthermore, it announced the introduction of a childcare tax credit in 2003. Other countries have a tax allowance or subsidise the provider.

The effectiveness of different policy options

There are different ways to make work pay. An interesting question is which policy is the most effective in employment terms. In the Netherlands different proposals with the same budgetary amount have been compared with the help of a general equilibrium model, the so-called MIMIC-model (see Graafland et al. (2001)). Although these simulations are stylised, they can be useful for understanding the effectiveness of different policy options. If the main objective of the tax reform is to reduce the unemployment among the low skilled, an in-work tax credit is more effective than reducing the basic rate. A tax credit is at least two times as effective as reducing the basic rate. Phasing out the in-work tax credit makes it even more effective in reducing the unemployment among the low skilled, although there can be some drawbacks in incentives for training and labour supply in hours for the low-skilled workers. In terms of labour supply (in hours) reducing the basic rate is a better instrument than an in-work credit.

A higher basic tax credit (or basic allowance) reduces labour supply through income effects. Moreover, it raises the replacement rate. Therefore, the impact on employment is relatively small compared to the other two tax simulations. Of course, the income of benefit recipients is better off in this simulation.

Also for the UK simulations with the tax reform are available. According to the study of Blundell and Brewer (2000) the impact of the WFTC on employment for families with children in the UK varies between –0.83% for women in couples with a working partner and 1.85% for single parents. Apparently, for the first group the income effect dominates. If the employment tax credit is individualised, such negative effects on employment for women in couples will not occur as is shown by Dutch simulations. It should be noticed that the WFTC is also aimed at people on income support.

5. Conclusions

With the exception of Germany, in the countries surveyed in this paper there seems to be a consistent policy of making work pay through the introduction of a substantial in-work tax credit and a small decrease of the basic rate. Although already important efforts have been made to make work pay, it is commonly agreed that further efforts are needed. In most countries the cumulative marginal deduction rates of tax and benefit schemes still reach levels close to 100 per cent at the minimum wage level. If, as is the case in the Netherlands, local policy is designed to alleviate poverty for a small group, the poverty trap will become more severe. This means that there is hardly any income gain when leaving the benefit situation.

It should be noticed that in the surveyed countries the in-work credit has been worked out in different directions. In the UK and Ireland the in-work credit is targeted towards families and phases out quickly. In other countries it is targeted towards individuals and it phases out more slowly (or not in the Netherlands). In policy discussions the shape of the in-work credit has been debated heavily and the outcome depends on the labour market situation, the distributional aspects and the wage distribution. These circumstances can be quite different in the surveyed countries.

Given limited resources for future tax reforms increasing in-work credits seems appropriate for further progress in making work pay. However, several interesting issues are accompanying such a policy choice. Firstly, which group should the in-work credit be targeted at? As presented by Brewer and Blundell (2000), choosing a family with children seems to have disincentive effects for the second partner. Therefore, in the March 2000 Budget the UK announced a programme of future reforms including an employment tax credit as well. Secondly, for some groups, especially single persons with children, there seems a need for an integrated system that incorporates the different types of support, such as childcare. Thirdly, the relation between the in-work credit and other income dependent benefits should be studied carefully. For example, in the UK raising the WFTC can be offset by lower housing benefits. Fourth, it is very important to have more information about wage progression on the lower side of the labour market and to discuss the relation between tapering away the tax credit and the reduction of incentives and wage progression. Thereby, the relation between the taper rate, the minimum wage and wage distribution is important.

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