Assessing and Measuring Incentives
The Role of Benefits and Taxes for the Jobless in Eastern Europe

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Overview

1. Conceptual framework
   - Focus on labor market transitions

2. Measuring (dis-)incentives for (formal) work
   - Using the OECD tax and benefit model

3. Descriptive analysis of work (dis-)incentives
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4. Which (dis-)incentives matter?
   - Characteristics of labor markets in non-ECA OECD, the New EU Member States, the Balkans, and Turkey

5. Conclusions
1. Conceptual framework
Incentive-Compatible Benefits for the Jobless

- Comprehensive view on active labor market policies (ALMPs)
  - Support people to look for, find, and keep the right job
- Activation policies are essentially based on the principle of mutual obligations:
  - Income support (UB, SA, in-work benefits, etc.) conditional on compliance (search job, keep job, train, etc.)
- Many different labor market transitions where activation policies can help
- Financial incentives are key for mutual obligations
- How do financial incentives compare between high-income OECD and ECA countries?
- In high-income countries, focus is on unemployment benefits (UB), but other benefits are taken into account more and more
  - Move towards integrated SP systems
- In ECA, UB coverage is relatively low
  - But what about other benefits?
Labor market transitions

- Between employment
  - Between formal and informal
  - Formal to formal
  - Informal to informal

- Between unemployment and employment
  - Employment to unemployment (w/ or w/o benefit)
  - Unemployment (w/ or w/o benefit) to employment

- Between inactivity and (un)employment
  - Inactive to active job seeker
  - Active job seeker to inactive/discouraged
  - Between inactivity and employment
Measuring incentives between labor market transitions

- Incentives and disincentives between these various labor market transitions can be measured
  - Requires analysis of tax and benefit system
- But: the degree to which these disincentives matter will very much depend on country context
- Largely driven by the characteristics of labor markets
  - Which transition matter mostly?
- Focus on transitions from unemployment/inactivity to formal employment
- Work in progress, preliminary findings
2. Measuring (dis-)incentives for (formal) work

Using the OECD tax and benefit model
Labor market transitions of interest

- **Average effective tax rate (AETR):** What share of gross income of the accepted formal job—including in-work benefits—is taxed away through personal income tax (PIT), social security contributions (SSCs), and lost benefits (UB, SA, family and housing benefits)?
  - Unemployment to formal job
  - Inactivity to formal job

- **Net replacement rate (NRR):** What share of net income is replaced through benefits when losing/giving up a formal job?
  - Formal job to unemployment
  - Formal job to inactivity

- **Marginal effective tax rate (METR):** What share of additional gross income is taxed away when expanding work hours?
  - Full-time to part time

- **Formalization tax rate (FTR):** What share of informal income is taxed away through PIT, SSCs (employer and employee), and lost benefits when formalizing at the same wage level?
  - Informal job to formal job
3. Descriptive analysis of work (dis-)incentives

Non-ECA OECD, the Balkans, New EU Member States, and Turkey
AETR from unemployment to formal job: high and fairly similar across regions; higher in the Balkans for families

Source: OECD Tax and Benefit model (2009)
AETR from inactivity to formal job: more diverse, highest in OECD, lowest in Turkey; more similar for families (role of family benefits in Balkans and NMS)

Source: OECD Tax and Benefit model (2009)
NRR: highest in NMS, fairly similar for higher-wage earners (except Turkey)

Source: OECD Tax and Benefit model (2009)
Summary

- Comparative descriptive analysis of work disincentives in OECD, Balkans, NMS, and Turkey

- From unemployment (with unemployment benefits) into a formal job:
  - Disincentives are fairly similar across regions
  - High at 60 to 70 percent average effective taxation
  - Higher for families, especially in the Balkans (role of family benefits)

- From inactivity (with means-tested benefits like social assistance, housing, family benefits) into formal job:
  - Overall, disincentives are lower than with UB
  - Without children: much more diverse across regions because much lower for Balkans, NMS, and Turkey
  - With children: fairly similar across regions, but lower for Turkey
4. Which (dis-)incentives matter?

Characteristics of labor markets in non-ECA OECD, the Balkans, the New EU Member States, and Turkey
Household survey data: UB coverage (share of unemployed receiving UB) much lower in Eastern Europe

Source: EU-SILC (2008)
Administrative data: low UB coverage (share of registered unemployed receiving UB) in Balkans, Turkey, and most NMS

**UB recipients as % of registered unemployed (2009)**

Source: Kuddo (2012)
Why low coverage?
Long-term unemployment is higher in ECA

Why low coverage?
High informality rates in ECA

Note: Measurements between LFS, SILC and TUIK not fully comparable
Coverage of social assistance benefits (as share of unemployed)

Source: EU-SILC (2008)
Coverage of housing benefits (as share of unemployed)

Source: EU-SILC (2008)
Coverage of family benefits (as share of unemployed)

Source: EU-SILC (2008)
Summary

- Labor market context in ECA countries differs from high-income OECD countries
  - High informality
  - Coverage of UB benefits in ECA countries is low when compared to high-income OECD countries
  - How shall activation policies work if the income support component of the mutual obligation is irrelevant?

- But: when taking into account the consumption other benefits (SA, housing, and especially family benefits) among the unemployed, maybe there is potential to exploit the financial incentives for activation policies
  - Coverage of SA, housing and family benefits among the unemployed is considerably higher than coverage of UB
  - Considerable potential for aligning incentive structure across benefits in line with activation principles
  - Move toward integrated SP systems
5. Conclusions
Conclusions

- Financial incentives are important for the activation agenda
  - In particular, conditionality and eligibility rules building upon UB are key for incentivizing the unemployed
- Disincentives stemming from the design of unemployment benefits and related benefits and taxes are overall fairly similar in ECA countries when compared to OECD countries
  - Indicates room for activation conditionalities
  - Only for inactive households without children AETR and NRR seem considerably lower in ECA (less generous SA)
  - Family benefits seem to play an important role
- But: labor market contexts are very different
  - High informality and long-term unemployment
  - Low UB coverage
- Potential for better designed, incentive-compatible and integrated SP systems (including UB, but also other benefits) that set the incentives for transitioning to the right job and complement/support ALMPs
  - Integrated SP systems not only require aligned incentive structure, but also capacities to monitor and enforce mutual obligations (enhanced role of public employment services)
Annex
FTR: In NMS and Serbia, opportunity costs of formal work tend to be highest at lower wage levels

Source: Koettl and Weber (2012)
Empirical analysis: do disincentives for formal actually work matter?

- Koettl and Weber (2012), using EU-SILC and OECD tax and benefit model for NMS
  - Matching work disincentives on individual level (FTR, METR, tax wedge)
  - Find significant positive correlation between FTR/METR and probability of being informal
  - 1 percentage point increase in FTR (METR) increases probability of being informal by 1.1 (0.8) percentage points
  - Correlation twice as high for low-wage earners
Coverage of last-resort social assistance benefits (as share of total population)

Source: Europe and Central Asia Social Protection Database, World Bank
Coverage of housing benefits (as share of total population)

Source: Europe and Central Asia Social Protection Database, World Bank
Coverage of family benefits (as share of total population)

Source: Europe and Central Asia Social Protection Database, World Bank