

Does it Pay to Work? – A Summary

The number of unemployed and disability pensioners has increased in Sweden as in many other European countries. The increasing benefit dependency is a threat to public finance, labour market functioning and eventually to social integration in society. The conflicting goals of work incentives related to taxes and benefits and the accuracy of social insurance are in focus in most countries and in many recent reports.

This study investigates net replacement rates in unemployment insurance and disability pensions in Sweden and the combination effects of social insurance, taxes, benefits and income dependent charges. The analysis is based on simulation experiments for representative sub-samples of unemployed and employed and stylized case calculations.

In the first simulation all unemployed are given their former wage, or in some cases, an estimated wage, and then all taxes, housing benefits and child care fees are recalculated. The net replacement rate (NRR) is on average 85 per cent, assuming the gross replacement rate for 1998 of 80 per cent. NRR is the household disposable income in unemployment in per cent of the disposable income in employment when simulations are implemented individually. About 4 per cent of all unemployed would not have an increasing disposable income in work while more than one of three would only improve the disposable income by 10 per cent or less. High NRR is frequent among families with children, women and low wage earner. These high NRR are explained by combination effects from taxes, housing allowances, social assistance and high and progressive child care fees. Returning to work, unemployed would keep only 17 per cent of the new wage, the rest is lost in reduced housing allowances,

unemployment benefits and increased taxes. This implies high average taxes on wages.

Corresponding simulation experiments are presented where all individuals in work are assumed to be unemployed. The average NRR for employed is 78 per cent, which is notably lower than the NRR for the unemployed. This difference is explained by selection effects. Those with high unemployment risks – younger persons with lower wages and persons with more children – have higher NRR.

These simulation results are validated with a statistical comparison between disposable income among unemployed and those in work. Composition differences due to age, sex, education, region, immigration and employment is controlled for, using a standard regression technique. The large differences in disposable income between unemployed and employed are mostly explained by composition differences. Controlling for these, unemployed (except single without children) have a disposable income averaging 85–95 per cent of the income of those in work, depending on family type.

The simulation of disability pension (including collective supplements) for all individuals presently in work shows that more than one of three should lose less than 10 per cent of disposable income if receiving a pension, when considering combination effects of taxes and benefits. Individuals with high risk of disability – women, part-time workers and low wage earners – often have NRR close to 100 per cent.

Net replacement rates for unemployed when returning to work, for employed when assumed being unemployed or being disability pensioner

	Net Replacement Rate, Per cent							
	-59	60-69	70-79	80-89	90-99	100	Total	Average
Unemployed to Work	6	6	11	36	38	4	100	85
Employed to Unemployment	12	12	22	36	18	1	100	78
Employed to Disability pensions	1	4	15	43	27	9	100	86

In another simulation marginal effective tax rates (METR) are calculated for all employed including effects from taxes, benefits, child care fees and social assistance. Assuming an individual wage increase of SEK 1 000, the METR is on average 46 per cent. Most wage earners have METR in the interval 30–40 per cent but there are also more than 240 000 individuals with METR around 60–70 and 14 000 with METR higher than 70 per cent. High METR is again explained by combination effects of taxes, housing benefits, single parent benefits, child care fees and social assistance and is most frequent among families with children, especially single parents.

This report also includes a brief summary of results from an international project comparing NRR in disability pensions and other early exit schemes for those aged 60 or older. The analysis is based on stylized tax and benefit calculation for a single person with a wage between half and two times the Average Production Worker (APW). The NRR in disability pension is fairly high in Sweden, 84 per cent at APW level, compared to Denmark (77 per cent), Finland (65 per cent), the Netherlands (74 per cent) and United Kingdom (43 per cent). Only Italy and Spain have higher NRR. In other programs for early exits and in unemployment insurance, the NRR in Sweden is close to the levels in most other countries in the study.

The conclusion of the report is that for most wage earners in Sweden, it still pays to work. However, for vulnerable groups unemployment traps are created by the tax and benefit system, especially for families with children, single parents, low wage earners and young persons. Social insurance benefits are designed to be reasonable. Unfortunately, policy makers often disregard combination effects of taxes, benefits, social assistance and child care fees but these are integrated parts of the social protection for unemployed and long term sick. If the problems for vulnerable groups should be reduced, policy makers must take full and coordinated control of all systems that determine marginal effects, including child care fees and social assistance.