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Employment and the Labour Market

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SERIES EDITORS: ROBERT CHOTE AND CARL EMMERSON

Mike Brewer
Andrew Shephard

The Institute for Fiscal Studies

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Mike Brewer and Andrew Shephard*

Summary

- Since 1997, the employment rate has increased, with an additional 2 million individuals now in paid work. Over the same period, unemployment has declined and the rate of economic inactivity has remained effectively unchanged.
- The increase in employment has been particularly pronounced for lone parents.
- The national minimum wage introduced in 1999 raised the incomes of many low-wage individuals, although there does not appear to be evidence to suggest that it had any adverse impact upon employment.
- There are a number of different New Deal programmes, which provide assistance with job search and basic skills for different client groups. A relatively small proportion of individuals who leave some of the New Deal programmes move on to sustained employment, and many of these individuals may have found similar jobs anyway.
- In-work tax credits have had a large impact on the incomes of lower-income families, especially those with children. Many studies are in agreement that these changes, and others, have helped raise employment rates, especially for lone parents.
- The entire set of tax and benefit reforms since 1997 has had a mixed effect on financial work incentives. The majority of lone parents have a greater incentive to work than in 1997, and while those individuals who faced very high marginal tax rates have seen them reduced, those with lower rates have seen increases. While work incentives for childless couples have generally improved, couples with children now face a relatively stronger financial incentive, on average, to be a single-earner couple, rather than to have two earners or none, than in 1997. The marginal tax rates faced by this group have also increased significantly.
- The government has pledged to increase the child tax credit in line with earnings. This will have an adverse effect on work incentives, especially if the government continues to freeze the point at which higher incomes reduce working tax credit entitlement.
- Both the Conservatives and the Liberal Democrats view the New Deal as ineffective, and wish to either replace or modify certain programmes. However, it is difficult to tell whether their proposed replacements or modifications will be more or less effective.
- All parties would raise the national minimum wage. The Liberal Democrats would end the lower-rate minimum wage paid to those under 22, so that all individuals aged 16 and over would be entitled to receive the full minimum wage.

* Sections of this Briefing Note draw on the Joseph Rowntree Foundation (JRF) sponsored report, *Has Labour Made Work Pay?* by M. Brewer and A. Shephard (http://www.ifs.org.uk/publications.php?publication_id=3155). The authors are very grateful to the JRF for its financial support in that and other work.

1. Introduction

Since 1997, there have been changes in rates of employment, unemployment and inactivity. These changes have coincided with the Labour government's 'Making Work Pay' agenda, which has seen the introduction of in-work tax credits, the national minimum wage and various New Deal programmes.

Section 2 gives details of how the rates of employment, unemployment and economic inactivity have changed under the Labour government. Section 3 begins by detailing the national minimum wage and presents evidence on its impact, and continues in a somewhat similar vein, analysing the New Deal programmes and in-work tax credits. In Section 4, we show how financial work incentives have changed since 1997, and we briefly analyse the employment proposals of the main parties in Section 5. Finally, Section 6 concludes.

2. Recent trends in employment, unemployment and inactivity

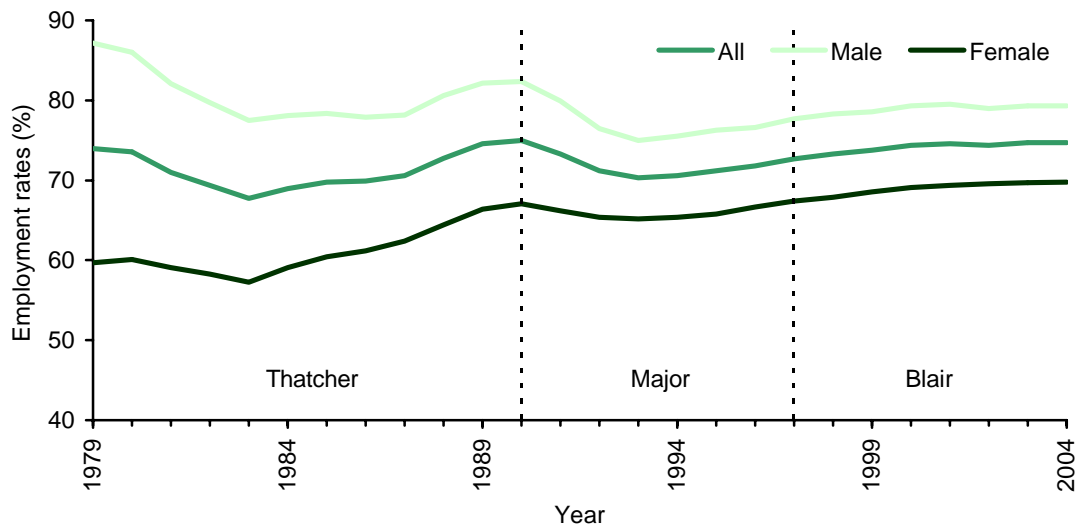
This section provides an overview of changes in the labour market since 1979, with a focus on the experience under the current Labour government. During this analysis, we divide the working-age population into the employed, unemployed and inactive (those who are neither working nor looking for a job) and show how their rates have been changing over this period.

2.1 Employment

Since 1997, the employment rate of women has increased from 67.2% to 70.1%, with the majority of this increase concentrated between 1997 and 2001 (see Figure 1). Over this same time period, the employment rate of men has risen from 77.7% to 79.3%. Taken together, these increases imply an increase in the overall employment rate from 72.6% to 74.9% and represent an increase in employment of around 2 million individuals. This rise in employment rates did not begin with the current Labour government, however, as employment has been increasing since the recession of the early 1990s. While it is true that the male employment rate is still lower than it was in the 1970s, the female rate is substantially higher than it was, and it is this increase that has helped to raise the employment rate to its highest level since the 1970s.

Some of the government's most high-profile employment policies – the working families' tax credit and the new tax credits – have been targeted either exclusively or largely at families with children. It is therefore useful to disaggregate the changing employment rates since 1997 by parental status. In doing so, we find that employment rates have risen across all six broad groups (single adults with and without children, and for both men and women in couples with and without children). While the percentage-point change in the employment rate has been similar across adult couples, regardless of whether or not they have children (not shown), for single adults we find that the increases have been far more substantial amongst parents. Figure 2 shows how the employment rates of single adults with and without children have changed since 1997. In Section 3, we discuss the extent to which various elements of government policy can explain this change.

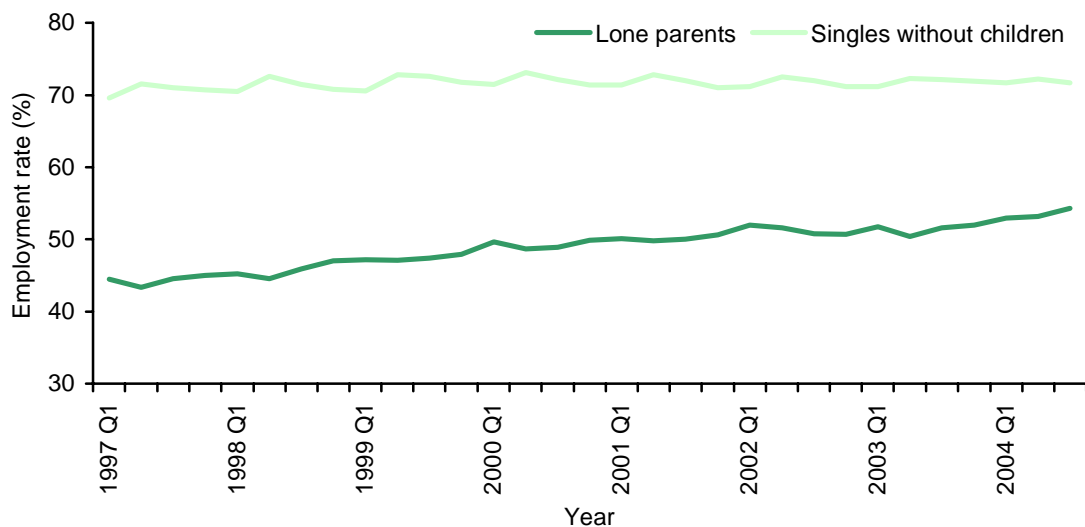
Figure 1. Employment rates



Notes: Seasonally adjusted. The employment rate is calculated as the proportion of the population of working age (16–59 for women and 16–64 for men) who are in employment (working at least one hour in the reference week or temporarily away from a job).

Source: Office for National Statistics.

Figure 2. Employment rates of single adults by parental status



Notes: Not seasonally adjusted. See Figure 1 for the definition of the employment rate used.

Source: Authors' calculations using Labour Force Survey, various years.

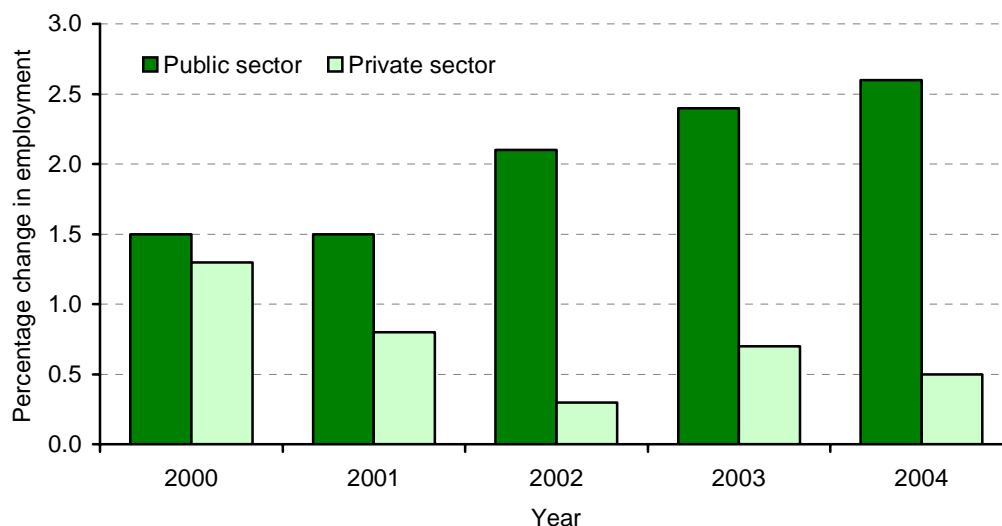
Public and private sector employment

Since 1997, there have been increases in the number of individuals employed in both the public and private sectors. However, in recent years, there has been stronger growth in public sector employment. In particular, between 2003 and 2004, private sector employment increased by 119,000 (or 0.5%) compared with an increase of 146,000 (2.5%) in the public sector. Furthermore, between the second quarter of 1999 and the first quarter of 2004, private sector employment increased by 631,000 while public sector employment increased by 540,000. These correspond to proportional employment increases of 2.9% and 10.4%

respectively, and as a result of these changes, public sector employment now represents 20% of overall employment, compared with 19% in 1999.

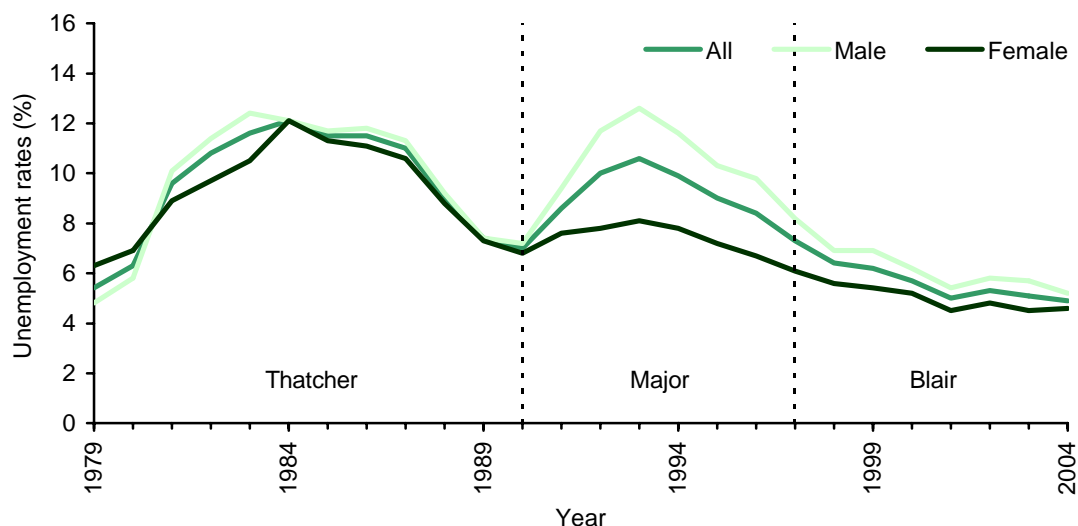
Figure 3 shows the employment growth rate since 2000 for both public and private sectors. It demonstrates that while private sector employment growth has been slowing, that of the public sector has been increasing.

Figure 3. Annual employment increase by sector (first-quarter headcount)



Source: *Labour Market Trends*, vol. 113, no. 4, pp. 139–47
http://www.statistics.gov.uk/articles/labour_market_trends/PSE_Apr05.pdf.

Figure 4. Unemployment rates



Notes: Seasonally adjusted. Unemployment is measured according to the ILO definition. This covers people who are: out of work, want a job, have actively sought work in the previous four weeks and are available to start work within the next fortnight; or out of work and have accepted a job that they are waiting to start in the next fortnight.

Source: Office for National Statistics.

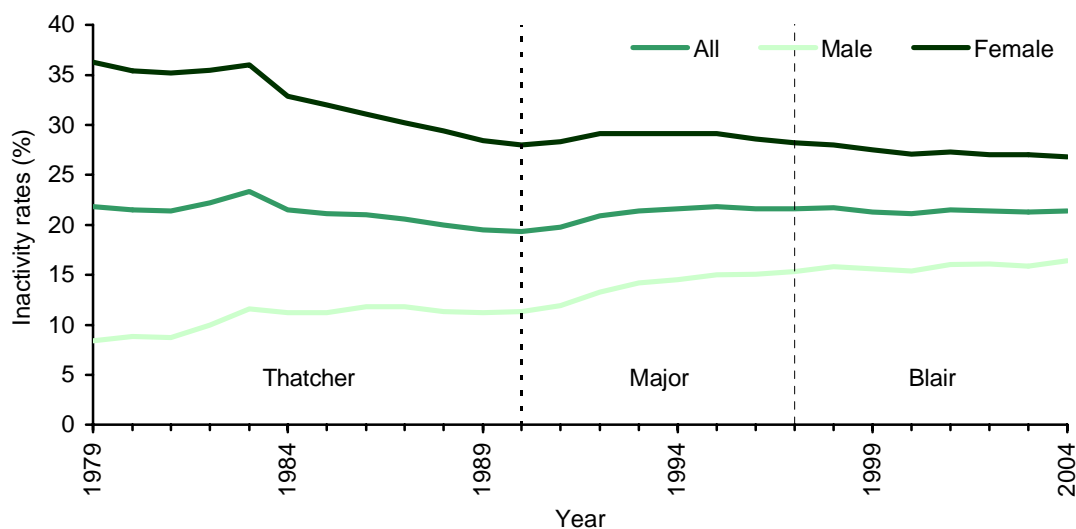
2.2 Unemployment

There have been almost continual declines in the rate of unemployment of both men and women since 1997, continuing the most recent downward trend that started in 1993. The majority of the decline under Labour occurred between 1997 and 2001, and since 1997 the overall rate of unemployment has fallen from 7.4% to 4.8%, with almost 700,000 fewer individuals now classified as being unemployed. As a result of these falls, unemployment is now at its lowest level for almost 30 years. The large gap between the unemployment rates of men and women, which emerged in the early 1990s, has been narrowing, and since 1997 it has shrunk from 1.1 percentage points in the first quarter of 1997 to 0.4 percentage points by the last quarter of 2004. Figure 4 shows the evolution of these unemployment rates between 1979 and 2004.

2.3 Inactivity

The rate of economic inactivity is much higher amongst women than amongst men. However, throughout the 1980s, the increasing rates of inactivity amongst men and decreasing rates amongst women saw the gap between the two measures narrow. This trend continued throughout the 1990s, and since 1997 the difference between the two rates has averaged about 11 percentage points. Under the present Labour government, the inactivity rate of women has fallen slightly, while that of men has risen. The net effect of these changes, as Figure 5 shows, is that the overall inactivity rate has remained effectively unchanged since 1997 (and is at a similar level to what it was in 1979).

Figure 5. Inactivity rates



Notes: Seasonally adjusted. The inactivity rate is calculated as the proportion of the working-age population who are neither employed nor unemployed (see Notes to Figures 1 and 4).

Source: Office for National Statistics.

It is possible to look at the reported reasons for why individuals are economically inactive. Data published by the Office for National Statistics in its *Labour Market Trends* publication¹ show that for men the most common reason is long-term sickness, followed by being in education, and being retired before reaching the state pension age. The slight rise in the inactivity rate amongst men since 1997 is explained by increases in the numbers of students and of those retiring early, and other factors. For women, the single most important reason for inactivity is if they are looking after family or their home (in 1997, this was cited as the reason by half of all inactive women). While the number of women who are economically inactive either through long-term sickness or because they are studying has increased since 1997, this rise has been more than offset by a decline in the number of women who care for family and/or their home. For both men and women, the proportion of the economically inactive who say they would like a job has declined since 1997 from 31.4% to 25.5%.

2.4 Summary

Since 1979, the employment rate amongst men has fallen, while that of women has increased. The rise in female employment is sufficiently large for the overall employment rate today to be at its highest level since the 1970s. Since 1997, the employment rates of all groups have been rising, but the increase has been largest for lone parents. Unemployment has been falling since the recession of the early 1990s and is now at its lowest level since the 1970s; with the output gap small, this decline does not seem to be simply the result of particularly strong economic growth. Economic inactivity rates are at a similar level today to what they were in the late 1970s, although they remain higher than the rates experienced in the 1980s. The small change in inactivity since the 1970s, as well as the more recent experience, masks some important changes in the inactivity rates of men and women.

3. Recent employment policies

3.1 National minimum wage

In April 1999, the national minimum wage (NMW) was introduced at a rate of £3.00 per hour for those aged 18–21 (the development rate) and at the higher rate of £3.60 per hour for those aged 22 and over. The Office for National Statistics estimated that in Spring 1998, before the NMW was introduced, 1.3 million individuals were paid wages below these introductory rates.² By the following year, the number of individuals being paid below these introductory rates had fallen to a little under half a million, and since then the number of individuals paid below the operating national minimum wage rates has been relatively stable, fluctuating slightly between about 230,000 and 340,000.

Both the main and development rates of the minimum wage have been subject to a number of above-inflation increases (see Table 1). It is also true that the value of the minimum wage relative to the economy-wide average hourly wage rate has been increasing. In 1999, the main

¹ Office for National Statistics, *Labour Market Trends – April 2005* (http://www.statistics.gov.uk/downloads/theme_labour/LMT_April05.pdf).

² *Labour Market Trends*, vol. 112, no. 12, pp. 481–3 (http://www.statistics.gov.uk/articles/nojournal/low_pay_estimates.pdf).

rate was equivalent to 36.8% (47.0%) of the mean (median) wage in that year, but by 2004 it was worth 39.9% (52.2%) of the respective mean (median) wage.³ Similar increases have also been observed for the development rate.

Table 1. National minimum wage

Rates effective from:	Main rate	Development rate
April 1999	£3.60	£3.00
October 2000	£3.70	£3.20
October 2001	£4.10	£3.50
October 2002	£4.20	£3.60
October 2003	£4.50	£3.80
October 2004	£4.85	£4.10

Notes: Main rate paid to workers aged 22 years and older. Development rate paid to workers aged 18–21 years inclusive and workers aged 22 years and above who are starting a new job with a new employer and doing accredited training. From October 2004, a new rate of £3.00 per hour was introduced. This applies to all 16-year-olds who are no longer of compulsory school age and to 17-year-olds.

Source: Inland Revenue (<http://www.inlandrevenue.gov.uk/nmw/>).

A study by Stewart⁴ assessed the impact that the introduction of the NMW had upon the employment outcomes of those individuals who were earning below the NMW prior to its introduction using a difference-in-differences methodology. This involved comparing the changing employment outcomes of these individuals against those earning just above the NMW, augmenting the specification to allow other factors to affect employment probabilities. The analysis was conducted separately for four different demographic groups – male and female adults and youths. For all groups, the effect of the minimum wage on employment was statistically insignificant from zero. Results were robust when using an alternative data source and alternative estimation procedures. In other words, there does not appear to be any clear evidence that the national minimum wage has resulted in job losses.

3.2 New Deal

The New Deal programmes have been an integral part of the UK government's welfare-to-work strategy since 1998. In terms of its aims of helping participants find jobs and boosting their long-term employability, the government considers the New Deal to be a resounding success. There are a number of different New Deal programmes, and while they are similar in terms of objectives and structure, they differ in terms of the client group that assistance is targeted towards. The main New Deal programmes are discussed shortly. First, Table 2 presents a list of the main New Deal programmes together with the estimated expenditure plans for 2005–06.⁵

³ The values of mean and median hourly earnings in these calculations are taken from the Annual Survey of Hours and Earnings, various years.

⁴ M. Stewart, 'The impact of the introduction of the UK minimum wage on the employment probabilities of low wage workers', *Journal of the European Economic Association*, 2004, vol. 2, pp. 67–97.

⁵ Two smaller New Deal programmes – the New Deal for Musicians and the New Deal for the Self-Employed – also exist. These are not considered in our analysis here.

Table 2. New Deal programmes and costs

New Deal programme	Plans for 2005–06 (£ million)
New Deal for Young People (18–24)	327
New Deal for 25 Plus	248
New Deal for 50 Plus	9
New Deal for Disabled People	42
New Deal for Lone Parents	91
New Deal for Partners	20
Total	782

Notes: Annually managed expenditure for New Deal 50 Plus is subsumed within the working tax credit from 2003–04. In 2002–03, this expenditure was £79 million. Total expenditure also includes expenditure on Action Teams (£47 million). Figures may not sum due to rounding.

Source: DWP Departmental Report 2004.

New Deal for Young People (18–24)

The New Deal for Young People (NDYP) was introduced across the UK in April 1998. Participation in NDYP is compulsory for all young people aged between 18 and 24 who have been claiming jobseeker's allowance (JSA) for at least six months, and involves up to four months of extensive assistance with job search from a personal adviser. If participants have not found employment by the end of this 'gateway' period, then they are offered up to four options, all of which seek to improve their employability (these are: subsidised job placement with training; education; voluntary work; and environmental work).

Following its introduction in April 1998, the number of participants on the NDYP reached a peak in 1999 when it exceeded 140,000. Since then, however, the number of participants has been falling steadily, and by the end of 2004 this figure had more than halved to under 70,000. By the end of 2004, there have been almost 1.2 million completed spells. The destinations of former New Deal participants have been varied, with 38% of the leavers entering sustained⁶ unsubsidised jobs, 11% transferring to other benefits, 20% leaving for other known reasons and the remaining 31% leaving for unknown reasons.

The Labour Party manifesto, together with numerous statements made by ministers, appears to suggest that the government views it as appropriate to measure the success of the New Deal by the number of people who go through the programme and subsequently enter employment. Such a calculation contains no meaningful information about the effectiveness of the New Deal. This is because many individuals who entered the programme would have found jobs anyway, even if the New Deal programme had not existed. By exploiting the area-based piloting and the age-related eligibility rules, an evaluation by Blundell et al.⁷ estimated that NDYP increased the probability of young men (who had been unemployed for six months) finding a job in the next four months by about 5 percentage points – this is equivalent to about 17,000 extra jobs created per year. With planned expenditure in 2005–06 equal to almost £330 million, this would imply a cost per job created of about £19,000, which is much higher than the annual salary that most individuals who leave the New Deal will go on to earn.

⁶ A sustained job is defined as one lasting for more than 13 weeks.

⁷ R. Blundell, C. Meghir, M. Costa Dias and J. Van Reenen, 'Evaluating the employment impact of a mandatory job search program', *Journal of the European Economic Association*, 2004, vol. 2, pp. 569–606.

However, because much of the expenditure on the New Deal comprises the unemployment benefits that would have been paid had the programme not existed, the true cost per job is likely to be much more modest. A study by Van Reenen⁸ used these employment estimates to perform a more detailed cost-benefit analysis, and he found that the benefits of the programme exceed the wider economic costs, so that NDYP does, indeed, represent a welfare gain. More recently, De Giorgi⁹ estimated that the New Deal programme enhances employability by about 6–7%. Furthermore, he found no evidence to suggest that this positive effect of the New Deal diminished over time.

New Deal for 25 Plus

The national New Deal 25 Plus programme (ND25+) was launched originally in June 1998 and was reformed in April 2001. The programme focuses upon the long-term unemployed, with mandatory participation for all individuals who have been claiming JSA for 18 of the last 21 months. The programme now shares common features with the NDYP, beginning with an initial ‘gateway’ period lasting for up to four months, followed by an ‘intensive activity period’ (IAP) typically lasting for no more than 26 weeks. The IAP includes flexible packages of support which can combine work experience/placements, work-focused training and help with motivation and soft skills. If employment has not been successfully found after the IAP, there is a period of ‘follow-through’ support.

While the number of participants on ND25+ is lower than the number on the New Deal for Young People, it shares a similar general downward trend in participation. A total of 50,000 individuals were participating on ND25+ by the end of 2004, with a cumulative total of almost 720,000 individuals having been through the programme by this time. A total of 210,000 people went from the New Deal into jobs, with over three-quarters of these being sustained jobs.

New Deal for Lone Parents

The New Deal for Lone Parents (NDLP) is a voluntary programme open to all lone parents who are in receipt of income support and whose youngest child is under 16 years old. As with other New Deal programmes, participants in the programme are assigned a personal adviser, who assists with a range of job-search and childcare-provision activities.

In contrast to the New Deal for Young People, the number of participants on this programme has been increasing over time, and by the end of 2004 the number of current participants had reached over 70,000 (and so slightly exceeded the number currently on NDYP). The differences in the trends of the two programmes may in part reflect the fact that NDLP is a voluntary programme (eligible lone parents are sent an invitation letter explaining what the programme can offer).

By the end of 2004, almost 700,000 lone parents had left NDLP, and nearly 370,000 jobs had been gained by participants on the programme, with 320,000 individual lone parents gaining a job.

⁸ J. Van Reenen, ‘Active labor market policies and the British New Deal for young unemployed in context’, in D. Card, R. Blundell and R. Freeman (eds), *Seeking a Premier Economy*, Chicago University Press, Chicago, 2003.

⁹ G. De Giorgi, ‘Long-term effects of a mandatory multistage program: the New Deal for Young People in the UK’, IFS, Working Paper no. W05/08, 2005 (www.ifs.org.uk/wps/wp0508.pdf).

New Deal for Disabled People

The New Deal for Disabled People is a voluntary programme that offers support to people who are receiving either a disability or a health-related benefit in finding and retaining paid employment. Since its introduction in July 2001, the number of participants on this New Deal programme has increased almost continuously. By the end of 2004, there were almost 90,000 current participants, with around three-fifths of these being male. There have been 130,000 starts on the New Deal for Disabled People, with 50,000 former participants moving into paid employment.

New Deal for 50 Plus

Introduced in April 2003, the New Deal for 50 Plus is a voluntary programme that offers dedicated help and assistance to eligible individuals aged 50 and over. People of these ages who have been receiving income support, jobseeker's allowance, incapacity benefit, severe disablement allowance or pension credit for at least a six-month period are eligible to take part in the programme.

The number of individuals who have taken part in the programme and have gone on to find employment has been increasing steadily since its introduction, reaching 34,000 by the end of 2004. The majority of these individuals are male, with roughly half of them from the 50–54 age group.

3.3 In-work tax credits

The government's make-work-pay policies have undoubtedly been dominated by tax credits – the replacement in 1999 of family credit with working families' tax credit, which was in turn replaced by the child and working tax credits. This section briefly describes the reforms and presents some evidence on their employment impact.

The working families' tax credit

In October 1999, the government replaced family credit – the main form of in-work support for lower-income working families with children – with the working families' tax credit (WFTC). This was considerably more generous than the family credit system that it replaced, and during its lifetime, incremental reforms were made to increase the generosity of the tax credit further (details of the reform are discussed in by Dilnot and McCrae¹⁰ and by Brewer et al.¹¹). The government had very clear stated aims about what the WFTC reform should achieve: it should relieve poverty, encourage work and reduce stigma (see Brewer and Shephard¹²).

¹⁰ A. Dilnot and J. McCrae, *Family Credit and the Working Families' Tax Credit*, IFS Briefing Note no. 3, London, 1999 (<http://www.ifs.org.uk/bns/bn3.pdf>).

¹¹ M. Brewer, A. Duncan, A. Shephard and M. J. Suárez, 'Did working families' tax credit work? Analysing the impact of in-work support on labour supply and programme participation', Inland Revenue Working Paper no. 2, 2003 (<http://www.inlandrevenue.gov.uk/research/ifs-laboursupply.pdf>).

¹² M. Brewer and A. Shephard, *Has Labour Made Work Pay?*, Joseph Rowntree Foundation, York, 2004 (http://www.ifs.org.uk/publications.php?publication_id=3155).

The new tax credits

In April 2003, the working families' tax credit was replaced by the working tax credit and the child tax credit – referred to collectively as the new tax credits. These tax credits combine WFTC with other existing elements of the tax and benefit system, whilst also making some innovations. Brewer, Clark and Myck¹³ explore the rationale behind the new tax credits in detail, while the review of Brewer¹⁴ provides an overview of the finalised system. The child tax credit effectively replaces:

- the children's tax credit, which was introduced in April 2001 and reduced the income tax bills of around 5 million income-tax-paying families with children;
- the per-child elements of WFTC;
- the per-child elements of the income support system and income-related jobseeker's allowance (which provide extra money to about 1.2 million families with dependent children who are not in work). These elements of IS and JSA were only replaced by the child tax credit one year later than the rest of the reforms (i.e. in April 2004).

The working tax credit (WTC) comprises:

- the adult component of WFTC for families with children;
- the childcare support element of WFTC;
- support for low-income working families without children. This is an entirely new feature of the UK tax and benefit system. The working tax credit is not as generous for childless single people and couples as for families with children, and the eligibility conditions are tougher; only people aged 25 and over are eligible, and they have to be working 30 hours or more per week to qualify.

The employment impact of tax credits and other make-work-pay policies

Several studies have attempted to estimate the impact of Labour's make-work-pay policies on the employment rates and labour market behaviour of parents. The results from these studies are summarised in the table in the Appendix.¹⁵ There is general agreement on the qualitative impact of the policies, regardless of the methodology used:

- Labour's policies increased the proportion of lone parents in employment and increased the hours worked, on average, of those who do work. Estimates of the size of the

¹³ M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001.

¹⁴ M. Brewer, *The New Tax Credits*, IFS Briefing Note no. 35, London, 2003 (<http://www.ifs.org.uk/bns/bn35.pdf>).

¹⁵ These studies use one of two different methodologies. The more common method is the 'difference-in-differences' approach. This relies on the assumption that, in the absence of the Labour government's policies, the labour market behaviour of parents would have followed the same trend as otherwise-identical individuals of the same gender without children (more details can be found in any of the studies referred to). By their design, these studies cannot focus just on Labour's make-work-pay policies, or even on the impact of all personal tax and benefit changes; strictly speaking, they estimate the impact of all of Labour's policies that have influenced parents' propensity to work differently from adults who are not parents, which might include the New Deals and policies affecting childcare. The two studies that do not use the difference-in-differences approach (Brewer et al., 2003 and Blundell et al., 2004b) use an economic model of parents' labour supply behaviour to predict how parents would respond to particular tax and benefit changes. The economic model is estimated by relating the behaviour of parents in the labour market – how many of them choose to work and how many hours they work – to the underlying financial incentives to work and progress. By contrast to the studies using difference-in-differences, these two studies can focus solely on Labour's make-work-pay policies.

employment impact vary considerably, though, from +1 percentage point (ppt) to +7 ppts. Some of this variation is explained by the time period investigated by the different studies: the paper with the smallest estimate examined the employment rates just before and just after the introduction of the WFTC.

- Not all of the studies estimate the impact of Labour's policies on individuals in couples, but those that do suggest that the effect is small, overall. Two studies find the effect on mothers in couples to be negative, and one finds it to be positive.

It should also be noted that all of the studies that use difference-in-differences use data from 2002 or earlier; we do not yet have a good idea of how the new tax credits, introduced in April 2003, actually affected employment amongst parents.

3.4 Summary

The national minimum wage did not have any adverse effects on employment. The employment impacts of both the New Deal and various in-work tax credits have been largely positive but small, and considerably more modest than the statements of the government would seem to suggest.

4. Financial work incentives

A direct goal of the Labour government's 'make-work-pay' policies is to improve financial work incentives. This section will present some evidence on how work incentives have changed between 1997 and 2004, focusing exclusively on the impact of tax and benefit changes. We begin by setting out how we shall go about measuring work incentives.

4.1 Measuring work incentives

An individual's incentive to work depends, in general, on the shape of the relationship between hours of paid work and after-tax-and-benefit income (or net income), given an hourly wage (this is known as a 'budget constraint'). There are two important dimensions of the budget constraint that we attempt to quantify and summarise:

- the financial reward to doing any work, measured by some function of incomes in and out of work;
- the incentive for those already in work to work harder, or the incentive to progress in the labour market.

We summarise what has happened to the financial incentive to work at all by the replacement rate. This measures the incentive to work by calculating the ratio of net income when not working to net income in work; it is the inverse of the proportional increase in income that an individual achieves by working. A lower replacement rate is associated with a greater incentive to work.

The incentive to increase work effort is measured by the marginal effective tax rate. This measures the incentive for individuals to increase their earnings slightly, whether through working more hours or through promotion, qualifying for bonus payments or getting a better-

paid job. We use the term ‘incentives to progress’ to capture all of these concepts, with a lower marginal effective tax rate associated with a greater incentive to progress.

Both of these work incentive measures are discussed in much greater detail in a study by Brewer and Shephard,¹⁶ which also provides a much more detailed assessment of how work incentives for parents have changed between 1997 and 2004. Meanwhile, in Section 4.2, we discuss how incentives have changed for parents, and Section 4.3 then looks at what has happened to the work incentives faced by non-parents.

Table 3. The impact of tax and benefit changes from 1997 to 2004 on the replacement rates of working parents

	Replacement rates		
	April 1997	(%) April 2004	Change
Lone parents			
Mean	67.9	65.0	-2.9
Median	71.9	65.9	-6.0
25 th centile	55.8	52.3	-3.5
75 th centile	81.9	80.4	-1.5
<i>Proportion whose rate rises</i>		21.3%	
<i>Proportion whose rate falls</i>		56.7%	
Individuals in couples with children whose partner does not work			
Mean	59.3	61.1	+1.8
Median	62.6	65.5	+2.9
25 th centile	41.3	45.3	+4.0
75 th centile	80.6	79.5	-1.1
<i>Proportion whose rate rises</i>		52.7%	
<i>Proportion whose rate falls</i>		26.6%	
Individuals in couples with children whose partner does work			
Mean	59.2	62.5	+3.3
Median	58.5	62.7	+4.2
25 th centile	45.6	50.4	+4.8
75 th centile	74.3	76.0	+1.7
<i>Proportion whose rate rises</i>		53.8%	
<i>Proportion whose rate falls</i>		6.6%	

Notes: Excludes parents aged over 55 and the self-employed. The row marked ‘25th centile’ reports the replacement rate that is higher than 25% of all replacement rates faced by that family type. The row marked ‘75th centile’ reports the replacement rate that is higher than 75% of all replacement rates faced by that family type.

Source: Authors’ calculations from Family Resources Survey 2002–03 and IFS tax and benefit micro-simulation model, TAXBEN.

¹⁶ M. Brewer and A. Shephard, *Has Labour Made Work Pay?*, Joseph Rowntree Foundation, York, 2004 (http://www.ifs.org.uk/publications.php?publication_id=3155).

4.2 The work incentives of parents

In Table 3, we show the impact of tax and benefit changes from 1997 to 2004 on the replacement rates of working parents, summarising some of the features of the changing distributions. Similarly, Table 4 shows how the distribution of marginal effective tax rates has changed. Both sets of statistics have been calculated by holding constant the characteristics of the population and considering the real impact of tax and benefit changes on the work incentive measures.

Table 4. The impact of tax and benefit changes from 1997 to 2004 on the effective marginal rates faced by working parents

	Effective marginal tax rates (%)		
	April 1997	April 2004	Change
Lone parents			
Mean	58.0	58.3	+0.3
Median	72.5	69.0	-3.5
<i>Proportion whose rate rises</i>		31.2%	
<i>Proportion whose rate falls</i>		46.9%	
Individuals in couples with children whose partner does not work			
Mean	43.0	48.2	+5.2
Median	35.7	42.1	+6.4
<i>Proportion whose rate rises</i>		45.4%	
<i>Proportion whose rate falls</i>		21.0%	
Individuals in couples with children whose partner does work			
Mean	32.5	36.8	+4.3
Median	33.0	34.9	+1.9
<i>Proportion whose rate rises</i>		39.4%	
<i>Proportion whose rate falls</i>		10.0%	

Notes: Excludes parents aged over 55 and the self-employed. The row marked '25th centile' reports the marginal tax rate that is higher than 25% of all marginal tax rates faced by that family type. The row marked '75th centile' reports the marginal tax rate that is higher than 75% of all marginal tax rates faced by that family type.

Source: Authors' calculations from Family Resources Survey 2002-03 and IFS tax and benefit micro-simulation model, TAXBEN.

The changes to the tax and benefit system between April 1997 and April 2004 imply that:

- Lone parents face relatively weak incentives to work, with a mean replacement rate of 67.9% under the April 1997 tax and benefit system. The majority of lone parents now face a larger financial reward to work than in 1997.
- Labour's tax and benefit reforms have hardly changed the mean effective marginal tax rate faced by working lone parents, while the median effective marginal tax rate has fallen. More lone parents have experienced a strengthening of their incentive to progress than have experienced a worsening.

- Low-earning lone parents face stronger financial incentives to progress in the labour market, whilst medium- and high-earning lone parents face smaller financial incentives to progress (not shown in tables – see Brewer and Shephard, 2004).
- A small number of couples with children face an increased financial reward for having one adult in work, but many more face a smaller financial reward. The same set of reforms since 1997 has weakened the financial reward to having a second earner. Together with the first effect, this means that a couple with children now faces a relatively stronger incentive, on average, to be a single-earner couple, rather than to have two earners or none, than in 1997.
- The financial incentives to progress for the majority of workers in couples with children have worsened, with the mean effective marginal tax rate faced by individuals in couples with children 5 percentage points higher than in 1997, thanks to Labour’s tax and benefit reforms. The increases in the median effective marginal tax rate have not been as large, however.

Table 5. The impact of tax and benefit changes from 1997 to 2004 on the replacement rates of working adults without children

	Replacement rates (%)		
	April 1997	April 2004	Change
Single adults without children			
Mean	38.4	35.0	–3.4
Median	29.7	26.8	–2.8
25 th centile	21.2	19.3	–1.8
75 th centile	44.5	39.4	–5.2
<i>Proportion whose rate rises</i>		1.4%	
<i>Proportion whose rate falls</i>		78.2%	
Individuals in couples without children whose partner does not work			
Mean	48.9	45.0	–3.9
Median	48.1	44.8	–3.2
25 th centile	28.8	27.1	–1.7
75 th centile	66.3	63.1	–3.2
<i>Proportion whose rate rises</i>		2.4%	
<i>Proportion whose rate falls</i>		71.2%	
Individuals in couples without children whose partner does work			
Mean	52.8	52.3	–0.5
Median	52.4	51.8	–0.5
25 th centile	42.0	41.9	–0.1
75 th centile	63.2	62.2	–1.0
<i>Proportion whose rate rises</i>		12.8%	
<i>Proportion whose rate falls</i>		60.4%	

Notes: See Table 3.

Source: See Table 3.

4.3 The work incentives of adults without children

This section provides the same summary information as in Section 4.2, but focuses upon the changing work incentives of working adults without children. Table 5 presents information on replacement rates, while Table 6 shows how the incentive to progress has changed.

Table 6. The impact of tax and benefit changes from 1997 to 2004 on the effective marginal rates faced by working adults without children

	Effective marginal tax rates (%)		
	April 1997	April 2004	Change
Single adults without children			
Mean	34.1	36.1	+2.0
Median	33.0	33.0	+0.0
<i>Proportion whose rate rises</i>		20.0%	
<i>Proportion whose rate falls</i>		6.4%	
Individuals in couples without children whose partner does not work			
Mean	41.6	44.6	+3.1
Median	34.9	36.1	+1.1
<i>Proportion whose rate rises</i>		30.9%	
<i>Proportion whose rate falls</i>		6.9%	
Individuals in couples without children whose partner does work			
Mean	33.5	34.1	+0.6
Median	33.0	33.0	+0.0
<i>Proportion whose rate rises</i>		19.1%	
<i>Proportion whose rate falls</i>		6.1%	

Notes: See Table 4.

Source: See Table 4.

Some key findings are as follows:

- Amongst working families without children, the incentive to work at all is strongest for single adults and weakest for individuals in couples whose partner is working. Since 1997, this incentive has improved for the majority of singles and couples without children.
- While the incentive to progress in the labour market is unchanged for the majority of working adults without children, for those adults who have experienced a change, the incentive is more likely to be weaker than stronger.¹⁷

4.4 Summary

The introduction and expansion of tax credits have helped to improve the incentive to work at all for the majority of lone parents and have reduced the number of lone parents who face

¹⁷ These calculations have assumed full take-up of all benefits, including the working tax credit. As take-up of the working tax credit is likely to be low, these figures are likely to overstate the true change in marginal rates between 1997 and 2004.

very high marginal effective tax rates; the number who are now facing modestly high rates has increased. For parents in couples, there is now a stronger incentive to have a single earner. Furthermore, the increased generosity of the tax credits has increased the marginal effective tax rates of many parents in couples, reducing their incentive to progress in the labour market. Adults without children have seen improvements in their incentive to work at all, and the majority of them have not seen any change in their marginal tax rates since 1997.

5. Employment proposals of the main parties

5.1 New Deal

Both the Conservative Party and the Liberal Democrats have voiced their dissatisfaction with the New Deal programmes. The Conservative leader, Michael Howard, wants three of the highest-profile New Deal programmes abolished and has referred to them as ‘wasteful spending’ and ‘unnecessary government activity’.¹⁸ In the James Review of Taxpayer Value, the Conservative Party argues that by abolishing the New Deal for Young People and the New Deal 25 Plus, and introducing a replacement policy, Work First, it would achieve savings of £380 million per year. At the same time, it argues that the contracting-out (or privatisation) of Jobcentre Plus to independent providers would allow for more effective, efficient delivery of services. The party claims that this would generate further savings of over £1,200 million per year.

The Liberal Democrats have voiced similar concerns regarding the New Deal programme. Vince Cable, the Liberal Democrat Treasury spokesman, has said that the New Deal programmes have left people on ‘unnecessary or ineffective schemes rather than getting them into real jobs’. He added that a Liberal Democrat system would ‘tailor assistance so that jobseekers receive the package of support they need to get proper, permanent work’.¹⁹ However, given that the government itself has stated that it is looking at ways to extend flexibility and to develop a more personalised approach to respond better to the needs of individual clients, the concerns of the two parties may not be too dissimilar. The Liberal Democrats have, however, pledged to remove benefit sanctions, which they claim ‘leave genuine claimants unable to feed and house themselves’.²⁰ This contrasts with the harder line taken by Labour, who have been adamant that there is no ‘fifth option’ of remaining on the unemployment register.

While there is some evidence to suggest that the social benefits of the New Deal for Young People exceed the social costs, there is much less evidence for the other New Deal programmes, which have not been as extensively studied. Hence, it is unclear whether abolishing certain New Deal programmes would or would not represent a welfare gain, and whether the benefits of any such replacement would exceed its costs.

¹⁸ Conservative Party Election launch speech by Michael Howard, 5 April 2005.

¹⁹ Quoted in Liberal Democrats News, 7 April 2005 (<http://www.libdems.org.uk/news/story.html?id=8489&navPage=news.html>).

²⁰ *The Real Alternative*, Liberal Democrats’ manifesto, April 2005.

5.2 The national minimum wage

In its manifesto, the government has pledged to implement the recommendations of the Low Pay Commission and raise the main rate for the national minimum wage to £5.05 from October 2005 and to £5.35 from October 2006. On the same day that the Labour Party manifesto was launched, the Shadow Chancellor, Oliver Letwin, pledged that a Conservative government would implement the same planned increases in the minimum wage. The Liberal Democrats, meanwhile, have pledged to end the lower-rate minimum wage paid to those under 22 (the development rate), so that all individuals aged 16 and over would be entitled to receive the full minimum wage.

In Section 3.1, we reviewed evidence that suggested that the minimum wage did not have any detectable effect on employment when it was first introduced. While it is possible that the proposed further increases in the minimum wage (and ending the lower rate as the Liberal Democrats propose) may have little effect upon employment, there is the possibility of a negative effect, especially if the growth in the minimum wage continues to outpace growth in average earnings. David Frost, director-general of the British Chambers of Commerce, stated that the planned increases in the minimum wage were ‘not sustainable and could have a serious impact on jobs and competitiveness’.²¹

5.3 In-work support

The government has pledged to increase the child tax credit at least in line with earnings up to and including 2007–08. While this may help the government to achieve further reductions in child poverty, it will have a negative effect on work incentives, especially if the government continues to erode the value of working tax credit by freezing the point at which higher incomes reduce tax credit entitlements.

The Liberal Democrats have claimed that they would simplify the benefit and tax credit system, although with few details available it is unclear what effect this simplification is likely to have on work incentives and employment. The Liberal Democrats have also proposed to amend the tax credit system (including the childcare element of the working tax credit) so that families receive awards that are fixed for six months, in much the same way that the former working families’ tax credit used to work. This change would mean that families would know for certain how much tax credit they would receive for six months. It would also mean that families could not run up debts by not reporting changes in their use of formal childcare to the Inland Revenue, as is currently the case. However, it would mean that tax credits would be less responsive to changes in circumstances, and that some families would have to fill in more claim forms than is currently the case.

6. Conclusion

This Briefing Note has examined recent trends in the rates of employment, unemployment and inactivity. Since the current Labour government came to power in 1997, there have been

²¹ Quoted in Business section of the *Sunday Times*, 27 February 2005 (see <http://www.timesonline.co.uk/article/0,,2095-1502285,00.html>).

increases in employment, particularly amongst lone parents, and declines in the rate of unemployment. Over the same period, the overall rate of inactivity has remained approximately unchanged.

The government often points to the New Deal programmes and its in-work tax credits – the working families’ tax credit and, more recently, the child tax credit and working tax credit – in explaining this recent labour market performance. However, it is likely that the impact that these policies have had, while positive, is far lower than the statements of the government would appear to suggest.

All three main political parties would continue to offer in-work support through tax credits, although the Liberal Democrats have pledged to simplify the system. The current approach of the government – increasing the child tax credit in line with earnings and freezing the point at which higher incomes reduce working tax credit entitlement – is unlikely to be sustainable, due to the negative effect that this has on work incentives.

While both the Liberal Democrats and the Conservative Party view the New Deal programmes as somewhat ineffective, there is some evidence to suggest that the benefits of the most high-profile New Deal – the New Deal for Young People – exceed the costs. While it is possible that the proposed replacement or modification will prove even more beneficial, it is difficult to be confident, given that few details have been announced.

Appendix. Estimates of the impact of Labour's make-work-pay policies on the labour market outcomes of parents

Study	Data	Reforms analysed	Estimated impact on lone parents	Estimated impact on couples	Other notes
Difference-in-differences approach					
Gregg and Harkness, 2003	LFS and GHS, 1979–2002	Changes affecting lone parents between 1998 and 2002	Increased employment by 5 ppts	n/a	Estimated that reforms also increased hours worked and weekly earnings.
Francesconi and van der Klaauw, 2004	BHPS, 1991–2001	Policies affecting lone mothers between 1998 and 2001	Increased employment by 4 ppts in 1998 and 7 ppts by 2001 (lone mothers only)	n/a	Uses longitudinal data. Estimated that lone mothers' fertility and propensity to cohabit or marry declined after 1998.
Leigh, 2004	LFS, 1999–2000	All changes affecting parents between September and November 1999	Increased employment by around 1 ppt	Increased employment by around 1 ppt	Estimated that reforms also increased hours worked and earnings by parents.
Blundell et al., 2004a	LFS, 1996–2002	All changes affecting parents between 1999 and 2002	Increased employment by 3.6 ppts (lone mothers) and 4.6 ppts (lone fathers)	No statistically significant impact for mothers Reduced employment by around 0.5 ppts for fathers	
Structural model approach					
Brewer et al., 2003	FRS, 1995–2002	All changes to taxes and benefits made in October 1999 and April 2000	Increased employment by 3.4 ppts (lone mothers only)	Reduced employment by –0.4 ppts (men and women)	Estimated that reforms also increased hours worked by lone mothers.
Blundell et al., 2004b	FRS, 1995–2002	All changes to taxes and benefits made in April 2000 and April 2003	Increased employment by 3.4 ppts (lone mothers only)	Reduced employment by –0.3 ppts (women) Increased employment by 0.9 ppts (men)	Uses same model of behaviour as Brewer et al. (2003).

Notes: LFS is Labour Force Survey; FRS is Family Resources Survey; BHPS is British Household Panel Survey; GHS is General Household Survey. For more details, see individual papers. Sources: R. Blundell, M. Brewer, R. Reed and A. Shephard (2004a), 'Analysing the working families' tax credit using difference-in-differences', mimeo, IFS; R. Blundell, M. Brewer and A. Shephard (2004b), *The Impact of Tax and Benefit Changes between April 2000 and April 2003 on Parents' Labour Supply*, IFS Briefing Note no. 52; M. Brewer, A. Duncan, A. Shephard and M. J. Suárez (2003), 'Did working families' tax credit work? Analysing the impact of in-work support on labour supply and programme participation', Inland Revenue Working Paper no. 2; M. Francesconi and W. van der Klaauw (2004), 'The consequence of in-work benefit reform in Britain: new evidence from panel data', ISER Working Paper no. 2004/13; P. Gregg and S. Harkness (2003), 'Welfare reform and lone parents in the UK', CMPO Working Paper no. 03/072; A. Leigh (2004), 'Optimal design of earned income tax credits: evidence from a British natural experiment', mimeo, ANU.