

An Anglo-German Foundation Report

Optimal In-work Support and Employment in Ageing Societies – Britain and Germany Compared

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Executive Summary

How would the current tax-benefit systems in Britain and Germany have to be reconstructed in order to allow the labour market to cope with ageing societies in these two countries? How could tax-benefit systems help to raise the level of employment by alleviating long-term unemployment, discouraging early retirement and raising the labour market participation of women? These vital policy questions are analysed in this comparative Anglo-German study, with the following empirical starting points:

- Contrary to what is often assumed in public discussions, out-of-work benefits are similar in both countries; however, in Britain in-work credits make labour market participation for the target groups more attractive.
- Wages of older workers are much less flexible in Germany than in Britain, due to the pronounced wage-tenure profile prevailing in Germany, and this affects the employment rates of older people in the two countries differently.

Basing our country-specific micro-simulation models accounting for labour supply responses on these observations, we have analysed the potential labour market effects of introducing British-style in-work tax credits in Germany and find mixed results:

- While labour force participation of single individuals would increase by approximately 100,000 people, labour supply of men and women living in couple households would fall by about 70,000. Further to these ambiguous distributional effects, such a reform would cause substantial net fiscal costs of about €11 billion (£7.2 billion) per year.
- Simply 'importing' the in-work support system from Britain to Germany without further changes to the tax-benefit system would therefore have no overall positive effect.

We then investigate the optimal design of the tax-benefit system in Britain and Germany with regard to its inherent trade-off between equity and efficiency. Public in-work support, which aims at improving financial work incentives for low-income groups by providing a sufficient income for those who take up work, has not only the wished-for positive labour market effects but potentially also unintended welfare effects. If public support of low incomes induces a part of the working population to reduce their labour supply, this causes extra public costs and jeopardises the success of the tax-benefit reforms. In our analysis of this trade-off, focused on lone mothers as one of the main target groups of in-work support, we obtain two main results:

- Currently existing tax-benefit systems in both countries, which do not feature *negative marginal tax rates*, are only optimal if the government puts a relatively high *welfare weight on the well-being of non-working lone mothers* and has a relatively low preference for *redistribution* towards working lone mothers.
- In-work credits with negative marginal tax rates would be optimal from a social welfare perspective in both Britain and Germany given relatively modest or medium preference for redistribution.

Regarding policies to increase work incentives of older unemployed people, we analyse three policy reforms: an hourly wage subsidy, an in-work tax credit and a subsidy of social security contributions ('employment bonus'). We find that:

- The employment effects of the three policy reforms would be rather similar and of moderate size, ranging between 20,000 and 30,000 additionally employed older women and between 10,000 and 20,000 men.
- The hourly wage subsidy would yield the highest income and welfare gains, especially for people living in couple households and for single women, whereas for single men these effects are largest for the in-work tax credit.
- We conclude that for older unemployed workers targeted wage subsidies of the type investigated in this report could be an efficient alternative to just relying on the British model of flexible market wages.

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Notes to the editor:

The Anglo-German Foundation contributes to the policy process in Britain and Germany by funding comparative research on economic, environmental and social issues and by organising and supporting conferences, seminars, lectures and publications which encourage the exchange of knowledge, ideas and best practice, both between the two countries and between researchers and practitioners.

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