Improving Work Incentives in a Means-tested Welfare System: The 1994 Australian Social Security Reforms

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**IMPROVING WORK
INCENTIVES IN A MEANS-
TESTED WELFARE SYSTEM:
THE 1994 AUSTRALIAN
SOCIAL SECURITY REFORMS**

by Peter Saunders

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Tony Eardley
Editor

Abstract

The dramatic rise in unemployment after 1990, particularly long-term unemployment, prompted the Australian Government to establish an expert committee to advise it on how best to respond to these developments. The release in 1994 of a White Paper on Employment and Growth foreshadowed a range of reforms in a number of areas. The expansion of labour market programs for the long-term unemployed was a central feature of the overall package, but so too were a number of significant reforms of the social security system. A major goal of these reforms is to provide a social security system more consistent with current labour market trends, and one which, whilst still heavily targeted, is designed to provide increased work incentives. This paper explains the nature of the social security reforms and analyses their impact, focusing on their consequences for incentives to increase participation in paid work.

1 Introduction

Shortly after its re-election in March 1993, the Australian Government established an expert Committee to advise it on how best to respond to the unemployment crisis. Between May 1990 and May 1993, the total number of unemployed people in Australia rose from 549 thousand to 924 thousand. Over the same period, the number of long-term unemployed people (defined as those out of work for a year or more) trebled, rising from 121 thousand to 362 thousand. The deteriorating unemployment situation seemed worse when set against Australia's impressive employment achievement over the 1980s (Saunders, 1994) and was more severe than that experienced by most other OECD countries in the early 1990s (OECD, 1994).

The main task set for the Committee on Employment Opportunities (CEO), as set out in its Terms of Reference, was:

to assess and report on the labour market and options for addressing unemployment and improving labour market programs and income and other support for the unemployed. Special attention should be given to the problem of long-term unemployment. (Australia, CEO, Green Paper: iv)

The Committee was chaired by the Secretary of the Department of Prime Minister and Cabinet and comprised the Secretaries of the Departments of Social Security and Employment, Education and Training, the Senior Advisor on Social Policy in the Office of the Prime Minister and three academics - two labour economists and a social policy analyst. Six months after its establishment the Committee released a Discussion Paper *Restoring Full Employment* (hereafter, the Green Paper) which formed the basis for 'extensive consultations' with interested parties in the early months of 1994,¹ a process which culminated in the release of *The White Paper on Employment and Growth* and the companion report *Working Nation: Policies and Programs* (Australia, Prime Minister, 1994a; 1994b).²

Following the diagnosis developed in the Green Paper, the White Paper emphasised the key role of economic growth in any sustained reduction in

1 According to Stilwell (1994) over 2200 submissions were received by the CEO, around two-thirds of them in writing.

2 Much of the subsequent discussion draws on material from the more detailed companion report, which will be referred to henceforth for convenience as the White Paper.

unemployment. It concluded that economic growth of between 4.5 per cent and 4.75 per cent a year would be required to reduce the unemployment rate to 5 per cent by the turn of the century. However, growth alone was necessary but not sufficient for the task. It needed to be accompanied by other measures if the expansion of output was to translate into a decline in unemployment, particularly long-term unemployment. A range of reforms were thus proposed, designed to improve the macroeconomic and microeconomic environment for growth, covering industry policy, training initiatives, reform of labour market assistance, social security and regional policy.

The focus of this paper is on the social security reforms announced in the White Paper.³ In large part, these reflect the proposals contained in the Green Paper which were, in turn, heavily influenced by the paper submitted to the CEO by the Department of Social Security (DSS, 1993a).⁴ The DSS submission began with the proposition that:

Dramatic changes have occurred within the Australian labour market, especially in the last decade, which challenge the current structure and rationale of the income support system, particularly in relation to unemployment payments. (DSS, 1993a: 2)

The need for the social security system to adapt to changes in the labour market is echoed in the White Paper, which begins its chapter on income support with the statement that:

Social Security arrangements for unemployed people still largely reflect the unemployment benefit system introduced in the 1940s around the time of the release of the *White Paper on Full Employment*. (Australia, Prime Minister, 1994b: 143)

3 The other elements in the overall reform package are only referred to where they have a direct bearing on the changes to social security.

4 The DSS submission in turn drew upon two further Departmental reports which assessed the rationale for dependency-based social security payments and the work incentive effects of the system of income support for the unemployed, respectively (DSS, 1993b; 1994a).

This is an exaggerated claim. The latter half of the 1980s had seen the establishment of the Social Security Review which devoted considerable effort to reviewing the entire social security apparatus and proposing reforms in a broad range of areas, including support for the unemployed (Cass, 1988).

The pace of social security reform in Australia since the mid-1980s reflects both the changing economic situation - which provided the underlying motivation for change; the categorical, means-tested, tax-financed nature of the system itself - which provided a framework within which change could take place; and the reformist zeal of the government - which saw the potential for change translated into action. The flexible nature of the Australian system can be regarded as both a strength and a weakness: a strength because it facilitates the reform process, but a weakness because it exposes the fragility of the social contract which underlies the system as a whole. While many other countries look with envy at the apparent ease with which the social security system can be changed in Australia, one of the consequences of change is uncertainty and one of its limitations is administrative feasibility - both of which impose costs on those who rely on the system for income support.

In what follows, the social security reforms announced in the White Paper are described and contrasted with previous arrangements in Section 2. This is followed in Section 3 by an assessment of the impact of the reforms on work incentives, their main underlying motivation. Section 4 briefly addresses some of the cost and financing aspects of the reforms, while Section 5 summarises the main conclusions.

2 Defining the Problem and Formulating the Response

Problems with the Existing System

Following the work of the Social Security Review in the late 1980s, a new active society strategy for support for the unemployed was introduced in July 1991. Two new forms of support were introduced:

- Job Search Allowance (JSA) payable (after a seven day waiting period) to men aged 16 to 64 and women aged 16 to 59 (and to certain 15 year olds) during the first year of their unemployment; and

- Newstart Allowance (NSA) payable to those unemployed for twelve months or more, and linked to labour market programs and other assistance designed to assist the long-term unemployed back into work.

Eligibility for both payments was conditional upon the satisfaction of an activity test which assessed whether claimants were available for and actively seeking employment or approved forms of education or training courses, or undergoing a course of rehabilitation. The amount of payment received was subject to an income test and an assets test. Under the assets test, JSA or NSA entitlements were withdrawn once the value of assets (excluding the principal home and certain other items) exceeded specified limits, ranging from \$112,500 for single home owners to \$240,500 (combined) for non-home owners couples (DSS, 1993c).⁵

Those with assets below these limits were subject to an income test. Since September 1993, all non-allowance income reduced the maximum allowance of single allowees according to the following scale:

- nil for the first \$30 (the ‘free area’)
- nil for the next \$15 a week of earnings (the ‘earnings disregard’);
- 50 cents for each dollar between \$45 and \$85 a week; and
- dollar for dollar for income in excess of \$85 a week.

For married allowees, the basic free area was also \$30, but this was supplemented by an earnings disregard set at \$25 a week each.⁶ In the case of couples, the income test applied to the income of either partner, with total income aggregated, although where the partner was also in receipt of a benefit, the combined income was divided and applied separately to each person’s benefit.

The structure of the income test gave rise to concern over high effective marginal tax rates (EMTRs), despite several attempts during the 1980s to reduce these by raising the effective free area. At September 1993 benefit rates, the dollar-for-dollar income test withdrawal rate imposed an EMTR

5 All figures are expressed in Australian dollars.

6 The earnings disregard for couples was raised from \$15 a week each to \$25 a week each in September following an ALP election commitment made in February 1993. The disregard for single people was also introduced at that time.

of 100 per cent over non-benefit weekly income ranging from \$85 to \$242 for single people in receipt of Rent Assistance. For a single-earner couple, the 100 per cent taper applied to weekly incomes from \$95 to \$338 (Australia, CEO, Green Paper: 171). Furthermore, the fact that basic benefits were taxable while supplementary payments such as Additional Family Payment and Rent Assistance were not, compounded these problems once basic benefit entitlement had been exhausted. Beyond this point, the 100 per cent income test withdrawal rate applying to supplementary payments was reinforced by income taxation, because the substitution of taxable private income for non-taxable benefit income caused **taxable income** to rise even when **total income** remained constant. The consequence was an EMTR well in excess of 100 per cent (DSS, 1994a: 22-6).

A second concern expressed in the Green Paper was that the application of the income test to the joint income of couples provided little incentive for the partners of the unemployed to seek paid employment. Indeed, if one partner in a dual-earner couple lost their job, the other partner could also leave their job (particularly if it was part-time or low-paid) without causing much of a further decline in their combined income. A third concern was the lack of incentive for either partner in an unemployed couple to seek a low-paid, full-time job - a situation which was becoming increasingly acute given the relatively strong growth in the number of low-paid jobs (Gregory, 1993).

Finally, reliance on the couple as the unit of eligibility was seen as providing insufficient flexibility for the unemployed and low income earners (particularly those caring for children) in choosing between work and family responsibilities. Many spouses in low income families who might prefer to remain outside the workforce in order to care for their children needed to be given greater financial encouragement to do so. This suggested that being a **parent** rather than a **partner**, had more legitimacy as the basis of eligibility for income support.

All four concerns reflected the belief that social security benefit eligibility and entitlement conditions were creating disincentives to work and distorting labour market choices. The first three problems made it financially unattractive for beneficiaries and their partners to engage in paid work in the labour market. The fourth acted in the opposite direction, imposing a harsh financial penalty on those parents wishing to remain at

home in order to care for their children. Unless these issues were addressed through changes to the system's incentive structure, the Green Paper argued that the unemployed would be prevented from sharing in the employment expansion generated by economic growth. Incentives thus had to be improved, not as a substitute for introducing equitable reforms, but in order to complement other strategies for achieving more equitable outcomes.

The first of the four problems mentioned above relates to the poverty trap, a situation in which high EMTRs distort work choices at the margin or, more realistically, over relatively small discrete income ranges. The next three concerns relate, directly and indirectly, to the relativity between income support payment levels and wages: the replacement rate question.

Attempting to address the poverty trap and replacement rate issues simultaneously is a complex and difficult task. Reducing the severity of the poverty trap tends to be expensive, not only financially, but also economically because the benefit system is extended well into the wage distribution (Gallagher, Gunasekera and McDiarmid, 1992). This runs the risk of any encouragement of those on low incomes to work more being offset by the stronger disincentives causing those currently on low or modest wages to work less.

On the replacement rate question, the choices are similarly stark. In order to lower the benefit replacement rate, either benefits must be cut or (disposable) wage incomes increased. Attempts to follow the latter route through the provision of income-related payments to low-wage workers with children in the late 1980s were being offset by declining real wages (aided, in some cases, by increased real income tax burdens) for the low-paid. Lowering the replacement rate through benefit reductions was politically unacceptable, particularly during a recession, which was in any case putting further downward pressure on wages, exacerbating the problem.

The Response

No single reform has the potential to address each of the concerns identified above. In prioritising its tasks, the CEO identified as a primary objective the need 'to provide a financial return for every dollar earned' (Australia, CEO, Green Paper: 184). Changes to the income test were thus required, specifically the removal of the dollar-for-dollar withdrawal range. This

change itself would not, however, be sufficient to address the next two identified problems and it was in seeking to address these that the fourth problem mentioned above - the restrictions imposed by the benefit and wage systems on the choices of single-income couples with children - becomes important.

Single-income families were finding it increasingly difficult to survive on one income. If assistance was provided to the caregiver (normally the wife) in her own right, on the basis that she was a **caregiver** not because she was a **wife**, it would be possible to make it more attractive for one person to remain in the home performing caregiving duties while also making it more financially attractive for the family to have the other partner in paid employment. Furthermore, by establishing a separate entitlement for each partner, the benefit paid to each would depend on their own individual income, thus avoiding the situation where the incentive facing one person depends upon the income of their partner.

The response adopted in the White Paper, following closely the recommendations in the Green Paper, comprised the following three main elements:

- **reform of the income test**, involving an effective lowering of the free area to \$30 a week through abolition of the earnings disregard and a reduction in the dollar-for-dollar 100 per cent withdrawal rate to 70 per cent;⁷
- introduction of a new **Parenting Allowance** (payable at half the married rate of benefit) available to the spouses of JSA/NSA recipients and low income parents caring for children under 16;^{8 9} and

7 The Green Paper recommended that the two-tier 50 per cent/100 per cent income test structure be replaced by a uniform 65 per cent withdrawal rate above the free area.

8 The Green Paper proposed that the Parenting Allowance be paid to all parents caring full-time for children aged under 12, but that those with children aged between 12 and 16 be required to look for part-time work in order to satisfy the activity test. By making Parenting Allowance free of any activity test for all those with children up to the age of 16, it was kept in line with social security payments for sole parents.

9 On its introduction on 1 July 1995, the Parenting Allowance will subsume the Home Child Care Allowance (HCCA) which in turn replaced the Dependent Spouse Rebate for those with dependent children in September 1994. The maximum rate of HCCA was \$30 a week and the fact that it was non-taxable and

- payment of a **Partner Allowance** (set at the same rate as Parenting Allowance) for spouses born before 1 July 1955 (i.e. aged over 40 at the time of its introduction) who have little or no recent work experience and no dependent children.¹⁰

Those persons who do not meet the eligibility criteria for Parenting Allowance or Partner Allowance will have to satisfy the conditions of eligibility for other payments. Generally, this will be Job Search Allowance in which case the activity test will be applied.¹¹ Together, these changes will have the effect of making the system of support for the unemployed operate on an individual entitlement basis.

In principle, the new income test will apply separately to each individual benefit recipient. However, in order to restrict the cost of the introduction of individual benefit entitlement, a joint income test was proposed for higher-income couples. Under this arrangement, the new income test will apply first to the high-income partner until their benefit entitlement is exhausted, with any remaining income then applied to the income test on their partner's benefit until that too is reduced or eliminated. This will ensure that the wives of high-income husbands will lose their benefit entitlement, while the wives of low-income husbands will retain part (or all) of theirs. The joint income test will come into operation once one partner's income exceeds \$231 a week - the benefit cut-out point at prevailing payment levels under the new income test.¹² Beyond this point, their partner's benefit will be withdrawn at the 70 per cent rate, being exhausted completely at an additional income of \$330 ($=\$231/0.7$) a week.

income-tested on the income of the dependent partner (not family income) made it, at least in the context of the heavily targeted Australian system, close to universal. This feature of HCCA was maintained, with an equivalent floor of \$30 a week set on Parenting Allowance subject to the same conditions.

- 10 A restricted form of Partner Allowance had already been introduced in September 1994, although this only involved separate payment of one half of the benefit to the unemployed person's partner, with no change to eligibility conditions.
- 11 The activity test replaced the work test as part of the 1991 active society reforms by extending the range of activities which the unemployed could be seeking to undertake to include participation in an approved training program.
- 12 The rate of allowance in mid-1994 was \$132.65. Under the new income test the benefit would be exhausted entirely when non-benefit income is equal to $\$30 + \$40 + (\$132.65 - \$20)/0.70 = \$230.90$.

Payment of an individual benefit entitlement to each partner in couples (with the benefit to each paid at half the married rate of benefit) will be made conditional upon each partner satisfying the requirements of the activity test (discussed further below). As a result of the changes, married women will no longer be eligible to receive assistance solely because they are **wives**, but only after they have satisfied the same eligibility (activity test) and entitlement (incomes and assets tests) as their husbands, i.e. after they have established that they are actively seeking but unable to find suitable paid work and have low incomes or asset holdings. At the same time, by subjecting these women to the activity test, they may become eligible to participate in the Job Compact (see below), other labour market programs or other forms of assistance. The basic principle underlying the new social security arrangements is thus one in which all adults not caring for children are expected to be either in paid work or looking for a paid job, irrespective of their marital status.

As a result of these proposals, all individuals will face lower EMTRs because of the general easing of the benefit income test, while the disposable incomes of low-income couples, particularly those with only a single earner, will be increased. The easing of the income test alone could guarantee the former but not the latter. The shift to individual entitlement in effect provides a subsidy to low-wage, single-earner (and some dual-earner) couples because such low incomes will not entirely disqualify spouses from their benefit entitlement. Part of the cost of this subsidy will be met from the savings resulting from the denial of Partner Allowance to those of spouses JSA/NSA recipients aged under 40 without children who do not satisfy the requirements of the activity test. The income test ‘carrot’ is thus accompanied by extended application of the activity test ‘stick’.

One of the immediate consequences of the restructuring of the income test will be a reduction in the disposable incomes of JSA/NSA recipients with private earnings as a result of the lowering of the effective free area from \$45 to \$30 due to abolition of the earned income allowance. For those beneficiaries with higher private incomes, this loss will gradually be offset by the lowering of the higher 100 per cent withdrawal rate back to 70 per cent (Bradbury, 1994). The dollar-for-dollar benefit withdrawal rate is removed, but some recipients with low private income will be made worse off by the changes, at least initially (see Section 3 below).

The Job Compact

It is important to note at this stage that the central feature of the White Paper reform package as a whole is the Job Compact, a labour market program designed to make the long-term unemployed 'job ready' so that they can share in the benefits of economic recovery. Under the Job Compact, which builds upon the existing wage-subsidy Jobstart program, a guaranteed job offer of up to 12 months duration will be made available to all those who have been receiving unemployment allowances for over 18 months. It is envisaged that most of these jobs will be in the private sector, where employers will receive wage subsidies of between \$100 and \$230 a week to induce them to offer employment to the long-term unemployed.

The Job Compact is described in the White Paper as imposing a 'reciprocal obligation' on the government and the long-term unemployed, with the government assuming responsibility for providing a job offer and the unemployed 'under an obligation to accept a reasonable offer of a job or lose entitlement to income support for a period' (Australia, Prime Minister, White Paper, 1994b: 116). It is estimated that almost 160,000 job opportunities will be offered each year under the Job Compact, which will result in long-term unemployment declining by around 200,000 by June 1998.¹³

A key element of the Job Compact is the reform of the delivery of labour market assistance through the adoption of a 'case management' approach, under which:

... assistance will be tailored to the needs of individual job seekers, and training will be better linked to employment opportunities. The emphasis will move away from processing large numbers of job seekers through relatively rigid national programs. The key elements of the new strategy are an accurate assessment of the needs of job seekers and an intensive plan to assist particularly disadvantaged people. (Australia, Prime Minister, White Paper, 1994b: 127)

Case management is thus the mechanism through which labour market assistance is to be targeted to meet the needs of the long-term unemployed,

¹³ According to the latest (December 1994) labour force statistics, economic growth has seen long-term unemployment already fall considerably, from 340,000 in December 1993 to 278,500 by December 1994.

as well as the instrument for achieving a more flexible and adaptable system of support for the unemployed.¹⁴ It provides the linkage, operating via the activity test, between labour market programs and an active social security system.

Case management represents a more client-focused targeting strategy, one used already in Australia (albeit on a much smaller scale) in some labour market and community care programs. Its introduction as a targeting mechanism provides the leeway for easing the income test without compromising the targeted nature of the system as a whole. An important (but currently unknown) determinant of the success of this part of the reform package will be how well the flexible and discretionary case management approach can mesh with the more traditional administrative model on which the social security system operates.

3 Assessing the Reform Proposals

On the face of it, the fact that the White Paper social security reforms are primarily designed to increase **labour supply** is a somewhat perverse response to the problem of unemployment - a situation where supply already exceeds demand, at least in aggregate. Such supply-side measures are, however, consistent with improving overall labour market flexibility, thereby contributing to a lowering of the 'natural' rate of unemployment (Australia, Prime Minister, White Paper, 1994b: 7). The emphasis on the supply-side was also seen as necessary because:

In the medium term, economic growth will not be limited by insufficient demand ... It has been the weakness and rigidity of Australia's supply capacity which has constrained our growth performance in the past. (Australia, Prime Minister, White Paper, 1994b: 5-6)

Whatever the **general** merits of this case for supply-side policies, there remains the more **specific** issue of whether the White Paper reforms will actually succeed in freeing-up supply. If they do not, the main

14 There appears to be a good deal of support for the Job Compact among labour economists (e.g. Dawkins, 1994; Langmore and Quiggin, 1994), although Freeland (1994) has questioned its ability to operate at the levels proposed in the White Paper. Less supportive are Wooden (1994) and Sloan (1994), who has described the proposal as lacking in detail and its success as 'essentially an act of faith' (Sloan, 1994: 73).

macroeconomic impact of the package will result from its fiscal stimulus to aggregate demand, an effect which will occur whatever happens on the supply-side.

Leaving the macroeconomic consequences to one side, the following discussion focuses on the supply-side responses, specifically those resulting from changes in work incentives. In order to assess the impact of the White Paper reforms on work behaviour, three pieces of information are required. The first explores how the budget constraint facing benefit recipients (and low-paid workers) changes, in what ways and by how much. Of particular interest here, is how the reforms affect the structure of EMTRs facing those in specific circumstances. The second concerns the numbers of people in each set of circumstances, grouped according to the change in the EMTR (substitution effect) and in disposable income (income effect). The third is evidence on the size of the labour supply elasticities relevant to each group.

Because the effect of the reforms are greatest for couples, the following discussion focuses on the changes to EMTRs facing couples and their likely behavioural consequences. In trying to unravel the impact of what is a complex series of reforms on work incentives and work behaviour, it is useful to separate the effects of the easing of the income test from the changes to benefit entitlement for couples. The former change is mainly intended to encourage part-time employment among all those receiving unemployment assistance payments, while the latter focuses more specifically on improving the work incentives of both partners in couples on benefit.

The Income Test

The easing of the income test will reduce the high EMTRs which characterise the poverty trap (Office of EPAC, 1988; Whiteford, Bradbury and Saunders, 1989). The key questions are, by how much, and with what effect? It is difficult to dispute the proposition that a 100 per cent withdrawal rate produces disincentive effects, particularly when account is taken of interactions with other elements of the tax-benefit system and the costs of working. In the past, attempts to reduce the 100 per cent withdrawal rate have foundered because of their immediate budgetary cost and the fact that the initial (income) benefits are concentrated mainly on beneficiaries with the highest private incomes (Gallagher, Gunasekera and McDiarmid, 1992). The White Paper approach reflects a longer-run and more dynamic perspective on this issue, one which recognises that the

longer-term benefits in terms of increased labour-supply and reduced benefit dependence can outweigh these short-run costs and reverse the immediate distributional consequences.

The effect of the White Paper reforms on the EMTR facing couples is illustrated in Figures 1 and 2. These schedules, derived from modelling work undertaken within the Department of Social Security, incorporate the interactions between the income test, income tax arrangements (including the phasing-in and out of relevant tax rebates) and the Medicare levy which partially funds the health care system.¹⁵ They compare the EMTR schedules as they existed prior to the introduction of the reforms in September 1994 with those prevailing under the new regime (assuming, for ease of comparison, that September 1994 benefit levels remain in existence).

Both sets of data reveal a similar pattern, with the EMTR declining from around 100 per cent to between 70 per cent and 80 per cent over a broad range of private income, ranging from around \$100 a week up to between \$350 and \$370 a week. Over this range, the reductions in the EMTR are greater for two-earner couples than for single-earner couples, reflecting the introduction of Parenting and Partner Allowance. The reductions are also somewhat greater for couples with children than those without. Below and above these limits, the EMTR will rise, at the lower end because of abolition of the earned income allowance, and at the upper end because of interactions with the tax system resulting from the reduction of the 100 per cent taper to 70 per cent.

Labour Supply Responses

Lack of data prevents any systematic and accurate attempt to combine the changing EMTR schedules shown in Figures 1 and 2 with distributional data indicating the numbers likely to be affected in each income range. The latest income distribution survey undertaken by the Australian Bureau of Statistics (ABS) for which data are available was undertaken in the latter months of 1990 - before the recession began - and is unlikely to provide reliable estimates for 1994-95.

15 The author acknowledges the assistance of Ken Oliver and his colleagues in DSS in providing the data underlying Figures 1 and 2 but remains solely responsible for how these data have been used and interpreted here.

Figure 1: Effective Marginal Tax Rates, Allowee Couple with No Children: September 1994 vs July 1995^(a)

Figure 2: Effective Marginal Tax Rates, Allowee Couple, Two Children Under 13: September 1994 vs July 1995^(a)

Administrative data published by DSS can provide no more than a rough indicator of the magnitudes involved.¹⁶ Thus, in May 1993 out of a total of 889.6 thousand JSA or NSA recipients, 271.3 thousand (30.5 per cent) received the married rate of payment. Of these, approximately 134.5 thousand (49.6 per cent) had dependent children, leaving around 137 thousand people eligible for Partner Allowance, where the largest incentive effects might be expected to occur.¹⁷ In terms of non-benefit income, 651.4 thousand (73.2 per cent) of all recipients reported no income in May 1993, 109.7 thousand (12.3 per cent) reported incomes between zero and \$30 a week, with the remaining 128.5 thousand (14.5 per cent) reporting incomes in excess of \$30 a week (DSS, 1993c, Table 82). Imperfect though these statistics are for current purposes, they do at least suggest that the numbers affected by the changes are large enough for the behavioural effects to be substantial, if the individual responses are significant.

On the question of the behavioural impact of the social security system, there is relatively little Australian evidence on which to draw, and most of what is available is, at best, circumstantial. A survey of how DSS clients are affected by the poverty trap revealed that for many of those surveyed:

... the decision to work had not been influenced significantly by the effect of earning additional income on their income support entitlement ... The majority of respondents were largely unaware of how the income test works and the effect that earning income had on their allowance or pension ... the impact of social security income tests tends to be misinterpreted in that they are generally viewed as being harsher than they actually are. (Puniard and Harrington, 1993: 13-14)

In any case, the benefit income test is not the only factor contributing to high EMTRs. As noted earlier, interactions between the withdrawal of social security payments and the income tax on Medicare levy arrangements can exacerbate the problem in some instances. These elements can cause the EMTR to exceed 100 per cent even after the benefit withdrawal rate has

16 For an earlier attempt to superimpose distributional data on EMTR schedules using unpublished DSS administrative data, see Whiteford, Bradbury and Saunders (1989).

17 These figures have been derived from data presented in the DSS *Annual Reports* for 1992-93 and 1993-94.

been reduced to the 70 per cent announced in the White Paper (DSS, 1993a: 73).

More generally, the work decisions of benefit recipients are also influenced by the way benefits are administered and the penalties this imposes (sometimes inadvertently) on those considering re-entering the labour force. Where administrative procedures are cumbersome and time-consuming, or where the rules themselves discourage benefit re-application (e.g. by imposing waiting periods) the perceived risks of accepting a job can offset any potential gain in income. Although the government has recognised these problems and begun to address them with a number of recent initiatives, the two leading welfare agencies have argued for more to be done in this area, and neither gave particular priority to easing the income test in their submission to the CEO (Australian Council of Social Service (ACOSS), 1993; Brotherhood of St. Laurence, 1993).

All of these arguments suggest that the effect of the easing of the income test on work behaviour may not be great. The White Paper provides 'conservative estimates' that the easing of the income test will induce an extra 33,000 unemployed people into part-time work¹⁸ and that an (unspecified) proportion of the 132,000 beneficiaries working part-time will be induced to increase their hours of work. The basis for these estimates is not clear.

Even if a response of this magnitude in part-time employment among beneficiaries did occur, a more fundamental problem relates to the operation of the activity test used to determine benefit eligibility. The success of the White Paper strategy requires that the activity test be capable of dealing with the expansion in the numbers on benefit receiving some earnings from part-time employment. If this is not the case, then any increase in willingness to engage in part-time employment as a result of the easing of the income test will be frustrated by the problems involved in administering the activity test. However, before turning to that question, the effects of the White Paper reforms on the work incentives facing couples is considered.

18 This corresponds to around 5 per cent of the 651 thousand JSA/NSA recipients reporting zero income in May 1993 (DSS, 1993c, Table 82).

Work Incentives for Couples

The changed arrangements for couples are the most radical and important element of the social security reform package. The previous application of a joint benefit income test to the combined income of both partners meant that each had little or no financial incentive to undertake paid work, particularly given the structure of the income test. It is interesting to note that although the move to individual entitlement could have been defended on equity or philosophical grounds, the case was argued in both the Green and White Papers mainly on incentive grounds. The social security reform chapter in the White Paper is headed 'Income Support Incentives', while the Green Paper presented the case for reform in the following terms:

The major rationale for moving towards individual entitlement is that it would encourage greater and more effective job search by both partners of a married couple. This would respond to the fact that many of the job opportunities are more likely to be gained by women than men given the increase in part-time work and the greater increase in jobs in traditionally female areas of the labour force. (Australia, CEO, Green Paper, 1993: 187)

A range of evidence was presented in the Green Paper in support of the proposition that the joint income test creates serious work disincentives among the wives of unemployed men. The most commonly cited evidence was that the employment rates of the wives of unemployed men are well below those of the wives of employed men, from which it was concluded that the difference reflects the effects of the benefit income test (Pech, 1991; DSS, 1993a; 1993b; Wilson, 1994).

However, this kind of evidence relates to the **combined** impact of both the income and substitution effects of the benefit system on the wife's labour supply **and** the 'pure' income effect arising from the husband's fall in income. Furthermore, the fact that the employment rates of the wives of unemployed men are lower than those of the wives of employed men does not, of itself, imply that the benefit income test alone accounts for the difference (Bradbury, 1994; King and Bradbury, 1995). There are a range of other possible explanations including location effects (both husband and wife may suffer from the same lack of localised job opportunities), skill effects (both partners may have similarly low levels of skill and education

and thus suffer from the same lack of job opportunities) and gender role or 'bruised machismo' effects (values and attitudes may prevent the wife from seeking paid employment because it undermines the husband's role as main breadwinner) (Bradbury, 1995: 1-2).

Some light on this issue can be gleaned by comparing the behaviour of the wives of those men who have **just become unemployed** with the behaviour of the wives of employed men and of the wives of men who have been unemployed for some time. The evidence presented in Table 1 uses unpublished labour force data to explore the labour force patterns of husbands and wives, classified by the husband's labour force status and duration of unemployment. These data indicate that the employment rate of the wives of all employed men (65 per cent) is more than twice that of all unemployed men (28 per cent). However, the employment rate of the wives of those men who have been unemployed for less than two weeks is 40 per cent. Thus, 25 of the 37 percentage points difference (almost two-thirds) between the employment rates of the wives of employed and unemployed men existed even before they had experience of the benefit system.¹⁹

Bradbury (1995) explores this issue further using longitudinal data derived from DSS administrative records, while King and Bradbury (1995) report results from a survey of a group of the wives of men receiving unemployment payments. Both studies reach similar conclusions regarding the factors contributing to the observed differences in unemployment rates among wives. Bradbury, for example, concludes that personal characteristics are far more important than effects which can be directly attributable to the operation of income test or other attributes of the social security system (Bradbury, 1995: 45).²⁰

Unfortunately, neither Bradbury nor, in their larger study, King and Bradbury (1995) are able to identify which personal characteristics are most important, although the latter study concludes - albeit on the basis of a small and non-representative sample - that the labour supply decisions of women are dominated by their role caring for children, their own ill-health or disability, and general labour market discouragement. Financial incentives

19 This statement would need to be modified if repeat spells of benefit receipt were widespread, but there is no evidence on this.

20 This contrasts with the recent finding reported by Davies, Elias and Penn (1992) that the benefit system is more important in the United Kingdom.

Table 1: Labour Force Status of Married Women Aged 20 to 59 by Husbands' Labour Force Status and Unemployment Duration (Percentages)

Husband's Labour Force Status	Wife's Labour Force Status					Total
	Employed full-time	Employed part-time	Employed total	Unemployed	Not in the labour force	
Employed	35	30	65	3	32	100
Unemployed ^(a)	15	12	28	18	55	100
less than 2 weeks	22	18	40	10	50	100
2-3 weeks	23	18	41	15	44	100
4-51 weeks	17	14	30	18	52	100
52-103 weeks	12	8	21	21	59	100
104+ weeks	5	6	11	18	72	100
Not in the labour force	13	11	24	2	74	100
Total	32	27	59	4	37	100

Note: a) These unemployment durations refer only to men looking for full-time work.

Source: Bradbury, 1995, Table 1.

appear to play only a minor role overall. However, both studies are careful to emphasise that the lack of evidence of any systematic and substantial net impact arising from the structure of the social security system may reflect gross effects which could be substantial but offsetting. Thus, it remains a possibility that a large benefit-induced disincentive effect arising mainly from the high EMTR facing the wife is offset by a positive income effect arising from the loss of family income associated with the husband's unemployment. However, such an interpretation provides no indication of the work incentive effects likely to be induced by the White Paper changes.

The Activity Test

The above discussion of incentives has focused on the consequences of the reforms which encourage work behaviour by easing the income test. Attention now focuses on the role played by the activity test. The activity test establishes whether a person is eligible to receive unemployment assistance, as distinct from the income test which determines their benefit

entitlement. The two basic conditions which have to be satisfied under the activity test are that the person has to be **actively seeking** and **willing to undertake** suitable paid work.

These conditions were summarised in the DSS submission to the CEO as follows:

Determining whether a person is 'unemployed' involves an assessment of their commitment to obtaining 'suitable paid work', defined as work a client is able to perform and which provides no less than the award wage and standard conditions for the type of work. While such work may include casual, temporary or part-time work, it is generally considered to be full-time work during the day. (DSS, 1993a: 20)

In establishing that they are actively seeking suitable work, DSS clients are required to describe their attempts to find employment, including providing the names of at least two employers approached (either personally or in writing) over the previous fortnight. The scope of 'suitable paid work' encompasses full-time permanent employment, but can also include casual, short-term, temporary or part-time work (DSS, 1994b, paragraph 12.2420). What is not clear is whether someone who is working part-time and who wishes to remain so is considered to satisfy the activity test when, strictly speaking, they are not available for full-time work.

In practice, these difficulties are avoided by those clients who are working part-time indicating that they would accept a suitable full-time work offer if one were available (DSS, 1993a: 20). The practical question is whether or not the activity test can withstand the increased incidence of these situations resulting from the reforms to the income test and benefit entitlement. If not, the inflexibility of the activity test will sit somewhat uncomfortably with the desire to integrate the benefit system more effectively with a labour market increasingly characterised by part-time and casual work.²¹

21 Part-time employment accounted for around 24 per cent of total employment in December 1994, up from 18 per cent a decade earlier. Norris (1993) estimates that casual employment (defined as workers with no entitlement to either annual leave or sick leave) increased from 16 per cent of all employees in 1984 to 24 per cent in 1990. (Changed data classification procedures prevent the derivation of more recent estimates on a consistent basis).

Reflecting these concerns, the DSS submission to the CEO recommended that the activity test be reformed so as to give recognition to the concept of 'underemployment' and to expand the definition of 'suitable paid work' to include part-time and casual work and other forms of atypical employment (DSS, 1993a: 87).²² Such a change would be consistent with the findings from a recent DSS Survey, which observed a tendency for DSS participants in labour market programs to obtain part-time and casual employment more frequently than full-time employment (Jordan, 1994). Although acknowledging that his evidence is largely conjectural, Jordan posited that the emphasis given to full-time employment in the activity test may need to be changed, a point also emphasised by Bradbury (1994).

However, although the White Paper contained a number of changes to the activity test designed to encourage unemployed people to undertake a broader range of activities while remaining eligible for social security payments, there was no explicit reference to the treatment of part-time employment. The prevailing activity test provisions which formally require people to seek full-time employment have been retained, even though the income test changes are designed to encourage greater part-time employment.

It is of relevance to note in this context that in its discussion of the Job Compact, the White Paper noted that while the obligation on a Compact participant will be to accept any reasonable job offer:

A case manager may also decide that people who have substantial part-time work or regular temporary work may be best to continue if the work is likely to lead to further, more substantial opportunities. (Australia, Prime Minister, White Paper, 1994b: 126)

It is also made clear that only part-time employment in excess of 20 hours a week - well above the average of around 16 hours a week actually worked by part-time workers²³ - would be acceptable under the Job Compact, while

22 One way of resolving this problem could have been to apply to all of the unemployed the activity test as it currently applies to NSA recipients aged over 50, who are not required to establish that they are seeking full-time work in order to satisfy the activity test (DSS, 1993a: 20-1; Welfare Rights Centre, 1994: 275).

23 ABS (1995), *The Labour Force, Australia. December 1994*, Catalogue No. 6203.0, Table 17.

‘temporary casual positions will not be considered’ (Australia, Prime Minister, White Paper, 1994b: 125).

Even these rather limited changes will have no impact on shorter-term unemployed people who are not eligible to receive assistance under the Job Compact. For these people at least, the situation appears to be that if they are working part-time and receive an offer of full-time work, they must either accept that offer or lose their benefit eligibility under the activity test, even if part-time work is their preferred choice. If, in order to avoid this, the activity test was changed so that part-time employment was more consistent with its requirements, problems would arise in the treatment of benefit recipients who are combining part-time work with a part-rate benefit, compared with the treatment of those existing part-time workers who, because they have had no contact with the benefit system, do not take-up the part-rate benefit to which they are in principle entitled.

At one level, this is an issue of take-up but it also raises broader issues about the equitable treatment of part-time workers who are in contact with the benefit system and those who are not. Furthermore, in light of the changes to the income test and introduction of individual benefit entitlement announced in the White Paper, the number of married women in this latter situation is likely to increase, possibly substantially. Overall, it seems that the emphasis given in the activity test on the need to search for full-time employment sits rather uneasily with the thrust of those White Paper reforms designed to encourage benefit recipients to engage in part-time employment now as a route to full-time employment later. While those administering social security may see part-time (or casual) employment as the stepping stone to a full-time job (with its implied expenditure savings), the reality is that part-time employment is for many the only alternative to unemployment, while for others it is their preferred choice.²⁴

24 As Jordan observes:

... the idea that large numbers of people can make a transition from unemployment through casual or part-time to full-time work, attractive though it be, should be regarded with scepticism. Too little is known of the circumstances under which it occurs. The strongest justification for encouraging employment that provides less than a full livelihood is that for many it may be the only alternative to complete and permanent unemployment. (Jordan, 1994: 71)

4 Costs and Finance

The estimated cost of the White Paper proposals as a whole in their first full year of operation (1995-96) is \$1.73 billion, equivalent to about 1.35 per cent of total estimated Federal budget outlays of \$127.9 billion. Over the four years to 1997-98, the package is estimated to add \$6.54 billion to outlays. Increased expenditure is concentrated in the area of employment and training, where outlays are estimated to rise by \$4.83 billion, accounting for almost three-quarters of the total cost of the package. Of this, the Job Compact and other labour market programs add \$3.44 billion to outlays, equivalent to 53 per cent of the total cost of the White Paper reforms. The increase in employment and training expenditure is net of the estimated savings in social security outlays as a consequence of the participation of benefit recipients in the Job Compact and other labour market initiatives which form part of the reciprocal obligations arrangements described earlier.

When viewed against these costs, the impact on outlays of the social security reforms are surprisingly modest. In fact, the **net** impact of the reforms on social security expenditure is negative, reflecting the benefit savings from the long-term unemployed (and other benefit recipients) who participate in the Job Compact and other labour market programs and move off the social security budget. The estimates of the **gross** costs of the social security reforms show in Table 2 reveal that by far the main contribution to increased expenditure is the introduction of the Parenting Allowance. The introduction of individual benefit entitlement through Partner Allowance and phasing-out of Wife Pension, combined with the changes to the income test are estimated to produce a net **saving** in social security outlays expenditure of around \$100 million in 1995-96, rising to over \$110 million by 1997-98.

The immediate budgetary consequence of the move to individual entitlement depends upon what proportion of the partners of current unemployment payment recipients satisfy the activity test. The initial budgetary impact of the changed income test is to reduce expenditure due to the abolition of earned income allowance, but to increase expenditure as a result of the lowering of the 100 per cent withdrawal rate to 70 per cent. Over time, the costings of these changes become more complex (and more problematic) as they depend on how behaviour responds to the new entitlement rules, specifically how many partners of the unemployed satisfy the activity test²⁵

25 The figures in the eighth line of Table 2 suggest that not many spouses will take up the option of labour market assistance, particularly in the initial years.

and thus receive Partner Allowance, how many of these decide to take up the offer of labour market assistance, and how many benefit recipients change their labour supply, by how much, and with what results, as a consequence of the introduction of Partner Allowance and the changes to the income test.²⁶

It has already been noted that the White Paper provides some estimates of the likely magnitude of the labour supply responses. If these occur, outlays will decline and offset (possibly entirely) the initial cost of easing the income test. Such an outcome could be regarded as being both efficient (in the incentive sense) and equitable. But this still leaves unanswered the question of the overall budgetary impact of the move to individual benefit entitlement. Only if this component of the reforms adds to social security expenditure *ceteris paribus* will it raise the disposable incomes of low income benefit recipients.

To the extent that some spouses do not satisfy the requirements of the activity test, the change to individual entitlement associated with the introduction of Partner Allowance will involve a reduction in expenditure corresponding to the decline in the incomes of those couples who are affected. Over time, some who satisfy the activity test will take up the offer of labour market programs which will add to expenditure (though not to social security expenditure) while any induced changes in labour supply will affect earnings and feed through into reduced benefit expenditure. The Green Paper (Australia, CEO, 1993: 188) notes that the change to individual entitlement will increase the number who are officially counted as unemployed by about 25,000 in the short-term, although this is likely to be swamped in the longer term by the induced effects on labour supply, at least if the official estimates are to be believed.

How large is this projected increase of 25 thousand in relation to the total number of unemployed couples in receipt of unemployment assistance? DSS statistics suggest that there were around 271 thousand people receiving either JSA or NSA at the married rate of payment in May 1993, of whom 49.6 per cent had dependent children, leaving about 136 thousand childless unemployed couples.²⁷ About 20 per cent of all JSA/NSA recipients were

26 It is possible that the wives of some low-wage employed men who are themselves in part-time employment may withdraw from the the labour force in order to receive Partner Allowance with little adverse effect on family income.

27 Department of Social Security, *Annual Report, 1993-94*, Table 3(a): 127. Readers should be wary of the apparent errors contained on this page of the Annual Report.

Table 2: Estimated Gross and Net Impact of the Reforms on Social Security Outlays^(a) (\$million)

Measure	1994-95	1995-96	1996-97	1997-98
Social security changes:				
Individual entitlement and modification of income test	0	-96.0	-94.9	-96.5
Introduction of Parenting Allowance combined with the Home Child Care Allowance	27.6	366.6	386.7	416.2
Other social security measures ^(b)	9.6	7.9	-21.7	-26.6
Gross impact on outlays	37.2	278.5	270.1	293.1
Offsets to social security outlays:				
Labour market assistance	-224.7	-641.2	-668.1	-596.1
Entry level training	-24.0	-60.2	-78.4	-80.2
Youth training initiatives	-40.2	-114.9	-135.1	-140.8
Labour market assistance to newly activity-tested spouses of the unemployed	0.0	-3.2	-11.8	-17.3
Other offsets ^(c)	-0.1	-3.5	-14.0	-26.1
Total offsets	-289.0	-823.0	-907.4	-860.5
Net impact on outlays	-251.8	-544.5	-637.3	-567.4

Notes:

- a) Figures refer to the Australian financial year commencing on 1 July.
- b) Includes phasing out of existing Wife Pension, extended eligibility for entry level training, broader range of allowable activities for JSA/NSA recipients under the activity test, and advance of future income support payments.
- c) Includes offsets in programs for Aboriginal and Torres Strait Islander People and assistance for people with disabilities.

Source: Australia, Prime Minister, The White Paper, 1994b: 181-4.

aged over 45 and if this is taken as an estimate of the percentage of married recipients whose spouses would be eligible for the Partner Allowance free of the activity test, only the remaining 109 thousand childless couples would have to satisfy a separate activity test.

These estimates are admittedly rather crude and the data used to derive them are rudimentary. Taken at face value, they suggest that the Green Paper estimate of 25 thousand additional unemployed implies that around 84 thousand women aged under 40 without children whose husbands are receiving unemployment assistance will not satisfy the activity test requirements as individuals in their own right. This is likely to be an over-estimate, for several reasons. Included amongst these is the fact that a substantial number of the recipients of the married rate of JSA or NSA are not in fact the partners of unemployed people but of people receiving some other form of payment. In addition, the level of unemployment has declined considerably since May 1993. Internal Departmental estimates based on more recent data suggest a substantially lower figure.

However, whatever the actual numbers involved, the point is that many women will be affected in ways which are worthy of more detailed study. Some of these women will presumably fail the activity test because they are able to find a job. Others will fail it because they were not regarded as actively seeking and available for suitable paid work or other approved activities. For this group, the immediate effect of the changes would thus be to make them (and the couple as a unit) financially worse off, at the same time as changing the incentive structure they face so as to encourage their labour market participation. How they respond to these changed incentives, and whether sufficient job opportunities are available to satisfy any increase in labour supply are crucial in determining the longer-term impact of the reforms on both efficiency and equity.

5 Conclusions

The package of social security reforms announced in the 1994 *White Paper on Employment and Growth* reveals two broad aspects of the Australian response to the unemployment problem. The first is the seriousness with which the Australian Government has viewed the rise in unemployment and the strength of its commitment to developing an effective and timely response designed to assist the long-term unemployed back into the workforce. The second is the flexibility provided by a tax-financed, targeted

social security system to respond to, and facilitate, economic and labour market changes.

The discussion in this paper has focused on the impact of the White Paper social security reforms on incentives to work, this being one of the main factors motivating the changes. In light of this emphasis, the discussion has highlighted the fact that while there is a good deal of information available on how the income and activity tests influence **incentives**, not enough evidence currently exists for Australia on how these translate into actual **behaviour**. In any case, the emphasis on work incentives might seem to be something of a side issue in light of the significant changes to benefit entitlement for couples which lie at the heart of the White Paper reforms.

With the introduction of Partner Allowance and individual income testing, the system has taken a substantial movement towards a system of support for the unemployed based on the individual as the unit of assessment. With the introduction of Parenting Allowance, the basis for support has shifted away from dependency (being a spouse) to performing important caring work for children (being a parent). Whatever their effects on work incentives, these changes have considerable merit in their own right, in philosophical as well as equity terms, and they have generally been welcomed by most commentators (ACOSS, 1994; Travers, 1994).

In terms of how the reforms affect the incentive structure, the abolition of the dollar-for-dollar income test withdrawal rate is a significant and long-overdue change. This change recognises that the ultimate benefits of any induced behavioural changes have the potential to outweigh the more immediate equity and cost implications. Given the easing of the income test structure itself, the incentive, as opposed to the equity or philosophical, effects of the move to individual entitlement remain unproven. In the longer-run, how successful the new incentive structure is in encouraging benefit recipients back into the labour force will depend on how well the operation of the income and activity tests can cope with a more diverse labour market and the more varied pattern of prevailing work opportunities and choices. There is something of a contradiction in the continued emphasis in the activity test on the need to look for full-time work and the encouragement of part-time work resulting from the changes to the income test and the new Parenting and Partner Allowances.

Ultimately, the success of the social security reforms will lie in how well they stand the test of practical implementation. It has been argued here that the need to restructure social security arrangements so as to enhance work incentives is not derived from clear evidence that this will result in beneficial behavioural changes, and that the activity test reforms may not go far enough in encouraging benefit recipients to engage in the range of employment opportunities emerging in the labour market. Having said this, however, it is difficult to deny the general proposition that the structure of any social security system can give rise to serious disincentive effects. The practical issue is not whether this **can** occur, but whether it **does** occur. From this perspective, the impact of the White Paper social security reforms on work incentives remains, at best, an open question.

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