

# SUPPLEMENTING FAMILY INCOME

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**Tim Callan, Ciarán J. O'Neill and Cathal O'Donoghue**

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Responsibility for the content of the study rests wholly with the authors.

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## GENERAL SUMMARY

### *Context of the Study*

State support for the incomes of families with children aims to achieve a balance between sometimes competing objectives. These include: poverty alleviation - through the provision of income support to low-income households with children; sharing of the costs of children across the community and across the life-cycle - through the provision of a universal child benefit to all families with dependent children; and the maintenance of work incentives - by ensuring that families with children will gain from employment and from increased earnings.

Almost nine-tenths of expenditure on the current system is accounted for by Child Dependant Additions (CDAs) - typically just over £13 per child per week - for social welfare recipients; and Child Benefit - averaging about £5 per child per week - paid to all families with children. But a key role in maintaining work incentives has been given to two smaller elements of the child income support system: the Family Income Supplement, introduced in 1984, and the system of child additions to income tax exemption limits, introduced in 1988. The Family Income Supplement pays a benefit to full-time employees (over 20 hours per week), with gross incomes below a limit depending on the number of children. The amount of the benefit is a proportion of the gap between actual income and the relevant income limit. For example, an individual or couple with 4 children, and earnings of £150 per week, could receive a payment of £14.25 per child per week in FIS. Child additions to the income tax exemption limits have a somewhat lower value of under £5 per child per week.

How effective are these supports in maintaining work incentives? What are the problems arising from their operation and their interaction? Could these problems be overcome by incremental changes? And how would such incremental improvements compare with the gains sought from a more radical restructuring of the child income support system? This study aims to shed light on these questions.



### *Family Income Supplement*

Payments under most social welfare schemes, including Unemployment Benefit and Unemployment Assistance, take account of the number of people depending on the beneficiary. Wages do not, in general, take account of the number of people depending on the wage-earner. This means that the gap between incomes in-work and out-of-work tends to be narrower the greater the number of dependants. The "unemployment trap", whereby a family may be financially "better off on the dole" is an extreme case of this.

The primary aim of the Family Income Supplement has been to ensure that incomes in work are significantly higher than incomes out of work for low income families supported by an employee. To qualify for a payment, an individual or couple must be employed for at least 20 hours per week, have at least one dependent child, and have a gross income below a limit depending on family size. The amount of the payment is now 60 per cent of the gap between actual income and the relevant income limit. For example, a 4-child family with earnings of £150 per week would receive £57 per week in Family Income Supplement.

This structure has had some success, at a modest budgetary cost, in ensuring that employment, even at low earnings, carries a financial reward for families. Thus, it helps to combat what is often called the "unemployment trap". But the interaction of FIS and the income tax system has contributed to the creation of what is often termed a "poverty trap", whereby an increase in gross earnings can leave a family worse off in terms of disposable income. An extra £10 per week in earnings can lead to a reduction in FIS of £6 per week, and an increase in tax and PRSI of over £4 per week, leaving the family worse off. Over time, improvements in the income support offered to low income families by FIS and by the introduction of child additions to the income tax exemption limits have helped to combat the "unemployment trap" but have tended to expand the "poverty trap". While the most severe form of "poverty trap" - a marginal tax-cum-benefit withdrawal rate of 100 per cent or more - may not affect very many families, there is a strong case that the maximum rate facing all families should be much lower than 100 per cent.

### *Take-up of Family Income Supplement*

One of the main problems with Family Income Supplement in Ireland, and with similar schemes in other countries, is that it may not reach its intended recipients. The extent to which it does reach the target population is measured by the rate of "take-up": the proportion of those eligible for a

payment who actually receive it. Estimates of take-up based on the ESRI's 1987 Survey suggest that take-up was, at that time, very low. More limited estimates of take-up were developed using the ESRI's tax-benefit model to take account of changes in policies, incomes and population characteristics between 1987 and 1994. These estimates are subject to considerable uncertainty. They suggest some increase in take-up over the period, but that low take-up remains a substantial problem. It seems likely that no more than half of potential expenditure on FIS is actually claimed and received by its intended recipients.

The reasons underlying low rates of take-up for in-work benefits are many and complex, as research in other countries has shown. But low take-up certainly reduces the effectiveness of FIS in improving the incentives facing those currently unemployed to move into employment. US evidence suggests that a high rate of take-up - over 80 per cent - is achieved for a somewhat similar scheme which operates through the tax system. While there are considerable differences in the nature of tax administration in Ireland, this does suggest that the possibility of effecting a FIS-type payment through the tax system should be investigated.

### *Policy Options*

There is a widespread consensus that the current system of child income support is in need of reform. Views differ, however, as to the extent of the changes needed and the broad shape which a reformed system might take. Options analysed in this study, and an earlier, related study (Callan, O'Donoghue and O'Neill, 1994) offer a menu ranging from incremental reforms at low budgetary cost to radical, and sometimes quite costly, reforms.

If the FIS structure is to be retained, a substantial increase in the take-up rate should be a priority for policy. In our view, this is most likely to be achieved by making use of the tax system to identify, and if possible to pay, potential beneficiaries. An incremental reform of the FIS structure, making the payment dependent on income after, rather than before, tax and PRSI deductions would help to eliminate the most severe forms of "poverty trap" found in the current structure. Families would face marginal tax-cum-benefit withdrawal rates of no more than 75 to 80 per cent at most. The cost of a FIS reform package along these lines could range from £20m to £50m per year, depending on the degree of success in increasing take-up.

A more substantial restructuring was suggested by the incoming government in December 1994. It centres around a Child Benefit Supplement "payable to all social welfare recipients and to low and middle income families", and replacing FIS and Child Dependant Additions. Our preliminary investigation identified some of the key decisions which would have to be made in designing such a Supplement, building on the earlier analysis of FIS. Our assessment indicates some of the advantages and disadvantages of a Child Benefit Supplement, based on a payment of about £13 per week, withdrawn gradually over incomes ranging from £9,000 to £20,000 for most families. These can be compared with the pros and cons of other restructured schemes: a "basic income for children" - involving a Child Benefit of about £80 per child per month - and an "integrated child benefit" - a similar scheme, but with the increased child benefit being liable for tax. In our view, both an "integrated child benefit" and a Child Benefit Supplement offer scope for significant improvements over the current system. The balance of advantages between these two broad approaches depends not only on the weight attached to different objectives, but on the details of implementation, which deserve further investigation.

## Chapter 1

### INTRODUCTION

#### *1.1 Context of the Study*

The position of families depending on low-paid employment has been a focus of concern for income maintenance policy for some time. In recent years, the phenomena known as the "poverty trap" (whereby an increase in gross earnings can leave a family worse off in terms of disposable income) and the "unemployment trap" (whereby a family may be worse off in financial terms when a member is in employment rather than unemployed) have attracted particular attention. Employees with low earnings relative to their family size - or unemployed persons with dependants and low potential earnings - are those most seriously affected by these disincentives, which arise from the complex interplay of tax and welfare policies, particularly as they relate to state-provided child income support.

The current system of child income support can be seen as attempting to balance concerns about work incentives for low income families with a number of other objectives. Nolan (1993b) identifies four objectives with which child income support may be concerned: poverty alleviation; a sharing of the costs of child rearing across the lifecycle and across the community; maintenance of adequate incentives to work at low income levels; and the provision of some independent income to mothers working in the home. Child income support uses a combination of four instruments to strike a balance between these sometimes conflicting objectives, and the overall budgetary cost of child income support:

1. *Child benefit* is a universal payment, made in respect of all dependent children at a rate of £20 per month for each of the first two children, and £25 for the third and subsequent children;
2. *Child dependant additions* (CDAs) are paid to those relying on the various social welfare schemes, such as Unemployment Benefit and Unemployment Assistance, at a rate of £13.20 per week for each dependent child (a higher rate is paid to widows and other lone parents);
3. *Child additions to income tax exemption limits* (CAITELs) help to reduce or eliminate tax liabilities for those on low incomes. The general income tax exemption limit is raised by

£450 for each of the first two children, and by £650 for each subsequent child: these additions have a maximum value of about £5 per week per child;

4. *Family Income Supplement* (FIS) pays a benefit to those employed for over 20 hours per week, and with gross incomes below a limit depending on the number of children. The amount paid depends on the gap between income and the relevant income limit: higher amounts are paid to those with more children and with lower earnings. For example, someone with 4 children, earning £150 per week could receive about £14.25 per child per week in FIS.

Total expenditure (including income tax foregone) under these headings was almost £600m in 1994. Over nine-tenths of this expenditure was accounted for by Child Benefit and CDAs. Roughly equal amounts were spent on each of these schemes<sup>1</sup>: Child Benefit was paid for over one million children, and CDAs for about half that number, but the much higher rate of payment for CDAs brings total expenditure on the two schemes into approximate balance. The cost of the child additions to income tax exemption limits and of FIS was about £20m each in 1994. Despite this low share of aggregate expenditure on child income support, FIS and child additions to exemption limits play a key role in providing income support and a financial incentive to work for a specific target group: families with low earnings relative to their size.

The development of the child income support system to its current state, and the continuing debate about the overall structure of the system has been well documented (NESC, 1979, 1990; McCashin, 1988 and Carroll, 1994). NESC's most recent detailed appraisal (NESC, 1990)<sup>2</sup> concludes that the consolidation of all existing child income supports into a single, taxable child benefit remains a benchmark against which incremental changes in the system should be evaluated. Such a reform was proposed by the National Planning Board, and endorsed by the government in 1984, stating that:

A new Child Benefit scheme will be introduced, which will unify in a single payment State support towards the cost of rearing children. Selectivity in favour of the less well-off will be achieved

<sup>1</sup>Recent estimates suggest expenditure of £267m on Child Benefit and £280m on CDAs.

<sup>2</sup>NESC (1993) concludes that the recommendations made on this issue in 1990 are still appropriate: this includes a diminution in the scope of CDAs, and an enhanced role for Child Benefit.

mainly by treating the new monthly child benefits as assessable income for tax purposes. The restructured scheme will be carefully designed to channel available resources to those most in need and to provide an independent income for mothers whose work is in the home. It will also help to improve the incentive to work by being more neutral than the existing system as between situations in which a head of family is in employment or out of work (Ireland, 1984).

In the event, these formally stated intentions were not fully implemented, and the system evolved in a more complex fashion. FIS, a highly targeted income support was introduced in 1984. Child tax allowances<sup>3</sup> were abolished in 1986, while the universal payment (renamed child benefit) was increased: this change was in line with the intentions stated in 1984. Child additions to the income tax exemption limits were introduced in 1988, providing further targeted income support to low income earners. CDAs have remained a very important part of the structure, with different rates across schemes gradually being aligned, and the overall level remaining high relative to the universal child benefit payment.

This integrated (taxable) child benefit proposal, and a similar radical proposal for a single non-taxable "basic income for children" were the subject of a recent report (Callan, O'Donoghue and O'Neill, 1994). A recurring theme in the debate on these issues is that such proposals for "root and branch" reform of the system of child income support are costly, and that a more targeted approach to the supplementation of family income may be preferable. Opinions on this issue will undoubtedly vary according to the weight placed on different objectives - such as poverty alleviation, work incentives and the share which society should take in the costs of rearing children. But information on the experience to date with such targeted schemes, and on the scope for improvements in targeted schemes is clearly essential for strategic choices on this issue.

It is this information which the present study seeks to provide. It reviews the structure and scope of the Family Income Supplement, noting its interaction with the income tax system; examines the difficulties which the scheme has had in reaching its target population; and considers some changes to the structure which could help to improve the trade-off between

<sup>3</sup>Child tax allowances should be distinguished from child additions to income tax exemption limits. Child tax allowances reduce the liabilities of all taxpayers with children, and benefit top rate taxpayers most; child additions to income tax exemption benefits those with incomes just above the current exemption limits, with no gain accruing to those on the highest incomes.

the level of support at low incomes, marginal tax-cum-benefit withdrawal rates for recipients, and the budgetary cost of the scheme. The final chapter draws on these findings to reconsider some of the broader strategic issues in restructuring child income support. The strategy indicated in *A Government of Renewal* (the policy agreement which led to the formation of a new government in December 1994) includes a proposal for a Child Benefit Supplement, replacing FIS and CDAs, which would be paid to all social welfare recipients and to low and middle income earners. The concluding chapter also builds on earlier analysis to elucidate the trade-offs involved in such a strategy.

### *1.2 Structure of the Report*

Chapter 2 describes the background to the introduction of the Family Income Supplement scheme, and the objectives it was designed to achieve. It also shows how the structure of the scheme itself, and its interaction with the income tax system, have changed over time. Chapter 3 reviews the evidence on take-up of FIS at the time of the ESRI's Survey of Income Distribution, Poverty and Usage of State Services in 1987. The many changes in the scheme since that date have led to significant increases in the numbers claiming the benefit, and in expenditure on the scheme. But the effects of the changes on take-up are not clear, because the numbers eligible, and the amount of their entitlement, may have grown equally or more rapidly. This issue is assessed with the help of estimates from the ESRI tax-benefit model. Some options for the improvement of take-up are also considered.

Chapter 4 deals with analyses of possible changes to the current structure and scope of the Family Income Supplement. It compares the options of basing FIS assessments on net income after tax and PRSI deductions with a change to a UK-style Family Credit scheme; and also discusses the alternative structure provided by the US-style Earned Income Tax Credit. Each of these options would remove the extreme "poverty trap" phenomenon inherent in the current interaction between FIS and the income tax system. Reforms of the FIS structure involving a net income basis of assessment are analysed by simulating entitlements using the ESRI model. The cost and other implications of the changes are clarified in this way. The final chapter summarises the main conclusions and sets them in the context of the broader debate on restructuring of child income support. Particular attention is given to the proposal in *A Government of Renewal* for a Child Benefit Supplement, replacing FIS and CDAs, which would be paid to all social welfare recipients and to low and middle income earners.

## Chapter 2

### *FAMILY INCOME SUPPLEMENT: GENESIS AND STRUCTURE*

#### *2.1 Introduction*

In this chapter, we look back at the origins of the Family Income Supplement, and the objectives which it was intended to serve. The basic structure of the scheme is set out, and the major changes made since its inception are noted. The interaction between FIS and the income tax system in determining disposable incomes at various gross income levels is addressed. The implications of recent changes in the structure of FIS and the structure of the income tax system are also explored.

#### *2.2 Genesis of FIS*

During the 1970s and early 1980s, unemployment rose sharply in Ireland, as in many other OECD countries. Macroeconomic shocks, such as the two oil price hikes, and the associated international recessions, obviously played a major role in this rise. But in Ireland, as elsewhere, increasing attention was also given to the possible role of microeconomic factors in explaining the rise in unemployment. One factor which received particular attention was the potential disincentive effect of unemployment compensation payments which were high relative to potential earnings.<sup>1</sup> An extreme form of this phenomenon is often labelled an "unemployment trap" - a situation in which a person is financially better off unemployed and receiving social welfare benefits rather than working. At a more general level, situations in which incomes when unemployed formed a high proportion of potential net income in employment (a high "replacement rate") were seen as potentially damaging the incentive to work for such individuals.

A number of developments in the Irish income tax and social welfare systems in the 1970s and early 1980s tended to reduce the disposable income achievable at low earnings relative to the income available from unemployment compensation. Income tax allowances were not indexed in line with inflation, and rates of tax also increased. Revenue Commissioners' statistics show a rise in the "average effective rate of

<sup>1</sup>See, for example, Blackwell (1985).



income tax" from 21.5 per cent in 1976/77 to 25.2 per cent in 1983/84. These developments put downward pressure on in-work incomes, at a time when there were significant increases in the amounts payable in Unemployment Benefit, including an element of pay-related benefit from 1974 on.

Table 2.1: *Hypothetical Replacement Rates at 2/3 of the Average Industrial Wage, 1983*

<i>Unemployment compensation</i>	<i>Marital/family status</i>			
	<i>Single</i>	<i>Married, no children</i>	<i>Married, 2 children</i>	<i>Married, 4 children</i>
	<i>Replacement rate (per cent)</i>			
UB plus maximum PRB	76	89*	109*	124*
Flat-rate UB	47	65	86	102
Long-term UA	39	57	76	90

*Notes:* Calculations are based on weekly cash benefits; secondary benefits, possible income tax refunds, and non-cash benefits are not taken into account.

\*Restriction of pay-related benefit under the "wage-stop" rule could have limited ratios marked with an asterisk to 85 per cent of net earnings in employment.

The potential impact of these developments is illustrated by calculations of hypothetical replacement rates for 1983, the year before FIS was introduced. (Table 2.1). These show disposable income when unemployed, and receiving alternative forms of unemployment compensation, as a proportion of disposable income when employed. The examples chosen involve single individuals or single-earner married couples, taxed under PAYE and paying employee PRSI contributions at the standard rate. It is assumed that when unemployed, the individual or family receives Unemployment Benefit and the maximum Pay-Related Benefit (row 1); the maximum flat-rate Unemployment Benefit (row 2); or the maximum long-run Unemployment Assistance (row 3). Secondary benefits (such as fuel allowances and Christmas bonus) and income-related non-cash benefits (such as the value of a medical card or reduced rents under the local authority differential rent scheme) are not taken into

account. It is assumed in all cases that in-work income is at two-thirds of the average industrial wage: this is because the replacement rate issue is of particular concern at low wages, and the average potential wage of the unemployed is below that of other individuals.<sup>2</sup> At higher wage levels, replacement rates are, of course, lower. But a similar pattern of replacement rates across marital and family status is found at higher wage levels.

For each type of unemployment compensation, replacement rates are higher for one-earner married couples than for single people; and rise with the number of children in the family. This reflects the fact that unemployment compensation includes elements of income support for adult dependants (the "adult dependant addition" or ADA), and child dependants ("child dependant additions" or CDAs). Wage rates do not, in general, take account of the number of people depending on the earner. This means that the gap between in-work and out-of-work income tends to be narrower for those with an adult dependant, and narrower still for those with large numbers of children.

It was against this background that the Family Income Supplement scheme was introduced in 1984.<sup>3</sup> It was designed to improve the position of low income families supported by an employee. Official statements at the time emphasised the need to combat labour market rigidities by improving the position of working families on low pay relative to what they would receive on social welfare. "The main objective of the scheme is to maintain the incentive to work by providing cash support for workers with families who are on low incomes and as a result, are only marginally better off working than if they were claiming Social Welfare benefits", (Comprehensive Public Expenditure Programmes, 1984, p.291).

<sup>2</sup>Nolan (1987) reports that average pre-unemployment wages in O'Mahony's (1983) sample were 72 per cent of the average industrial wage; and Callan, O'Donoghue and O'Neill find that the average predicted wage rate for those currently unemployed, on the basis of their education, experience and other characteristics, was about two-thirds of the average hourly wage rate in industry.

<sup>3</sup>The introduction of a FIS-type scheme was considered in a report to NESC (NESC, 1979) as a means of tackling poverty among the in-work population. The Council hoped that a child benefit scheme might reduce or eliminate the need for a FIS-type scheme, but accepted that if this were not practicable a FIS-type scheme should be considered.

The evolution of replacement rates over the period since the introduction of FIS has been subject to many conflicting influences. Pay-related benefit (PRB) was one of the main factors contributing to high replacement rates in the early 1980s. The reduction of rates of PRB over time, and its eventual elimination for recipients of Unemployment Benefit in the 1994 Budget, have therefore been a factor tending to reduce these high replacement rates over time. On the other hand, special increases in the rates of payment for Long-Term Unemployment Assistance have been a factor tending to increase replacement rates for groups dependent on this scheme. The development of FIS, and the introduction of child additions to the income tax exemption limits, have been part of the policy package aimed at improving the balance between incomes in work and out of work. An indication of the role of FIS within the current policy package is given in Section 2.4 below, which shows the impact of FIS on replacement rates facing those with low earnings relative to family size.

### 2.3 Structure of FIS

The structure of FIS is as follows. To be eligible to receive the benefit, a claimant must be working a certain minimum number of hours per week and must also have at least one child dependant. Until 1989 a claimant had to work this minimum number of hours himself or herself but since then, it has been possible to combine the hours worked by both spouses/partners to reach the minimum. The definition of dependent children for FIS is persons aged under 18 (or between 18 and 21 if in full-time education) who normally reside with the claimant.

Once eligibility has been established, FIS payments are then calculated as a percentage of the shortfall between the family's gross income (from any source, though some items such as child benefit and investment income are excluded) and fixed income limits for each family size. Until 1991, there was a further provision that payments could not exceed a specified maximum amount for each family size. The income limits are designed to ensure that the benefits are restricted to employees with low pay relative to their family size. The percentage rate applied to the shortfall has a dual role. On the one hand, it acts as a *multiplier* providing income support to the low paid by closing a portion of the gap between gross income and a "target" income (the income limit). On the other hand, it also acts as a *withdrawal rate* which serves to gradually withdraw the benefit as gross income gets closer to the income limit. In effect, it is a tax rate since, for every extra £1

of gross earned income, a portion of benefit (specifically the increase in gross income, in this case £1, multiplied by the withdrawal rate) is withdrawn.

FIS has changed quite substantially since its introduction. The main changes are set out in Table 2.2 below. These include substantial increases in the weekly income limits, a reduction in the required minimum hours of work and an increase in the FIS multiplier/withdrawal rate. However, with the exception of the removal of the maximum payment condition in 1991 and the introduction of a minimum guaranteed payment of £5 in the same year, the basic *structure* of FIS, as described above, has remained intact.

Table 2.2: *Changes to FIS, 1986-1994*

<i>Income Limits</i> £ p w	1986	1987	1988	1989	1990	1991	1992	1993	1994
<b>Family with</b>									
1 child	100	104	108	112	118	140	155	175	185
2 children	120	126	131	136	143	160	175	195	205
3 children	140	148	154	160	168	180	195	215	225
4 children	160	170	177	184	193	200	215	235	245
5 children	180	192	200	208	218	225	240	260	270
6 children	180	192	200	218	229	242	260	280	290
7 children	180	192	200	228	240	259	277	297	307
8 children	180	192	200	238	251	276	294	314	324
<b>Maximum payment</b>									
-1 child		10	16			NO LIMIT			
-4 children		22	37			NO LIMIT			
Minimum Hours	30	24	24	24	20	20	20	20	20
Multiplier/ Withdrawal rate	33%	50%	50%	60%	60%	60%	60%	60%	60%
Minimum Payment, £s	0	0	0	0	0	5	5	5	5

Source: Social Welfare Rates Booklets, 1986-1994.

Income limits have been raised by about 65 per cent, on average, for the period 1986 to 1993, substantially more than the rate of inflation.<sup>4</sup> This has had the effect of extending the scope of the scheme to higher real income levels. This, coupled with the relaxation of the minimum hours requirement, has tended to increase the numbers eligible for FIS payments. At the same time, the removal of the maximum payment limits and the increase in the multiplier/withdrawal rate, together with the increase in the income limits, has served to make FIS payments increasingly generous over the period concerned. There have, indeed, been increases in both the number of recipients and the average payment per family over the period, shown in Table 2.3 below. The average weekly payment per family almost trebled between 1986 and 1993, while the number of recipient families almost doubled during the same period.

Table 2.3: *Numbers Receiving FIS and Average Payment, 1985-1993*

	1985	1986	1987	1988	1989	1990	1991	1992	1993
<i>Number of Families</i>	4,664	4,979	5,532	5,159	6,066	6,569	7,157	7,735	9,605
<i>Expenditure, (£ 000s)</i>	2,211	3,020	4,373	5,022	6,323	8,745	10,370	12,631	16,438
<i>Average Weekly Payment Per Family<sup>1</sup> (£)</i>	9.1	11.7	15.2	18.7	20.0	25.6	27.3	31.4	32.9

*Source:* Statistical Information on Social Welfare Services, 1985 to 1992

*Notes:* 1. Calculated as total expenditure divided by number of families

Two other interesting points arise from these recent changes to FIS. First, given the possible increase in the eligible population as a result of the increase in income limits and the relaxation of the minimum hours requirement, it is unclear whether the substantial increase in the number of recipients represents an increased, decreased or unchanged rate of take-up

<sup>4</sup>The highest increases were for those with small or large numbers of children (about 80 per cent for those with 1 child or with 8 children), with the lowest increases (about 50 per cent) for those with 4 or 5 children.

for FIS on a case-load basis. Second, given the increase in FIS entitlements, the nature of the change in the take-up of FIS on an expenditure basis, is equally unclear. These points are taken up again in the next chapter.

#### 2.4 The Impact of FIS on Incentives

At the outset of this chapter, the concept of an unemployment trap (the situation where, given the interaction between the tax and benefit systems, there is little financial incentive for the unemployed to take up paid employment) was discussed. It was noted that this was an important justification for a scheme offering benefits to low-paid employees. Indeed, the development of FIS since its introduction clearly demonstrates that "the supplement has been targeted at those facing the highest replacement rates [and, thus] it has concentrated on alleviating the unemployment trap", (Feeney, 1990, p.38). To illustrate this, some hypothetical replacement ratios for families of various sizes and income levels in 1994 are set out below in Table 2.4. By showing the calculated ratios before and after FIS, we can get an idea of the effect which FIS has on the balance between income in work and income when unemployed.

Table 2.4: *Hypothetical Replacement Ratios Before and After FIS, 1994/95*

<i>Gross Weekly Earnings</i>	<i>Replacement Ratios</i>			
	<i>Married Couple, 2 Children</i>		<i>Married Couple, 4 Children</i>	
	<i>Without FIS</i>	<i>With FIS</i>	<i>Without FIS</i>	<i>With FIS</i>
	<i>%</i>	<i>%</i>	<i>%</i>	<i>%</i>
£100	128	80	149	85
£125	105	76	123	81
£150	90	74	105	78
£175	82	74	92	75
£200	76	74	87	76
£225	71	71	81	77
£250	66	66	76	76

*Note:* The calculations of unemployment income are based on the rate of Long-Term Unemployment Assistance, which is identical with the Unemployment Benefit rate.

It is clear that FIS entitlements can reduce replacement ratios very significantly for families with children. The reduction is very substantial at the lowest pay levels. But even for jobs at £150 per week, FIS reduces the replacement rate by almost 30 percentage points for the 4-child family and by 16 percentage points for the smaller family. Microsimulation estimates in Callan, O'Donoghue and O'Neill (1994, Table 6.4, p. 69) explore the impact of FIS on the distribution of replacement rates facing the unemployed. They show that if FIS could reach all those eligible for the payment, the proportion with replacement rates over 80 per cent would be just over 4 per cent; but at a take-up rate of one-third, almost 10 per cent of the unemployed would face a replacement rate of over 80 per cent. These calculations show that FIS has an important potential impact on the target group; but that the degree to which it reaches that target group - measured by the take-up rate - is of critical importance if that potential is to be realised.

Replacement rates are designed to summarise the incentives surrounding decisions concerning employment and unemployment. But they do not capture all of the effects of FIS on work incentives. If a person is in employment, and in receipt of FIS, can he or she improve family income by working longer hours or earning higher wages? And what of the incentive facing a spouse to take up paid employment? The structure of FIS, particularly when it interacts with the income tax system, can have quite damaging effects on these work incentives. For families in employment and in receipt of FIS, benefit withdrawal combined with taxes can make it difficult to increase the net disposable income of the family by increasing the work hours or earnings of either partner.

The introduction of FIS exacerbated disincentive problems of this type since the combination of the FIS withdrawal rate, the marginal relief rate of income tax and the rate of PRSI can mean that, over some income ranges, effective marginal tax rates can exceed 100 per cent.<sup>5</sup> The policy of increasing the FIS multiplier/withdrawal rate over time - with the primary aim of increasing in-work incomes for FIS recipients at a modest budgetary cost - has improved the balance between in-work and out-of-work incomes for the target group, but makes it more difficult for these same families to achieve higher disposable incomes through increases in earned income. The experience with FIS highlights the trade-off faced by policy in dealing

<sup>5</sup>Withdrawal of non-cash benefits, such as a medical card, or, for local authority tenants, increases in rent under the differential rent scheme, can also contribute to high effective marginal tax rates.

with the two disincentive effects discussed here, commonly labelled the "unemployment trap" and the "poverty trap". On the one hand, increases in FIS income limits and in the FIS withdrawal rate, have improved the position of families entering the labour market relative to the benefits they received when out of work. On the other hand, the increases in the multiplier/withdrawal rate have added to the disincentive facing those already in low paid employment.

### *2.5 Interactions between FIS and Income Taxes, 1986 and 1994*

Some calculations of the interaction of FIS and the income tax system in 1986, the changes since then and the current situation are described below with a view to looking at the problem of high marginal tax rates at low family income levels. As with the replacement ratios presented above, care should be taken in interpreting data on the disincentives facing low-paid families. The nature of the disincentives will depend on the exact specification of disposable income (e.g., whether the purchasing power equivalent of a medical card or housing subsidies in local authority rent has been included) and "there is considerable scope for disagreement about important aspects of the calculations involved" (NESC, 1990, p.213). More generally, any specific calculation refers only to the unit (in this section, a married couple with 4 children) for whom the calculations are made, and care must be taken to see that conclusions drawn from such examples are not misleading.

Figure 2.1 shows the relationship between gross and disposable incomes for a married couple with 4 children (one PAYE earner) in 1986 and 1994. Disposable incomes are defined as gross incomes less taxes and PRSI plus FIS payments and child benefit. The imputed value of a medical card is not included but the fact that employees with medical cards do not have to pay the Health and Employment and Training Levies is taken into account.<sup>6</sup> Figure 2.2 shows the effective marginal tax rates derived from this table. At every income level it shows the total amount taken in income tax, PRSI, levies and/or withdrawal of Family Income Supplement from a £10 increase in weekly earnings.

<sup>6</sup>Until 1994, liability for the Health Contribution and the Employment and Training Levies for employees who were medical card holders lay with the employer. The 1994 Budget removed this anomaly, as recommended by the Expert Working Group on Integration of the Income Tax and Social Welfare Systems. The Budget also provided a similar exemption for those earning less than £9,000 per annum (£173 per week).



Figure 2.1: *Gross Earnings and Disposable Income, 1986 and 1994*

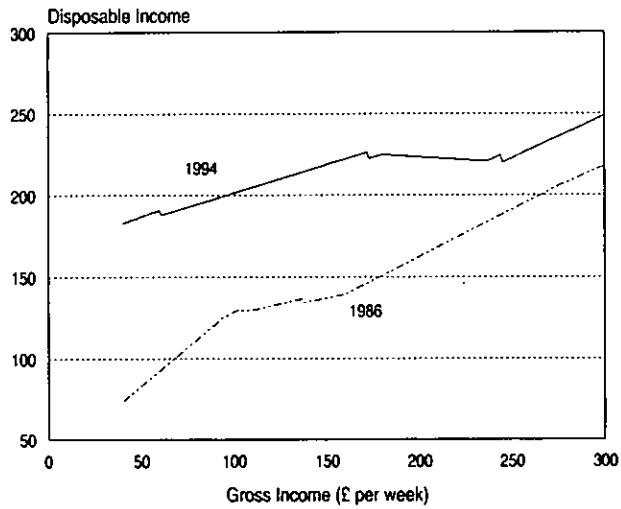
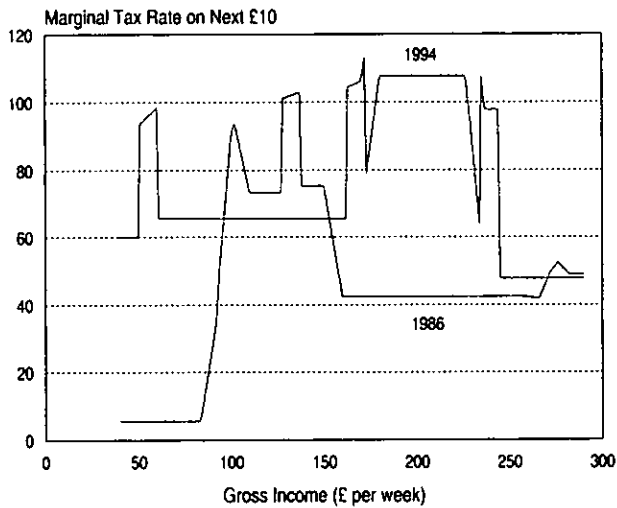


Figure 2.2: *Gross Earnings and Marginal Tax Rates, 1986 and 1994*



Over the period 1986 to 1994, a variety of welfare and tax measures were aimed specifically at those in low paid employment. The changes on the welfare side (i.e., in FIS) have been described above. From the point of view of the effective marginal tax rates facing FIS recipients, a key feature was the rise in the FIS withdrawal rate to 60 per cent. On the income tax side, key changes included modest increases in personal allowances; more substantial increases in the general exemption limits; the introduction of child additions to the income tax exemption limits; a reduction in the standard rate of income tax from 35 to 27 per cent; and a reduction in the marginal relief rate to 40 per cent, which led to a widening of the income range over which marginal relief applied. Two main changes were made to the PRSI/levy rates for low income workers. All those with incomes below £9,000 per annum, equivalent to a weekly income of £173, are now exempt from the Health Contribution and Employment and Training levy. In addition, those whose weekly earnings are below £60 are (since 1990) exempted completely from PRSI. Figures 2.1 and 2.2 show how these changes affected incomes and incentives for various positions on the income scale: it should be remembered that average wages increased by about 55 per cent over the period.

It is clear from Figure 2.1 that this combination of policy changes has increased disposable income at every level of earnings. The removal of the maxima on FIS payments is of particular importance for those at the lowest incomes; for those at low incomes, increases in the generosity of the FIS scheme (higher income limits and a higher multiplier/benefit withdrawal rate) play the major role; and at somewhat higher income levels, reductions in income tax rates, increases in income tax exemption limits, including child additions to those limits, also contribute to increased net incomes.

In 1986, the effective marginal tax rate over most of the income range illustrated (£40 to £300 per week) was less than 50 per cent. For incomes between about £100 per week and £160 per week, however, marginal tax rates were substantially higher: about 75 per cent over much of the range, when the standard rate of income tax (35 per cent) was combined with withdrawal of FIS (a further 33 percentage points) and PRSI and levies (about 8 percentage points). An effective rate of over 100 per cent applied over a narrow range of incomes, affected either by the combination of the marginal relief rate of income tax, FIS withdrawal and PRSI, or by the withdrawal of a medical card. It is likely that the numbers in this group were quite small: some estimates of the numbers actually and potentially facing these disincentives are presented later in this section.

In 1994, the income range over which the highest effective marginal tax rates apply is much wider, and is at a higher (nominal and real) income level. Over much of the range between £163 per week and about £245 per week, a £10 increase in income attracts an effective marginal tax rate of over 100 per cent. For most of this range, the key factors are the marginal relief rate of income tax (40 per cent) combined with FIS withdrawal (60 per cent) and PRSI (at least 5.5 per cent). At £173 per week, the exemption limit for the Health Contribution and Employment/Training Levy is passed. For earnings below that level, the employee does not contribute to these levies; but for earnings above that level, the levy is payable on *all* earnings. When considering a £10 increase in pay which moves an employee above this limit, a loss of almost £4 per week in PRSI has to be combined with FIS withdrawal of £6, so that the effective tax rate is close to 100 per cent. This disincentive problem is reinforced by a similar change in employers' PRSI at the £173 income level, which means that both employers and employees face an incentive to keep earnings below that level.<sup>7</sup>

The band of income over which highest marginal tax-cum-benefit withdrawal rates (at or over 100 per cent) apply is now wider than in 1986, and the income range over which these rates apply has been shifted up the income scale in real terms. It might be expected that this would increase the numbers actually and potentially affected by such rates. The numbers potentially affected are those in the relevant income range who are entitled to FIS payments; the evidence in the next chapter on changes in the eligible population is relevant here. But the greatest concern may be for those who actually face such disincentives to increased earnings.

Atkinson and Sutherland (1990) discuss the potential and problems of administrative statistics in measuring the size of such problems. Translating these concerns into the Irish context, two problems in particular may be noted. First, the statistics on FIS recipients do not have full information on the characteristics relevant to income tax liabilities; but an estimate of the tax position is needed in order to predict the tax-cum-benefit withdrawal rate. Second, while it may be possible to estimate the marginal tax-cum-benefit withdrawal rate on an extra £1 of earnings using published statistics, it will not be possible to say what the corresponding rate on an

<sup>7</sup>If the value of a medical card were taken into account the "spike" in the effective marginal tax rate at this point would be even more dramatic, as the medical card income limit for a 4 child family is about £175 per week. There is also a similar spike in the effective marginal tax rate close to the £245 earnings level, at which the family loses its entitlement to the minimum FIS payment of £5 per week.

extra £20 of earnings would be. While recognising these problems, we have attempted to establish limits on the numbers facing the highest tax rates (of 100 per cent or more) in 1986 and 1992 from published data on the numbers of families receiving FIS payments at different levels, cross-classified by family size. This analysis assumes standard allowances and exemption limits for married couples, and takes account of the extreme disincentives faced by the small number of lone parent FIS recipients. It suggests that fewer than 1,000 FIS recipient families could have faced rates in excess of 100 per cent in 1986; and fewer than 3,000 families could have faced such rates in 1992.

Changes between 1992 and 1994 may have increased these numbers significantly. The reduction in the marginal relief rate from 48 per cent to 40 per cent implied a substantial widening in the band of incomes over which marginal relief applied. The "levy" exemption limit at £173 per week introduced in 1994,<sup>8</sup> may also affect greater numbers, including not only families with children but *all* individuals in particular regions of the earnings distribution, irrespective of marital and family status. But even with substantial increases, the numbers of families facing a poverty trap *related to FIS* would be modest in absolute terms.

Do these relatively low numbers indicate that the FIS-related poverty trap phenomenon is unimportant? As pointed out by Dilnot and Webb "the fact that there are relatively few people in the poverty trap may in fact imply that high marginal tax rates *are* important and that individuals have adjusted their labour supply accordingly" (Dilnot and Webb, 1988, p. 40). But what form would such adjustment take? Disposable income is maximised by a gross income which is just below the income tax exemption limit; it is reduced by opting out of work, since FIS improves the incentive to take up a job. Again, the administrative statistics show no indication of substantial numbers altering their behaviour in this way.

There are, however, two broader reasons why the existence of such a severe poverty trap has, quite rightly, become a focus of concern, despite the limited numbers directly affected. First, it must be regarded as unfair that two almost identical families could end up with different disposable incomes, whereby the family with the greater earned income would have a lower disposable income. Avoidance of this sort of "horizontal inequity" may be regarded as a constraint which policy ought to satisfy. Second, in some circumstances, the existence of the low income poverty trap may

<sup>8</sup>A similar exemption applied to the temporary income levy in 1993.

make certain job offers financially unattractive relative to income from unemployment benefits. While it may be the case that an individual could achieve a higher disposable income if a *lower* wage or shorter hours could be agreed, it seems unlikely that such renegotiation of job offers is common. Thus, while there is in general a trade-off between policy efforts to tackle the two distinct incentive issues - the incentive to take up or remain in low paid employment, and the incentive to increase earnings in low income employment - a policy change which eliminated effective tax rates of over 100 per cent could represent an improvement on both fronts.

### 2.6 Conclusion

FIS was introduced in large part as a response to the existence of high replacement rates for low-paid earners with children. Its primary aim, therefore, has been to ensure that incomes in work are significantly higher than incomes out of work for such families. Changes in the scheme over time, such as the increase in the multiplier/withdrawal rate and the removal of the maximum payment have strengthened its role in providing a floor to incomes in work, which is above the income available if unemployed. Part of the trade-off for increasing this floor, without substantial increases in the cost of the scheme, has been an increase in effective marginal tax-cum-benefit-withdrawal rates facing such families. High marginal tax rates on increased earnings, given the overall public finance constraint, may be seen as part of the price for a floor for in-work incomes which lies significantly above the level of unemployment compensation. But effective marginal rates above 100 per cent, which arise because of the interaction with the income tax system, are not desirable on any grounds. Changes in FIS and the income tax structure in recent years have tended to widen the band of income to which such rates apply, and shift it up the income scale. The number of families actually affected by such rates is not very large; nor do many families appear to have reacted to this incentive structure by reducing their earnings. Thus, some of the concerns expressed about the impact of the current policy structures may be misplaced. However, there is still cause for concern. The phenomenon may mean that the disposable income associated with certain job offers is financially unattractive. Perhaps more fundamentally, the horizontal inequity created by the current system may simply be regarded as unacceptable. Changes in policy which could deal with these concerns will be examined in Chapter 4.

## Chapter 3

### *FAMILY INCOME SUPPLEMENT: ELIGIBILITY AND TAKE-UP*

#### *3.1 Introduction*

In this chapter we attempt to identify those eligible for FIS, so that we can explore the characteristics of the relevant population, and estimate rates of take-up. We begin by re-examining these questions in the context of the ESRI's 1987 Survey data, to establish a baseline estimate for the size of the relevant population, and a range within which take-up fell in 1987. This process involves a more detailed modelling of potential FIS entitlement than the earlier work in Callan, Nolan *et al.* (1989), and an intensive examination of the cases which were found to be eligible for FIS.

As seen in the previous chapter there have been considerable changes in FIS since 1986/87. The amounts payable under the scheme have been increased by a number of factors, and a number of measures designed to increase take-up have also been introduced. The numbers of claimants and the amount of benefit claimed have grown substantially. But what has happened to rates of take-up? In order to consider this question, we attempt in Section 3.3 to uprate the model and data to 1994 levels. This allows us to derive estimates of the size of the eligible population, and its FIS entitlements, for 1994. When combined with administrative data on actual caseload and expenditure on FIS, this can give some idea - though not a precise estimate - of where the take-up rate now stands.

In Section 3.4 we turn to the causes of non-take-up. Because FIS is received by such a small proportion of the population, a general survey such as that conducted by the ESRI produces a very limited number of cases in receipt. This means that detailed analysis of the characteristics of those taking up the benefit, as against those not taking up the benefit, is not possible. The relevant sample size is also too limited for econometric analysis of the causes of non-take-up. But it is possible to draw on studies of non-take-up in other countries to shed some light on the issues involved. UK studies dealing with Family Income Supplement, and its replacement, Family Credit, are likely to be of particular relevance, and are given special attention. Section 3.5 considers some options for the improvement of take-up, and the main conclusions of the chapter are drawn together in Section 3.6.

### 3.2 Eligibility and Take-up of FIS in 1987

Initial estimates of the population eligible for FIS, based on the ESRI Survey, were set out in Callan, Nolan *et al.* (1989). It was estimated on this basis that approximately 20,000 families were eligible for FIS on the basis of their current incomes and family circumstances. Blackwell (1989) arrived at a similar estimate based on alternative sources, noting that the error of estimate could be as much as plus or minus 5,000. These estimates suggested very low rates of take-up. No more than one family out of every five families entitled to FIS appeared to receive it; and no more than £2 out of every £5 of FIS entitlement appeared to be claimed. These take-up rates were considerably lower than take-up rates for FIS in the UK, which had themselves given rise to concern about the effectiveness of the scheme.

In this section we re-estimate the eligible population and rates of take-up, using the ESRI Survey. The revised estimates share the problem of small sample numbers with the earlier estimates, but in some other respects they are of higher quality. First, they incorporate any revisions or corrections to the data used earlier, following intensive checking of the relevant cases. Second, they pay close attention to the date at which families were interviewed: this has implications for both the FIS rules which are applied in estimating entitlement, and for the appropriate official statistics with which comparisons may be made. The estimates are still, of course, dependent on the accuracy of the earnings data reported in the survey. The extensive validation checks reported in Callan (1991) suggest that there is a high degree of concordance between the distribution of taxable income in the survey and the distribution as recorded in the Revenue Commissioners' statistical reports. There is a particularly close correspondence between survey-based figures and those of the Revenue Commissioners for the PAYE sector, which is of most relevance when modelling FIS.<sup>1</sup>

We begin by clarifying some of the concepts underlying the measures of take-up actually implemented. First it should be noted that entitlement to FIS, once established, lasts for a period of one year. This means that some of those currently receiving FIS would not qualify if assessed on the basis of current circumstances. Similarly, not all of those who could

<sup>1</sup>Evidence to the Tribunal of Inquiry into the Beef Processing Industry suggested that in certain cases, employee pay as reported to the Revenue Commissioners did not reflect full cash remuneration of the employee. Such practices could result in survey-based estimates tending to under-estimate take-up rates; but some of the survey-based estimates presented here are based on assumptions which are likely to have an offsetting tendency.

potentially be receiving FIS at a given date would qualify on the basis of their circumstances at that date. This leads to two distinct concepts of take-up, as pointed out by Atkinson (1984):

- (1) Those currently receiving FIS as a proportion of all those who could have qualified during the past year;
- (2) Those currently receiving FIS, whose claims would still succeed if re-evaluated at present, as a proportion of all those whose claims would succeed at present.

In practice, most surveys, including the ESRI's 1987 Survey, can only be used to estimate take-up rates of the second type. They do not contain enough information on income changes during the previous 12 months to be able to estimate the total pool of those who could be entitled to FIS. Thus, they must concentrate on eligibility at the date of interview.

Secondly, the difference between take-up rates calculated on the basis of "caseload" and "expenditure" should be clarified. The term "caseload" is used to refer to a take-up rate which is defined in terms of the number of recipient units and the number of eligible units, including eligible non-recipients. It does not take account of the size of the potential payment. An expenditure-based take-up rate, on the other hand, is concerned with the amount of expenditure on the scheme, as a proportion of the expenditure if all eligible cases received their full entitlement. Several UK studies have found that small amounts of entitlement are less likely to be taken up. Other things being equal, this will lead to a higher rate of take-up on an expenditure basis than on a caseload basis - with the extent of the difference giving some indication of the strength of the relationship between size of entitlement and receipt of the benefit.

Thirdly, it should be noted that the ESRI Survey somewhat underestimates the number of FIS recipients: the revised survey-based estimates show 3,156 families recorded as receiving FIS, as against a figure of 4,947 cases actually being paid in December 1986. The implications depend on the nature of the underrepresentation. If the survey underrepresents both recipients and eligible non-recipients of FIS to a similar extent, then the rate of take-up estimated from survey data alone may well be quite accurate. If, instead, the survey underrepresents FIS recipients, but represents eligible non-recipients accurately, the take-up rate calculated from the survey estimates will be too low. A correction using administrative data to measure the number of recipients, and survey data to measure the number of eligible non-recipients, is possible. Such a measure has been used, for example, by the Department of Social Security in the UK. A third possibility is that FIS claimants are underrepresented in the



survey data, and eligible non-claimants are overrepresented. This might arise, for example, if receipt of the benefit was not declared by a responding household, or was misclassified. Particular attention was given to the recording of FIS payments in the survey, so that this combination of circumstances does not seem especially plausible. Alternatively, the rate of non-response might be higher than average among recipients, but lower than average among eligible non-recipients. Again, this is not particularly plausible: precisely the opposite is often argued, on the basis that a willingness to respond to surveys is positively correlated with a willingness to fill in application forms such as that for FIS. Nevertheless, we include estimates of take-up rates which allow for this possibility by using administrative data to measure the numbers of recipients, and survey data to estimate the numbers of all those eligible, both claimants and non-claimants. Estimates on this basis may be thought of as an upper bound on take-up; and it will be of interest to see how close other estimates may be to this upper bound, since the upper bound estimate is the only one available to us when considering developments since 1987.

Table 3.1: *Survey-based Estimates of the FIS Population, 1987*

	<i>Unweighted N in sample</i>	<i>Caseload<sup>1</sup></i>	<i>Aggregate Amount<sup>1</sup> £'000 p w</i>
Currently eligible and receiving	7	2,535	28.7
Currently eligible but not receiving	37	13,061	113.0
Not currently eligible but currently receiving	2	621	3.6

*Source:* ESRI Survey of Income Distribution, Poverty and Usage of State Services.

*Note:* 1. Survey figures grossed-up by weighting factors to estimate the population size.

Table 3.1 shows the survey-based estimates of the breakdown between those currently eligible and receiving FIS, those currently eligible and not receiving FIS, and those ineligible on the basis of current circumstances but who are in receipt of FIS. The small numbers in the sample - a total of only 46 cases - warn against over-interpretation of the results. Nevertheless, some differences from the initial estimates in Callan, Nolan *et al.* (1989) may be noted. Corrections to the data and improvements in the modelling procedure have resulted in a lower number of cases being assessed as

eligible for FIS. A significant contributory factor is that almost 90 per cent of the relevant cases were interviewed before mid-July 1987. Thus, the minimum hours cut-off, and the rates of payment, are set at their 1986 values in the vast majority of cases. We have seen that some take-up rates require the use of administrative data on the number of cases in payment. The initial estimates of such rates were based on data for December 1987. But it is clear from the fact that the vast majority of the relevant cases were assessed under 1986 rules that the administrative data for December 1986 (when the 1986 rates and conditions were in force) are more appropriate than data for December 1987 (when the 1987 rates had come into operation). This makes relatively little difference to figures concerning caseload (4,947 in 1986 as against 5,532 in 1987), but average weekly expenditure per case differed by about £6 in the two years, so it does have an impact on expenditure-based take-up rates.

Table 3.2: *Estimated Take-up Rates for Family Income Supplement, 1987*

<i>Method</i>	<i>Caseload</i>	<i>Aggregate Expenditure</i>
(A) Survey-based estimate <sup>1</sup>	16%	25%
(B) Administrative data for recipients <sup>2</sup> , survey estimate for eligible non-recipients	23%	38%
(C) Administrative data for recipients <sup>2</sup> , survey estimate for all those eligible	25%	46%

*Source:* ESRI Survey of Income Distribution, Poverty and Usage of State Services.

*Notes:* 1. Based entirely on sample data.

2. In using the administrative data, it is necessary to take account of the fact that some cases currently in payment would not qualify for FIS on the basis of their current circumstances. This is done by multiplying the numbers officially recorded as being in receipt by a sample estimate of the proportion of cases currently in receipt who would qualify on the basis of current circumstances; a similar adjustment is made by the DSS in their take-up estimates (see Craig, 1991, p.541). About 80 per cent of cases in payment were found to be currently qualified, accounting for 89 per cent of expenditure. Accordingly, these figures are used as adjustment factors to the administrative statistics. Given the very small number of cases in payment which are found in the ESRI sample, these adjustment factors are subject to a high degree of error. UK estimates suggest that a lower proportion of cases and expenditure would qualify for FIS on the basis of current circumstances; this leads to lower adjustment factors, which tend to reduce estimated take-up rates.

These counterbalancing influences are reflected in the estimated take-up rates presented in Table 3.2. The revised estimates of take-up rates are between 16 and 25 per cent on a caseload basis, and between 25 and 46 per cent on an expenditure basis. These ranges lie somewhat above those in the initial analysis of Callan, Nolan *et al.* (1989), but the broad picture of low take-up rates remains. At most about 1 family in 4 of those eligible for a payment receives FIS. The take-up rate on an expenditure basis is higher, though a rate of over 40 per cent depends on some strong assumptions regarding the nature of non-response to the ESRI sample. We have seen earlier that approach (C) requires some non-recording of FIS by survey respondents, or a lower response rate for FIS recipients than eligible non-recipients, neither of which is judged to be very likely.

The higher rate of take-up on an expenditure basis suggests a significant relationship between take-up and the amount of the entitlement. But low take-up is not confined to those with low entitlement. The take-up rate for cases with an entitlement of over £5 per week is estimated at between 27 and 39 per cent (using methods A to C). The average unclaimed entitlement (including those with entitlements of less than £5 per week) is estimated at about £6.50 per week.

Going behind these figures, what can be said about the characteristics of the eligible population? Once again, the small sample size (44 cases currently eligible) does not allow for detailed breakdowns. Some characteristics, however, do stand out. All but one of the eligible cases in the ESRI sample are made up of married couples: this pattern is also found in the administrative data on recipients, where upwards of 95 per cent of cases are married. But there may, in fact, be a significant number of eligible non-recipients who are lone parents. Administrative data on the Lone Parent's Allowance in 1991 showed a significant number who are not on the maximum rate of payment; for many of these, the reason may be that they are in employment. Given the structure of the means test for Lone Parent's Allowance, it seems likely that many of this group could also be entitled to FIS. Recent changes in the means test for Lone Parent's Allowance eased the withdrawal of benefit from lone parents who took up employment; one might expect, therefore, that the number of lone parents eligible for FIS could have increased further since 1991.

In the ESRI sample, in all but four of the families eligible, the husband is an employee, while the wife is not engaged in paid work. Thus, the typical eligible family in the sample consists of a male employee in a single-earner family. About a quarter of the families have 1 or 2 children, half have 3 or 4, and the remainder have 5 or more. The composition of

recipients in the official statistics is somewhat more skewed to higher family sizes, in line with the tendency for take-up to be greater for higher entitlements.

In the UK those eligible for FIS were often also eligible for housing benefit. Part of the explanation for low take-up of FIS in these circumstances may have been that housing benefit provided an easier route to achieving a similar disposable income level. Is it possible that in Irish circumstances some individuals classed as eligible for FIS but not in receipt of it are receiving other social welfare payments which leave them at least as well off? In particular, it might be thought that some individuals working regularly for part of a week might find that part-week unemployment compensation would pay them more than FIS.

This possibility was investigated from a number of different perspectives. Unemployment benefit or assistance can continue to be paid while an individual is on systematic short-time for up to 3 days per week. In such circumstances, the combination of pay from employment and unemployment compensation could yield a higher disposable income than a combination of pay and FIS. But this does *not* contribute to an explanation of low take-up of FIS. In many circumstances, an individual combining part-week work with part-week unemployment compensation would find themselves above the FIS thresholds; thus they would not be measured as being part of the eligible non-recipient population, or contributing to a "problem" of non-take-up. If they did find themselves below the FIS threshold, they would still appear to qualify for FIS, albeit for a reduced payment: in such a case they would genuinely be part of the eligible non-recipient population. In the ESRI data we find little evidence of this combination actually occurring: only 2 of the 44 families eligible for FIS are actually in receipt of *any* short-term social welfare payment, and their modelled entitlement to FIS is very small. Thus, overall, the receipt of other social welfare benefits does not contribute significantly to an explanation of low take-up of FIS.

### *3.3 What Has Happened to Take-up?*

Since 1986/87, there have been considerable efforts to improve the rate of take-up of FIS. An extensive information campaign was developed and continued to make those eligible aware of their potential entitlement; a minimum payment of £5 per week has been introduced; and the exclusion of FIS payments from medical cards means tests has been formalised nationwide. At the same time, there have been substantial changes in the scope of the FIS scheme, and the level of payments. The reduction in the

minimum number of hours of work required to qualify for FIS, together with the over-indexation of the income limits, will have tended to increase the potential client pool. The total potential expenditure under the scheme has also been increased by the increased income limits, and by a number of other factors, including the abolition of maximum payments, and the increase in the "multiplier" or "withdrawal rate".

Given the increase in the potential client pool for FIS, increased rates of payment, and the efforts to increase the rate of take-up, substantial growth in the numbers of FIS recipients and expenditure on the scheme could have been expected. There have, indeed, been increases in the numbers of FIS claimants and in the amounts claimed, as shown in Chapter 2. But have rates of take-up, on either a caseload or expenditure basis, increased, decreased, or remained roughly stable? In order to answer this question, we attempt to estimate the size of the eligible population in 1994.

Because the microsimulation model explicitly takes into account policy parameters such as FIS income limits, there is no difficulty in taking into account relevant policy changes between 1987 and 1994. The data used by the model must also be uprated in order to capture the key characteristics of the 1994 population for FIS purposes. The methods used to uprate the data are outlined in Callan, O'Donoghue and O'Neill (1994, Chapter 6). Here we may note that the basic method involved reweighting of the survey households to represent changes in the composition of the population. From the point of view of FIS analysis the important factors were a rise in employment, and a fall in the number of children, particularly a fall in the number of larger families. Incomes were uprated using separate growth factors for employment income, self-employment income and farm income. For present purposes, it is not necessary that this uprating of incomes should be accurate for the entire population. It would suffice if it is accurate in respect of the relevant population: low income families containing an employee. The key factor here is the growth in employment incomes for each employee in that population.

One estimate of this growth rate can be provided by assuming that growth in earnings per employee was equally spread over the wage distribution, so that the incomes of each employee in the sample are increased by the same percentage: the average growth in wage income per

employee at national level (41 per cent over the period 1987 to 1994).<sup>2</sup> In order to give some idea of the sensitivity of our estimates to the uncertainties inherent in the uprating procedures, we consider alternative estimates of wage growth 5 percentage points higher and lower than this figure (i.e., wage growth for the relevant population of 36 or 46 per cent).

Having uprated the ESRI database to 1994 incomes in this way, we then apply the rules of the 1994 FIS scheme to estimate the eligible population. The central estimates suggest that the number of families eligible for FIS more than doubled between 1987 and 1994, to a level of about 33,000. Potential expenditure on FIS is estimated to have increased about five-fold, to a level of over £37m per year. Actual numbers of claimants almost doubled and actual expenditure on FIS increased almost five-fold over the same period. These figures suggest that take-up changed rather little over the period, an issue to which we now turn.

In the previous section, take-up rates for 1987 were calculated using three distinct methods. One was based purely on survey data; the second combined administrative data on receipt with survey estimates of eligible non-recipients; and the third used administrative data on benefit receipt in combination with a survey estimate of the eligible population, whether receiving or eligible non-recipients. In estimating take-up for 1994 based on uprated 1987 survey data, only the last of these methods can be used. This is because it is not possible to distinguish eligible non-recipients from recipients in 1994 without having up-to-date survey data. Implicit in the method used, therefore, is the assumption that the ESRI Survey underrepresents FIS claimants but overrepresents eligible non-claimants. As noted earlier, this assumption is not particularly persuasive, but it can provide an upper bound on the estimate of take-up. In the present context then, the focus should not be on the *level* of the take-up estimate for 1994, but on the *change* in the take-up rate between 1987 and 1994.

<sup>2</sup>National accounts data or estimates are used for the increase in non-agricultural wages and salaries; Labour Force Survey data or estimates are used for the growth in employment. We make similar assumptions with respect to income from other sources - farming, self-employment and social welfare transfers - but because of the composition of incomes in the relevant population, changes in these assumptions have very little impact.

Table 3.3: *Estimated Take-Up Rates for Family Income Supplement, 1987 and 1994*

		<i>Caseload</i>	<i>Aggregate Expenditure</i>
1987		25%	46%
1994	Earnings growth of 41 per cent	26%	50%
	Earnings growth of 46 per cent	29%	57%
	Earnings growth of 36 per cent	23%	43%

*Notes:* Take-up rates based on estimates of the eligible population from *SWITCH*, the ESRI tax-benefit model, combined with estimates from administrative data on actual caseload and expenditure in 1994. An adjustment is made to allow for an estimated 20% of caseload and 11% of expenditure not eligible for FIS on the basis of current circumstances, as outlined in the notes to Table 3.2.

The central estimate, assuming earnings growth of 41 per cent applied uniformly across the wage distribution, suggests that take-up was roughly constant on a caseload basis, but increased slightly on an expenditure basis. A higher earnings growth figure of 46 per cent for the relevant low paid population would mean that take-up had risen by about 4 to 11 percentage points for caseload and expenditure respectively. But take-up would have fallen slightly between 1987 and 1994 if earnings growth for the low paid was below average. The Programme for National Recovery and the Programme for Economic and Social Progress made special provisions for minimum flat-rate increases in pay at low income levels, which could have given higher percentage increases to the low paid. If this tendency was not offset by other factors, take-up may have risen somewhat over the period. However, it seems probable that there were offsetting factors<sup>3</sup> so that the central estimate, implying only a small rise in take-up, is the one on which we concentrate.

There are obvious difficulties in the process of uprating incomes and other data to attempt to capture changes in the population. It may be difficult to capture shifts in the composition of employment as between low-paid and high-paid groups, or differential increases in wage growth. While the estimates presented here are, of course, affected by these

<sup>3</sup>These could include failure to pay these minimum increases for a variety of reasons, and additional increases having been received by higher paid groups in both the private and public sectors.

difficulties, they do help to give some indication of developments in take-up over the period. A slightly different approach was taken in uprating take-up estimates for 1992, but arrived at similar conclusions.

Given that there is a relationship between size of entitlement and take-up, the distribution of entitlements by size is relevant to changes in take-up rates. If the changes between 1987 and 1994 had produced large numbers of small entitlements, this might tend to depress the take-up figures for the later year. But this does not seem to have been the case. In 1987, about half of the entitlements seem to have been less than or equal to £5 per week. In 1994, £5 per week was the minimum payment. But even uprating the £5 per week cut off by the average increase in wages, we find that the proportion of small entitlements had *fallen* substantially. Thus, an improvement in take-up might have been expected on this basis alone. Our estimates suggest that the rise in take-up was rather modest.

As regards the level of take-up, it should be remembered that the method used to estimate take-up for 1994 is not comparable with, for example, those used to derive take-up estimates in the UK. While the method used here is the only one available to us in deriving a 1994 estimate, it was found to produce a higher estimate of take-up than the two alternative methods in 1987. Thus, it seems likely that rates of take-up on both a caseload and expenditure basis remain below the rates obtaining in the UK for Family Income Supplement and its successor, Family Credit. Department of Social Security estimates for 1985/86 put take-up of Family Income Supplement at 48 per cent on a caseload basis and 54 per cent on an expenditure basis (DSS, 1991). Other estimates also suggest figures of close to 50 per cent. Recent estimates (Marsh and McKay, 1992) put take-up of Family Credit for employees at 64 per cent on a caseload basis and 70 per cent on an expenditure basis.<sup>4</sup> Part of the explanation of low take-up of FIS in the UK was that potential claimants could end up almost as well off by making a claim for Housing Benefit instead. This factor does not seem to operate in Ireland, since the eligible non-claimants identified in the ESRI Survey were not in receipt of other social welfare payments. Thus, the take-up problem for FIS in Ireland seems to be more severe than that in the UK.

<sup>4</sup>Because of differences in data sources, Marsh and McKay caution against a straightforward deduction that take-up of Family Credit is higher than that for FIS.



### 3.4 *Explanations and Causes of Non-take-up*

Thus far we have concentrated on *measuring* take-up of FIS, by identifying those eligible for the benefit from ESRI Survey data. This was the starting point for research on take-up in the UK, and indeed in many other countries. But as Craig's (1991) recent review makes clear, there are other strands in the UK research on take-up.<sup>5</sup> In particular, there have been a number of approaches to the identification of factors causing non-take-up of benefit; and the development of alternative models which attempt to establish how these different factors fit together.

Early qualitative studies attempted to identify individual factors leading to non-take-up of benefits. The results pointed towards a number of factors inhibiting take-up: administrative complexity, ignorance and misperceptions of the schemes, and stigma. A more structured approach to the identification of factors influencing take-up was provided by Kerr's (1983) model of the claiming process. His model posited six thresholds which must be passed before a claim is made:

1. Perceived need: the individual's perception of his or her difficulty in making ends meet.
2. Basic knowledge: the individual's awareness of the existence of the benefit;
3. Perceived eligibility: the individual's perception of the likelihood that he or she is eligible for the benefit;
4. Perceived utility: the individual's perception of the utility of the benefit in meeting his or her specific needs;
5. Beliefs and feelings about the application procedure and consequences of applying;
6. Perceived stability of circumstances

A failure at any one of these thresholds is regarded as preventing a claim. Kerr's model does not allow for the possibility that a high score on one threshold can counteract a low score on another threshold. An alternative view, to be found in several studies of take-up, is that there may be scope for at least some trade-offs between factors influencing take-up. For example, a strong perceived need may help to compensate for negative feelings about the application procedure. Davies and Ritchie (1988) find evidence that the strict threshold model tends to predict non-claiming better

<sup>5</sup>Much of the review of research which follows draws on Craig (1991).

than claiming. This, they argue, is due to the fact that each threshold is treated as a necessary condition for a claim, so that negative factors are overstated, while the effects of strongly positive forces are discounted.

The competing models can have differing implications for the design of strategies to improve take-up. A threshold model suggests that it may be necessary to take actions which will increase the likelihood of individuals passing more than one threshold. A trade-off model suggests instead that actions which markedly increase one key positive factor, or reduce a key negative factor, could be as effective. There is some agreement, however, on the key areas for intervention from research based on the threshold model (Corden, 1983; Graham, 1984) and approaches which allow for some trade-offs between different factors (Davies and Ritchie, 1988; Corden and Craig, 1991).

Corden's (1983) study of the process of claiming FIS found that the threshold of "perceived eligibility" was numerically the most significant; and that "beliefs and feelings" about the consequences of applying also played a strong role. Corden's work also pointed to the fact that negative feelings arising from the experience of claiming other benefits could have a spillover effect on the likelihood of claiming FIS; and that the fear of rejection played a significant role in making claims less likely. Graham (1984) also found that perceived eligibility was important in explaining whether or not eligible persons claimed FIS; and that beliefs and feelings, not just about the FIS procedures, but about the role of welfare and the nature of eligible groups, could have an influence through several routes.

Davies and Ritchie (1988), in a study which included FIS, but was numerically dominated by individuals eligible for Supplementary Benefit and Housing Benefit, found three significant negative factors inhibiting take-up: a lack of perceived need, uncertainty about eligibility and negative attitudes towards the claiming process. They found that these factors were interlinked, and suggest that a change in any one of the elements could reduce the deterrent effect of the other. On the positive side, they found that personal advice or encouragement to claim could play a key role in triggering a claim. More recently, Corden and Craig's (1991) study of the early experience with Family Credit, found a similar link between perceptions of eligibility and perceptions of need. State benefits are often seen as being for traditional "needy" groups - the old, the sick and the unemployed. This attitude may be coupled with negative connotations of dependence on state benefit, and can reduce likelihood of claiming. Corden and Craig also found that women were more willing to investigate the possibility of an entitlement to Family Credit and to apply for it. There was

more resistance to the idea from husbands. It may be, therefore, that information spread through networks which reach women may be more effective in terms of increasing take-up.

Corden and Craig's (1991) study contains some new insights into the value of the scheme as an incentive to move into, or stay in, paid work. They undertook detailed interviews with a small number of claimants, of likely eligible non-claimants, and with potential claimants, i.e., those currently not at work but with recent labour market contact. The Family Credit scheme which replaced FIS in the UK aimed at ensuring that families would be better off in work than out of work. But the experience of claimants pointed to the risk and delay involved in establishing a successful claim as factors tending to reduce the incentive value of the scheme. Even without the risk factor, the transitional period while the claim was established and processed (information on pay for 5 weeks, or 2 months for those paid monthly, being required) was found to be a difficult one, during which debts and arrears could build up.

Increases in housing costs which accompanied a move from unemployment to employment were also found to be significant. While this reflects the nature of Housing Benefit in the UK, similar considerations could be relevant in Ireland: assistance with housing costs under the Supplementary Welfare Allowance is not provided to those in full-time work, and a move from unemployment to employment could trigger a significant increase in differential rent. Despite the small scale of the Corden/Craig study, it is noteworthy that they found no individual who had worked out his or her entitlement to Family Credit before moving into work; some had, however, relied on advice from other sources that they would find themselves better off in employment.

From the point of view of individuals already in work, some of these factors are less important. But re-assessment at six-monthly intervals does give rise to some insecurity. It is possible also that claimants could become discouraged as pay increases get eaten up by a combination of taxes and benefit withdrawal.

### *3.5 Measures to Improve Take-up*

For take-up and incentive reasons, it is important that those who are currently unemployed and have children should know about FIS. Corden and Craig's small scale study found little evidence of Family Credit being perceived as an incentive to work by such "potential recipients". Given that even those who did claim the benefit were found not to have calculated it in advance, it seems likely that if such schemes are to have maximum

incentive effect, additional efforts to inform potential recipients of their potential entitlement would be worth considering. It might be possible, for example, to tailor information on their likely entitlements to their family circumstances. For a recipient of Unemployment Benefit or Assistance, the number of children for which unemployment compensation is paid is known, as is the fact of whether or not the spouse of the claimant is earning above £55 per week. It seems possible, therefore, that currently unemployed individuals could be informed of their likely entitlements under FIS at different rates of pay. Whether or not this would be a cost effective strategy would depend on a number of factors. This might be investigated using a pilot scheme.

As regards those currently in employment, it may be useful to explore the potential of tax records for identifying potential FIS recipients. A precise identification of those eligible for FIS is not possible from the annual tax returns processed by the Revenue Commissioners; but there would appear to be sufficient information in these data to identify those *likely* to be eligible for FIS. For example, the Revenue Commissioners may have information that a taxpayer is exempt from income tax, or receives marginal relief from income tax, on the basis of a certain number of children. Given that the number of children is known, examples of their likely FIS entitlement at different weekly wage rates could be provided which might encourage take-up.

A more fundamental question is whether the tax system could be developed in such a way that it could make a FIS-type payment automatically. The experience with the Earned Income Tax Credit (EITC) scheme in the US would be relevant here. The differences between the structure of FIS, the UK-style Family Credit (FC), and the US-style EITC are considered in the next chapter. Here we consider only those issues which are linked to the implementation of the payment through the tax system. Estimates suggest that take-up of EITC, which operates through the tax system in the US, are high: Scholz (1994) suggests rates of over 80 per cent. These high rates reflect the fact that in the US most taxpayers do file an annual return with the tax authorities, and the fact that such returns have been adjusted by the tax authorities to give the benefit of the EITC to eligible taxpayers, even if it was not specifically claimed. The structure of tax administration in this country is rather different: many taxpayers do not make an annual return, and the role played by employers can be more important. This may mean that the US model of administration cannot be directly applied in the Irish case; but a closer examination of the scope for achieving high take-up through the tax system is in order.

FIS, Family Credit and EITC are each designed to support families in low income employment. FIS works from an assessment of income over a period of weeks, with a 12 month entitlement. FC also works with a relatively short period of assessment, and a 6 month entitlement. For EITC, the fiscal year is both the basis of assessment and the period of entitlement. If FIS was to be paid through the income tax system, some change in its assessment basis would be necessary; but this need not be seen as a drawback. The strongest arguments in favour of the current basis of assessment seem to be based on practicalities rather than principle. If the overall objective of supporting families in low income employment can be attained more effectively through different administrative mechanisms, we need only be concerned that these new mechanisms are themselves practical.

A switch in the basis of assessment is not simply a technical matter: one issue of principle does arise. Under an annual income basis of assessment, support would be provided not only to families with a low weekly income from employment, but also to those with a higher weekly employment income if they experienced a sufficiently long spell of unemployment during the tax year. This would increase the exchequer cost of the support provided; in some circumstances, it could lead to an incentive to give up employment for a part of the tax year. This potential drawback is related to the fact that unemployment assistance is not included in taxable income, and FIS is related to gross rather than net income. If each of these conditions changed, the use of an annual income basis to provide income support to working families might be considerably more attractive.

If, for whatever reason, it is decided that an annual income basis is not appropriate, can the tax system still serve as an automatic payment mechanism for income support? One possibility would be that the "tax credit" element would operate only for weeks in which there was an employment income. This is somewhat at odds with the cumulative and annual nature of the income tax assessment, but is similar in structure to the £60 per week PRSI exemption limit. In other words, the tax credit could operate on the basis of current weekly or monthly income. But this would require that it be implemented by employers, rather than directly by the tax authorities. A key difference between the PRSI exemption scheme and the "tax credit" scheme is that PRSI depends wholly on individual circumstances, while the tax credit would depend on family circumstances, including the earnings of a spouse and the number of children. Most couples eligible for income support of this type are likely to have only one earner, so it might be productive to examine ways around this difficulty.

### 3.6 Conclusions

Re-examination of the ESRI Survey data for 1987 confirms that take-up of Family Income Supplement in Ireland was then at rather low levels. No more than about a quarter of eligible families appeared to be receiving the benefit, and no more than £3 to £4 out of every £10 of potential expenditure was claimed. Estimates of the rates of take-up for 1994, based on uprating of the incomes in the ESRI Survey, and of the relevant policy rules, were subject to even more uncertainty. However, they provide the only available information on that subject. They suggest that take-up remains rather low, even when compared with take-up rates for Family Credit in the UK. Low take-up cannot be explained on the basis of small entitlements not being taken up. Changes since 1986 have not led to a rise in the proportion of entitlements which are small; indeed, the reverse is the case.

Some important questions about the eligible population cannot yet be answered definitively - even in the UK context, where take-up has been the subject of many research studies. For example, what proportion of that population are only eligible for a brief period? And what are the main routes out of eligibility - transitions to unemployment, or to higher paid employment? To answer these questions we would need relatively large-scale dynamic studies, capable of identifying the eligible population accurately. Walker and Ashworth (1994, Chapter 8) use administrative records to provide some insights into the first of these questions. They find that most claims for Family Credit are for a single 6-month period; repeated spells on benefit are the exception.<sup>6</sup> This suggests, they argue, that Family Credit functions as a transitional benefit for most claimants, "bridging families across a short-lived set of circumstances". If this is so, it may help to explain why take-up can be a greater problem for such benefits: most potential claimants will not have previous experience of making a claim.

The small size of the target population for FIS means that very small numbers are found in a general household sample such as that surveyed by the ESRI. This greatly limits the analysis of causes of non-take-up which can be identified in the ESRI data. There was evidence that in 1987, more than half of eligible non-claimants were unaware of the existence of the scheme. Information campaigns in the 1987-94 period are likely to have had an impact on this figure. But, as UK research has shown, basic information is a necessary but insufficient condition for a benefit to be

<sup>6</sup>Nevertheless, a snapshot of those in receipt at a point in time will find quite a high proportion of repeat claimants, as they tend to accumulate in the "live caseload".

taken up. Research on UK experience with FIS and Family Credit points towards perceived eligibility being a major factor inhibiting claims for FIS, together with negative attitudes towards dependence on state benefit and the process of claiming. Encouragement to claim is also seen as a powerful factor in stimulating take-up of benefit. Corden and Craig's qualitative study also suggests that families do not attempt to calculate their entitlement, even under the somewhat more transparent Family Credit structure; and that misperceptions of eligibility can arise from focusing on inappropriate examples. This suggests that information on likely entitlements at a range of wages, for the relevant family size, may have more impact than information which requires potential applicants to make their own calculations.

The possible attractions of using information from the tax system to make an automatic FIS-type or "tax credit" payment were noted. One major issue which arises is what impact a move to an annual basis of assessment would have. The tax status of unemployment compensation payments is critical in this regard. Unless all unemployment compensation payments (Unemployment Assistance as well as Unemployment Benefit) are included in taxable income, an annual income basis for a tax credit might not be desirable. There would seem to be greater difficulties in using the tax system to make a payment based on weekly or monthly income. But if the form of income support provided is to make transitions from unemployment to employment more attractive, a system which provides an automatic and quick response would be desirable. The feasibility of using the tax system to make an automatic short-term payment is therefore worth further consideration.

## Chapter 4

### *POLICY OPTIONS: IN-WORK BENEFITS*

#### *4.1 Introduction*

The problems caused by the interaction of the existing FIS and income tax structures were outlined in Chapter 2. Here we return to these issues, in the context of some possible reforms of the FIS structure itself. The focus in this chapter is on reforms of the structure of in-work benefits for employees, and on possible extensions of the scope of such benefits. The concluding chapter sets the findings in a broader context, including other possible reforms of the child income support system.

We begin by setting out in detail the relationship between disposable and gross income<sup>1</sup> for families in work under 1994/95 tax and social welfare policies. This provides a baseline against which alternatives can be compared. The first specific alternative structure considered is a move to the assessment of FIS on a net income basis. The nature of the relationship between disposable and gross income implied by this reform is clarified, and the cost, distributive and incentive implications are investigated using *SWITCH*, the ESRI tax-benefit model to simulate FIS entitlements under the existing and reformed policies for a nationally representative sample of households.

Two systems in operation in other countries - the UK Family Credit scheme, and the US Earned Income Tax Credit (EITC) - are sometimes seen as offering an improvement in the trade-off between the level of income support at low incomes, the height of effective marginal tax rates on beneficiaries, and the numbers affected by such tax rates over and above what can be offered by a FIS-type structure. In Section 4.3, we clarify the nature of the UK Family Credit scheme and the US EITC. We show that the Family Credit scheme is, in effect, rather similar to a FIS scheme operating on a net income basis. Neither it nor the EITC represent a clear improvement in the trade-off from which policy makers must choose: they do, however, represent rather different choices from similar trade-offs.

<sup>1</sup>More precisely, it is the relationship between income before transfers and income after transfers which is of interest; but in the examples illustrated income before transfers coincides with gross income, so we use the more familiar term.



Two extensions of the scope of the existing FIS structure are also considered. The first is an extension to include couples, at least one of whom is at work, but who do not have children: there is at present no "safety-net" income support for such individuals. Microsimulation modelling is used to assess the cost and extent of the support which would be implied by this change. Self-employed individuals, particularly those outside the farm sector, can also fall outside the "safety-net" provided by the welfare system. The difficulties in extending income support to such groups are also considered.

#### *4.2 FIS on a Net Income Basis*

It is useful to begin by illustrating the differences between the disposable-from-gross income schedules for the existing tax-welfare structure, under which FIS is assessed on a gross income basis, and a structure involving FIS on a net income basis. Table 4.1 shows the FIS entitlement, tax and PRSI liability and disposable income (including child benefit of almost £21 per month) of a one-earner married couple with 4 children at different gross income levels. The tax and FIS rules are those applying in 1994/95; thus the income limit for FIS is £245 per week, and the exemption limit for income tax purposes, including the additions for children, is approximately £180 per week. The precise shape of the schedule will be influenced by a number of factors not taken into account in this hypothetical example,<sup>2</sup> and family size will also affect the shape and location of the schedule; but the impact of the different bases of assessment is similar. The microsimulation analysis later in this chapter will take account of the diversity of family circumstances relevant to tax and welfare policies.

<sup>2</sup>For example, the composition of gross income is relevant: here it is assumed that the gross income is from earnings as an employee, but for some families, payments under other social welfare schemes will be relevant.

Table 4.1: *Gross and Disposable Incomes of FIS Recipient : Current Structure (Married recipient with 4 children)*

<i>Weekly Gross Income</i> £	<i>FIS</i> £	<i>Tax Liability</i> £	<i>PRSI</i> £	<i>Disposable Income</i> <sup>1</sup> £
40	123.00	0.00	0.00	183.79
60	111.00	0.00	0.00	191.79
80	99.00	0.00	4.40	195.39
100	87.00	0.00	5.50	202.29
120	75.00	0.00	6.60	209.19
140	63.00	0.00	7.70	216.09
160	51.00	0.00	8.80	222.99
180	39.00	0.00	13.95	225.84
200	27.00	7.89	15.50	224.40
220	15.00	15.89	17.05	222.85
240	5.00	23.89	18.60	223.30
260	0.00	31.89	20.15	228.75
280	0.00	39.89	21.70	239.20
300	0.00	47.89	23.25	249.65

*Note:* 1. Disposable income includes child benefit of almost £21 per week.  
*Memorandum item:* A couple on Long-term Unemployment Assistance with 4 children would receive a total cash income of £171.19 per week, including child benefit.

Gross income levels below £40 per week are neglected, since a minimum of 20 hours per week is required to qualify for FIS; few if any of those likely to qualify for FIS will, therefore, have a weekly wage below this level. Cash income if unemployed, and receiving long-term Unemployment Assistance would be £171.19 per week (including child benefit). FIS payments ensure that disposable income in work is above this level, by about £30 for a wage of £100 per week, rising to £55 for a wage of £180 per week. The tax-cum-benefit withdrawal rate starts at 60 per cent, and rises to over 100 per cent for incomes between about £173 and £235. While marginal rates fall thereafter, there is no gain in disposable income for an increase in gross income from £173 to about £255. This extreme form of "poverty trap" has been the focus of much concern.<sup>3</sup>

<sup>3</sup>It also affects the balance between disposable income in work and out of work: the gap falls to about £50 per week for earnings of £235 per week.

It is the assessment of FIS on the basis of gross income which, together with the marginal relief on income tax in the region above the exemption limit, gives rise to the most severe form of "poverty trap". The reduction of the marginal relief rate in the 1994 Budget has somewhat reduced the severity of the trap, but has expanded the range over which it applies. For each additional £1 earned, a family in these circumstances would find that 60p is withdrawn because of the FIS multiplier/withdrawal rate, and the tax bill rises by 40p. When PRSI is taken into account, it is possible for such a family to find itself 8p worse off for every additional £1 of earnings, over a significant range of earnings. We have seen that the numbers facing these severe disincentives to additional earnings are rather limited; nor is there much evidence of families reacting to the disincentive posed by this trap by keeping earnings low so as to maximise disposable income. Nevertheless, there is a strong case for ironing out these extreme forms of disincentive.

One strand of the argument can be based on considerations of "horizontal equity". The existing system sets up a structure whereby disposable income is maximised by keeping gross earnings just below the income tax exemption limit. Two families, similar in all other respects, may differ only in that one is able to reduce its weekly hours of work in order to achieve that objective, while the other is not. The existing system does not treat these similar families equally; instead, it results in a higher disposable income for the family with the lower earnings. Avoidance of such a result may be regarded as a constraint which a reasonable tax/benefit system should meet. Another strand is based on consideration of the effects of the current system on the comparison between incomes out of work and incomes in work for earned incomes which fall into the range of the extreme "poverty trap".

One way of ironing out this extreme disincentive is to have the withdrawal of FIS based on net income rather than gross income. In the area where marginal income tax relief applies the tax and PRSI bill can rise by 48p for every extra £1 of earnings. When FIS is assessed on a gross income basis, a further 60p may be withdrawn, making a total of 108p. If, instead, FIS were assessed on the basis of net income, the amount withdrawn<sup>4</sup> would be 60 per cent of the rise in net income, i.e., 60 per cent of 52p, equal to 31p, bringing the total tax-cum-benefit withdrawal to 79p.

<sup>4</sup>It is assumed that the "multiplier/withdrawal rate" remains is unchanged.

Thus a £1 rise in earnings would result in an *increase* of about 21p in disposable income, when FIS is assessed on the basis of net income, rather than a decrease of 8p, when FIS is based on gross income.

Table 4.2 presents information on the relationship between disposable and gross income for a FIS scheme which uses net income as the basis of assessment.<sup>5</sup>In order to ensure that no family's FIS entitlement can be reduced under the transition to the scheme, the current FIS income limits and FIS multiplier/withdrawal rate have been retained. This ensures that even at the lowest incomes, no losses can arise. Thus at earnings of £40 per week, disposable income after taxes and FIS is still found to be £184 per week. But at higher income levels, where PRSI and/or income tax drive a wedge between gross earnings and net earnings, FIS entitlements and disposable incomes under the revised scheme are greater, as is clear from the table. This is because entitlements are calculated as a percentage of the difference between the original income limits and what is now a lower income figure: net earnings *after tax and PRSI*. A corollary of this change is that FIS is now payable at higher gross income levels than before. Under the current FIS structure, FIS was not payable for gross income levels above £245; but under the revised structure, some FIS is payable at gross income levels above £300.

<sup>5</sup>A choice has to be made between the use of standard allowances and actual allowances (including elements such as mortgage relief) in determining net income. In general, actual allowances will be greater than or equal to standard allowances. This means that the costs of a FIS scheme on a net income basis should be lower if actual allowances are used as the basis for assessment. There are some exceptions to this rule: actual allowances may incorporate a reduction in respect of rental income, which would reduce net income and potentially increase the FIS payment. But the number of such exceptions is likely to be very small. In general, a procedure which took income net of tax and PRSI as shown on a payslip would be relatively simple and accurate. Checks might be needed to ensure that allowances were not left temporarily unclaimed in order to maximise a FIS payment. In the modelling process, actual allowances have been used in calculating FIS on a net income basis.

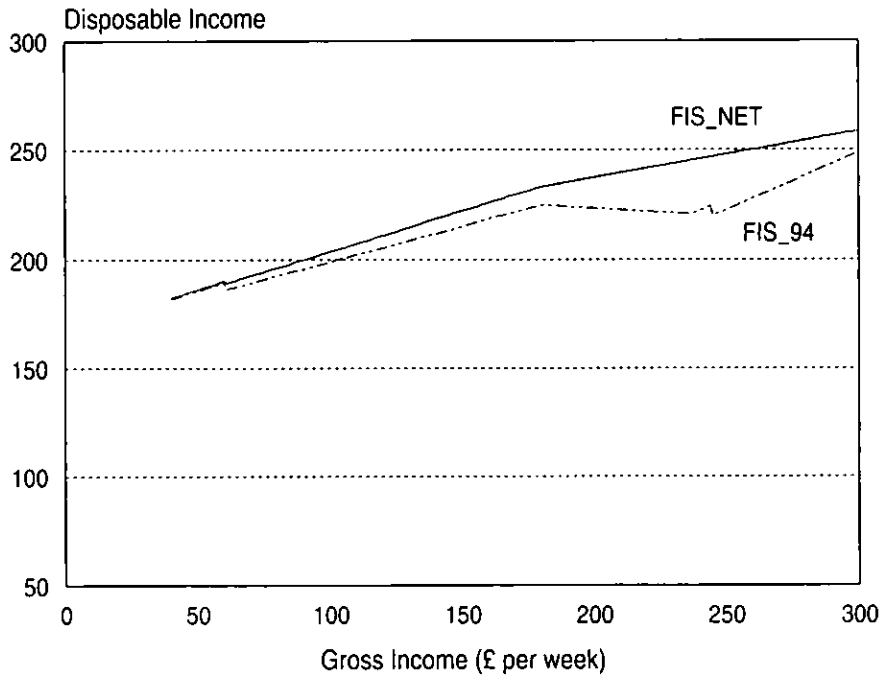
Table 4.2: *Gross and Disposable Incomes of FIS Recipient: After Tax Income Structure (Married, 1 earner, 4 children)*

<i>Weekly Gross Income</i>	<i>FIS</i>	<i>Tax Liability</i>	<i>PRSI</i>	<i>Disposable Income</i>
40	123.00	0.00	0.00	183.79
60	111.00	0.00	0.00	191.79
80	101.64	0.00	4.40	198.03
100	90.30	0.00	5.50	205.59
120	78.96	0.00	6.60	213.15
140	67.62	0.00	7.70	220.71
160	56.28	0.00	8.80	228.27
180	47.37	0.00	13.95	234.21
200	41.03	7.89	15.50	238.44
220	34.76	15.89	17.05	242.62
240	28.49	23.89	18.60	246.80
260	22.22	31.89	20.15	250.98
280	15.95	39.89	21.70	255.16
300	9.68	47.89	23.25	259.34

*Memorandum item:* A couple on Long-term Unemployment Assistance with 4 children would receive a total cash income of £171.19 per week, including child benefit of £21 per week.

Figure 4.1 is a graphic representation of the relationship between disposable and gross income under the existing FIS structure (labelled FIS\_94), and the revised structure (labelled FIS\_NET). The change to a net income basis eliminates the severe form of "poverty trap" represented by a decline in disposable income starting at about £173 per week. If income support to those at the lowest incomes, who pay no tax or PRSI, is to be maintained at current levels, then it is necessary to maintain the income limits unchanged. This involves a considerable extension of FIS up the income scale, so that individuals with gross incomes of over £300 per week may still qualify for a payment.

Figure 4.1: *Disposable-from-gross Income Schedules for Alternative FIS Schemes: Current Structure and Net Earnings Basis (Married, 1 earner, 4 children)*



The cost and distributive implications of this change are considered later in this section. However, it is clear that a reform which improves, or does not worsen, disposable incomes at all income levels may be costly. Lower cost methods of eliminating the severe disincentives may also be of interest. These could involve a similar change to the operation of FIS, so that entitlements are assessed on the basis of net earnings, but with a significantly reduced income limit. Families with very low earnings would find that their disposable incomes would be somewhat worsened by the change; while those with incomes above that level would find them increased. For any given expenditure level, there is a trade-off between the degree of income support given at the lowest income levels, and the rate of withdrawal of benefit above these levels. In principle, a tax-benefit system could be designed to yield any desired disposable-from-gross income

schedule. But the menu of options which can be achieved with the existing income tax structure and a move from gross to net assessment of FIS is much more restricted: full integration of the tax and benefit systems, or a degree of co-ordination which matched this, would be required to give full flexibility.

The situation is complicated still further by the structure of PRSI contributions. To show the nature of this we first simplify by considering incomes below the "levy exemption" limit of £173 per week, and below the income tax exemption limit (about £180 for a 4-child family), and above the £60 per week PRSI exemption limit. All families under consideration are, therefore, exempt from income tax, but pay PRSI at the rate of 5.5 per cent. FIS on a net income basis, with the same income limits as used in the existing system, will imply an increased payment to such families, because net income is typically  $(100-5.5)=94.5$  per cent of gross income. This factor alone will also result in higher payments further up the income scale. Thus exchequer expenditure will increase because *all* existing recipients would then receive higher payments.

Can this additional expenditure, related purely to PRSI liabilities which are not central to the major disincentive to be addressed, be avoided? In principle, it is not possible to do so without creating potential losses for some existing FIS recipients. But in practice it may be possible to do so without imposing substantial losses.<sup>6</sup> One option would be to re-scale the FIS income limits and the withdrawal rate to take account of the difference between net and gross income created by PRSI.<sup>7</sup> Under the existing system, FIS payments are determined as:

$$FIS\_GROSS = 0.60 \times (Gross\ Income - Gross\ Income\ Limit)$$

If net income is to be the basis of the assessment, FIS payments will be determined by

$$FIS\_NET = Withdrawal\ rate \times (Net\ Income - Net\ Income\ Limit)$$

Since, at the lowest income levels, net income is simply equal to 94.5 per cent of gross income, it is possible to ensure that the same payment is given

<sup>6</sup>Potential losses could arise for public servants paying a low rate of PRSI, who were exempt from income tax, and claiming FIS, but the amounts involved are probably rather small.

<sup>7</sup>Another approach would be to make FIS assessable on the basis of income after tax, but without allowing for PRSI deductions: this would make the income concept used less familiar to recipients than net income after tax and PRSI.

in such cases. This can be done by setting net income limits equal to 94.5 per cent of the corresponding gross income limits, and increasing the multiplier/withdrawal rate slightly to  $(60/94.5) \approx 63$  per cent.<sup>8</sup>

Each of these options has been analysed using the *SWITCH*, the ESRI tax-benefit model. The data have been uprated to represent the 1994 situation, as outlined in the previous chapter and more fully described in Callan, O'Donoghue and O'Neill (1994).

Table 4.3: *Alternative Estimates of Cost of Moving to Assessment of FIS on a Net Income Basis*

	<i>Unchanged take-up</i>	<i>Increased take-up take-up</i>
	<i>£m p a</i>	
Unchanged income limits and multiplier/withdrawal rate	19	26
Adjusted income limits and multiplier/withdrawal rate <sup>1</sup>	9	15

*Source:* *SWITCH*, the ESRI Tax-Benefit Model.

*Note:* 1. Income limits for the "adjusted" scheme are set at 94.5 per cent of income limits under existing scheme, and the multiplier/withdrawal rate is increased from 60 per cent to 63 per cent.

Table 4.3 presents the estimates of the additional cost of moving from FIS on a gross income basis to FIS on a net income basis. The baseline position is given by the FIS scheme for 1994/95. Baseline expenditure is estimated, using the central take-up rate of 50 per cent of expenditure, at approximately £21m per annum. Expenditure on a net income scheme, with precisely the same income limits and multiplier/withdrawal rate, is estimated at £40m, if take-up is unchanged from that central estimate. This represents an increase of £19m in a full year. A reduction of approximately 5.5 per cent in the income limits, to take into account the effects of PRSI

<sup>8</sup>In practical terms, this result could be approximately achieved by moving from a gross to a net income basis, increasing the multiplier withdrawal rate, and non-indexation of the income limits for a period of between one and two years.



liabilities on FIS, would reduce this cost to £9m in a full year. If take-up increased substantially, to about 60 per cent, expenditure could rise by a further £7m on a full year basis.

The near-doubling of expenditure, assuming constant take-up and "adjusted" income limits, reflects a modest increase in the average payment and a very substantial increase in the number of families who would qualify for a FIS payment. The average payment (initially about £22 per week) increases by less than 5 per cent; but the number of families qualifying for a payment increases by over 80 per cent. Thus, while the move to a net income basis reduces the numbers facing effective tax-cum-benefit withdrawal rates in excess of 90 or 100 per cent, it increases the numbers facing rates in the region of 70 to 80 per cent. It was recognised, and accepted, that the UK move to Family Credit would involve a similar trade-off.

The fact that the increased expenditure arises mainly from an increase in numbers rather than aggregate expenditure does not give a clear indication of the distributional consequences of the change. It is possible that the additional entitlements tend to be small, while the existing entitlements are increased substantially. But inherent in the objective of the reform is an increase in income for those in the income tax net rather than below the income tax exemption limit. What does this mean for the overall distributional consequences of such a reform? There are obvious difficulties in attempting a distributional analysis of the change. It is known that take-up rates are low; that they are related to size of entitlement; and that they may be affected by the change in the FIS scheme which is envisaged. Nevertheless, an analysis of the distributive effects of the change based on 100 per cent take-up of the baseline and reformed systems is of some value in pointing to the likely distributive implications.

Table 4.4: *Distribution of Changes in FIS Entitlements: Net Income vs Gross Income as a Basis of Assessment<sup>1</sup>*

<i>Disposable income per adult equivalent<sup>2</sup> under 1994/95 tax-benefit system</i>		<i>% of population</i>	<i>% of gainers</i>	<i>% of aggregate gain</i>
<i>More than</i>	<i>Less than</i>			
<i>£ per week</i>				
	55.44	7.0	0	0
55.44	59.20	8.1	0	0
59.20	62.60	12.2	0	0
62.60	70.60	11.2	2	1
70.60	83.22	10.1	48	56
83.22	108.70	10.4	39	34
108.70	135.75	9.3	9	8
135.75	165.41	9.9	1	1
165.41	212.90	10.4	0	0
212.90		11.5	0	0
ALL		100.0	100.0	100.0

*Notes:* 1. The change involves a move from a gross to a net income basis of assessment for FIS, with unchanged income limits.  
2. The equivalence scale used to derive income per adult equivalent (income adjusted for family size and composition) is 1 for the first member of a "tax unit", 0.66 for a spouse, and 0.33 for each child.

*Source:* ESRI Survey of Income Distribution, Poverty and Usage of State Services.

Most of those who gain from a move to a net income basis of assessment are found close to the median income level - in the fifth and sixth deciles of the income distribution adjusted for family size and composition.<sup>9</sup> There are no gains in the bottom three deciles. This is not surprising. In part it reflects the fact that current FIS entitlements bring most of the relevant population up from the very lowest income levels. The potential aggregate gain in money terms is also heavily concentrated close

<sup>9</sup>While the income ranges in the table do not correspond precisely to deciles (equal 10 per cent groups of the population, ranked from poorest to richest), it is clear that the gains are concentrated in the 5th and 6th deciles.

to the median income level: about 90 per cent of potential expenditure goes to families in the fifth and sixth deciles of income. - a weekly disposable income of between £71 and £109 per adult equivalent.<sup>10</sup>

The microsimulation analysis of the option involving a net income basis with reduced income limits and an increased multiplier finds a small number of cases where FIS entitlements would be reduced. This possibility can arise because some income - usually social welfare income in the cases identified here - is not subject to (full) PRSI. The number of cases involved is very small, and a high proportion of these may not face a loss in actual income because they are not taking up their existing entitlement. The potential losses are less than £3 per week on average.

The fact that making FIS assessable on a net income basis results in the extension of FIS to higher gross incomes, and a lower effective tax-cum-benefit withdrawal rate might suggest that an alternative strategy could be used to achieve similar results: reduction in the FIS multiplier, to reduce the tax-cum-benefit-withdrawal rate, coupled with increases in the gross income limits, to ensure that the amounts paid to those on the lowest incomes are not adversely affected. We have examined this strategy as a "stand-alone" option, and as a possible "staging-post" for a transition to FIS on a net income basis. In order to achieve a similar reduction in the effective tax-cum-benefit withdrawal rate, the reduction in the FIS multiplier would have to be quite substantial. The change to a 40 per cent marginal relief rate of tax in the 1994 Budget has widened the income range over which this rate applies. A reduction in the FIS multiplier to about 32 per cent would be required to cut the effective tax-cum-benefit withdrawal rate facing those on FIS and marginal relief to around 80 per cent.

Our microsimulation analysis indicates that such an option would be much more costly than simply putting FIS on a net income basis. Furthermore, a 2-stage process, whereby a move to a net income basis followed an initial income limit increase and multiplier reduction, would be substantially more expensive than a direct move to a net income basis for FIS. This 2-stage option is therefore unattractive: it requires a greater cost to achieve the same reduction in marginal tax cum benefit rates for the group most affected, or given the same resources, would not achieve as much as a direct move to a net income basis for FIS.

<sup>10</sup>The gains in the upper half of the income distribution refer mainly to a small number of lone parents, who receive the same level of income support as two-parent families under FIS; they therefore have higher incomes per adult equivalent.

### 4.3 UK Family Credit and US Earned Income Tax Credit

Do the UK-style Family Credit scheme and/or the US style Earned Income Tax Credit (EITC) represent distinct alternatives, which might be preferred to FIS assessed on the basis of net earnings? Here we assess these questions purely in terms of the relationship between disposable and gross income which each scheme gives rise to. Other factors may enter into the choice between these schemes, such as the degree of transparency, or the likely effects on take-up; but the question of primary interest in this section is whether Family Credit and/or EITC enriches the menu of possible policy options from the point of view of the disposable-from-gross income schedule.

A brief description of the UK Family Credit scheme is set out in Appendix 4.1. The essential features of that structure are that entitlements are assessed on the basis of after-tax income<sup>11</sup>; a threshold income; and a maximum credit, which depends on the number of children.<sup>12</sup> If after-tax income falls below the threshold, then the family is entitled to a *maximum family credit* consisting of an adult credit plus additional credits for each child. The child credits are set at the same level as the additions for children under the Income Support scheme. The threshold income is equal to the entitlement of a claimant plus spouse under Income Support. These two features are designed to rationalise payment structures across schemes, and ensure that there is an incentive to take up (full-time) employment. If income exceeds this threshold, the payment is reduced by a proportion of the excess:

$$\text{Family Credit} = \text{Maximum Credit} - \text{Taper} \times (\text{Net Earnings} - \text{Threshold})$$

This structure appears to be rather different from that of FIS on a net earnings basis. Indeed, there are significant differences between the option of assessing FIS on the basis of net income, and implementing a UK-style Family Credit structure with similar parameters to those in the UK. But the differences arise simply from the choice of parameters under each scheme.

<sup>11</sup>The income measure used takes capital assets into account in establishing eligibility and entitlement. This does not bear on the central issue: capital assets could be taken into account in a similar way within a FIS-type structure.

<sup>12</sup>Child credits are age-related; this reflects the use of age-related scales for children throughout the UK social security system. Since the Irish system does not generally use age-related payments, this aspect - which, again, does not bear on the central issue of relationships between disposable and gross income - is neglected here.

It can be shown that FIS on a net earnings basis can be adjusted to yield exactly the same payments at each gross income level as Family Credit, and *vice versa*, as demonstrated in Appendix 4.2.

The US Earned Income Tax Credit (EITC) also appears, at first sight, to represent a very different structure. The scheme was revamped under the Omnibus Budget Reconciliation Act of 1993, which envisaged the expansion of EITC to become "the largest cash or near-cash program directed at low-income households" (Scholz, 1994). The structure of the revised scheme can be illustrated using the figures envisaged for 1996, deflated to 1994 prices. Taxpayers with 2 or more dependent children would be eligible for a refundable tax credit<sup>13</sup> at the rate of 40 per cent of earnings, up to an income of \$8,425 per annum. Thus, the maximum tax credit would be about \$64 per week, which would be payable on earnings between about \$160 and \$210 per week. The tax credit would then be reduced by just over 21 cents for every dollar of income above \$210 per week, implying that the credit would be fully withdrawn when income reached about \$517 per week. One-child families would receive a slightly lower level of support (34 per cent of earnings with a maximum credit of just under \$40 per week) with a lower withdrawal rate of just under 16 per cent.<sup>14</sup>

This structure differs significantly from FIS on either a net or gross income basis. One of the key differences is that the amount of support offered under the EITC structure does not increase for families with more than 2 children. Given the structure of child dependant additions in the Irish social welfare system, it is critically important that the amount of in-work benefit for families with children should increase with the number of children. However, it would be possible to envisage an EITC structure which did increase support in line with the number of children. A further difference is that the amount of support at the lowest incomes is positively rather than negatively related to earnings. Under the current FIS structure, very high amounts are payable to those on the lowest incomes; under an EITC structure, the amounts payable are very small.

<sup>13</sup>A refundable tax credit means that if the tax credit is greater than the person's tax bill, he or she would receive a refund of the difference.

<sup>14</sup>A limited support (7.65 per cent of earnings, up to a maximum credit of just under \$6 per week) was also available to taxpayers without children, and was phased out at a much lower rate (7.65 per cent).

One of the main attractions of the EITC structure is that the withdrawal rate is very much lower than FIS, at 16 per cent for a 1-child family and just over 21 per cent for a 2-child family. The withdrawal rate for the initial (1975) EITC scheme was 10 per cent, but over time there have been increases in the level of support at low incomes, with increases in the withdrawal rate helping to restrict the budgetary cost. A further attraction is that take-up rates for the programme appear to be high. Scholz (1994) reports estimated take-up rates of between 80 and 86 per cent. As noted in Chapter 3, the high take-up is related to the use of the tax system, under which most of the relevant taxpayers file an annual return with the US tax authorities.

Despite these attractions, the EITC structure does not offer a clear-cut improvement in achieving the objectives of the FIS scheme. In broad terms, it is similar to a slowly tapered FIS, offering lower levels of support at low incomes than the current FIS scheme. The differences in structure are significant; but the most important difference is in the trade-off chosen between the amount of support offered at low incomes, the rate at which that support is withdrawn, and the budgetary cost of the scheme. If income support at low income levels was to continue at the rates currently provided by FIS, the use of a low withdrawal rate would lead to a substantial increase in the numbers qualifying for support, and corresponding increases in costs. For example, FIS would currently provide of £75 per week to a 4-child family with earnings of £120 per week. If this support were to be withdrawn at the rate of 21 per cent, then a 4-child family with an annual income of over £25,000 would qualify for support.

#### *4.4 Extending the Scope of FIS*

As noted earlier, the introduction of FIS was in many respects a response to the problems posed by high replacement rates facing low-paid earners with children. But FIS can also be seen as playing a role in ensuring an adequate income for such families. It is, however, restricted to families with children. There is no corresponding income support to childless couples in work, which may partly reflect the fact that they tend to face lower replacement rates. It is of interest, therefore, to see whether the extension of the FIS scheme to provide income support to low-paid earners without children could play a role in reducing poverty among those working as employees.

Many of those below low pay thresholds (such as the lowest decile of adult male earnings) are young single people, living in their parental households. This results in a very limited overlap between low pay (defined on an individual basis) and poverty (defined on a household basis). Nolan (1993a) finds that the first round cash gains from a national minimum wage (abstracting from employment effects) would be widely spread across the equivalent income distribution. If FIS were payable to all individuals, irrespective of family circumstances, this would have similar effects. But what if FIS were extended in a more limited way, to provide income support to childless couples as well as families with children?

Analysis using the ESRI model suggests that the potential client pool for such an extension of FIS would be very small. Using data and FIS policy parameters updated to approximate 1993 values, no more than about 3,000 childless couples would appear to qualify. The sample numbers do not permit an analysis of the characteristics of this small population; but it is noteworthy that most of the individuals concerned are over 50 years of age. In contrast to the effects of a national minimum wage the gains in disposable income under an extended FIS would accrue to those towards the bottom of the income distribution. Over 80 per cent of potential expenditure under this extension would go to tax units in the bottom 30 per cent of the income distribution. Even if take-up rates were higher than average for this new group, additional expenditure under the scheme would be unlikely to exceed £2m in a full year.

FIS is also confined at present to low-paid *employees*. But there are significant numbers of farmers and other self-employed individuals who are in similar circumstances to low-paid employees. It might be argued, therefore, that an extension of FIS to provide income support to self-employed individuals would be desirable. Some income support is provided to low-income farmers and the self-employed via the unemployment assistance scheme, although the rates and structure are different from those inherent in FIS. However, the implicit benefit withdrawal rate is 100 per cent. It could be argued that a FIS-type scheme for the self-employed would improve the incentive to become, or remain, self-employed rather than unemployed; and would help to provide a "safety-net" level of income to this group similar to that provided for employees. A major difficulty, however, is the measurement of self-employment income which is required to identify the individuals who would qualify for such support.

The self-employed were included as part of the population eligible for FIS in the UK. Income was assessed on the basis of business accounts. With the move to Family Credit, the assessment system was changed. Applicants could either provide business accounts,<sup>15</sup> or a simple summary of incomings and outgoings over the 26 weeks prior to application. These approaches will tend to produce differing estimates of income. It is not clear *a priori* which is the more appropriate for purposes of benefit assessment; but in the current UK system, the applicant is free to choose which is used. It is possible, therefore, that applicants will tend to use the method which produces a lower income measure, in order to maximise their Family Credit payment. But this tendency may be offset by the cost in terms of time and effort of producing the relevant information for each approach. Applicants who regularly produce standard business accounts may claim on that basis; while others may rely on the simpler statement of incomings and outgoings.

Whichever method, or combination of methods, is used to assess self-employment income, the issue of equity with respect to employees arises. There are widespread concerns that self-employment income as measured by normal business accounting conventions for income tax purposes does not adequately represent the command over resources enjoyed by self-employed individuals. The evidence on living standards at similar measured income levels in the ESRI Survey provides some support for this view. Tax liabilities for farmers and the self-employed estimated from the ESRI data are higher than the actual tax payments; this suggests that recorded incomes for farmers and the self-employed are higher in the ESRI Survey than incomes reported to the tax authorities. Despite this, comparisons of indicators of standard of living suggest that households headed by a farmer or self-employed person are better off than other households at similar measured income levels (Callan, Nolan and Whelan, 1993). Thus, it would seem that income as measured for tax purposes does tend to understate the "command over resources" which is more closely related to actual living standards.

There is, then, a dilemma concerning the treatment of self-employed individuals. There are undoubtedly significant numbers of self-employed persons whose incomes, if measured on a comparable basis to employees, would fall below the thresholds used for FIS. Restriction of FIS to employees can, therefore, leave the incomes of some self-employed

<sup>15</sup>It was initially proposed that only *audited* accounts would be acceptable, but the requirement for a formal audit was dropped in December 1988.



individuals below what their entitlements would be if unemployed. On the other hand, there may be many self-employed individuals who have a higher living standard than employees on FIS, but because of the nature of self-employment income, and the methods used to measure it, would be able to arrange to qualify for FIS. Thus, the extension of FIS to the self-employed or farm sectors could run the risk of a large increase in expenditure going to groups whose living standards were not adequately reflected by their incomes.

There is no clear resolution of this dilemma. The experience of the UK Family Credit system in dealing with the self-employed, which is currently under review, and the experience of the Irish social welfare system in dealing with low-income farmers may help to provide some guidance. Differences between the nature of employment and self-employment, and the different kinds of self-employment have to be recognised. Thus, while a FIS-type structure may be suitable for those in employment, something more akin to the "safety-net" structure of smallholder's unemployment assistance may be more appropriate to the self-employed. One must also ask if a one-period loss for any self-employed individual is to be taken as sufficient to qualify for such income support. The UK system appears to allow for Family Credit payments on the basis of a 6-month or one year period of low self-employment income, but it is not clear that this is desirable. It could be argued that the level of income over a number of years may also be relevant. An enterprise might have experienced losses in the most recent 6-months or year, but have given rise to a high profit over a multi-year period.

#### *4.5 Conclusions*

The interaction between the current FIS scheme, based on gross incomes, and the income tax system can give rise to effective tax-cum-benefit withdrawal rates of over 100 per cent. Such rates are not desirable on any grounds, and have given rise to considerable concern. One way of reducing these rates, to something in the order of 80 per cent, is to base FIS entitlements on calculations involving after-tax income. The costs of doing so were estimated at about £19m in a full year, if income limits were to remain unchanged: this would ensure that no family could lose from the change, and almost all would benefit to some degree. These costs could be reduced to around £9m if income limits were adjusted to take into

account the increase in FIS entitlements which would accrue purely because of PRSI deductions, under the revised scheme: a small number of families might lose slightly from such a change.

It may be useful to summarise what would and would not be achieved by such a move. First, it would remove the anomaly of effective tax-cum-benefit withdrawal rates in excess of 100 per cent. This would directly improve the incentives to increase earnings over the relevant part of the income range. It would also remove the inherent unfairness of penalising extra work with a reduction in disposable income. Second, it would improve the incentive to take up employment in this range of income: the balance between in-work income at such levels, and out of work income, would be improved. Third, the aggregate increase in expenditure would be concentrated in the middle of the income distribution. Fourth, the change would almost double the number of families entitled to FIS payments. One corollary is that the numbers facing marginal tax rates of close to 80 per cent would be increased. It would not, therefore, eliminate the problem of high effective marginal tax rates facing low earners. Fifth, it would not improve the incentive to take up or remain in employment for those at the lowest earnings levels.

Appendix 4.1 *UK Family Credit Scheme*

Family Credit was introduced in the UK as a replacement for the Family Income Supplement, after the implementation in 1988 of the 1986 Social Security Act. As with FIS, the scheme is designed to supplement the incomes of low-income families in full-time work with responsibility for at least 1 child. The benefit is available to married and unmarried couples and to lone parents as long as they satisfy the conditions. The parameters of the scheme, and the general eligibility rules are set out below.

*Full Time Work:* In 1992, this means that the claimant or their partner (but not both combined) must be working a total of 16 hours per week (this may be in more than one job). For those working irregular hours, a weekly average is calculated.

*Responsibility for a Child:* The claimant, or partner, must be responsible for at least 1 child under the age of 16, or a young person aged 16-18 in full-time education up to A-level standard who is living with them as a member of their family.

*Income:* The amount of family credit depends on the normal earnings of the family plus any other income they may have coming in (whether received by the claimant or the partner). Income so calculated includes take-home pay, commissions, bonuses, tips, occupational or personal pensions, sick pay, some social security benefits, net weekly profits for those in self-employment (actual receipts less business expenses), and any *tariff income* (income from capital- see below).

*Capital:* The value of any savings, investments, lump-sum payments and property (except principal residence and personal possessions) are also relevant to the calculation of family credit eligibility and entitlement. Capital, so defined, is treated in the following way. The first £3,000 of capital is ignored. For capital values between £3,000 and £8,000, £1 of weekly *tariff income* is added to calculated family take-home income (as above) for every £250 of capital - an implicit rate of return of over 20 per cent. If total capital is greater than £8,000, however, the family will not be eligible for any payment.

*General Eligibility Formula:* If the total weekly income (so-calculated) of eligible claimants, falls below a specific threshold (£66.60 in 1992), the family is entitled to the *maximum family credit*. This consists of an *adult*

*credit* (only one per family) with additional *child credits* for each child (dependent on the age of the child). The April 1992 rates of maximum family credit are shown below.

Table A.4.1: *Maximum Credits under UK Family Credit Scheme, 1992*

<i>Description</i>	<i>£ per week</i>
Adult Credit- one per family	41.00
Child Credit- for each child aged under 11	10.40
Child Credit- for each child aged 11 to 15	17.25
Child Credit- for each child aged 16 to 17*	21.45
Child Credit- for each child aged 18*	29.90

\* Must be in full-time education up to A-level, or equivalent, standard.

However, if income exceeds the threshold a credit withdrawal rate of 70 per cent is applied to the amount of that excess. In this case,

$$\text{Family Credit} = \text{Maximum Family Credit} \\ - (70 \text{ per cent of } [\text{Income less Threshold}]).$$

Entitlement is reviewed every 26 weeks; previously, FIS was paid for 52 weeks regardless of changes in the family's circumstances. The use of net income as the basis for assessment was intended to overcome the worst cases of the poverty trap. Two other important aspects of the scheme are that

- (a) credits for children are consistent across the Income Support and Family Credit schemes
- (b) that the threshold for Family Credit is the same as the basic personal allowance for a married couple on Income Support.

These features were designed to ensure that there would be a financial incentive to accept job offers, at least if the gross weekly wage were at or above the threshold level.

*Appendix 4.2 Relationship between Family Credit  
and FIS on a Net Income Basis*

The fact that Family Credit remains at a constant level below threshold income can be captured by a maximum payment under a FIS structure; but a net income based FIS structure without a maximum payment can be approximated by a Family Credit structure with a sufficiently low threshold - say, zero income - and a sufficiently high adult credit. The way in which parameters must be set to ensure equality of payments under FIS and Family Credit can be demonstrated algebraically, as follows.

For the after-tax FIS scheme, entitlements are defined by

$$\text{FIS} = ([\text{Income Limit less Income After Tax}] \times \text{FIS withdrawal rate})$$

or

$$\begin{aligned} \text{FIS} = & (\text{Income Limit} \times \text{Withdrawal rate}) \\ & - (\text{Income After Tax} \times \text{Withdrawal rate}) \end{aligned}$$

For the Family Credit-type scheme, the formula is

$$\text{FC} = \text{Maximum Credit} - (\text{Taper} \times [\text{Income after tax} - \text{Threshold}])$$

The taper for Family Credit must be equal to the multiplier/withdrawal rate under the FIS scheme; and, if the FC Threshold is set at 0, the formula for entitlement to Family Credit simplifies to:

$$\text{FC} = \text{Maximum Credit} - (\text{Income after tax} \times \text{Withdrawal rate})$$

From this it is clear that if the FC Maximum Credit is set equal to the FIS Income Limit times the Multiplier/withdrawal rate, the two schemes will give identical entitlements to all cases with positive incomes.

The consistency between child credits and child dependant additions under income support can be achieved in a FIS structure by setting the income limits so that the addition to the income limit per child, multiplied by the FIS multiplier/withdrawal rate, is equal to the child dependant addition. The existing FIS income limits approximate this structure.

## Chapter 5

### CONCLUSIONS

#### *5.1 Introduction*

In this chapter we draw some lessons from the experience to date with the Family Income Supplement (FIS), based on our analysis. Section 5.2 pays particular attention to the scope for improvement of FIS, in two key areas: the extent to which the scheme reaches its intended recipients, and the high marginal tax-cum-benefit withdrawal rates which arise from the interaction of FIS with the income tax system. In the remainder of the chapter, we set our findings in a broader context, which takes into account the lessons of our detailed study of FIS for the wider debate on the restructuring of child income support. Section 5.3 sets out some of the key questions arising in the design of a Child Benefit Supplement to replace FIS and the Child Dependant Additions (CDAs) currently paid to social welfare recipients. Many of the trade-offs involved in the design of the scheme are illustrated, building on our earlier analysis. Section 5.4 considers some of the implications for the broad debate on restructuring of child income support, in which a "basic income for children" - an increased, non-taxable child benefit payment sufficient to allow for the abolition of CDAs and FIS - and an "integrated child benefit" - a similar scheme, but with the child benefit payment included in taxable income - have figured prominently.

#### *5.2 Family Income Supplement*

The Family Income Supplement scheme was introduced with the primary aim of improving the balance between in-work and out-of-work incomes by providing support to low income families in employment. Over the years, increases in income limits and the FIS multiplier have led to greatly increased support for such families. There are, however, two major difficulties associated with the scheme. First, the rate of take-up appears to have remained stubbornly low, despite extensive efforts to improve access to the benefit. Our estimates suggest that out of four families eligible in 1987, only one was likely to take-up the benefit. Because families with greater benefits were more likely to apply, a higher proportion of potential expenditure was likely to reach its target: perhaps up to 40 per cent. Take-up seems to have increased somewhat in the last seven years, but not dramatically. Even on an expenditure basis, it seems likely that take up is no higher than about 50 per cent.

The second major difficulty is that increases in the FIS multiplier, which have improved the level of support for in-work incomes, have also acted as increases in the rate of benefit withdrawal. Thus, the rate of tax-cum-benefit withdrawal can still exceed 100 per cent for those affected by the marginal relief provisions of the income tax code. For those on the standard rate of tax, the marginal rate of tax-cum-benefit withdrawal can still exceed 90 per cent.

In this paper, we have examined the scope for improvements in the FIS scheme in these two critical respects. While take-up of FIS in Ireland appears to be particularly low, experience from elsewhere suggests that the maximum take-up rate that can be expected for such benefits is well below 100 per cent. The complexities and uncertainties which tend to reduce take-up may also make the scheme less effective in boosting the financial incentive to move from unemployment to employment. If a greater degree of take-up is required, a more fundamental change in the system of providing in-work benefits may be needed. This could involve using the tax system to identify those eligible for a benefit, or even, in some circumstances, to effect a payment in a more automatic fashion.

The highest rates of tax-cum-benefit withdrawal associated with the interaction of FIS and the income tax system could be moderated by making FIS assessable on the basis of net income. This would reduce the maximum tax-cum-benefit withdrawal rates from over 100 per cent to about 80 per cent. If the level of support provided to those on the lowest incomes was not to be reduced, this would involve gains to those higher up the income scale, and a substantial rise in the number of families eligible for FIS. On the basis of a constant rate of take-up, a change of this type could cost in the order of £10m to £20m per annum, depending on the details of the implementation and the possible response in terms of increased take-up of benefit.

While the elimination tax-cum-benefit rates above 100 per cent would represent an improvement, the restrictions imposed by a combination of FIS with the existing income tax structure must be recognised. Even if FIS is assessed on a net income basis, the interaction of FIS and the current income tax rates would lead to effective tax-cum-benefit withdrawal rates of the order of 75 to 80 per cent. It is not just families currently facing extreme rates of over 100 per cent who would be affected by such high rates; the total numbers affected by rates of 70 per cent or more would be increased by such a change.

At a broader level, the analysis points to the need for a strategic view to be taken of the desired relationship between gross and disposable incomes for those in employment, and the relationship between disposable income in employment and out of employment. Implementing a desired relationship between disposable and gross incomes, and in-work versus out-of-work incomes, may require changes not just to the structure of in-work benefits, but to universal benefits (such as child benefit) and the income tax system.<sup>1</sup> Closer links between the tax and welfare systems may also be required. We turn to some of these wider issues in the next two sections, starting with a consideration of the recent proposal for a Child Benefit Supplement.

### 5.3 Child Benefit Supplement

*A Government of Renewal*, the policy programme agreed as part of the formation of a new government in December 1994, states that:

We will work towards a basic income system for children by systematic improvements in Child Benefit, and the creation of a Child Benefit Supplement payable to all social welfare recipients and to low and middle income families.

The Child Benefit Supplement will eliminate some of the worst poverty and unemployment traps in the tax and social welfare systems.

It will replace Child Dependant Allowances currently payable to social welfare recipients and Family Income Supplement which is currently payable to very low income families (*A Government of Renewal*, December 1994, p. 31).

While this statement falls does not spell out the precise structure of a revised child income support system, it seems that a Child Benefit Supplement (CBS) replacing both FIS and CDAs is to have a key role. Such a supplement could take many forms. Here we identify some of the critical decisions which will have to be made in designing such a supplement; and attempt to explore some of the trade-offs which arise in

<sup>1</sup>For example, increases in personal allowances could help to reduce, and eventually eliminate the role played by income tax exemption limits. The consequent abolition of marginal relief would reduce the maximum marginal effective tax rate from 108 per cent to 95 per cent.



making such decisions. These trade-offs are closely linked to those faced by the FIS scheme, so that much of our analysis of the issues builds on what has been learned from studying FIS.

It is stated that the CBS will be paid to "low and middle income families", implying that it will not be paid to high income families. The CBS must, therefore, be withdrawn over some income range or at some income level. We work on the assumption that the supplement will be withdrawn smoothly over a range of income, rather than abruptly withdrawn at a particular income level: if not, it would be creating a "trap" to substitute for those it seeks to eliminate.

The key decision variables for a scheme with this structure include the following:

1. What is to be the amount of the supplement?
2. At what income level will withdrawal of the supplement begin, and at what rate will it be withdrawn?
3. Is FIS to be wholly abolished, or would it have a residual role?
4. How will the supplement interact with the tax system?
5. Who will be eligible for the supplement?

We examine each of these issues in turn.

It is stated that a Child Benefit Supplement (CBS) is to replace CDAs. We assume that this means it is intended to fully replace CDAs. It seems safe, therefore, to assume that the *amount of the supplement* would be no less than the £13.20 per child per week currently paid as a CDA on most social welfare schemes. In what follows, we consider a CBS set at approximately the current rate of CDAs, £13.20 per child per week. This simplifying assumption allows us to derive some preliminary microsimulation results using *SWITCH*, the ESRI tax-benefit model.<sup>2</sup> In doing so, we assume that take-up of the new CBS will be complete: the question of the likely impact on take-up is considered later. A higher level of CBS than that assumed here would represent a greater support for those

<sup>2</sup>The key assumption is that the amounts paid to social welfare recipients remain as at present - including the higher rate for lone parents. This allows us to focus on modelling the CBS as a replacement for the FIS scheme, possibly extended to self-employed and farmers. While this approximation will not capture all of the features of a revised structure, it does offer some useful insights into the elements involved.

on low incomes, whether on welfare or in employment, but its impact on the absolute gap between incomes in work and incomes when unemployed would be the same as that examined here.<sup>3</sup>

Given the level of resources to be devoted to the CBS, there will be a trade off between a low *rate of withdrawal* and the *income level at which withdrawal begins*. A low rate of withdrawal would depend on a relatively modest income level for the start of benefit withdrawal.<sup>4</sup> For example, we find that if income withdrawal started at £9,000 per annum<sup>5</sup>, a withdrawal rate of 20 per cent could imply a cost of the order of £60m per annum, *if the CBS were restricted to employees and welfare recipients*.<sup>6</sup> A higher withdrawal rate of 25 per cent could reduce this figure by about £10m per annum; a higher starting point for withdrawal, of about £10,000 per annum, would add about £10m to the budgetary cost. Under a 20 per cent rate of withdrawal, a 4-child family with an annual income of up to £23,000 would receive some payment; a 25 per cent rate of withdrawal would reduce this figure to about £20,000.

FIS currently provides very large payments to families on very low incomes, which help to create a gain from income when employed over and above the income level received when unemployed. A CBS structure cannot, of itself, achieve this objective. This is illustrated in Figure 5.1, which shows, for a married couple with 4 children, the gain from income in employment relative to the income package received when unemployed. Under the current (1994/95) income tax and welfare system the family would receive about £171 from a combination of Long-Term Unemployment Assistance (or Unemployment Benefit) and Child Benefit: the gain in income from employment is measured relative to that level.

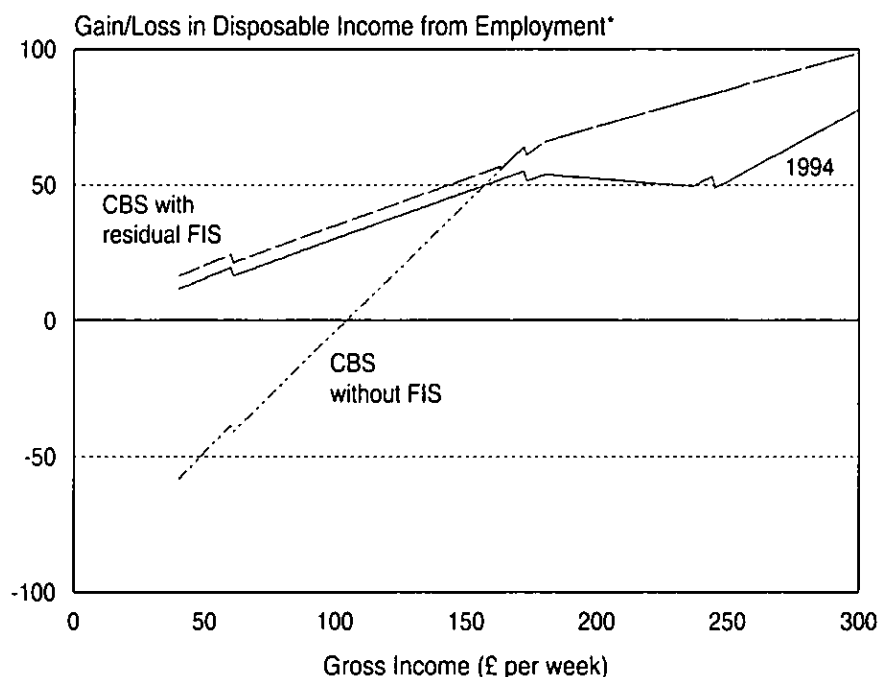
<sup>3</sup>An increase in CBS would, other things being equal, tend to increase the replacement rate (the ratio between income when unemployed and income when in employment). This is because it would increase both numerator and denominator by the same absolute amount.

<sup>4</sup>If withdrawal were not to start until a very high income level, then no matter how fast the benefit was withdrawn, the scheme would approximate a universal child benefit.

<sup>5</sup>This is the cut-off for exemption from the Health Contribution and the Employment and Training Levies at present.

<sup>6</sup>This figure gives some idea of the cost of CBS as a replacement and extension of the FIS scheme for employees; the possible extension to self-employed and farmers is dealt with below.

Figure 5.1: *Gain or Loss in Disposable Income from Employment Earnings: 1994 Structure and Child Benefit Supplement (Married couple, 1 earner, 4 children)*



*Notes:* Child Benefit Supplement can be set at any level, but withdrawal is assumed to begin at £173 per week, at a rate of 20p per £1 of earnings.

\*The gain or loss in disposable income is measured relative to a baseline income composed of Long-Term Unemployment Assistance (or Unemployment Benefit), including CDAs, and Child Benefit. In 1994/95 this was just over £171 per week.

Under a CBS structure, the amount of income received when unemployed will depend on the precise amount of the CBS payment; but the gap between income when employed and when unemployed is not affected by the size of the CBS payment, since the payment is the same for those on welfare and at low income levels. Thus, the unemployment trap cannot be tackled by increasing the supplement to amounts higher than

what is currently paid as CDAs. The graph shows that a simple CBS scheme would not maintain the incentive to take up employment at income levels below about £160 per week; for smaller families, this figure would be closer to £165 per week. In other words, a simple CBS scheme would worsen the "unemployment trap" for families where potential earnings were below this level, while improving the balance between incomes in-work and out-of-work for families with higher potential earnings, and eliminating the poverty trap at all income levels.

It is possible, however, for a modified CBS, with a *residual role for FIS*, to overcome the difficulties at low income levels. The CBS automatically offers higher support than the current FIS structure to families with earnings over £165 per week. A residual FIS scheme<sup>7</sup> could ensure that the relatively small number of families below that income level did not suffer an income loss from the revised structure, and ensure that the incentive to take up employment at such income levels was not reduced. It would guarantee families earning less than this amount a payment equal to 60 per cent of the gap between their income and £165, in the form of a "top-up" to their CBS payment. Since the information required to ensure assess payments of CBS would be identical to that required for residual FIS, it should be possible to administer both CBS and a residual FIS scheme on the basis of a single application.

A number of interesting issues arise concerning the *relationship of a CBS to the tax code*. First, would the CBS be taxable or non-taxable? The CDA payments which it would replace are, at present, mostly taxable; the FIS payments which it would replace are not taxable. But the CBS is designed itself to be explicitly withdrawn as income increases: this would seem to sit more naturally with a non-taxable payment. It would not, therefore, provide a route to the integrated, taxable child benefit recommended by NESC (1990), but represents a distinct alternative to that structure. There would be some loss in tax revenue associated with the movement from taxable CDAs to a non-taxable CBS.<sup>8</sup> A second issue which arises is whether withdrawal of the benefit would be on the basis of gross income, or of income net of tax and PRSI deductions. Our analysis of the FIS scheme suggested some advantages in that context for a net income basis of assessment, in ensuring that marginal effective

<sup>7</sup>A similar residual FIS scheme was considered in Callan, O'Donoghue and O'Neill (1994).

<sup>8</sup>This effect is not included in our preliminary microsimulation analysis, and would add to the exchequer cost of the CBS scheme.

tax-cum-benefit withdrawal rates were not excessive. If the withdrawal rate for CBS were high - say, over 40 per cent - a similar argument might apply. But it is also possible to envisage a CBS scheme which has a low rate of withdrawal operating on a gross income basis, without high marginal effective tax rates: an example will be given below.

A further issue is that families benefiting from a residual FIS scheme could find income increases subject both to FIS withdrawal at 60 per cent, and to marginal relief at 40 per cent. Given the current values of the income tax exemption limits, and a residual FIS limit of £165 per week, the number of families likely to be affected by this is small. But the possibility of such poverty traps could be eliminated completely by a simple restructuring of the child additions to income tax exemption limits. This would make the income tax exemption limits for *all* families with children equal to £165 per week.<sup>9</sup> This would mean that the marginal tax-cum-benefit withdrawal rate could not exceed 60 per cent plus the rate of PRSI. The highest rates would be made up of a combination of residual FIS withdrawal at 60 per cent and PRSI; or of marginal relief at 40 per cent, CBS withdrawal at 20 per cent, and PRSI; but no combination with a higher effective tax rate would be possible.

At present, only employees working over 20 hours per week (or couples with combined working hours above this limit) are eligible for FIS. Thus far, we have considered a CBS scheme which covers this group and social welfare recipients, but does not include the self-employed or farmers. The issues involved in including self-employed and farmers in a CBS scheme are similar to those considered in relation to FIS in Section 4.4. Here we may simply note that the cost implications are potentially important. We noted that a CBS of £13.20 per child, payable at incomes up to £9,000 per year and withdrawn at 20 pence in the pound thereafter could cost about £60m if restricted to employees in the same way as FIS. If, instead, all were eligible for the CBS scheme, including self-employed and farmers, the total cost could exceed £100m per annum.<sup>10</sup>

<sup>9</sup>At present, the exemption limit for a 1-child family is about £147 per week, rising to about £168 for a 3-child family, and by about £12.50 per child per week thereafter.

<sup>10</sup>The data on which the microsimulation model is based are not well-suited to estimating these costs, particularly since farm incomes were at a low point in 1986, the relevant year for the ESRI survey. It seems likely that the indicative figures quoted in the text are somewhat conservative.

In our analysis of CBS, we have assumed that take-up is complete. The actual take-up of CBS could depend crucially on how the scheme is administered. Automatic payment of the benefit through the tax system, if feasible, might guarantee the highest rate of take-up: the issues involved are similar to those discussed in Section 3.5, in the context of making FIS payable through the tax system. Transitions from unemployment into employment might also be facilitated in other ways. Social welfare recipients might retain the Child Benefit Supplement for a short period when in work, until the work income could be assessed to calculate a new entitlement. This might help to improve take-up of the benefit and ensure that it had the maximum impact on the incentive to take up employment.

What would be the likely impact of a CBS scheme, along the lines set out here, on the balance between in-work incomes and unemployment compensation? If there was a residual FIS element in the scheme, there would be little or no impact on replacement rates at earnings levels below £160: the residual FIS would ensure that the balance between in-work incomes and unemployment compensation did not become more unfavourable to employment, but it would not be improved. Replacement rates at higher income levels *would* be reduced, as in-work incomes would be boosted by the new CBS scheme, while incomes out of work would remain the same. Without the residual FIS element there would be a negative impact on the balance between employment at very low wages and unemployment compensation.

The virtual elimination of FIS would reduce the marginal tax-cum-benefit-withdrawal rates facing those currently receiving FIS. But withdrawal of CBS would affect a much greater number of people - if withdrawal began at an income of £9,000 per annum, at a rate of 20 pence in the pound, more than 60,000 families could be affected. Most of these would currently be facing marginal effective tax rates of between 30 and 40 per cent, and would see them rise by 20 percentage points.

#### *5.4 Child Income Support: Strategic Issues*

There appears to be a consensus that the current system of child income support is in need of restructuring. There are, however, substantially different views of the extent of the changes needed, and the broad shape which a reformed system might take. To a large extent these different views reflect differing weights placed on fundamental objectives such as the appropriate share for the community in the costs of rearing

children at differing income levels; the alleviation of family poverty through direct income support; and increasing employment by improving the incentive to work.

Our analysis in this report, coupled with that in Callan, O'Donoghue and O'Neill (1994), has identified a menu of options from which those with widely differing views on the balance between fundamental objectives can choose. Some may see the current system as striking a broadly appropriate balance between the objectives, but wish to tidy up defects relating to the low-take up of FIS, and the "poverty trap" created by the interaction of FIS and the income tax system. The most extreme forms of poverty trap related to FIS could certainly be cleared up by making FIS assessable on a net income basis. This would cost in the region of £10m to £20m per annum, depending on the details of the implementation. The take-up problem is more difficult to solve, but might be tackled by using the tax system to ensure the payment of an in-work benefit. If full take-up were achieved, and FIS put on a net income basis, the total cost could be closer to £60m per annum. This figure is more relevant for comparison with other reforms, such as an integrated child benefit, which include full take-up of benefits by the target group as a major element of a restructured system.

A "basic income for children" at about £80 per child per month - the total level of income support for children of welfare recipients at present - would indeed be sure to reach the intended beneficiaries. This benefit would not be withdrawn with income, so the current difficulties of high marginal tax rates at low earnings would also be resolved. The major difficulty with this scheme is that it would involve a net increase in exchequer cost, allowing for savings from the abolition of CDAs, of over £400m per annum. This would require a much greater redistribution of resources towards families with children, including those at higher levels of income. An *integrated child benefit* would reduce this cost substantially, by clawing back some - though not all- of the gains from higher income families through taxation of the now substantially increased child benefit. The integrated child benefit would retain many of the advantages of a basic income for children at a substantially lower cost - something in the order of £220m per annum.

A *Child Benefit Supplement* can achieve similar improvements in the support for families with children at low or moderate income levels at lower budgetary cost, but with the disadvantage of a higher marginal effective tax rate affecting substantial numbers of families. Over time, such a structure could develop in quite distinct ways. One would lead to a "basic income for children", either by increasing Child Benefit and reducing the

Supplement, or by extending the payment of the supplement gradually up the income scale until it reached all families with children. This approach would give priority to the elimination of high marginal tax rates, and to the provision of support for families at all income levels. An alternative approach would give greater priority to increase the amount of the supplement, leaving the withdrawal provisions unchanged. This would improve income support at the lowest income levels, without reducing the absolute gap between in-work and out-of-work incomes, though the ratio of income replaced by total unemployment compensation package would rise. A middle path would involve increases in Child Benefit payments, which would increase support for families with children at all income levels.

Changes in the child income support system in the near future are likely to have a long-lasting impact on the structure of the system. Our assessment is that *either* an integrated child benefit, *or* a child benefit supplement, could provide a system of support which represents a considerable improvement on what is currently in place. The choice between these two approaches depends, of course, on a long-term view of the desired balance between different objectives. But it also requires a long-term view of what can be achieved under these two broad alternative structures, and the advantages and disadvantages which they involve. Our present study contributes towards an understanding of the trade-offs involved; and also points to fruitful areas for further consideration.



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