

CENTRE FOR ECONOMIC POLICY RESEARCH

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DISCUSSION PAPERS

I. Comment on The ‘Five Economists’ Plan: The Original Idea and Further Developments

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Comments on “The ‘Five Economists’ Plan: The Original Idea and Further Developments”

Why an EITC Program Should be Rejected

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1. Introduction

In this paper Peter Dawkins argues for the “wage-tax trade-off” proposed by the “Five Economists” as part of their policy package for reducing unemployment. As he explains, the trade-off involves using an earned income tax credit (EITC) scheme “as a way of increasing the incomes of low-wage earners in low-income families, rather than increases in the award wages safety net”.

My comments will focus on the EITC component of the package, taking as an example the Lambert (2000) scheme reported in the paper. I will also concentrate on the effects of the scheme for two-parent families.

Section 2 of the paper provides a summary of the Five Economists’ plan, emphasising the central role of the wage-tax trade-off. Section 3 then presents results from Richardson and Harding (1998) which show that low wage earners are not concentrated at the bottom of a decile ranking of households by equivalent income but, instead, tend to be spread throughout the distribution. Dawkins interprets these results as empirical support for the proposition that “living wage” increases are a “very blunt equity instrument”. In his view, the advantage of an earnings credit is that, unlike increases in the award wages safety net, it targets benefits to low-wage earners in low-income households. There are no benefits going unnecessarily to low-wage earners in families not in the bottom deciles of household income.

This argument for an earnings credit rests on a fundamental error. Dawkins’ interpretation of the Richardson and Harding results assumes that living standard comparisons can be made on the basis of household income. It is now well established that this is a fallacy. Family living standards and household income (with or without an equivalence scale adjustment) are poorly correlated, particularly in the case of two-parent families.

One of the most important reasons for this is that parents with the same number of children, in the same phase of the life cycle and with the same wage rates and non-labour incomes, make very different choices regarding the way in which they provide for their children. In some families one parent works in the market place while the other specialises in providing child care and domestic services at home. In other families, both parents work in the market place and buy-in child care and related services. In these circumstances, studies which use household income to make living standard comparisons confuse low-wage dual-income families working long hours with higher wage single-income families enjoying a much higher standard of living. Many of the dual income families spread across the middle deciles of household income are found in the bottom deciles of a ranking defined on a more accurate measure of living standards.

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Empirical research shows that errors of this kind are large in studies of inequality based on household income. Examples I will present later will illustrate this.

An EITC program is not a good “equity instrument”. In fact, it is straightforward to show that it is seriously deficient for reasons of both equity and efficiency, due to the changes in effective tax rates that it implies. An earnings credit which phases out on the basis of household income above a minimal threshold raises effective marginal tax rates (EMTRs) for families just above the threshold, as an alternative to raising them on high *individual* incomes. This has the effect of treating the secondary earner, typically the mother, in low and median-wage dual income families particularly unfairly.

The withdrawal of the credit on the basis of household income usually means that a low wage married mother who goes out work does not receive the credit and she repays the primary earner’s credit. And so both low-wage parents in a dual income family are uncompensated for pay cuts, as is the single low-wage individual. As a component of a “wage-tax trade-off”, the EITC program therefore contributes to an overall increase in inequality. Furthermore, the higher EMTRs faced by second earners as the credit is withdrawn can be expected to reduce economic growth, due to disincentive effects on family labour supply and saving.

These limitations of the policy also characterise the system of family tax benefits now in place, following a series of reforms over the past two decades. Prior to the early 1980s, Australia combined a highly progressive individual income tax system with universal family allowances. The overall rate structure of the system was fundamentally sound but there was an urgent need for reforms designed to reverse revenue losses from the excessive use of tax minimisation schemes. Unfortunately, changes of the kind and on the scale required have never been at the centre of the tax reform agenda.

Instead, the focus of reform has been on switching towards a highly targeted family benefit system, now labelled Family Tax Benefit (FTB) Part A and Part B,¹¹ together with a less progressive income tax system. A key feature of assistance for children through FTB Part A is the phasing out of benefits on family income, as in the EITC program.¹² The policy has the effect of funding higher welfare payments for low-wage, low-income families, necessitated by a decline in their real level of pay, by reducing entitlements across the middle of the distribution of household income. Since the last two decades have also seen a fall in the top marginal tax rate, the main winners of this direction of reform have been high-wage, high-income households.¹³

The fundamental criticism of an EITC program is that it is “more of the same”. It is essentially a mechanism for extending targeting further along the distribution of household income, for the purpose of shifting the cost of welfare support for a growing population of “working poor” to families in the middle of the distribution of household income. Those most disadvantaged will be low and median wage dual income families. I will now present examples to show how these distributional outcomes are a consequence of the changes in tax rates implied by the program. I will also comment briefly on incentive effects.

¹¹ And also including Child Care Benefit.

¹² FTB Part B is phased out on the second earner’s income only, and therefore discriminates more immediately against mothers who go out to work.

¹³ It is of interest to note that the Five Economists have argued for an EITC program as a step towards a negative income-tax comprising a universal credit financed by a flat rate of tax on income. Both Dawkins et.al. (1998) and Garnaut (1999) see this as a way of lowering the top rate of tax. Dawkins et.al. suggest that in “the short term a 45 per cent marginal rate on high incomes looks achievable and as time goes by this should be able to be brought down steadily”. Garnaut, who proposes the withdrawal of the credit at a rate of 30 cents in the dollar, cites a rate of 36 per cent as achievable by around 2006. Pursuing a policy of this kind would mean that those on very high incomes would gain even more at the cost of low and median wage workers.

2. Effective Tax Rates

The EITC program outlined in the Dawkins' paper specifies a maximum credit of \$30 per week (\$1560 per annum) in 2003/04, to be implemented over a three year period. As set out in Appendix 1B of the paper, in the first year, 2000/01, the earnings credit is phased in from the first dollar of wage and salary income at a rate of 5.5 cents in the dollar up to \$28200 (the threshold of the lower income test for FTB Part A as of 1 July 2000). While phased in on the basis of individual earnings, the credit is phased out, at a rate of 30 cents in the dollar, beginning at the point where the FTB Part A, excluding the base rate, is completely phased out.

The examples to follow illustrate the impact of this program on the structure of effective tax rates by comparing the rates that families face under the existing income tax system with the rates that they would face if the EITC program were introduced. The "existing system" is taken to be that of the 2001 tax year, calculated to include personal income taxes, the Medicare Levy, and Family Tax Benefit (FTB) Part A and Part B. Results are presented for families with two children, one aged 0-4 and the other 5-12 years.

The effective tax rates faced by family members under the existing system and under the proposed EITC program depend critically on whether the family is single-income or dual-income. For this reason, separate results are presented for each of these family types. The examples assume all income is earned.

(i) Single-Income Families

Table 1 first of all lists the 2001 schedule of marginal tax rates (MTRs) on personal income (column 2) and the bands of taxable income to which they apply (column 1). The table also presents the new profile of EMTRs when the Medicare Levy is included (column 4) and the new income bands to which they apply (column 3).¹⁴

Table 1 EMTRs under Income Tax and Medicare Levy

<i>Taxable Income \$pa</i>	<i>MTR</i>	<i>Taxable Income \$pa</i>	<i>EMTRs (inclusive of Medicare Levy)</i>
\$0-\$6000	0.00	\$0-\$6000	0.00
\$6001-\$20000	0.17	\$6001-\$20000	0.17
		\$20001-\$27579	0.30
\$20001-\$50000	0.30	\$27580-\$29815	0.50
		\$29816-\$50000	0.315
\$50001-\$60000	0.42	\$50001-\$60000	0.435
\$60000+	0.47	\$60001-\$76000	0.485

The personal income tax system is simple. There are just five income bands and the schedule of marginal rates is progressive. The tax base is individual income. Once the Medicare Levy is added in, the overall system is not so simple, and the tax base shifts partly to household income.

The key point to note is that the Medicare Levy not only has the effect of increasing the number of bands, it also introduces a fundamental change in the structure of marginal rates. The highest rate no longer applies to the top income band, but to a middle band. As we will now see, FTB Part A and the EITC program have the same effect.

¹⁴ The Medicare Levy rate is 1.5 cents in the dollar. For a family with two children, there is an exemption up to \$27,579 of family income followed by a claw-back, at a rate of 20 cents in the dollar, up to a family income of \$29815.

The maximum rate of FTB Part A is \$3029.50 for a child aged 0-12 and the base rate is \$974.55 (child 0-18) for each child. Benefits up to the base rate are withdrawn at a rate of 30 cents in the dollar on every dollar above the lower family income threshold of \$28200.¹⁵ For the family with two children aged 0-4 and 5-12, the income limit at which the benefit, excluding the base rate, is completely phased out is \$41900. The maximum rate of FTB Part B for a family with a child aged 0-5 is \$2602.45. Single income families receive the maximum rate, and so the benefit does not affect their EMTRs.

Table 2 lists the EMTRs (column 2) and the much more complicated set of income bands to which they apply (column 1) when FTB Part A is included in the calculation. As the table shows, EMTRs up to the \$28200 threshold are unchanged. But from this point on up to \$41900 families face EMTRs of 80.0 and 61.5 cents in the dollar, due to the withdrawal of FTB Part A above the base rate.¹⁶ Like the Medicare Levy, FTB Part A undermines marginal rate progressivity, by raising effective rates across middle income bands.

Table 2 EMTRs under the 2001 Tax System and EITC Program

<i>Taxable income \$pa</i>	<i>2001 EMTR</i>	<i>EITC</i>
\$0-\$6000	0.00	-0.055
\$6001-\$20000	0.17	0.115
\$20001-\$27579	0.30	0.245
\$27580-\$28200	0.50	0.445
\$28201-\$29815	0.80	0.80
\$29816-\$41900	0.615	0.615
\$41901-\$47100	0.315	0.615
\$47101-\$50000	0.315	0.315
\$50001-\$60000	0.435	0.435
\$60001-\$76000	0.485	0.485
\$76001-\$82497	0.785	0.785
\$82497+	0.485	0.485

Column 3 of the table gives the new profile of EMTRs when the EITC is added in. As Dawkins explains, it is integrated with FTB Part A, and so the phase-out of 30 cents in the dollar begins at \$41901. The highest marginal rates now appear across the income range from \$28200 to \$47100. In other words, the EITC is a device for extending targeting further along the distribution of household income. The changes could equally well have been introduced by announcing modifications and an extension to FTB Part A.

How far the EMTRs of 61.5 cents in the dollar extends across the middle of the distribution of family income depends, of course, on the number of children. If there is a third child aged between 13-15, the family faces this rate up to an income of \$54700 under the existing system, and then up to \$59900 under the EITC program.

(ii) Dual-Income Families

Now consider what happens to the dual-income family. For the purpose of illustration, we take the case of a family in which the income of the primary earner for full time work is \$28200 pa and that of the secondary earner, also working full time, is \$23100.¹⁷

¹⁵ Details of the FTB system are available on (www.ato.gov.au)

¹⁶ The base rate is withdrawn at a rate of 30 cents in the dollar on family income over \$76000 (the lower income limit for two children). The benefit is completely phased out at \$82497.

¹⁷ A secondary income of \$23100 is chosen to avoid income ranges over which the earnings credit is withdrawn faster than it is earned. This is a serious structural defect in the proposed program. At \$41900 of family income the credit starts being phased-out while still being phased-in on the secondary earner's income. The increase in the EMTR beyond this point is therefore 24.5 cents in the dollar until an income level is reached where either the credit is fully phased in or fully phased out. A secondary income of \$23100 is where both coincide.

Table 3 lists the EMTRs (column 2), and the respective income bands (column1), that the primary earner would face under the 2001 tax system if the family remained single income. The rates are the same as those in the preceding table for a family with an income of up to \$28200. FTB Part A and Part B sum to \$8661 and income taxes and Medicare Levy, to \$4964, so the primary earner receives a transfer of \$3697, reported as a negative net tax in the table.

Table 3 EMTRs for Primary and Secondary Earners

<i>Taxable income \$pa</i>	<i>2001 EMTR Primary</i>	<i>2001 EMTR Secondary</i>	<i>EITC Primary</i>	<i>EITC Secondary</i>
\$0-\$1616	0.00	0.50	-0.055	0.445
\$1617-\$6000	0.00	0.615	-0.055	0.56
\$6001-\$10290	0.17	0.785	0.115	0.73
\$10291-\$13700	0.17	0.485	0.115	0.43
\$13701-\$20000	0.17	0.185	0.115	0.485
\$20001-\$23100	0.30	0.315	0.245	0.56
\$23100-\$27579	0.30	-	0.245	-
\$27580-\$28200	0.50	-	0.445	-
Net tax \$ pa	-3697	10692	-5257	12252
ATR per cent	-13.18	46.28	-18.64	53.04

Column 3 shows the EMTRs faced by the second earner, typically the mother, on going out to work. With an additional income of only \$13700 she loses FTB Part A above the base rate, which amounts to \$4110. She also loses all of FTB Part B. The maximum rate of \$2602 is reduced by 30 cents in each dollar of the secondary earner's income over \$1616, which means that it is entirely phased out at an income level of \$10290. In addition, the second earner pays the remainder of the claw-back of the Medicare Levy exemption on her husband's income, which is \$323, as well as her own Medicare Levy and income taxes.

If the second earner's income is only \$13700, her loss of benefits, together with the income taxes and the Medicare Levy she pays on this income, amount to \$8460. Her ATR is 61.75 cents in the dollar. She is left with a net income of only \$5240.

If she increases her hours of work to earn \$23100, she pays \$3657 in income taxes and Medicare Levy on her own income. With the withdrawal of FTB Part A and Part B, her effective net tax is \$10692. Her ATR is 46.28 cents in the dollar.

Columns 4 and 5 of the table show what happens when the EITC program is added. EMTRs for the husband are reduced by 5.5 cents in the dollar and on the mother's income up to \$13700, the point at which FTB Part A above the base rate is fully phased out. At this point, the earnings credit begins to phase out.¹⁸ The result is that the high EMTRs on the second earner's income under the existing FTB system are extended from \$13700 to \$23100. The total amount the second earner loses is \$12252, and her ATR rises to 53.04 cents in the dollar.

If we consider families in which the primary earner has a higher income, so that FTB Part A is partly withdrawn on his income, then the EITC program can result in EMTRs approaching 80 cents in the dollar on the secondary earner's income. This is because the range of income over which it is phased out can coincide with that over which FTB

¹⁸ Note that it is still being phased in on the second earner's income, and so the effective phase out rate is 24.5 cents in the dollar.

Part B is phased out. In a broader analysis which includes the GST, secondary earners in many families on median wages can be found to face effective tax rates exceeding 80 cents over significant ranges of income.

Effective taxes at this level leave many mothers working full time with barely enough to pay for child care using government approved care, which is the only way they can access the Government's Child Care Rebate. The result is that almost two thirds of working mothers find child care in the informal sector and get no benefits. For those that do claim Part Rate of Child Care Benefit, this is likely to cover less than the tax they pay on the additional income they earn to pay for child care. Thus the existing benefit system, comprising FTB Part A and Part B and Child Care Benefit, already has the effect of severely restricting the market-domestic work choices of many women in lower income families. Introducing an EITC program would restrict their options even further.

Note that if we compare the dual-income family on a joint income of \$51300 in Table 3 with a single-income family working only half the hours to earn the same income, we find that the two families pay almost the same taxes. This reflects the fact that under successive governments, and now the Howard Government, the Australian system of individual taxation has been almost entirely replaced by one of joint taxation. Such a system can only be justified if we assume that household income is a reliable measure of family living standards. As already indicated, this implies that mothers who care for their children at home make no contribution to family welfare. This is clearly counterfactual, and so joint taxation is nothing more than a policy instrument for discriminating against mothers who work, and against their families.¹⁹ The same is true of an EITC program, due to the withdrawal of the credit on the basis of household income.

3. Incentive Effects

Dawkins reports that "preliminary findings" from a micro-simulation model indicate that the EITC program has only small negative effects for secondary earners. A final result of this kind would be very surprising, given that the rate of withdrawal of the credit is added to already excessively high marginal rates, as shown.

Empirical research has long suggested that married women as secondary earners tend to have relatively high wage elasticities.²⁰ Dawkins cites more recent studies, such as Duncan and MacCrae (1999), which obtain relatively low wage elasticities for second earners. However, the studies typically specify models of the family that do not take account of market child care as a substitute for domestic child care. In many cases the former is treated as a cost of working while home child care is defined as leisure. This asymmetric treatment of child care at home and in the market place can be shown to lead to an underestimate of the wage elasticities of secondary earners.²¹

For a model explicitly incorporating domestic child care and work, we obtain large wage elasticities for married mothers, particularly in the early phases of the life cycle. Using the results to simulate the effects of a change in tax rates of the kind implied by an EITC program, we find that there are strong negative effects on the labour supply of secondary earners and also on household saving.²² The latter is not surprising given

¹⁹ Extensive empirical research also shows that joint taxation is a seriously deficient tax system due to its disincentive effects on labour supply. See, for example, Feldstein and Feinberg (1996). For formal analysis of the detrimental effects of joint taxation based on available empirical evidence, see Apps and Rees (1999).

²⁰ For a review article see Heckman (1993).

²¹ It is worth noting that Eissa and Hoynes (1998) in their analysis of EITC expansions between 1984 and 1996 in the US find that the labour force participation of married women fell by a full percentage point. They conclude that the EITC program "effectively subsidizes married mothers to stay at home". The most damaging aspect of the program is that the subsidies are, in effect, financed by higher taxes on working married mothers in low wage families.

²² See Apps and Rees (2001a).

that the data show that household saving is undertaken mainly by two-earner families at any given wage level. In a further study we also find that the same type of reform, by lowering the net wage for mothers, simultaneously has a negative effect on female labour supply and fertility.

These results suggest that policies which continue to raise EMTRs for secondary earners, in response to the rising cost of welfare due to labour market reforms, can be expected to lead to net reductions in labour supply, saving and family size in the short term. In the longer term we can expect a downward spiral in aggregate output and economic growth, and a more unequal society.

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Comment on “The ‘Five Economists’ Plan”: The Original Ideas and Further Developments”

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I want to begin this comment by saying that in my opinion the development of the ‘Five Economists’ Plan’ has been a good thing. High unemployment is the most significant economic and social problem in Australia today, and has been now for almost three decades, yet it has not received consistent attention from policy-makers. The ‘Five Economists’ Plan’ serves a very useful role therefore in directing attention towards the problem. It also deserves plaudits for being a policy proposal that is worked out in significant detail – in terms of methods of implementation and budget implications. Applying their knowledge to develop detailed policy proposals is an area where academic economists have not been notably active in Australia in recent years, yet it could be argued that this is a part of our social obligation to taxpayers. The ‘Five Economists’ Plan’ is again a lesson in this regard.

In the main part of my comment I will focus on the question of whether the safety net wage freeze proposed in the ‘Five Economists’ Plan’ would significantly reduce unemployment, and whether it seems like a good way to try to achieve that objective.

To estimate the effect that a safety net wage freeze will have on unemployment, it is necessary to have some model to make the calculation. The most plausible simple model involves two steps – modeling how the safety net freeze affects employment; and how the change in employment affects unemployment:

$$\% \text{ change in employment} = (\% \Delta w)(\text{Share of workforce})(\varepsilon_w) \quad (1)$$

Where: $(\% \Delta w)$ = Percentage change in real wages from safety net freeze;
 $(\text{Share of workforce})$ = Proportion of workforce that receive safety net wage increases; and (ε_w) = Wage elasticity of labour demand.

Change in rate of ue =

$$[(UE_{\text{base}})/(EMP_{\text{base}} + UE_{\text{base}})] - [(UE_{\text{postfreeze}})/(EMP_{\text{postfreeze}} + UE_{\text{postfreeze}})] \quad (2)$$

Where: $EMP_{\text{postfreeze}} = EMP_{\text{base}}(1 + \% \Delta EMP)$;

$UE_{\text{postfreeze}} = UE_{\text{base}}(1 - (\% \Delta EMP)(EMP_{\text{base}})(\phi_{LS}))$; and

ϕ_{LS} = per cent increase in labour supply in response to a 1% increase in employment.

The size of the wage elasticity of employment depends on a substitution effect and scale effect. The substitution effect is the degree to which labour is substituted for capital, and in the case of a change in wages that affects the relative wages of different groups of workers, the degree to which one type of labour is substituted for another type of labour. The scale effect is the effect on employment that follows from a change in output demand due to any change in the output price.

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With this framework it is possible to make several general points about the debate that has occurred with regard to the 'Five Economists' Plan' over the effects of a safety net wage freeze on employment. First, it shows that the Dawkins paper is correct to say that evidence on the elasticity of employment to minimum wage changes in the United States cannot be taken to say anything about the effect of a safety net wage freeze in Australia. Primarily, this is because the share of workers affected by a minimum wage change in the United States is much smaller than the proportion that would be affected by a safety net wage freeze in Australia. Second, the framework shows that in order to estimate the effect of the safety net wage freeze we need to know the value of the wage elasticity of labour demand. In Australia we have a variety of studies that give fairly consistent evidence that for private sector workers the substitution component of that elasticity is -0.7 . But we do not really have any reliable evidence on the magnitude of the scale effect. (Note that the scale effect is not the same as the coefficient on the output variable in a labour demand regression model. The scale effect is the effect of the change in wages on prices, multiplied by the price elasticity of output, multiplied by the effect of output on employment.) In the absence of reliable data on the size of the scale effect, we have to say that any estimate of the effect of the safety net wage freeze will indeed be an estimate. Third, the framework is informative about the relative effect of the safety net wage freeze on low wage employment and on aggregate employment. In the Dawkins paper it is suggested that the effect on low wage employment might be larger than the effect that is calculated assuming the safety net wage freeze imposes a uniform cut in real wages of all workers. The framework above demonstrates that while this may be correct, it is important to note that all of the difference may simply be explained by the substitution of low wage workers for high wage workers that occurs when the safety net wage freeze is concentrated on low wage workers.

The framework can also be used to make a back-of-the-envelope calculation of the effect of the safety net wage freeze on the rate of unemployment. Plausible assumptions about the value of the variables in the framework seem to me to be that (a) 25 per cent of the workforce is affected by the safety net wage freeze (AIRC, 1997, p.124); (b) the safety net wage freeze reduces real wages of workers affected by 12 per cent over four years; and (c) a wage elasticity of employment of -1 . With these assumptions employment would increase by 3%, equal to about 274,000 jobs in terms of aggregate employment at August 2001. Assuming that one-third of the increase in jobs transfers to a reduction to unemployment (and the other two-thirds is absorbed by an increase in labour supply – see Dixon, 1994), then unemployment is reduced by about 91,000. Using the rate of unemployment at August 2001 as a base, the change in employment and unemployment from the safety net wage freeze would produce a fall in the rate of unemployment from 6.6 per cent to 5.6 per cent – an overall effect of one per cent.

There are several points to make about this estimate. First, it seems plausible. For example, more sophisticated methods give similar findings. For example, the general equilibrium modeling of Dixon and Rimmer (2001a) gives an estimated long-run effect on employment of about 4 per cent, only slightly higher than the estimate obtained here. Second, the magnitude of the effect on the rate of unemployment is considerably smaller than the effect of 1.5 to 2 percentage points first claimed in the letter from the Five Economists to the Prime Minister. Third, it is an effect that would occur with some lag after the implementation of the policy – that is we are looking at a time frame of probably at least six years for the full effects to impact on the economy.

The main point from the discussion thus far is that the safety net wage freeze would have some effect on unemployment, albeit less than is claimed by the Five Economists. Of course, any reduction in unemployment (other things equal) should be seen as a gain for society. So this might suggest that the Plan should be supported. But I believe that there are several reasons why caution is needed before drawing such a conclusion.

First, there may be better ways of achieving a reduction in labour costs than through the safety net wage freeze. One possibility is that – where it is decided that an appropriate policy response is to seek to adjust relative wages of low-skill and high-skill workers – this may be done through changes to labour costs apart from wages. For example, wages of some groups of low-skill employees might be exempted from payroll tax. (This is already done for junior workers and apprentices in some states – see Dixon et al., 1988, p. 298.) One advantage of using payroll taxes to adjust relative labour costs would be that it may allow the adjustment to be targeted more specifically at low-skill workers than through a safety net wage freeze.

Second, a critical component of any policy program to reduce unemployment must be some policies to deal with long-term unemployment. In the Dawkins paper it is suggested that the major impact of the safety net wage freeze on unemployment would be to reduce long-term unemployment. This statement is based on modeling undertaken by Dixon and Rimmer (2001b). Two points need to be made here. First, this result mainly comes about because a reduction in short-term unemployment lowers the inflow to long-term unemployment, and not because the policy is inducing employers to hire those persons who were long-term unemployed prior to the implementation of the safety net wage freeze. Second, in the modeling the category of short-term unemployment is essentially completely determined by inflows from employment. The magnitude of these inflows is primarily determined by assumption – hence the model almost forces the result that it is long-term unemployment that adjusts to implementation of the safety net wage freeze.

Third, the other important aspect of the ‘Five Economists’ Plan’ is a proposal to introduce an earned income tax credit scheme that is in part intended to compensate ‘losers’ from the safety net wage freeze. Some concerns about substituting a fiscal instrument for direct labour market regulation do exist. First, political economy factors may mean that a fiscal instrument provides less assurance that incomes of low wage earners will be maintained in the long run than does maintaining direct regulation of wages. Second, some evidence suggests that individuals derive greater psychic benefit from labour market income than from welfare payments (Kelley and Evans, 1993). On the other hand, the work of Richardson and Harding that is cited in the Dawkins paper suggests that an earned income tax credit may be a better means of targeting income assistance to low income households than is safety net wage regulation.

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