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Paid parental leave

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POLICY BRIEFS

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Paid parental leave

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About this Policy Brief

Among the OECD Australia (including the United States) is one of the few countries not to have universal paid leave for at least one parent. In this Policy Brief, three contributions are offered on parental leave. Ralph Lattimore outlines the key issues from a public policy perspective. Bruce Chapman and Tim Higgins describe how an income contingent loan scheme could be used to supplement a government or employer funded paid parental leave. Joshua Gans proposes a tax credit scheme for employers to mitigate potential discrimination against those most likely to take parental leave. The tax credit paid would depend on the length of the leave and whether the employee returns to part or full-time employment.

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Research Director

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Ralph Lattimore is Assistant Commissioner at the Productivity Commission. Other than a three year spell at Oxford researching his doctorate into savings and consumption behaviour, he has spent his time in Australia with several organisations as an economic researcher on a wide variety of Australian policy issues. His research has covered areas as diverse as gambling, innovation, ageing, assistance to the unemployed, fertility and private health insurance. He is currently leading the staff team in the Productivity Commission study on parental leave. He can be contacted at rlattimore@pc.gov.au

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Paid parental leave

The Productivity Commission inquiry into paid parental care: the issues

Ralph Lattimore

There are more than 250,000 children born each year in Australia, requiring antenatal and post-natal absences from work by their parents. About 45 per cent of women and somewhere between 35 and 40 per cent of men are entitled to paid parental leave as part of voluntary arrangements negotiated with their employers. Such arrangements tend to dominate in higher-paid, more skilled occupations. The remainder of parents have no paid arrangements (or are unaware of them). Many employees are, however, entitled to unpaid leave. A parent who has been with the same employer on a regular and systematic basis for at least 12 months before the birth of their child is entitled to unpaid leave to care for newborn children for 52 weeks, with a guaranteed option of return to the same job. Many casuals with multiple employers could, however, miss out on this entitlement.

Against this background, the Australian government has asked the Productivity Commission to inquire into the costs and benefits of various models of paid parental leave for parents of newborn children up to two years of age.

There are many criteria against which to judge various models. Their weighting depends on people's views about the appropriate objectives for policy. Some of the objectives often cited include:

- improvements in child and parental, especially maternal, welfare (for example, any increased bonding and attachment with a baby)
- greater longer-run attachment to the labour force for women
- the likelihood of greater attachment and return to work with existing employers after parental leave
- recognition of the combined role of women as workers and mothers

- financial assistance for parents with newborn children
- promotion of gender equity.

There could be trade-offs between the various objectives that are important in model designs. For example, long durations away from work could have benefits for child and parental welfare, but could depreciate skills and reduce labour force attachment.

There are many choices about the configuration of models, each with implications for their effectiveness, costs and risks. The two biggest choices relate to the duration of benefits and their funding source; these two design features distinguish most models from one another. The various financing options include:

- taxpayer-funded models
- employer-funded arrangements (for example, requiring individual businesses to finance the leave arrangements of their own employees; or a contributory scheme in which employers make payments to a common pool based on their payrolls)
- employee-funded arrangements, either through past contributions (the social insurance model) or by borrowing from future income.

Many models envisage a combination of these financing models. Common models involve fully taxpayer-funded provision of a certain level of wages, with voluntary or mandatory 'top-ups' by business to achieve replacement wages. There are, however, other hybrid options, such as tax concessions to business or government-subsidised loans to parents.

As outlined in the Productivity Commission's issues paper, several factors need to be considered when weighing up these various options. Someone needs to pay for any model. Who should that be? Is that equitable or efficient? Will the party that is apparently paying be the ultimate payer? For example, levies on

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business based on their payrolls could eventually be reflected in reduced wages—so that employees, not employers, ultimately pay for their leave.

The generosity of payments is a major focus of debate, centring on the tension between what is needed to provide effective financial assistance while parents are off work looking after newborn children, and the affordability of the measure to those who fund it. For those focusing on gender equity and workplace attachment, the issue of generosity is less one of income support and more the desire to recognise paid parental leave as similar to other leave—linked explicitly to a workplace and with full income replacement.

While choices about the duration and financing issues are often the central features of different models, the Productivity Commission must consider many other important design questions. Above all, who should be eligible for parental leave? In New Zealand, for example, there is a requirement for the employee to have worked with the employer for six months before the leave for at least 10 hours a week. That means many casual workers are excluded, even if they work in multiple jobs for the same hours as some full-time workers.

The role of fathers (or other principal carers) in parental leave is also important, raising questions about the portability of leave between mothers and fathers, the relative duration of leave for fathers and any restrictions on when they can take leave. Understanding current usage patterns of leave by fathers and other principal carers to support newborns is a matter being explored.

Ultimately, the crucial test of the effectiveness of the various models depends on how they change the behaviour of people. A key issue for the inquiry is therefore to analyse how people change their time spent away from work looking after newborn children, what happens to their health and that of their children and their workforce participation decisions. Increasingly in this inquiry, participants are also raising the issue of how employers treat women in the workplace on becoming pregnant and on their return to work. The inquiry will explore the effects, if any, of a paid parental leave scheme on such conduct.

Any scheme creates ripples that spread far beyond these direct impacts. For instance, some models will alter the extent to which parents draw on other government transfer payments or services, such as family tax benefits and childcare assistance.

Some indirect effects could be cultural. Parental leave schemes could change workplace culture, normalising the aspirations of workers to balance work and family life. They could also alter the perception that child rearing is 'women's work' that should not intrude on the workplace. Some have suggested that even a modest scheme could signal the value to society of children and of unpaid child-rearing work.

Various models could also change people's behaviour in quite unexpected ways. For example, people could save less (in accumulated leave or through cash savings) to finance their own leave if someone else finances it. Statutory schemes could 'crowd out' the voluntary arrangements that employers have in place. A common concern with arrangements where the employer is required to fund the leave of their own workers is that employers might then discriminate against females to avoid future liabilities. An evidence-based approach identifies whether these unanticipated effects really occur or matter much.

There are practical implementation issues, too. Some schemes are relatively easy to put in place, but more complex designs could create administrative costs for government and compliance burdens for business. So, while pooled financial arrangements can avoid discrimination against women, they can be more complex to administer.

The Productivity Commission must balance all of these complex considerations when analysing the various options for paid parental leave. A more detailed treatment of the issues has been set out in an Issues Paper available from the commission's web site (<http://www.pc.gov.au/inquiry/parentalsupport>). Many participants in this inquiry have already outlined detailed, often novel, proposals—and these can be seen in their submissions and in their oral testimony to hearings the commission has undertaken around Australia (these are also on the commission's web site). It is clear that there is a vigorous community debate about what should be done.

We will reach some interim conclusions in a draft report to be released in September 2008, and then, in response to feedback, we will put out a final report for the government to consider in February 2009. Below, two participants in this inquiry outline their alternative models. Many others have suggested quite different approaches. The Productivity Commission has reached no conclusion about the merits of any of these. We are open to all options and welcome relevant research and evidence that will inform our deliberations.

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Paid parental leave and income contingent loans

Bruce Chapman and Tim Higgins

Background

In a submission to the Productivity Commission's inquiry into paid parental leave, Chapman *et al.* (2008) proposed an income contingent loan facility to assist as a supplement, rather than as a replacement, to government and/or employer funded paid parental leave. Such a scheme would allow parents the opportunity to replace lost income during a period of parental leave beyond what might otherwise be available. The modelling reported in Chapman *et al.* (2008) explores how a loan of this type might work in practice.

This work has no direct bearing on the question of whether or not taxpayer-provided grants should be available for a universal system of paid parental leave (PPL). Nevertheless, whether or not a universal scheme is implemented, there is an argument that as some benefits of post-natal leave accrue to parents, rather than to society generally, there is a case for arrangements that allow parents to contribute at least partially to the costs of their leave.

There are close connections between the scheme proposed here and the Higher Education Contribution Scheme (HECS).

- They are both responses to an apparent market failure. Borrowing funds from commercial banks would not be feasible in most cases when there is no collateral. This situation for funding parental leave is very similar to that arising in higher education funding, in which there is market failure due to graduates' future income risks and the absence of collateral.
- The repayment mechanism is contingent on income, so only households that have the capacity would have to repay. When future

incomes are low, no payment is required. A consequence is that the scheme offers the most assistance to those households that are the least advantaged over the life cycle.

- As has become apparent with respect to HECS, the collection of debt through the Australian Taxation Office can be made administratively straightforward.

An income contingent loan in this context is an instrument that smooths consumption, allowing parents the opportunity to transfer financial resources from their future, when there is more household income, to current circumstances in which household incomes are low due to non-participation of a parent in the paid labour force.

How the proposed scheme might work

For illustrative purposes, we have chosen certain parameters for the proposed income contingent loan scheme, and these are provided in Chapman *et al.* (2008). In this policy brief, we wish to highlight the potential viability of the general idea, rather than the particular parameters chosen, which can be modified easily as desired by policy designers.

Although we recognise that the employer could play a role in an income contingent loan scheme, for illustrative purposes we assume that the scheme is provided by the government and excludes employer involvement.

We assume that a parent, after expiration of paid leave in the form of a grant, would be able to incur a debt with the Commonwealth, which provides funds as a partial income replacement for up to six months for each child. The amount borrowed for one child is assumed to be approximately \$14,000—which is the hourly national minimum wage received full-time for six months. This is doubled for two children. A cap could be imposed per household to limit the possibility of a large debt on the scheme, and the government would determine the size of the cap. The outstanding

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debt would be indexed at the rate of inflation only, and repayments would be made when assessable income exceeded a specified threshold.

So-called 'adverse selection' and 'moral hazard' are two legitimate concerns with income contingent loan schemes. Adverse selection occurs when individuals most likely to benefit from the arrangements are attracted to participate, while those least likely to benefit are discouraged. Moral hazard exists when there are incentives for those participating in the scheme to behave in unethical ways in order to avoid meeting their repayment obligations.

The costs of moral hazard and adverse selection are mitigated in this scheme by:

- Restricting eligibility to a parent or parents in employment prior to paid maternity leave. This limits the risk of borrowing by parents with relatively weak attachment to the paid labour force.
- Making both parents responsible for the debt obligation, provided both parents are present at the time of the leave. By modelling the debt as being shared and repaid from the incomes of both parents, this increases the chance of loan recovery.
- Imposing a 20 per cent surcharge on the loan, to be added to the debt. This means there is a real cost to debtors who repay relatively quickly. An implication is that the surcharge acts as a deterrent to participation by borrowers who simply wish to take out the loan due to the low debt indexation rates. Imposing a surcharge—as opposed to a real indexation rate—is beneficial from a net cost perspective for parents on low incomes who would take a long time to repay the debt.
- Choosing a low first income threshold below that applying to HECS, thereby increasing the chance of loan recovery. To ensure that this is not a burden on families, the rate of repayment for the lowest income threshold would also be low.

Details of these design features are given in Chapman *et al.* (2008).

What are the results for some typical households?

Four hypothetical scenarios were chosen to reflect realistic family units that might be expected to utilise the loan scheme. The four scenarios are:

1. A couple with two children, where the father is assumed to work full-time and the mother works part-time until the children are in school, and works full-time thereafter.
2. A couple with two children, where the father is assumed to work full-time and the mother works part-time.
3. A single mother with one child, where the mother works part-time until the child is in school, and works full-time thereafter.
4. A single mother with one child, where the mother works part-time.

Repayments and outstanding loan amounts have been projected for each scenario under three income cases based on Australian Bureau of Statistics survey data: median income and upper 75 per cent and lower 25 per cent income bands. Using a range of incomes, rather than just median income, allows an appreciation of the potential variability in the results.

The time until repayment of the total debt under the median income case for scenarios 1, 2 and 3 is approximately eight to ten years. Under the higher income case, the time until repayment of the total debt under the three scenarios is approximately six years. Under the lower income case, the time until repayment of the total debt under the three scenarios is approximately 16–20 years. For scenario 4—single mothers on part-time income—repayment takes more than 25 years under the median income case, and close to 10 years under the higher income case, though repayment durations are highly sensitive to income assumptions. No debt is repaid for those single mothers with incomes in the bottom 25 per cent, as income is always below the lowest repayment threshold.

There can also be a cost to government (and a benefit to the borrower) even if the loan is repaid, because the interest charged on the loan is low. This remains the case for borrowers on low incomes even after the 20 per cent surcharge is imposed on the loan because of the long time to repay the debt, which magnifies the opportunity cost of the funds provided by the government. These costs to the government are subsidies to the borrowers and can be expressed as the difference between the present value provided by the government and how much is repaid by the borrower. If a borrower repays none of the debt, this is equivalent to a 100 per cent subsidy to the borrower. For members of some higher income groups, the subsidy is negative since the amount repaid by the borrower exceeds the amount lent by the government due to the 20 per cent surcharge imposed on the debt.

The results illustrate that those families most in financial need over their lifetimes receive the highest positive subsidies, with single mothers with part-

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time incomes and families with low incomes taking the longest time to repay (or not repaying at all) and therefore receiving the highest benefits from the interest rate subsidies. It is important to stress that the projected time to repayment and subsidies are dependent on the chosen loan parameters and modelling assumptions, including the amount of debt accrued, the income thresholds and repayment rates, the indexation and surcharge arrangements on the loan and the projected income patterns.

What have we not yet considered?

Interactions with existing tax and welfare arrangements, such as the baby bonus and family tax benefits A and B, have not been considered. We believe this aspect of the PPL policy analysis is extremely important.

We have not explored potential aggregate costing in terms of budget outlays and subsidies. As a result, we are unable to examine the implications for initial budget outlays and the eventual taxpayer subsidies from the scheme, although we believe this would be straightforward in an accounting sense. The scenarios suggest that the burden of cost would be from single parents on low incomes. In so far as this group is a small proportion of the population targeted by this scheme, it is likely that costs would be reasonable.

We have illustrated this policy idea by restricting the loan to the minimum wage for a fixed period of six months. One could, however, envisage the loan being taken in varying amounts for a different period, as long as constraints were imposed on the total debt so as to limit the risk of non-recovery.

The scheme design considered to date has not included possible employer involvement. As raised by Joshua Gans in this policy brief, any scheme increasing the incentive for PPL could potentially increase discrimination against those most likely to take that leave.

Should an income contingent loan or indeed any PPL scheme proceed, employers would face costs from staff absence due to PPL; however, these costs would be greater should the employee never return, and take the form of lost returns to training investments. This factor suggests that the employer could benefit from participating in the financing of an income contingent loan for PPL if the scheme was used to maximise the prospects of an employee on leave returning to the original job. One way to achieve this would be for the employee to enter into a contract to return to work after leave on the condition of partial repayment of the debt by the employer.

A contract such as this could reduce—although it might not in itself remove—discrimination. The cost of lost employment to the employer would be replaced by

a monetary cost of debt repayment, but it is still a cost. In his policy brief, Gans explains how discrimination could manifest in the context of PPL, and he proposes a solution.

Concluding remarks

An optional income contingent loan allows parents the opportunity to access funds to replace lost income should they wish to extend parental leave beyond a mandated grant period, therefore providing flexibility and choice.

As benefits accrue to parents, there is a case for schemes such as income contingent loans, in which parents contribute to the costs. This is not to say that such a scheme is strictly ‘user pays’, as concessional indexation of the debt means that a benefit can arise to debtors, with a commensurate opportunity cost to government, even in the event of debt being totally repaid. In circumstances in which debt is repaid relatively quickly and subsidies are negative, parents might nevertheless find the scheme attractive as it provides a mechanism for accessing funds in a time of need.

Although the government faces costs from non-recovery of outstanding debt and concessional debt indexation, these costs can be mitigated through careful selection of design parameters, as discussed above.

Some costs will persist. However, our modelling of the different demographic make-ups of families receiving a range of future incomes suggests that the scheme would require little to no taxpayer contributions for the majority of families to which the loan would be targeted. Moreover, the largest costs to the budget would emerge for those parents with the lowest lifetime incomes, such as single parents with poor employment prospects. An attractive feature of an income contingent loan in this context is therefore that it provides not only liquidity, but doubles as a social insurance instrument.

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Return to work credits

Joshua Gans

The current Productivity Commission inquiry into paid parental leave has received hundreds of submissions. Most of these submissions argue for payments to be made to parents, particularly mothers, while they are on leave.

There are two arguments for this. The first is to alleviate the adverse effects of poverty on children and the ability of parents to take leave. This argument is similar to a social security or insurance rationale for leave and has broad support (and indeed current arrangements do achieve this to some extent).

The second argument is that payments will create incentives for employees to take more leave. This is usually justified on the basis of child development or health, although the evidence for both is weak. In fact, many of the benefits are private and, therefore, the proposal of Chapman, Higgins and Lin (2008) is directed at alleviating liquidity constraints that could exist.

In this policy brief, I raise a concern and propose a policy option in response to that concern. The concern is that by encouraging a greater incidence of parental leave, gender discrimination in labour markets might be exacerbated. The mechanism for this lies in the potential costs that temporary absences and family orientation impose on employers. Consequently, I propose a policy option aimed at mitigating such costs.

The potential for discrimination

Paid parental leave can create potential for discrimination—not just on the basis of gender but on the basis of any preference to spend more time with one's children. To see this, consider an employer who has a job that requires full attention. Suppose also that the employer has to invest in the worker for that job. If you were that employer and you faced candidates from identifiable groups (say, a man versus a woman) who had differing statistical likelihoods of wanting to scale back at some point, who would you take a bet on? And if every employer decides the same way, what does that do to the statistics? The answer: it reaffirms them and you have gender roles and a pay differential between genders. The inefficiency here is

that the wrong people could be ending up in the wrong jobs (see Gans 2008 for a model and Francois 1998 for a related treatment).

This discrimination can take many forms. The fact that when a baby arrives, maternity leave is taken more often than paternity leave could be because of stereotyping that constrains fathers who would like the reverse to be true. It is not an unreasonable hypothesis that one reason why fathers are not taking time off is that the discrimination against them is far worse than that against mothers. They potentially face greater stigma and far greater harm from signalling their family-oriented preferences relative to the norms. These add up to greater costs associated with staying at home.

Melbourne Business School researcher Isabel Metz interviewed 44 women who had left their primary employment during six years. She found that many who had had children and had taken maternity leave found it difficult to resume their chosen career paths. In some cases, this was because of unfriendly work practices. In others, it was because promises (say, to limit work hours) were unfulfilled. Most disturbingly, there was an apparent loss in status coupled with pressure to move ahead within their organisations.

Any policy that encourages greater levels of parental leave has the potential to increase discrimination towards those who are statistically likely, or have revealed themselves to have a preference, to take that leave. This is because employers face costs of temporary worker turnover (something that is more likely to be an issue for smaller than for larger firms) and so, in choosing which workers to hire, promote and train, there will be a commercial bias towards the non-family oriented. These costs will be even greater should firms be required to contribute to the payments to those on leave. Moreover, to the extent that women are identified as most likely to be family oriented, this mandate will disadvantage them relative to men in the labour market.

A possible solution

The above discussion suggests that there is a fundamental conflict between policies that create an incentive to exercise parental leave opportunities and

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discrimination in terms of employers having incentives to favour employees who are less likely to exercise that option. Indeed, to reduce discrimination, policies need to concentrate on reducing the costs faced by employers when their employees take parental leave.

This suggests an alternative way of using government expenditure to promote parental leave. Instead of paying employees who take leave, employers could receive a subsidy or tax concession. The idea would be that should an employee take leave for some minimal period (say, three months), the employer would receive a tax credit (perhaps in the order of 150–200 per cent) on the wages paid to that employee for a pro-rata basis related to the length of leave taken and whether the returning employment is full or part-time. The rationale for a tax credit rather than a one-off payment is that it ensures that the parent does return to work in a longer-term capacity. It is, however, the concept rather than the specific implementation details that I am considering here.

What would a return-to-work (RTW) payment do? First, it would create an incentive for employers to get employees back to work after parental leave and to give them the employment conditions that would make this happen. This includes flexible arrangements for continuing childcare and family issues as well as meaningful work conditions and career prospects. Second, it would create an incentive for employers to encourage their employees to take parental leave. To the extent that giving them paid parental leave is the way to do that, the employer can transfer the payment from the government to the employee. It is therefore an indirect way of achieving a paid parental leave system but without the potential cost associated with an increase in discriminatory outcomes. Third, it would create an incentive for employers to encourage more highly paid employees to take parental leave. To the extent that it pays men more than women, there is therefore a large incentive to get men to take that leave. All of these factors have the potential to change workplace cultures and attitudes—something that, in my experience, is a large factor in driving appropriate work–life balances.

That said, unlike income-contingent loans, this is not potentially self-funding. Instead, like paid parental leave, this will involve direct government expenditure. The key aspect here is that the expenditure is funding something with potential work productivity benefits and externalities of its own. Moreover, it does so in a way that serves to break down rather than reinforce discriminatory outcomes in labour markets. Put simply, this type of policy will subsidise the ability of family-oriented individuals to compete in the labour market.

Moreover, it can be conceived that, even if we don't give employees who have been working for a firm for a short period a right to parental leave, there is

no reason why this payment cannot be made should they be permitted to take leave and then return to work. That allows labour markets to function more smoothly—something that is generally considered to be a favourable outcome.

That said, as I have stated, the RTW payment would be available only to employers who were attracting back their previous employees. Conceivably, a RTW payment could be made to any employer who hired a worker after parental leave. This would be attractive to parents but, in reality, it would not appear to address the issues of discrimination that rely on firm-specific investments in worker productivity. Consequently, there is much to be said for a RTW payment made exclusively to pre-existing employees.

In addition, it could be asked, why should the payment be made on return to work (or after it)? Why not during parental leave itself, as some have suggested? The concern here is to eliminate moral hazard—that is, accepting a payment and encouraging leave from employees that a firm might wish to dismiss or limit in their career prospects. To create an incentive that will change workplace cultures and attitudes requires that the payment be made to firms who successfully reintegrate parents into the workforce after parental leave. The payment therefore needs to be after this fact rather than in expectation of it.

Conclusion

Paid parental leave policies could have the unintended consequence of increasing the potential for discrimination in labour markets. The sources for this are costs imposed on employers when employees have entitlements and incentives to take leave. Solving this problem is critical to making the case for policies that encourage leave to work without those consequences. Return-to-work credits should, therefore, be seen as complementary to other policies that allow parents to sustain income levels after childbirth.

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