SEPTEMBER 2009 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

In-Work Poverty: What Can Governments Do?

Introduction

While work is often the best pathway out of poverty, employment does not always guarantee an adequate living standard. At the outset of the current economic downturn, the risk of in-work poverty was significant in most OECD countries. Indeed, most working-age persons living in poverty were part of a household containing at least one worker. While the social safety nets in place substantially weaken the link between weak labour-market outcomes and poverty in virtually all OECD countries, the current jobs crisis is undoubtedly nudging poverty rates higher among the working-age population in many countries. Many workers have lost their job or work fewer hours, two situations that raise the risk of poverty.

Since the risk of poverty varies depending on individuals' history in the labour market, their family situations, and what workforce group they belong to, policies to fight poverty need to be well targeted. For the most vulnerable groups, working full-time does not always provide a solid pathway out of poverty: these workers could face even more severe economic hardship during the current economic downturn if their working hours are reduced because of bad labour-market conditions.

While in-work poverty is largely a structural problem, the urgency to address this issue is even greater in the current economic crisis. This *Policy Brief* highlights the workforce groups that are most at risk of falling into poverty and that constitute a priority target for policy makers, and suggests measures that governments can take to contain the poverty risk among these groups. ■

Observer oecd

Does work reduce the risk of poverty?

On average in the mid-2000s, one person in ten among the working-age population in the OECD area was poor – that is, she/he was living in a household with a disposable income below half the median income prevailing in his/her country of residence. As the latest edition of the OECD's *Employment Outlook* shows, Denmark has the lowest poverty rate among OECD countries, with 4.5% of the working-age population living in poverty. At the other extreme, the poverty rate reaches almost 18% in Mexico.

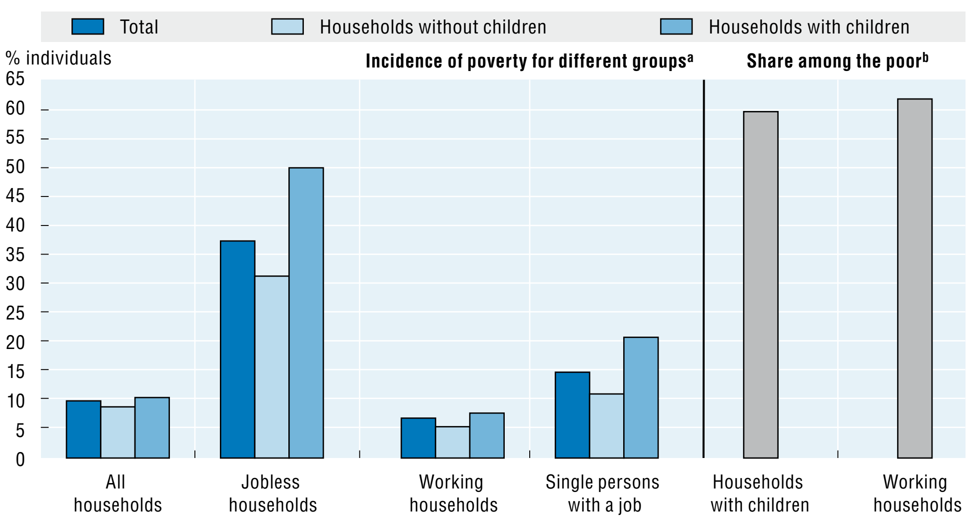
Employment considerably reduces the risk of poverty in all OECD countries. On average in the OECD area, 37% of individuals living in jobless households are poor, a proportion that is five times higher than that for households with at least one worker (Figure 1). In virtually all countries, the poverty risk among jobless households is more than triple the rate observed among working households and almost never falls below 20%. Thus, containing poverty during the current jobs crisis is a major challenge for most OECD governments. That said, employment is not a panacea: on average across OECD countries, 7% of individuals living in households with at least one worker are poor, and more than 10% of the working population in Japan, Mexico, Poland, Portugal, Turkey and the United States are poor. Since most working-age people are employed, the working poor constitute the largest target population for anti-poverty policies in all OECD countries; on average, they account for more than 60% of all working-age poor.

Households with children always fare worse than their childless counterparts with comparable employment status. On average in the OECD area, half of individuals living in a jobless household with children are poor; that

Figure 1.

INCIDENCE OF POVERTY IN THE OECD COUNTRIES

OECD averages, mid-2000s



Notes: Unweigted averages over 28 OECD countries (Turkey and Switzerland are excluded).

a. The bars represent the percentage of individuals living in a household with disposable income below 50% of the median income, among all individuals living in a household with a head of working age (with/without children). Poverty rates are also calculated for 3 broad subcategories of households: jobless households (with/without children), households with at least one worker (with/without children), and single persons with a job (with/without children).

b. The bars represent the percentage of individuals living in a household with children and with at least one worker, respectively, among all individuals living in a poor household.

Source: OECD Employment Outlook, 2009.

proportion is slightly more than 30% among childless households (Figure 1). Employment reduces the gap, but not uniformly across households. On average, 7.8% of individuals living in a working household with children are poor, only 2.4 percentage points more than among childless households, but at 20% of the working population, the rate of in-work poverty among lone parents is twice as high as it is for their childless counterparts. Overall, six in ten poor individuals live in a household with children, a pattern that is of particular concern since, in all OECD countries, social and economic status tends to be passed down from generation to generation. ■

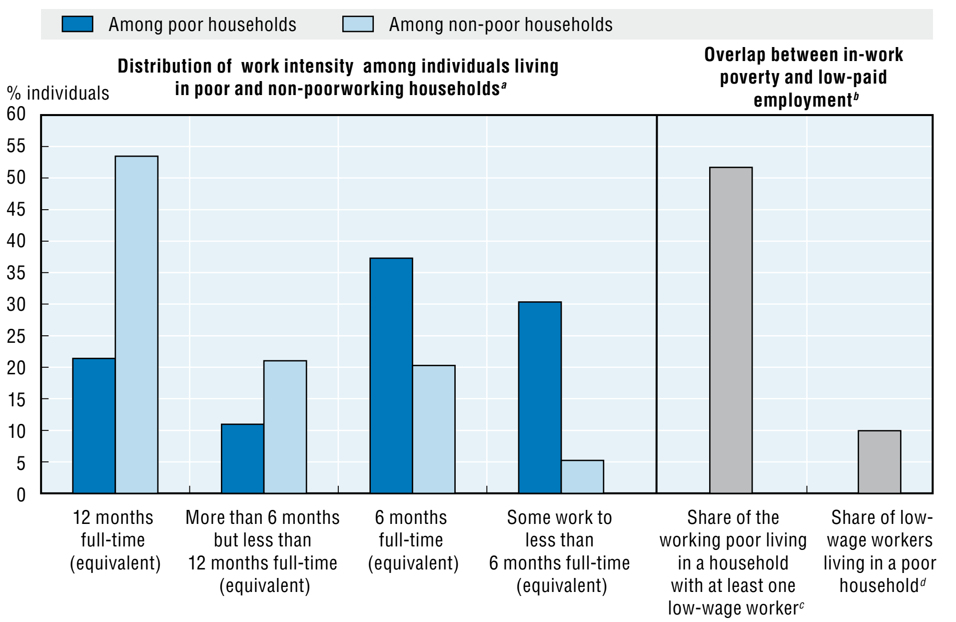
Who are the working poor?

While it would be natural to suppose that in-work poverty is largely confined to low-wage workers, the overlap between low-paid employment and in-work poverty is actually low (Figure 2). Evidence shows that hourly wages of the working poor are not necessarily at the very bottom of the wage ladder. On average over the 21 European countries for which data are available, only slightly more than half of the working poor live in households where there is at least one person employed in a low-paid job. Moreover, most low-wage workers are not poor: on average, less than one in ten low-wage workers in those 21 European countries lives in a poor household. This has

Figure 2.

WORKING TIME, WAGE RATE AND IN-WORK POVERTY

Averages over 21 European countries, population aged 20-64, 2006



Notes: Unweigted averages.

a. The bars represent, among all individuals aged 20-64 and living in a household with at least one worker, the percentage of individuals living in a household where the average time spent at work over the year, by head and spouse (when relevant), is: less than 6 months, 6 months, between 6 and 12 months, 12 months (in full-time equivalent months). Calculations have been made separately for poor and non-poor households.

b. Low-wage workers are defined as those with hourly wage below the lowest quintile threshold of the wage distribution.

c. The bar represents the percentage of individuals living in a household with at least one low-wage worker, among all individuals aged 20-64 and living in a poor household with at least one worker.

d. The bar represents the percentage of individuals living in a poor household, among all individuals aged 20-64 and living in households with at least one low-wage worker.

Source: OECD Employment Outlook, 2009.

strong implications for designing anti-poverty policies. Any measure that targets only individual low-wage workers leaves many of the working poor uncovered. Thus, such a policy primarily makes low-paid employment more attractive, but it tends to be relatively ineffective in alleviating in-work poverty.

Underemployment appears to be a key determinant of in-work poverty. Short part-time work and/or short employment spells over the year are a major problem for most of the working poor (Figure 2). Indeed, time spent at work among the working poor differs sharply from that observed among the rest of the employed population. Among all adults living in a poor household, only slightly more than 20% have a full-time job, and almost 70% of this group work on average six months or less over the year. In contrast, slightly more than 50% of adults in non-poor households work full-time, and only 25% of them work on average six months or less over the year. More than half of the working poor in all countries work on average six months or less over the year; and the lower the work intensity, the higher the risk of poverty. In the context of the current economic downturn, where workers face substantial reductions in working hours or are losing their jobs, the rate of in-work poverty may rise significantly. ■

Are existing safety nets adequate?

While the poverty risk is affected by a number of individual and household characteristics, including labour-market participation and household composition, similar households face very different poverty rates across OECD countries. In fact, differences in national systems of social transfers substantially affect comparisons of poverty rates among different countries.

Net social transfers – that is, the combination of gross cash public transfers and household taxes – play a key role in alleviating poverty in virtually all OECD countries (Figure 3). On average, they cut the poverty rate by almost half among the whole working-age population, and in countries such as Denmark, France and Sweden, the reduction is even greater. In contrast, the overall poverty rate falls by less than one-third after transfers in Canada, Japan, Korea, Mexico, Spain and the United States. The design of national transfer systems thus appears to be a key determinant of OECD country rankings with respect to poverty rates. In addition, the impact of social transfers varies substantially across household types. With the notable exception of lone parents, social transfers tend to be less effective in reducing poverty among families with children than among childless households. Social transfers also play a key role in reducing poverty among jobless people and, to a lesser extent, among those who are working.

There may be some room for reshaping national systems of benefits and taxes so as to provide further support to working families with low earnings potentials, notably among those with children. The income support provided to jobless households with children, which reaches, on average, 40% of the median income in OECD countries, considerably reduces the depth of poverty, even if recipients still live below the poverty line (Figure 3). But since the net amount of social transfers that these families receive declines rapidly with earnings, financial rewards from taking a low-paid job tend to be relatively low, and full-time employment does not always prove to be the best path towards economic self-sufficiency. On average, full-time employment in a low-paid job leaves the disposable income of lone parents slightly below the poverty line, while it brings incomes of two-earner couples with children to only 65% of the median income. In the current downturn, it would be difficult for these families to remain above the poverty line, even if both spouses stay employed, but face a reduction of working hours. In comparison, the average income of childless couples reaches 80% of the median income, which is significantly above the poverty line. ■

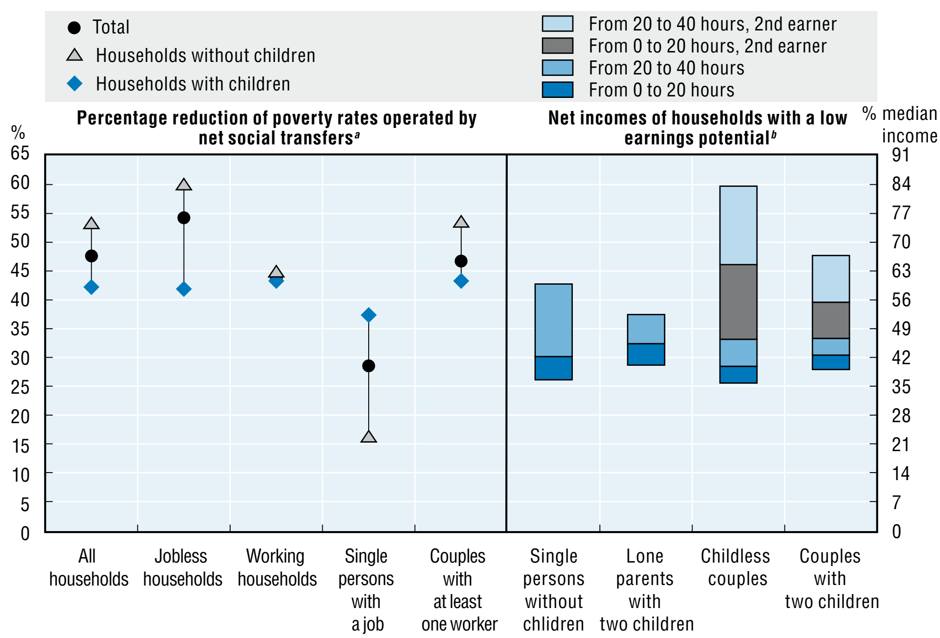
Can in-work benefits help?

More than half of OECD countries now offer in-work benefits (IWBs), that is, transfer payments that top-up the earnings of low-income workers. These schemes have a major advantage over more traditional social transfers: they do not only redistribute resources to low-income families, they also make employment more attractive for workers with low earnings potentials, since IWB payment is conditional on having a job. In other words, they strengthen financial incentives to work. Countries differ in the emphasis they give to these different objectives – namely, redistribution vs. incentives to take up a new job – which is reflected in the way these schemes are designed. There

Figure 3.

NET SOCIAL TRANSFERS AND IN-WORK POVERTY

OECD averages, mid-2000s



Notes: Unweigted averages over 24 OECD countries.

a. The effect of net social transfers is measured by comparing poverty rates based on disposable income, that is, after gross transfers and taxes, with the incidence of poverty that would be observed in the absence of gross transfers and households taxes. More precisely, poverty rates before net social transfers refer to the share of people with market income (*i.e.* pre-transfer/tax income) below 50% of household *disposable* income.

b. Households with low earnings potential refer to households containing low-wage workers only, that is, workers paid 40% of the average wage on an hourly basis, or the minimum wage rate when the latter is higher than 40% of the average wage.

Source: OECD Employment Outlook, 2009.

are two broad categories of IWBs: those targeted towards individual low-paid workers, which provide stronger work incentives, and those targeted towards low-income families, which are more focused on redistribution.

Given budget constraints, these programmes need to be tightly targeted for the benefit level to be generous enough to have a real impact on in-work poverty. In this respect, IWBs that are means-tested, based on families' income, have a major advantage: they make it easier to reach *only* low-income families. This is evident in the schemes in force in Ireland, New Zealand, the United Kingdom and the United States that provide generous benefits – the maximum amounts varying from 10% to 25% of the median income, depending on the country – to a limited number of families with low incomes, as compared to IWBs in force in the other OECD countries.

However, the effectiveness of IWBs in redistributing resources towards the most disadvantaged working families also depends on their impact on work incentives. Means-tested benefits tend to damage work incentives of other potential earners in the household, while individual-based IWBs avoid this adverse effect. Still, all these schemes may reduce financial incentives to move up the wage ladder and thus, to work more or to invest in human capital. However, evidence suggests that, provided that IWBs are large enough to create a sizeable difference between welfare income and work income, their overall effect on employment is positive, although relatively small in most cases. The positive effects of additional employment outweigh the costs created by reduced incentives to work more. Consequently, such schemes can have a marked impact on poverty, reducing both its incidence and its severity to business cycle fluctuations.

Moreover, evidence points towards rather low overall costs "per dollar transferred", especially as compared with more traditional redistribution policies, which may entail large "efficiency losses" if they strongly damage work incentives. In some countries, the cost to taxpayers of redistributing one euro in the form of an in-work benefit could be as low as one euro, implying an efficiency cost close to zero. Nonetheless, the effectiveness of IWB-type policies varies substantially across countries. IWB schemes are found to be either ineffective or very expensive in countries where the distribution of in-work earnings is relatively compressed at the bottom of the wage ladder. ■

Are minimum wages useful in fighting in-work poverty?

Since earnings from work are the most immediate determinant of in-work incomes, minimum wages are often seen as an important policy tool to fight in-work poverty. The critical issue is to set the minimum wage to an *appropriate level*. Indeed, minimum wages may constitute a valuable instrument to address in-work poverty problems among households in which all working-age adults are employed *full-time* in a low-paid job. But minimum wages are not designed to address specific family situations or specific employment conditions, such as part-time work. Therefore, as an anti-poverty tool, minimum wages are not well-targeted. For instance, they are less effective in supporting incomes of lone parents than those of childless couples, although lone parents are most at risk of poverty. More important, minimum wages provide little support to the large majority of the working poor who cannot find a full-time job.

Setting a very high wage floor would not help, since it could damage the employment prospects of the most vulnerable workers. High minimum wages tend to reduce employment among low-productivity groups. A number of countries have thus reduced employers' social security contributions at the minimum-wage level in order to mitigate these potential adverse effects. However, from the perspective of fighting in-work poverty, such policies may entail significant deadweight costs, since a large majority of the beneficiaries of these fiscal measures are not poor. High minimum wages also tend to compress the distribution of wages, thereby making it difficult to implement, for the most vulnerable families, a IWBs scheme that is not too expensive and that does not involve a steep benefit phase-out, which can have negative effects on the labour supply.

If the minimum wage is set to a reasonable level, however, there could be significant synergies between the IWBs and the minimum wage. Setting a wage floor prevents employers from "pocketing" the value of IWBs by lowering wages. Thus, combined with IWB schemes, minimum wages help to redistribute resources to low-wage workers, thereby increasing the effectiveness of IWB schemes. The congruence of policy objectives means that minimum wages can, to some extent, be traded directly against reduced IWB payments. As a result, overall expenditure on IWBs can be lower, as can the taxes needed to finance them. With minimum wages in place, the burden of supporting low-wage workers then falls to a larger extent on employers, as well as on their customers and employees, and to a lesser extent on taxpayers financing government transfers. ■

For further information

These issues are analysed in greater detail in Chapter 3 of the *OECD Employment Outlook 2009*. For more information on this *Policy Brief* and OECD work on poverty, please contact:
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The OECD Policy Briefs are available on the OECD's Internet site:
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For further reading

OECD (2009), **Employment Outlook 2009**, forthcoming.

OECD (2008), **Growing Unequal? Income Distribution and Poverty in OECD Countries**, ISBN 978-92-64-04418-0, € 70, 312 pages.

Immervoll, H. and M. Pearson (2009), "A Good Time for Making Work Pay? Taking Stock of In-Work Benefits and Related Measures across the OECD", OECD Social, Employment and Migration Working Papers, No. 81, OECD, Paris.

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