The Policy Response to Inequality: Redistributing Income

Ive Marx and Tim Van Rie

10.1 Introduction

If limiting income inequality, especially compressing the lower end of the income distribution, is desirable, in its own right or as a means of mitigating the potentially negative consequences of inequality, how is it then best done? This chapter focuses on policies that seek to redistribute income in a direct and immediate way, while the next chapter will address policies that seek to reduce economic inequalities in more indirect ways. Primary attention here will go to policies to redistribute income towards the bottom of the distribution in an effort to reduce or eradicate income poverty. Rather than attempting to review and summarize a massive literature, our aim is to address a number of questions that loom large in current debates. These questions include:

– Does effective redistribution require high levels of social spending and taxation, or can much be done with well-targeted redistributive efforts?
– Are social safety nets that offer adequate protection against poverty affordable and achievable?
– Should we expand and augment existing redistributive mechanisms or should we put our trust in new redistributive policies, notably earned income supplements?
– Does redistribution have to come with more strings attached?

We start this chapter with a discussion of trends in the share of taxes and benefits in rich countries, and we briefly review how the redistributive impact of taxes and transfers has evolved over the past decades. The remaining sections deal in turn with the questions just listed, and a final section concludes.
Public social expenditure is the most commonly used proxy variable for the size of the welfare state. While this indicator has certain limitations for welfare analysis, both conceptual (Esping-Andersen, 1990) and methodological (De Deaken and Kittel, 2007) spending clearly matters, not least in a context of general budget austerity. The share of public social spending in GDP ranges widely across OECD and EU countries, as shown in Figure 10.1.

Average social expenditure in the OECD rose rather strongly from the early 1960s to the mid-1990s, and then remained rather stable up to the Great Recession. Through its major impact on both expenditure and GDP, the current crisis has once again driven up social expenditure levels. Among industrialized countries there is a well-documented tendency for public social spending levels to converge (Wilensky, 1975, 2002; Schmitt and Starke, 2011; Caminada et al., 2010). In the EU, that convergence has grown stronger since the recent crisis (European Commission, 2012b). This is quite remarkable, in the light of the gaps that opened between EU member states in terms of (un)employment and overall living standards.

The conceptual critique states that welfare expenditure may give some indication of the total size of the welfare state, but fails to provide information on key dimensions such as rights and distribution of benefits. In the words of Esping-Andersen (1990: 21), ‘it is difficult to imagine that anyone struggled for spending per se’. The methodological critique relates to cross-national comparability of data. For example, it appears that there have been cross-national inconsistencies in the coding of mandatory cash benefits provided by employers.

Figure 10.1a. Public social expenditure as percentage of GDP, 1985–2010
Source: OECD SOCX.
If the level of spending is to a large extent driven by socio-demographic and economic parameters, its composition may shed some light on shifting policy priorities (Castles, 2009). In most industrialized countries, cash benefits represent a larger share of public social spending, compared to in-kind benefits. The latter had been growing in relative size in a large majority of countries, with healthcare spending playing a leading role. The recent crisis did, however, trigger an absolute and relative increase in cash spending in many countries, further underlining the role of income transfers as automatic stabilizers.

In terms of welfare functions, there is little indication so far that expenditure on new policy priorities, such as childcare and active labour-market policies, is crowding out funding of more traditional welfare functions, including old age pensions or unemployment benefits (Vandenbroucke and Vleminckx, 2011; Meeusen and Nys, 2012). Across the European Union, means-tested benefits represent approximately one-tenth of all public social expenditure. Since the mid-1990s, this share has remained fairly stable overall, but with considerable variation in national trajectories (Marx and Nelson, 2013).

It should be noted that more sophisticated analyses highlight the need to jointly analyse benefit and tax policies. Conventional measures of (gross) social expenditure tend to overestimate the cost of welfare in Denmark, Finland, and Sweden, where a significant amount of benefit spending is clawed back through taxation. Conversely, in the Czech Republic and Slovenia, a substantial share of social spending takes the form of tax breaks for social purposes rather than cash transfers (Adema et al, 2011).

Figure 10.1b. Tax revenue (including social security contributions) as percentage of GDP, 1985–2010
Source: OECD SOCX.
Immervoll and Richardson (2011; see also OECD, 2011) find shifting dynamics of income redistribution in OECD countries. Across the industrialized world, market income inequalities among the population aged below 65 increased particularly strongly between the mid-1980s and the mid-1990s. Over this period, there has also been a substantial increase in income transfers. This evolution was partly automatic, as pre-existing welfare systems interacted with a growing ‘burden’ of rising market inequalities. The public transfer systems failed to fully contain market forces, resulting in rising inequality of disposable income. From the mid-1990s to the mid-2000s, the dynamics changed, as market inequalities increased at a slower rate than previously. However, social spending stagnated and public transfer systems proved far less effective at redistributing income. As a result, the dispersion of disposable household incomes occurred at an even faster rate than in the previous decade.

Beyond general trends, there is considerable variation across countries and cash benefit functions, as well as over time. Van Mechelen and Bradshaw (2012), for instance, observe that throughout the 1990s child benefits for working families had generally escaped the welfare erosion that marked many other cash benefits. Since 2000, however, the size of the child-benefits package, expressed as a percentage of net disposable income, has declined in the majority of countries awarding these benefits.

In many cases, tax reform effectively exacerbated underlying rises in inequality over the course of previous decades. Country reports from the GINI project observing a strong decline in redistributive effect of public revenues include cases as diverse as Austria, Canada, Finland, France, Japan, Luxembourg, and Australia. The report on Germany, for example, documents how the tax system actually became less progressive during the period 2000–5, especially as a consequence of the income tax reform enacted in various steps by the government. Recently, there has been a proliferation of (semi-)flat tax regimes in Central and Eastern European Countries. Estonia introduced such a scheme in 1994, followed by the two other Baltic states in the mid-1990s, Slovakia (2004, but partly reversed in 2013), Romania (2005), the Czech Republic and Bulgaria (2008), and Hungary (2011). While these shifts annul progressivity of tax scales, their overall effect also depends on (intended) improvements in tax collection and concurrent shifts in the tax mix. The Danish country report shows that it is possible to reduce the overall marginal tax rate of income tax without affecting its distributive effect. Spain is an example where taxes have become more redistributive over time, through a broadening of the tax base and increased progressivity.

Benefits have a much stronger impact on inequality than social security contributions or taxes, despite the much bigger aggregate size of direct income transfers. However, social spending stagnated and public transfer systems proved far less effective at redistributing income. As a result, the dispersion of disposable household incomes occurred at an even faster rate than in the previous decade.
taxes. Redistribution policies have often been less successful at counteracting growing income gaps in the upper parts of the income distribution. In what follows we turn to the four questions posed at the start and consider more closely the link between the size of the welfare state and inequality and poverty outcomes.

10.3 How Much Does Redistributive Effort Matter?

Several studies have established a strong empirical relationship at country level between the overall level of social spending and various measures of inequality and inequality reduction, including (relative) poverty. This is arguably one of the more robust findings of comparative poverty research (Nolan and Marx, 2009; Kenworthy, 2011b; OECD, 2008; Immervoll and Richardson, 2011; see also Figure 10.2). A number of countries for which internationally comparative data became available recently (the Czech Republic, Slovakia, and Slovenia, as well as Korea) do combine fairly low levels of social expenditure with low relative poverty rates and income inequality. For the Central European countries, part of the explanation might lie in a reliance

![Figure 10.2](image_url)

**Figure 10.2.** Cash public social expenditure (%GDP) and income inequality at working age in OECD countries, late 2000s

*Note:* Gini coefficient of equivalized disposable household income among the population aged 18–65.

*Source:* OECD, 2011 (income inequality); OECD SOCX (social expenditure).
on tax breaks as social policy tools (which are not captured in gross social spending indicators). Moreover, cohabitation in multi-generational households may also play a role (European Commission, 2012b).

The relationship at the country level between the level of cash spending and poverty reduction probably does not simply reflect the direct impact of transfers: high-spending countries typically have other institutional features that contribute, notably high levels of minimum wage protection and strong collective bargaining compressing wages (hence limiting overall inequality), more extensive public and subsidized employment, as well as active labour-market programmes and higher levels of public spending on education. Indeed, the Danish country report identifies a combination of success factors: equal access to education, wage compression in the public sector, progressive incomes taxes, and a comprehensive system of (means-tested) cash transfers. The Italian report, by contrast, argues that a weak state implies not only a lack of effectiveness in redistribution, but also contributes to larger market inequalities ex ante.

Disentangling the effect of these various factors is inherently fraught with difficulties. There may in fact be mechanisms of mutual reinforcement between these factors. Barth and Moene (2009) argue that a more equal wage distribution leads to welfare generosity through a process of political competition. In turn, more income redistribution produces more equality. The authors hypothesize that this ‘equality multiplier’ operates mainly through the bottom of the income distribution: the amplification occurs where wages near the bottom of the distribution are compressed, not where higher incomes are compressed. They find empirical support in their analysis of eighteen OECD countries over the years 1976–2002.

While in theory low or moderate levels of social spending could produce low poverty rates if resources were well-targeted, the reality is that very few advanced economies achieve low (relative) poverty rates, or high levels of redistribution, with low levels of social spending. This raises important questions regarding the efficiency of expenditure.

10.4 Can More Be Done with Less?
On Targeting vs. Universalism

There is a long-standing controversy in welfare-state literature on whether targeting benefits towards the lower part of the income distribution enhances the redistributive impact of social transfers. This issue is of far more than academic importance. In its 2011 report on inequality, the OECD states that ‘redistribution strategies based on government transfers and taxes alone would be neither effective nor financially sustainable’. In this context the
OECD (2011) calls for ‘well-targeted income support policies’ while adding that ‘policies for more and better jobs are more important than ever’. Organizations such as the IMF and the World Bank have long advocated targeted benefits. The issue of targeting will probably gain even more traction in a post-crisis period marked by continued and in some cases increased budget austerity.

The debate on targeting is still marked by opposed views. On one side are those who think that a welfare state can only fight poverty effectively and efficiently (i.e. cost-effectively) when benefits are mainly targeted on those most in need. The straightforward argument here is that selective benefit systems are cheaper, as fewer resources are ‘wasted’ on recipients who are not poor. Lower public expenditures imply lower taxes, which in turn are said to be conducive to economic growth. Economic growth, the argument proceeds, benefits the poor directly (although not necessarily proportionally so) and at the same time increases the fiscal base for redistributive policies.

This view of selectivity has never been commonly shared. Two sorts of argument underpin a more critical stance. First, there are technical considerations. Van Oorschot (2002) sums up the most important dysfunctions associated with means-testing. To begin with, targeting tends to entail substantial administrative costs. Establishing need or other relevant criteria requires monitoring, whereas universal benefits allow for less complex eligibility procedures. Furthermore, the distributional effectiveness of means-tested benefits is hampered by non-take-up, often due to stigmatization issues. Finally, and perhaps most importantly, targeted benefits can give rise to poverty traps, where benefit recipients have little incentive to take up work. In such a case, modest and volatile earnings from work do not outweigh the loss of income replacement benefits that employment entails.

A second line of counter-argument is that proponents of selectivity pursue a ‘mechanical’ economic argument that abstracts from the political processes governing income redistribution. In this view, selective welfare systems garner less widespread public support, resulting in smaller welfare budgets. As a consequence, the redistributive impact of selective systems tends to be smaller. To put it differently, some degree of redistributive ‘inefficiency’ (what is sometimes called the ‘Matthew effect’) is required to foster robust political support for redistribution, including to the most needy. A universal welfare state creates a structural coalition of interests between the least well-off and the politically more powerful middle classes, i.e. the median voter. By contrast, a selective system entails an inherent conflict between the least well-off, by definition the sole recipients of social transfers, and the better-off, who fund the system without the prospect of getting much out of it.
The juxtaposition outlined above forms the starting point for Korpi and Palme’s (1998) highly influential ‘paradox of redistribution’. Their article presents empirical evidence in support of the hypothesis that targeted systems paradoxically redistribute less, simply because they are generally smaller systems.

Some scholars have expressed reservations because of the rather rudimentary character of the research methods in Korpi and Palme’s analysis (Bergh, 2005). The degree of redistribution, for example, is measured by comparing the actually observed degree of income inequality with a rather unsophisticated ‘counterfactual’ distribution. In theory this counterfactual ought to accurately reflect the income distribution that would prevail in the absence of social transfers, taking into account people’s responses in terms of work effort or family formation. However, the construction of this counterfactual is hampered by theoretical and practical problems. In most cases, including Korpi and Palme’s paper, pre-transfer income is simply calculated by deducting observed social transfers and re-adding observed taxes, ignoring any behavioural effects that such a dramatic change would entail. Still, as documented in Chapter 2, the behavioral impact of taxes is not clear-cut.

A further critique has been formulated by Moene and Wallerstein (2003), who have argued that redistribution needs to be analysed at a disaggregated level, rather than ‘the welfare system’ as a whole. The determining redistributive principles may differ substantially for, say, unemployment, healthcare, or pensions. Some schemes may rely heavily on the insurance principle, while others may put more weight on the need principle. From this perspective, universality and selectivity can coexist within one system. Still, Moene and Wallerstein (2001) concur that universal provisions provoke the largest political support, due to higher probabilities for middle class citizens to become beneficiaries. Some opinion-based studies also confirm that universal welfare schemes enjoy broader support (Forma, 1997; Kangas, 1995).

Recent studies, however, claim that the link between redistribution and universal provision has substantially weakened, or even reversed over time. Kenworthy (2011b) reproduces and updates Korpi and Palme’s analyses, which related to the situation in eleven countries as of 1985. Redistribution is measured by the difference between the Gini coefficients with and without tax-transfers relative to pre-transfer income; this corresponds to the difference of the Gini coefficients of market and disposable income relative to that of market income.

Still, as documented in Chapter 2, the behavioral impact of taxes is not clear-cut.
Targeting is captured through a concentration index (see, for example, Kakwani, 1977; Lambert, 2001; OECD, 2008; Whiteford, 2007). This measure takes into account both the size of transfers and the extent to which they benefit different sections of the income distribution. A concentration coefficient equal to the Gini coefficient suggests redistributive neutrality of transfers. Values below Gini indicate that units with the lowest (market) income gain more from the transfers. When the concentration coefficient exceeds the Gini, cash is transferred from the poorer to the richer.

Kenworthy’s replication confirms that countries with more universal benefits achieve more redistribution (measured in the size of redistributive policies in the budget) between 1980 and 1990. By 1995, the image becomes less clear. Data for 2000 and 2005 indicate that there is no longer any association (either positive or negative) between the two variables. Evidently, the findings are based on a small number of cases, which make them particularly sensitive to outliers. A trend towards more targeting in Denmark, in conjunction with an evolution towards more universal benefits in the USA, is largely responsible for the shift in conclusions. Moreover, the new findings may be driven to some extent by the growing share of pensions in social spending. Kenworthy (2011b: 58) writes, ‘This by no means settles the question, but it does suggest additional reason to rethink the notion that targeting is an impediment to effective redistribution.’

Marx, Salanauskaite, and Verbist (2013) consider additional evidence, including a larger set of countries, alternative data sources, and different methodological specifications. Figure 10.3a, taken from this study, supports the thesis of a weakened—even non-existent—relationship between targeting and redistribution.

The term ‘targeting’ may suggest that these outcomes are due solely to characteristics of the system. However, the distribution of benefits also depends on the traits of the underlying population, including socio-demographic structure, income inequality, and composition of income. Assume, for instance, a benefit that is designed in such a way that only children are eligible. If all children are situated in the bottom quintile, this policy may appear as targeted towards low incomes, even though its design did not include any means-testing or needs-based criteria. Strictly speaking, one should not derive policy intent from the concentration coefficient.

Figure 10.3 indicates that transfers are concentrated most strongly among low-income households in Australia, the United Kingdom, and Denmark. Yet, the redistributive impact of the transfers differs quite substantially across these countries, being strongest in Denmark. Moderate concentration coefficients (−0.2 to 0) can be observed in highly redistributive systems (Sweden and Finland), as well as in states that reduce inequality to a very limited extent (the USA, Canada, Israel, and Switzerland). For countries with positive
targeting coefficients the relationship tends to be negative, especially in the countries with the weakest pro-poor spending (Greece, Spain, and Italy). In the latter, the concentration coefficient shows segmentation between ‘insiders’ who are fairly well-protected and ‘outsiders’ receiving little or no financial support.
Why does a similar degree of targeting, as captured by the concentration index, produce stronger redistributive outcomes in Denmark as compared to the UK and Australia? Similarly, why do similar (quasi)-universal systems yield such different redistributive outcomes across countries? The pattern suggests that design features matter a great deal. It is notable that the relationship between the extent of targeting and the size of the system remains strong. There are exceptions: Denmark combines a strong degree of targeting with a high level of social spending.

The strongest redistributive impact is achieved by countries that combine moderate (Sweden and Finland) to strong (Denmark) targeting with comparatively high levels of spending. This suggests that the most redistributive systems are characterized by what is called ‘targeting within universalism’—that is to say, systems in which many people receive benefits but where the poorest get relatively more. Other studies yield similar results. Corak, Lietz, and Sutherland (2005), for example, find that universal child-related benefits that also have some degree of targeting at the poorest protect best against income poverty. Their conclusion is echoed by Van Mechelen and Bradshaw (2013) for child benefits for working families, while similar patterns have been found for social assistance benefits (Van Mechelen and Marchal, 2013).

Why then did the strong relationship between targeting and spending weaken over time, as documented by Kenworthy (2011b)? Arguably, strong work disincentives and (perceived) family formation incentives reduced political support for means-tested systems, which made them vulnerable to cuts. The last decades have seen an intensified attention to such incentives.
To address these concerns, earnings disregards have been introduced for recipients who make a (partial) transition from complete benefit dependency to part-time work.

As a result, means-tested benefits are no longer aimed exclusively at people who are not in employment. The French RSA (Revenu de Solidarité Active) scheme is a good example of a new-style means-tested benefit scheme that offers integrated support for the non-employed and (part-time) low-paid workers alike. The RSA was introduced in France in 2008 with the specific aim of remodelling the incentive structure for social assistance beneficiaries, and particularly to make work or returning to education a more lucrative financial prospect. The previous minimum income system (Minimum Integration Income—RMI) was based on a one-for-one trade-off of benefit for earned income. Under RSA a 62% slope (taper) is applied. Additional, non-monetary efforts have been made to encourage beneficiaries of RSA into employment, for example through assisted employment contracts and (improved) insertion mechanisms. In addition, the RSA has simplified the provision of social protection by combining several previously separate schemes into a single sum. A household with no earned income is eligible for the ‘basic RSA’, which is defined at the household level and takes into account the composition of the household. The ‘in-work RSA’ acts as a top-up for households with low earnings.

This demonstrates that targeted, means-tested systems look very different today from those present in the 1980s. Whereas the old systems were the focus of harsh welfare critiques, especially from the political right, the new targeted systems are lauded as the essential gateways from welfare to work. In the United States, the Earned Income Tax Credit—a transfer programme for households on low earnings—has become the country’s pre-eminent welfare programme (Kenworthy, 2011b). The system appears to enjoy far broader and more robust political support than earlier American anti-poverty programmes. The system also is less strongly targeted than earlier provisions and it caters to larger sections of the electorate, including the (lower) middle class, and this may account for that expansion. But an equally if not more important factor may well be that the system is perceived to encourage and reward work.

10.5 Are Effective Income Protection Arrangements Affordable and Feasible?

Much comparative poverty research that has sought to link observed variation in income inequality and poverty across countries to policy has relied on government (social) spending statistics as indicators of policy ‘effort’. As we have seen, the relationship across countries between the level of social
spending as a percentage of GDP, or some related indicator, and observed inequality or poverty levels is in fact by and large a rather strong one. This is in a way surprising because the level of spending mirrors as much the number of people receiving benefits as the level, and thus potential adequacy, of those benefits. A high level of spending may be achieved by providing very generous benefits to a limited section of the population, while it may also be the result of small benefits to a large number of people.

Likewise, measured outcomes, for example pre- versus post-transfer differences in inequality or poverty, also depend on a host of factors that are independent or only indirectly influenced by policy: contextual and compositional factors, including labour-market conditions (unemployment, employment patterns, wages), household composition (patterns of cohabitation, marriage, divorce, childbirth, etc.), and policies that influence these dynamics (education, ALMPs, childcare, etc.).

If we want to understand variations in outcomes, we need more sophisticated and accurate measures of policy effort and policy design than spending indicators. So-called institutional indicators aim to be directly reflective of policy intent and design. In this section we will focus solely on institutional indicators of minimum income protection. Such a focus is necessary because the design features of tax and benefits systems, and especially the way various programmes interact in specific situations, tend to be so complex that they are not accurately and validly captured in a limited number of parameters that allow for valid cross-country comparisons. Entitlements to social insurance benefits are particularly difficult to simulate because these depend on past wages, employment histories and contribution records.

A further reason to focus on minimum income protection provisions is that adequate protection against severe financial poverty is arguably the first duty of the welfare state. It is also an explicitly stated priority of redistributive and policy efforts in many countries, and at the EU level where a poverty reduction target is part of the Europe 2020 strategy. Additionally, minimum income protection provisions mark the floor for other income maintenance provisions; minimum social insurance levels and minimum wages are almost always above the level of the social safety net. In that sense, indicators of minimum income protection also tell us something about the generosity of other income maintenance provisions.

In this section we draw on the CSB Minimum Income Protection Indicators (MIPI) dataset (Van Mechelen et al., 2011). In this dataset net income packages are calculated using the so-called model-family approach, where the income package of households in various situations (varying by household composition and income levels) is simulated, taking into account all relevant benefits for which such households are eligible as well as taxes. While
providing valuable information about what policies are aiming to achieve in terms of the scope and level of income protection, it is worth pointing out that such institutional indicators have their limits. They are calculated for a limited number of family types and situations. The assumption is that there is full take-up of benefits and that people effectively and immediately receive what they are entitled to. In the case of minimum wages, the assumption is that these are fully enforced. However, this is not always the case, and this is one reason why the observed relationship between generosity levels as reflected in these indicators and outcomes is relatively weak (Nelson, 2012).

The importance of adequate social safety nets really hit home when an economic downturn of a magnitude unseen in decades struck after 2007. Despite some differences between individual countries, unemployment levels generally surged, causing dramatically increased demands for income protection. The impact of the crisis has been quite varied in Europe, not only in terms of its immediate effect on employment and wages, but also in terms of its impact on household living standards. As Jenkins et al. (2013) write, ‘Although GDP fell during the Great Recession, the real disposable income of households, as measured in national accounts by Gross Household Disposable Income (GHDI), actually rose between 2007 and 2009 in 12 countries of the 18 for which we have data (there was no change for Ireland, despite the large fall in GDP). The household sector was protected from the impact of the downturn by both automatic stabilisers and additional support of governments through the tax and benefit system.’ A host of new research papers document the role of tax and transfer systems, as well as labour-market institutions, in cushioning households from the recession (e.g. Dolls, Fuest, and Peichl, 2011, 2012; Figari, Salvatore, and Sutherland, 2011). The GINI country reports provide further illustration. Finland and Sweden (in the early 1990s) and the United States (during the Great Recession) emphasize the initial stabilizing role of cash income distribution, but also its political and fiscal challenges in the aftermath.

Safety nets have particularly important roles as the final barrier against severe poverty and the disruptive consequences thereof, including the potential impact on children, their development, and opportunities for education. Given the surge in non-standard work in the years before the crisis, minimum income schemes may have gained in relative importance (Immervoll, 2012).

Van Mechelen and Marchal (2013) analyse patterns and trends in the level of minimum income protection for able-bodied citizens in European countries. The chief focus is on means-tested benefits providing minimum income protection, usually in the form of social assistance. These general means-tested benefits provide cash benefits for all or almost all people below a specified minimum income level. In some countries separate schemes exist
for such groups as newly arrived migrants or the disabled. The study shows that the minimum income benefit packages for the able-bodied at working age have become increasingly inadequate in providing income levels sufficient to raise households above the EU at-risk-of poverty rate, defined as 60% of median equivalent income in each country (Figure 10.4). The overall tendency for the 1990s was one of almost uniform erosion of benefit levels, relative to the development of wages. This downward trend in the relative income position of families in receipt of social assistance changes somewhat in the 2000s, when the erosion of the level of benefit packages came to a halt in a number of countries. In the first years of the crisis a small number of countries took extra steps to increase protection levels (Marchal, Marx, and Van Mechelen, 2011). Despite a number of positive developments, net incomes of minimum income recipients continue to fall well short of the EU’s at-risk-of-poverty threshold in all but a few EU countries (Figure 10.4). The size of the gap between the level of the social safety net and the poverty threshold varies across countries and family types, but it is generally quite substantial.

This poses the question: why are social safety nets not more (potentially) adequate? Let us briefly consider two potential impediments: first, ‘adequate

![Figure 10.4](Image). The adequacy of minimum income protection packages for people at working age not in work, 2012, EU plus Norway and three US states

*Note*: In some countries, such as the USA, Italy, and Bulgaria, time limits apply, either formal or discretionary. In order to avoid additional assumptions, the levels displayed do not take these time limits into account. Where minimum income protection is a regional or local responsibility, levels refer to the situation in a large city or region (for Spain: Catalonia; for Italy: Milan; for Norway: Oslo; for Sweden: Stockholm). Poverty thresholds as available on Eurostat, 2011, referring to income 2010 (exception: Ireland: 2011 not yet published).

social safety nets are not affordable’, and second, ‘adequate social safety nets undermine the work ethic and people’s willingness to work’.

Are adequate social safety nets too costly? Final safety net provisions (social assistance schemes) generally constitute only a fraction of total social transfer spending (the bulk of outlays going to pensions, unemployment and disability insurance, child benefits, and other benefits). Vandenbroucke et al. (2013) have made tentative calculations of the redistributive effort required to lift all equivalent household incomes to the 60% of median level. In most European countries, this expenditure amounts to less than 5% of the aggregate equivalent household income that is above the 60% threshold. Nowhere is it higher than 9%. The countries that would have to make a relatively large effort are Southern and Eastern member states. Such a mechanical calculation ignores incentive effects and behavioural change (more poor people may prefer social assistance to low-paid jobs; the non-poor may reduce their work effort). The real cost of such an operation is probably higher than the mechanical effect, and the calculation may be seen as indicating a lower boundary for the distributive effort that is required. Still, the calculation also illustrates that the cost of an adequate social safety net is not necessarily outside of the realm of the conceivable.

Are adequate social safety nets compatible with work incentives? Despite recurring concerns over the potential work disincentive effects of social safety nets, empirical studies tell a more nuanced story (Immervoll, 2012; Marchal and Van Mechelen, 2013). The income gap between the situation of full-time dependence on minimum income benefits and a full-time job at the minimum wage (or the lowest prevailing wage) is in fact quite substantial in most European countries, especially for single persons. In some countries and under certain circumstances, particular groups, such as lone parents with young children, gain relatively little from moving into a low-paid job, especially when childcare costs are accounted for. Partial transitions into work—moving to a small part-time job—also do not pay in certain circumstances. But generally speaking, long-term dependence on social assistance benefits is not an attractive financial situation relative to a full-time minimum-wage job in most of Europe. The hypothetical Europe-wide introduction of social assistance minimum levels equal to 60% of median income would, however, create a financial inactivity trap in many countries, as is brought out by Vandenbroucke et al. (2013) and Marchal and Van Mechelen (2013). In countries such as Bulgaria, Estonia, Slovenia, and Lithuania, the net income of a single benefit recipient would be between 25% and 30% higher than the equivalent income of a single person working at minimum wage; in Spain and the Czech Republic, the relative advantage of the benefit claimant would amount to around 15%. This implies that if such countries wished to
move towards better final safety net provisions then minimum income floors would have to be raised at least in step.

This would require quite substantial increases in minimum wages, or in effective wage floors. In 2013, twenty member states of the European Union have a national minimum wage, set by government, often in cooperation with or on the advice of the social partners, or by the social partners themselves in a national agreement. In addition, a host of other labour-market institutions have an impact on effective wage floors (Lucifora and Salverda, 2009). The Nordic countries, for example, do not have statutory national minimum wages, but wage setting is highly institutionalized and coordinated, resulting in comparatively low levels of overall wage inequality, especially at the bottom end of the distribution. Governments can have an important indirect impact on wage inequality by making wages set through collective bargaining generally binding (OECD, 2004).

As is illustrated in Figure 10.5, presenting data for 2010, only for single persons and only in a number of countries do net income packages at minimum wage level (taking into account taxes and individual social security contributions, but also social benefits) reach or exceed the EU’s at-risk-of-poverty threshold, set at 60% of median equivalent household income in each

![Figure 10.5. Gross minimum wages and net incomes at minimum wage as a percentage of the relative poverty threshold, 2012, selected EU member states plus three US states.](image)

*Legend:* MW: minimum wage; C2C: couple with two children; NDI: net disposable income.


country. For lone parents and sole breadwinners with a partner and children to support, net income packages at minimum wage are below this threshold almost everywhere, usually by a wide margin. This is the case despite shifts over the past decade towards tax relief and additional income support provisions for low-paid workers (Marx, Marchal, and Nolan, 2013).

When it comes to the question of whether and to what level minimum wages and hence minimum income benefits in general could be increased, opinions clearly diverge. The debate over whether minimum wages destroy jobs, or stifle job growth, is as old as the minimum wage itself. A wealth of empirical evidence has been amassed by labour economists and it seems fair to state that the measured effects of actual changes (rather than the hypothetical increases needed to ensure poverty relief effectiveness among workers) have sometimes been positive, sometimes negative, sometimes neutral, but never very large (Dolado et al., 1996, 2000; Freeman, 1996; OECD, 1998, 2004; Kenworthy, 2004). As the OECD’s Martin and Immervoll (2007) state, ‘On balance, the evidence shows that an appropriately-set minimum wage need not have large negative effects on job prospects, especially if wage floors are properly differentiated (e.g. lower rates for young workers) and non-wage labour costs are kept in check.’

Concerns about work disincentive effects of social safety nets are legitimate, as are concerns over potential negative employment effects of minimum wages, especially if these were to be set at levels high enough to keep households solely reliant on that wage out of poverty. The fact remains, however, that countries like Denmark or the Netherlands combine what are comparatively among the highest levels of minimum protection for workers and non-workers alike with labour-market outcomes that on various dimensions are also among the best in the industrialized world.

Elaborate active labour-market policies, specifically activation efforts directed at social assistance recipients, coupled with intensive monitoring and sanctioning of non-compliance, appear to play a key role here. The strength of overall labour demand may also be a key contextual factor for such associated policies and practices to effectively result in low levels of long-term dependence. Moreover, in terms of quality of employment, Denmark and the Netherlands are clearly among the best performers in Europe (European Commission, 2008; Leschke et al., 2012), with relatively few workers in low-quality jobs (Eurofound, 2012). Replicating the activation, empowerment, and sanctioning aspects associated with comparatively generous systems may well be difficult enough in itself. Replicating a context where job growth is strong and where jobs are sufficiently rewarding and attractive may be even more difficult. It that sense we may not want to be overly optimistic about the possibilities of introducing similarly generous minimum income protection provisions in other settings.
10.6 Do We Need New Redistributive Mechanisms?

It is increasingly argued that more effective redistribution will not come from augmenting/expanding the traditional channels of income support, for example more generous social insurance or social assistance levels, or from higher minimum wages. These are seen not only as failing to address today’s social risks and needs, but as exacerbating underlying problems such as exclusion from the labour market and entrapment in passive benefit dependency. They are considered by some as standing in the way of innovative mechanisms of social protection that are proactive and self-sufficiency-enhancing, such as active labour-market policies and services such as childcare and improved education and training.

Therefore, the option is to consider other forms of (targeted) income supplements for households that provide some level of income protection but that are also conducive to labour-market participation. Kenworthy (2011b: 44) observes, ‘Given the importance of employment and working hours for the market incomes of low-end households, policy makers must guard against programs that provide attractive benefits without encouraging or requiring employment. An ideal transfer would be one that both boosts the incomes of low-earning households and promotes employment by able working-aged adults. As it happens such a program exists. Referred to variously as “in-work benefit” or “employment-conditional earnings subsidy”, it is best exemplified by the Working Tax Credit (WTC) in the United Kingdom and the Earned Income Tax Credit (EITC) in the United States.’

Under these schemes households with low earnings do not pay taxes but instead they receive additional money through the tax system. In the United States, the 1993 expansion of the Earned Income Tax Credit (EITC) turned it into the country’s pre-eminent anti-poverty programme for families of working age. The United Kingdom has also implemented and extended several schemes (and in fact did so earlier than the USA), now to be integrated with other means-tested benefits into Universal Credit. Clearly, Anglo-Saxon-style negative income taxes have been garnering increased interest of late. Immervoll and Pearson (2009: 16) remark, ‘Even in the mid-1990s, twenty years after such schemes were first introduced in the United Kingdom and the United States, they were being seen as interesting but unusual schemes…it seems reasonable to conclude that IWB schemes are now mainstream policies in many countries.’

That is perhaps somewhat of an overstatement. Several European countries have contemplated introducing Anglo-Saxon-style tax credits, or have done so in some form. Yet the reality is that most of these schemes exhibit only a
faint resemblance to the American EITC or the British WTC. Sweden has a scheme that goes by the same name in English as its American counterpart the EITC. It was introduced in 2007, and subsequently reinforced. The stated motive of the reform was to boost employment; in particular, to provide incentives for individuals to go from unemployment to, at least, part-time work. The Swedish scheme is different from the American scheme in that it is a non-refundable tax credit. Also, because the tax unit in Sweden is the individual and not the household, it works in effect as tax relief on low individual earnings. In that respect it is similar to measures elsewhere in Europe that target low-paid workers rather than low-earnings households.

Interest in EITC-type schemes remains strong, however, in the public debate and in the academic literature (Marx and Verbist, 2008; Kenworthy, 2011b; Figari, 2011; Allègre and Jaerhling, 2011; Crettaz, 2011; Marx, Vanhille, and Verbist, 2012). That interest seems entirely legitimate. The empirical evidence shows the American EITC, in combination with other policy reforms and several increases in the minimum wage, to have produced some significant results, including marked increases in labour-market participation and improvements in living standards among some segments of the population, especially single-parent households (Hotz and Scholz, 2003; Eissa and Hoynes, 2004). It needs to be noted, however, that these initial results happened in favourable economic circumstances, including strong labour demand and low unemployment. The relatively strong increases in labour supply of lone mothers in the American setting also resulted from welfare reform, notably the transformation of the social assistance scheme into a temporary support system with time limits on the duration of benefits. This clearly provided a strong push incentive, with the EITC acting as pull incentive. Not all who were forced out of passive dependence found their way to work (Grogger, 2003, 2004).

There are potential downsides to subsidizing low-paid work. While the EITC is intended to encourage work, EITC-induced increases in labour supply may drive wages down, shifting the intended transfer towards employers. Rothstein (2010) simulates the economic incidence of the EITC under a range of supply and demand elasticities and finds that in all scenarios a substantial portion of the intended transfer to low-income single mothers is captured by employers through reduced wages. The transfer to employers is borne in part by low-skill workers who are not themselves eligible for the EITC. There is some empirical evidence that corroborates the potential wage erosion effect of the EITC (Leigh, 2010; Chetty et al, 2013).

Yet whether EITC-type schemes can work elsewhere, as Kenworthy (2011b) and others suggest, is not self-evident. The socio-demographic make-up of the USA differs from that of most European countries; there are more single-parent households in the USA than in many European countries.
The dispersion in earnings is also much more compressed in most European countries, where, in addition, benefits are generally higher relative to wages (including minimum wages) and less subject to means-testing if they derive from social insurance. This also implies that benefit entitlements of household members are less interdependent, possibly weakening the potential impact on labour supply. Many countries have individual taxation, and the trend is away from joint taxation of couples.

In order to be effective as an anti-poverty device and at the same time affordable within reasonable limits, such measures need to be strongly targeted. However, strong targeting at households with low earnings is bound to create mobility traps, which can only be avoided if tapering-off rates are sufficiently flat. That comes at a very considerable cost if the lower end of the household earnings distribution is densely populated, as is the case in many European countries. This cost can only be avoided by making the amount of the tax credit itself smaller, but in that case the anti-poverty effect is reduced. Simulations in a wide range of European countries cast doubt on the applicability of EITC-type systems in other settings. In an earlier study, Bargain and Orsini (2007) investigated the effects on poverty of the hypothetical introduction of the British scheme (as it was in place in 1998) in Germany, France, and Finland, using EUROMOD for 2001. They found that the anti-poverty effects of a UK-type tax credit (similar in design and relative overall spending) would be very small in these countries, especially relative to the budgetary cost. For Belgium, the hypothetical introduction of the UK’s WTC is shown to yield a limited reduction in poverty at the cost of possible weakened work incentives for second earners (Marx, Vanhille, and Verbist, 2012). Figari (2011), simulating application in Italy, Spain, Portugal, and Greece, notes that the presence of extended families in Southern Europe does not allow for such policies to be well targeted at the very poorest. Bargain and Orsini (2007) have concluded that ‘interest in such schemes is destined to fade away’. Whether that is true remains uncertain and indeed doubtful, but EITC-type tax credits are not obviously suitable for wholesale emulation throughout continental Europe. In Germany, for example, the labour market has undergone some profound changes over the past decade. Low-paid employment has become far more prevalent and in-work poverty seems to have increased. It is not unlikely that a simulation like the one performed by Bargain and Orsini on 2001 data would yield different results today.

Clearly, simulations demonstrate that in-work benefit schemes that work well in certain settings do not necessarily perform equally well in a different context. Family composition, individual earnings distributions, and family income structures drive outcomes in a very substantial way. It remains to be explored whether alternative designs are conceivable that have better outcomes in continental European settings and that are realistically affordable.
10.7 Should Benefits Come With Strings Attached?

Making cash benefits conditional on certain behavioural requirements is a policy strategy that has gained prominence in many developing countries and that is also gaining increased attention in the developed world. The European Commission, for example, is calling on EU member states to pursue ‘simple, targeted, and conditional’ social investment policies (European Commission, 2013).

In the developing world such conditional cash transfers (CCTs) are increasingly used to promote human-capital accumulation or preventive healthcare for children (school enrolment, regular attendance, regular medical examinations, vaccinations). Some programmes in particular, such as Progresa in Mexico or Bolsa Escola in Brazil, have garnered much attention and debate. Organizations such as the World Bank have taken a leading and influential role in promoting and evaluating CCTs. In OECD countries, conditional cash transfers are mainly used within the context of labour-market policy (activation measures, job-search requirements). More rarely, yet increasingly, developed countries apply conditional cash benefits to human-capital accumulation for children.

Conditional cash transfer programmes have been subject to evaluations of effectiveness using experimental or quasi-experimental methods. Several meta-reviews are available. Rawlings and Rubio (2005) argue that evaluation results ‘reveal successes in addressing many of the failures in delivering social assistance, such as weak poverty targeting, disincentive effects, and limited welfare impacts’. They argue that there is clear evidence of success from the first generation of programmes in such countries as Colombia, Mexico, and Nicaragua in increasing enrolment rates, improving preventive healthcare, and raising household consumption. However, it remains less clear whether programmes that work well in one setting are transposable to other settings with equal results—contextual factors seem to matter in determining outcomes. It is also clear that CCTs have their limits in terms of addressing the broader range of challenges facing poor and vulnerable populations, and in preventing the intergenerational transmission of poverty.

Conditional cash transfers are part of a new line of thinking in social policy that seeks to understand and remedy the economic and psychological complexities in the lives of poor people, informed by social experiments and field observations. Banerjee and Duflo (2011) are its most prominent advocates. In a self-proclaimed effort to find a ‘new way of doing economics’, they focus very strongly on micro-level interventions. Their preferred policies entail small reforms at the margin, also informed by experiments—specifically randomized control trials (RCTs).
In a strong critique of such RCTs, Ravallion (2012) notes, ‘[T]he question of why the intervention did or did not have impact in that population remains most often open. Nor is it clear whether the intervention would have similar impacts in some other population.’ The issue of potential limits to upscaling initiatives that work well in controlled experimental or quasi-experimental settings seems especially pertinent, particularly since RCTs only control for unobserved variables within the setting of the experiment, not for the unobserved factors beyond that setting.

Perhaps Ravallion’s most trenchant critique concerns the fact that, almost by implication of their approach, Duflo and Banerjee only focus on small-scale policy aspects. These can probably only go some way to explaining why some countries have been far more successful than others in combating poverty and promoting higher levels of education and development among their populations. Pointing to the contrast between India and China, Ravallion writes, ‘Along with many developing countries, China’s leaders came to realise (in the late 1970s) that their reform agenda had to be based on evidence…but while China’s reformers were selective and cautious, there was nothing “small” about their reforms.’

This is very much in tune with what comes out of comparative poverty research, namely that macro-variables, such as sheer social spending levels, are strongly correlated with poverty outcomes, even though these may be partially driven or reinforced by other (macro-)correlates such as wage bargaining structures and spending on other items than social programmes.

Focusing on OECD countries, Medgyesi and Temesváry (2013) review the results of conditional cash transfer programmes to promote human capital accumulation. The authors reviews evidence concerning the impact of such programmes on human capital investments (enrolment, absenteeism from school, participation at health exams). They differentiate between ‘scholarship-type’ benefits, which entail education-specific benefits, and ‘sanction-type’ programmes, where non-compliance with regulations (e.g. truancy) implies (the threat of) discontinued benefit provision. For many of the interventions under consideration, impact assessments show statistically significant (positive) effects with regard to health and educational outcomes. To some extent, this finding echoes those in developing countries. Similarly, quite a few assessments in Medgyesi and Temesváry’s review show mixed results, and a number of important questions remain. First, the effect of the interventions tends to vary, with some groups (for instance, girls) more responsive than others. Second, there remains uncertainty regarding the long-term effects of the interventions. Under certain conditions, granting conditional rewards might even be harmful, crowding out intrinsic motivation. Third, there is no conclusive answer as to which interventions are more effective: programmes that apply positive or negative sanctions, focusing on
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performance or input. The exact design of the schemes varies substantially and appears to matter a great deal for the observed outcomes.

A crucial question regarding conditional cash transfers, then, is whether the effect of the interventions justifies their (administration) cost, and whether more beneficial outcomes could be obtained by other means, for instance investing in quality of service provision. These methods need not be mutually exclusive, and combining conditional transfers with improvements in service provision may yield better outcomes in terms of poverty reduction (as pointed out by Bastagli (2011), based on a literature review for Latin America). It should be clear, however, that conditionality of cash transfers cannot by itself be a ‘silver bullet’ or an adequate substitute for social provisions.

10.8 Conclusion

For all the rhetoric of permanent austerity, social spending has trended upwards rather than downwards over the previous three decades in the majority of industrialized countries. In most countries, cash benefits continue to represent the lion’s share of this expenditure, driven to a large extent by ‘automatic’ factors such as growing market inequality and population ageing (the latter also having an impact on a secular trend of rising healthcare expenditure). Across countries, there remains a negative and strong association between (active age) social expenditure and measures of income inequality. However, the redistributive strength of tax-benefit systems appears to have weakened in many countries over the past two decades. While growing market-income disparities were the main driver of inequality trends between the mid-1980s and mid-1990s, reduced redistribution was often the main reason why inequality rose in the ten years that followed.

The underlying causes of the rises in market income inequality are complex and there is also considerable variation across countries in the relative importance of various drivers. Yet it is striking that one major potentially compensatory trend—the rise in labour-market participation levels—did little to dampen income inequality or to reduce relative income poverty, as the next chapter will set out in more detail. This points to the key importance of adequate direct income support provisions for workers and non-workers alike. The crisis has certainly also added urgency to the issue of minimum income protection adequacy.

Minimally sufficient levels of minimum income protection are in theory not necessarily prohibitively expensive; in most countries additional redistribution equivalent to a couple of percentage points of GDP would suffice to eradicate relative income poverty altogether. Yet very few countries actually
have social safety nets that are high and wide enough to provide effective protection against poverty. The main barrier to adequacy is not first-round cost. Far more problematic is the fact that the hypothetical introduction of an income support floor equal to 60% of median income would create serious financial inactivity traps in many countries, simply because this floor would then exceed the minimum wage or the effective wage floor. Such inactivity disincentives could also be overcome by increasing minimum wage floors quite considerably. This is not self-evident as an option, however, especially in the short run, and particularly when unemployment is high. Countries that have relatively adequate social safety nets and that manage to keep chronic dependency levels low at the same time also have elaborate active labour-market policies, counselling, and other accompanying services attached to minimum income provisions. There is also intensive and continuous monitoring of recipients and sanctioning in case of noncompliance. Such accompanying policies are not only costly, but they also require considerable administrative capacity and expertise.

Increasingly, the search is for new forms of (targeted) income supplements for households that provide some level of minimum income protection but that are also conducive to labour-market participation. Ideally such transfers boost the incomes of low-earning households and promote employment by able working-age adults at the same time. Employment-conditional earnings subsidies as exemplified by the Earned Income Tax Credit (EITC) in the United States are seen by some as the way to go in redistributing income to households at working age. This may be the case, but programmes that work well in one setting do not necessarily work well in other settings in the same shape and form. Further analysis is needed to see if and in what modified form such systems are implementable and potentially effective elsewhere. This similarly applies to conditional cash transfers, the effect of which appears to depend to a large extent on the broader context in which they are deployed.

Finally, all the evidence suggests that adequate poverty relief requires more than well-targeted minimum income provisions in the form of generous social safety nets and/or negative income taxes and the like. It requires substantial social spending channelled through various programmes. New evidence sheds doubt on the now widely accepted social policy tenet that ‘systems for the poor become poor systems’. Korpi and Palme’s influential claim that ‘the more we target benefits at the poor, the less likely we are to reduce poverty and inequality’ no longer holds as a robust empirical generalization. Transfer systems that cater disproportionately for the poor are generally associated with higher levels of redistribution, if overall spending is high enough. The reality remains that the countries with the most redistributive systems combine a relatively strong
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level of targeting with a relatively high level of effort spending. In other words, ‘targeting within universalism’ appears to yield the best results if the aim is to maximize redistributive effect. This said, in current social policy discourses the status of systems for direct income redistribution has become somewhat unclear. While the general tendency is to acknowledge the continuing importance of traditional social security and social assistance arrangements, more direct redistribution is not generally seen as the way forward in countering (growing) inequalities at the market income level. Instead, employment and social-investment-based policies are seen as offering more structural, sustainable, and affordable responses. These are the focus of the next chapter.