PF4: Neutrality of tax/benefit systems

Definitions and methodology

Couple families with children can choose a range of possible labour supply options among parents to procure a desired level of disposable family income tax/benefit systems are here defined to be "neutral" if they do not affect the distribution of paid work among adults in such couple families.

The nature of the tax unit is an important factor in determining the extent to which tax/benefit systems favour dual earner couples or single breadwinner families. Under "joint" or "family-based" taxation systems, the marginal tax rate of the second earner – most commonly the female spouse – will be the same as the marginal tax rate of the primary earner, and if the taxation system is progressive, this will be higher than the marginal rate for a single person at the same level of earnings, with possible adverse incentives for female partners to participate in the paid labour market. Moreover, with progressive tax rates, individual taxation means that a second earner will be taxed less heavily than the primary earner for the same level of additional earnings, implying that couples can achieve higher levels of disposable income by becoming a dual-earner family. Individual tax systems with progressive income tax schedules include a certain bias towards spreading earnings across different household members.

In 2006, nineteen OECD countries had separate income taxation of spouses (OECD, 2003 and 2008). The countries with joint taxation, or with options for joint taxation, were the Czech Republic (for couples with children), France (families), Germany (married couples), Ireland (married couples), Luxembourg (married couples), Norway (optional), Poland (married couples), Portugal (families), Spain (optional), Switzerland (married couples), and the US (married couples). However, "neutrality" of tax/benefit systems is not simply determined by the tax unit. Indeed, many "individual" tax systems exhibit some "joint elements" such as tax reliefs and tax credits which are transferable between partners, as in Denmark, Iceland, and the Netherlands) and income-tested benefits (e.g. social assistance benefits) related to family composition. When the second adult in a couple- family starts earning, these earnings first off-set the value of these tax reliefs and lead to a loss of benefit income.

Key findings

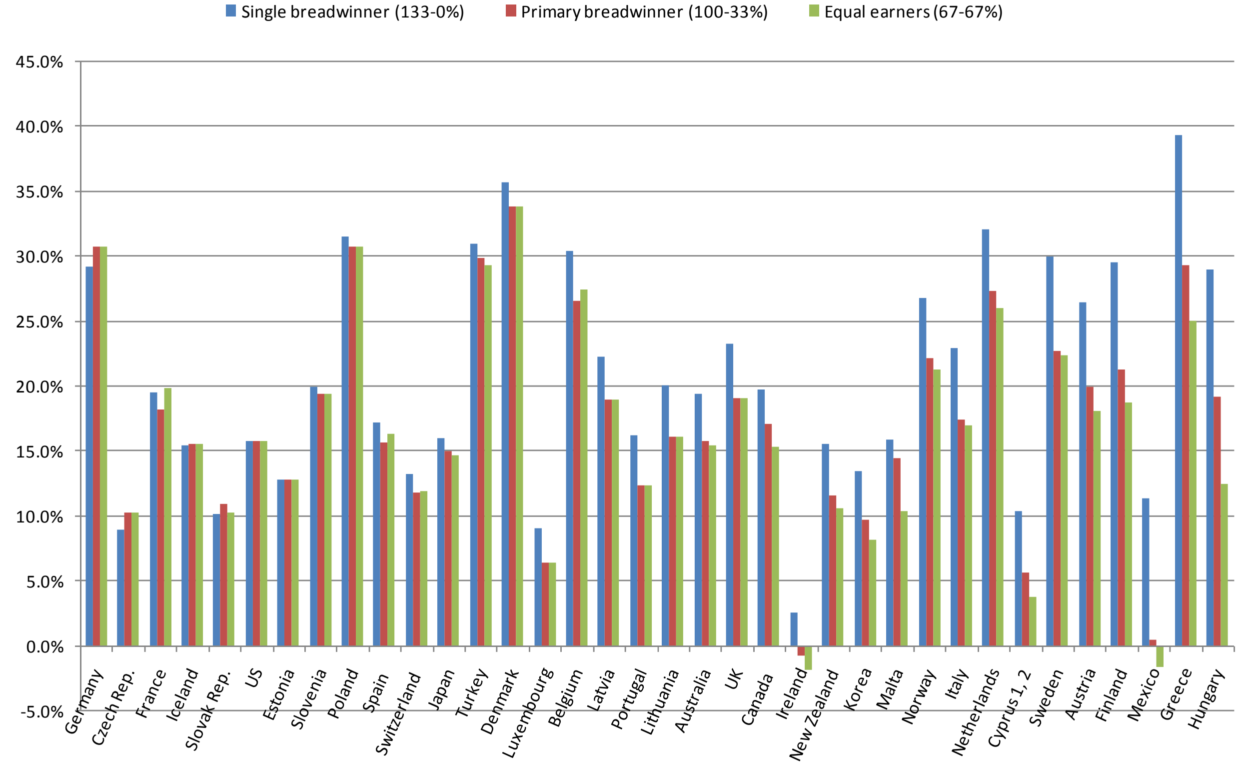
Chart 1 considers how tax/benefit systems may affect the distribution of earnings among spouses in a couple family (results will be different at different levels of household income). It looks at how couple families with an income of 133% of average earnings may best allocate earnings among themselves. Three alternatives are considered: i) the single breadwinner (first earner with 133% of average earnings); ii) the primary breadwinner (first earner with average earnings, second earner with one-third of average earnings); and iii) equal partnerships where both spouses earn the same. In each of these three cases, Chart 1 shows how much net transfers (the difference between taxes paid and family benefits received) would be from the household to the government. For example, in 2006, at 133% of average earnings net transfers for a Finnish single breadwinner family amounted to almost 30% of gross earnings, while this was around 20% for couples in which both partners had the same level of earnings. In other words, at the given level of household income, the Finnish tax/benefit system favours dual earner couples over single breadwinner families.

Other relevant indicators: Gender pay gaps (LMF5); Gender differences in employment outcomes (LMF6); Public spending on family benefits (PF2); Typology of family benefits (PF3); Key characteristics of parental leave arrangements (PF7); and, Childcare support (PF12).

At the given level of family income, tax/benefit systems appear to be largely neutral between dual and single-earner couples in France, Iceland, Japan, Poland, the Slovak Republic, Spain and the US, but in most countries tax/benefit systems have small but significant incentives towards a more equal sharing of market work (Chart 1). Only in the Czech Republic and Germanys does the tax/benefit system financially favour single breadwinner couples over dual-earner families.

Chart 1: **Tax/benefit systems in many OECD countries provide incentives towards a more equal sharing of paid work, but not in the Czech Republic and Germany**.

Average payments to governments as a percentage of gross earnings, at different earning distributions of a couple with two children age 6 and 11 (if tax reliefs or cash transfers vary within this age range, the most generous provisions are taken, and the case of twins is explicitly disregarded) and with family income equal to 133% of average earnings, 2006



Given the level of family income and the age of children, countries are ranked by the *difference* in net payments to government between single breadwinner families and dual earner couples wherein both adults earn the same. The Hungarian system is relatively most favourable to dual-earner couples and the German tax/benefit system appears to be the least favourable for dual-earner couples. Again, these results depend on assumptions, and Hungary would score rather differently if calculations concerned families with younger children than assumed here.

1) Footnote by Turkey: The information in this document with reference to « Cyprus » relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognizes the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

2) Footnote by all the European Union Member States of the OECD and the European Commission: The Republic of Cyprus is recognized by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

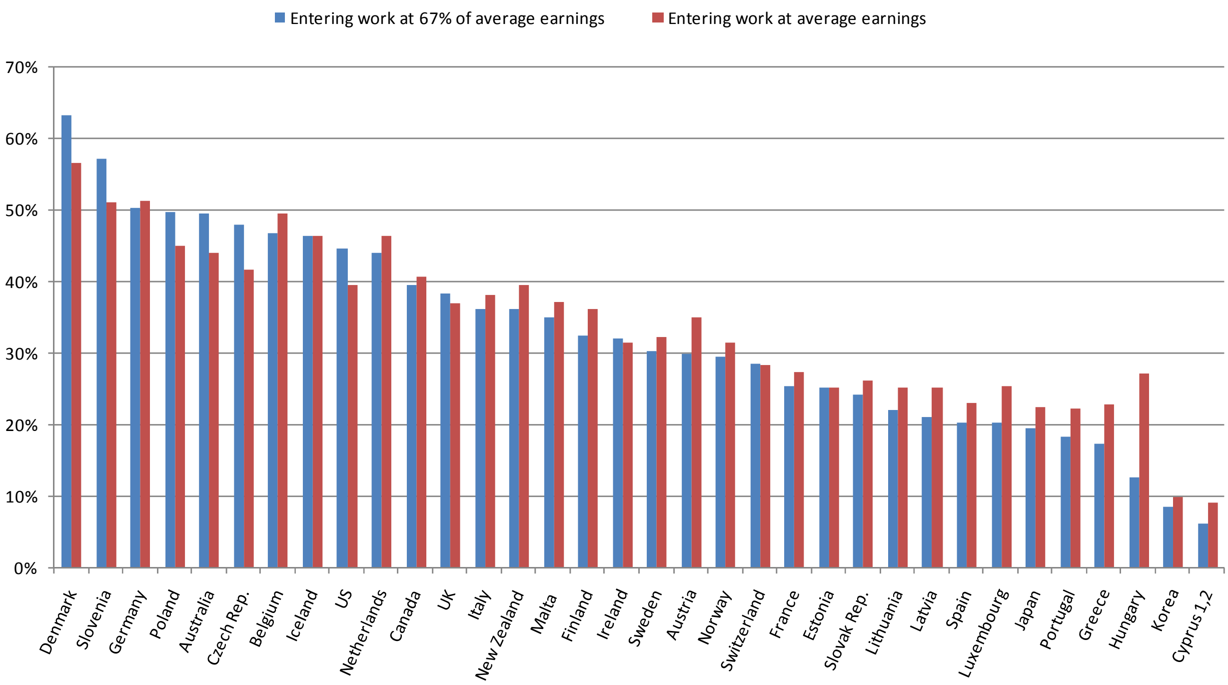
Source: OECD Tax and Tax/Benefit models

However, the attractiveness of entering paid work for potential second earners does not merely depend on the incentives within the tax benefit system to share paid work within households, but also on the overall financial gains second earners can make from being in work. In other words to what extend are in-work earnings effectively taxed away when the second earners moves into paid work?

Chart 2 shows the average effective tax rates (AETRs - which measure the proportion of any increase in earnings which is lost either to taxation or loss of benefit income) parents face if they are contemplating moving into paid employment, when their spouse has earnings equal to two/thirds of average earnings (these calculations do not account for the cost of childcare and are based on the assumptions inherent to the OECD Tax/Benefit models when calculating the tax/benefit position of persons, OECD 2007a). With AETRs generally well below 50%, work pays for potential second-earners in families who are not on income support themselves. However, in some OECD countries, financial incentives to move into work for mothers with a working spouse appear to be relatively weak in Belgium, Denmark, Germany, Iceland, the Netherlands and Poland.

Chart 2: **Before childcare costs, work generally pays for secondary earners**

Average effective tax rates for parents entering employment, who live in couple families with a spouse who has full-time earnings equal to 67% of average earnings, 2006



In the initial situation, the non employed parent does not receive unemployment benefits, but the household may be entitled social assistance and any other means and/or income-tested benefits (e.g. housing support) as available subject to the relevant income conditions. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.
Countries are ranked by the AETR faced by a potential second earner entering work at 67% of average earnings.
See also notes 1 and 2 to the previous chart.
Source: OECD Tax/Benefit models

The calculations underlying the results in Chart 2 do not account for the costs of formal childcare arrangements and implicitly assume that parents have access to free "informal" childcare. Indeed, many parents use informal childcare arrangements (relatives, neighbours), but not all parents have access to such services on a comprehensive basis. The provision of childcare services is heavily subsidised in Nordic countries, so that work pays for parents. In other countries, formal childcare facilities are not always available and they can be expensive. In Ireland and the United Kingdom, the costs of childcare can be so high, that in the short-term work does not pay for many second earners in couple families and this applies to sole-parent families in the Canadian province of Ontario, Ireland, France, and the city of Zürich in Switzerland (OECD, 2007a and OECD 2007b).

Comparability and data issues

As discussed, income-tested benefits, family based tax credits and transferable tax allowances introduce a bias towards single-earner couples in tax/benefit systems. Given that many social transfers (including social assistance and housing support) are specifically targeted towards low-income households, especially when children are present, potential secondary earners in low-income households are most likely to face weak financial incentives to work (OECD, 2007a).

The results presented in Chart 1 would be very different in some countries when calculations concerned families with children of a younger age than considered here. This is because some countries make significant family payments to families until age 3 which support single breadwinner models (as for example, in Austria, the Czech Republic, Finland, Hungary, Norway or the Slovak Republic, OECD 2007b).

Again, the calculations presented here do not account for the high childcare fees. These costs can have a significant effect on the financial incentives to work of secondary earners and thus on the distribution of paid work among parents in couple-families with children.

Sources and further reading: Immervoll, H., H.J. Kleven, C.T. Kreiner and N. Verdelin (2008), “Taxation of Couples in European Countries”, IZA Discussion Paper, *forthcoming*. OECD (2003), *Taxing Wages 2001-2002*, Special feature Taxing Families, OECD, Paris. OECD (2007a), *Benefits and Wages*, OECD, Paris, OECD (2007b), *Babies and Bosses, Reconciling Work and Family Life, A Synthesis of Findings for OECD Countries*, OECD, Paris; and OECD (2008), *Taxing Wages, 2006-2007*, OECD, Paris.