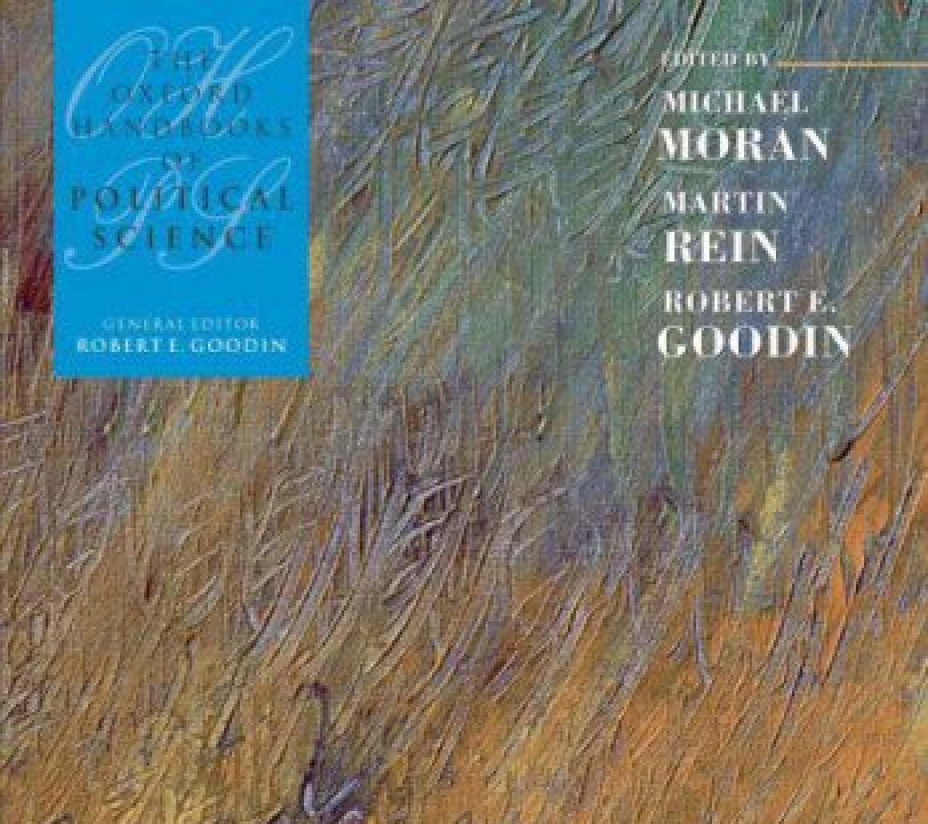

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CHAPTER 30

DISTRIBUTIVE AND REDISTRIBUTIVE POLICY

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1. Introduction

Whenever a government pursues a course of action towards a specific goal, there will inevitably be winners and losers, even if these distributional effects are unintended. In this broadest sense, virtually all government policy can be termed redistributive (Tullock 1997). But for the purposes of this chapter, the focus is on social and welfare[1] policies, where the redistributive motive is most prominent (Hills 2004). Most of the literature in this area is concerned with taxation and spending on cash transfers or in-kind services, though "legal welfare," such as minimum wage legislation, can also have significant distributional effects.

Social and welfare policies are often assessed as if their only purpose were to redistribute from rich to poor. If so, the effectiveness of welfare systems as a whole could be assessed by looking at their impact on overall inequality and poverty. Similarly, in assessing a particular policy or program, the crucial question would be which income groups benefit most. In common with most of the literature on redistributive policy, this chapter is largely concerned with these two types of question.

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[1] The word "welfare" is used here in the broader sense of social welfare policies, including cash and in kind transfers from government, not just in the narrower sense often applied in the USA referring only to assistance for certain poor groups. Similarly "social security" refers to all cash transfer programs, not just those for the elderly.

However, it is also important to recognize that redistribution from rich to poor is only one of several dimensions along which redistribution may occur and furthermore, that policies with redistributive effects may have dominant objectives other than redistribution. These issues are discussed briefly in the next section along with some of the implications for the analysis of redistributive policy.

In understanding empirical analysis of the redistributive effects of policy, it is also important to realize that this will entail an (often implicit) comparison with a counterfactual world where the policy was not applied. The use of different counterfactuals will change the results. One important aspect of this is that if one is looking at the impact of government spending, one usually has to ask which taxes would be lower in its absence. The answer may be crucial, but not obvious. But beyond this, many other aspects of behaviour may change too: without social insurance systems covering health care, individuals would make more use of private health insurance, with many knock-on effects through the economy. What economists call the "final incidence" of a tax or spending item is very difficult to measure, but cannot be assumed simply to equal the "first round" measurement of who administratively is the recipient or liable (Pechman and Okner 1974).

2. Alternative Forms of Redistribution

Low incomes are not the only reason for receiving cash benefits or services in kind. Many welfare policies provide insurance against adverse risks, such as unemployment or ill health, and provide a mechanism for smoothing income over the life cycle—what Barr (2001) refers to as the "Piggy Bank" function. This has received relatively little attention in the literature compared with the "Robin Hood" function (i.e. redistribution from rich to poor), but is arguably as, if not more important. Barry (1990) argues that whilst there is no reason for expecting the welfare state to have a single rationale, if it is to be identified with one objective, it is that of income *maintenance* rather than the relief of poverty.

This has several implications for analysis of redistributive policy. First, a snapshot picture of redistribution can be misleading. Education goes disproportionately on the young, health care and pensions on the old, while the taxes that finance them come mostly from the working generation. Much of the redistribution that appears to be taking place at a given point in time will be canceled out over people's lifetimes. According to Hills and Falkingham (1995), between two-thirds and three-quarters of welfare state spending in the UK in the 1980s and 1990s was life-cycle redistribution—redistribution of individuals' own lifetime incomes across different stages in their own lives, as opposed to redistribution between the "lifetime rich" and "lifetime poor."

Secondly, it may not always be appropriate to judge a particular benefit or service according to whether it benefits the poor more than the rich. Many public health care systems, whether social insurance based or tax funded, seek to provide equal treatment for equal need: as such, they are primarily designed to achieve horizontal redistribution between people with similar incomes, but different medical needs, as opposed to vertical redistribution between people with different incomes, but similar medical needs. Similarly, certain social welfare policies are designed to provide for the extra needs of families with children, to meet the additional costs incurred by disabled people, or to help counter the effect of other forms of disadvantage relating to age or race, for example. The key distributional question in these cases is whether the benefits people receive match their respective needs, irrespective of whether they are rich or poor—or possibly whether they compound disadvantage. Studies of the distributional effects of programs or policies may therefore emphasize the impact on different ethnic groups, age and/or gender groups, geographic areas, or some other relevant breakdown of the population, rather than, or as well as the impact on different income groups (Danziger and Portney 1988).

Nonetheless, even policies that are not primarily designed to redistribute from rich to poor can have a significant redistributional impact for a variety of reasons. Lower socioeconomic groups generally face a greater risk of experiencing the adverse events that social insurance schemes are designed to protect them against: they are more likely to experience extended spells of unemployment, to suffer ill health, or to be injured at work (Burchardt and Hills 1996; Ferrarini and Nelson 2003). Thus, even if all citizens were to participate in these schemes on equal terms (though as we see later on, social insurance schemes and universal public services almost invariably incorporate progressive elements), they would still involve redistribution from higher- to lower-income groups.

Furthermore, poverty alleviation is a *byproduct* of a "well-ordered" welfare state, even if that is not the primary objective of most of the individual policies that make up that system (Barry 1990). In a welfare state that provides a continuing income (above the poverty line) for the unemployed, the sick or disabled, and the retired; that provides an income for those not expected to work because they are looking after young children or adults who need constant care; that offers a universal child benefit set at a level sufficient to meet the costs of raising children; and that covers special expenses associated with personal misfortune, almost all the job of relieving poverty will be done by policies whose rationale is in fact quite different.

Thus, at the very least, redistribution from rich to poor is an important side effect or secondary objective of many social and welfare policies and collectively, they should ideally ensure that poverty is kept to a minimum, even if that is not their primary motivation. On this basis, it is often important to assess such policies in terms of their redistributive impact.

3. Other Aims

Two further points should be borne in mind in reading this chapter. First, redistribution is not only about redistributing incomes, but also about redistributing opportunities: access to better education, better job opportunities, and better health that may lead to greater equality in incomes in the long term, as well as being an end in themselves. The appropriate balance between more traditional tax-transfer forms of redistribution and what has been variously termed an "equal opportunity" or "active" welfare state has been the subject of a long-running debate among policy makers and academics (e.g. Haveman 1988; HM Treasury 1999). Most countries still rely mostly on the former to achieve their distributional objectives, but have over time attempted to shift the balance more towards the latter.

Secondly, social spending and taxation are not only (or even primarily) about redistribution in whatever form and therefore, should not be judged solely against this criterion. In particular, there is an efficiency, as well as an equity function to the welfare state. Even if all poverty could be eliminated, there would still be a need for institutions to enable people to insure themselves and to provide important services, such as health care and education. Uncertainty and other forms of imperfect information on the part of insurers mean that important areas of private insurance are likely to be inefficient or non-existent and external benefits may also mean that certain goods or services would be under-provided in a free market. In cases where market failure is costly and government is effective, state intervention can increase efficiency (Barr 2001).

Browning (1975), however, challenges the presumption that in-kind transfers are necessarily more efficient than cash transfers as a method of redistribution whenever there are external benefits associated with the consumption of particular goods. More generally, economists often maintain that the market system is a superior mechanism for allocating resources as there will always be a way of combining the price system (to achieve efficiency) with lump-sum transfers (to achieve distributional objectives). But as Weitzman (1977) points out, this is typically not very useful for policy prescriptions, because the necessary transfers are almost never paid. Furthermore, Arrow (1963) uses the example of the medical care industry to show that in some cases market conditions deviate markedly from those under which the "competitive model" (or free market) can be assumed to produce an efficient allocation of resources.

Another rationale for the in-kind provision of certain goods or services is that taxpayers have an altruistic, but paternalistic concern for the welfare of others; they may be prepared to pay for some kind of redistribution to the poor, but only if it takes the form of providing them with specific services, such as health care, food stamps, or subsidized housing (Le Grand 1982). This is sometimes referred to as the "merit good" argument. Similarly, Weitzman (1977) discusses a particular class of good or service, such as housing, whose just distribution to those having the greatest need for them might be viewed by society as a desirable end in itself. Tobin (1970) refers to this as "specific egalitarianism:" the view that certain commodities should be distributed more evenly than the ability to pay for them. Weitzman argues that the price mechanism of the market will be comparatively less effective in achieving an appropriate distribution of these goods (compared with a crude form of state rationing) when income inequality is relatively high, because those with larger incomes will tend to monopolize consumption of the goods in question.

Whilst these principles help to differentiate between in-kind and cash provision on "efficiency" or other grounds, the patterns of provision observed in different countries are also likely to be strongly influenced by historical circumstances and the power of different actors in the policy process.

4. Approaches to Redistributive Policy

Esping-Andersen (1990) provides a useful, though contested typology of welfare states with distinct approaches to redistribution, based on a broader conceptualization of the welfare state which recognizes that the level of social expenditure does not necessarily provide an accurate indication of a state's redistributive effort. This sets redistributive policy into an institutional context, helping to explain the political and economic values that underlie different welfare states. In the context of this chapter, the focus is on the notion of equity that underlies these welfare regimes and how this is reflected in different approaches to redistributive policy.

Liberal welfare regimes look to the market as their primary source of "welfare." The main role of the state is to ensure the smooth operation of the market, implying a minimalist role for redistributive policy. The state assumes responsibility only when the family or the market fails and seeks to limit its commitments to providing a safety net for marginal and deserving groups. Entitlement rules should be strict, and benefit levels modest and time limited so as not to crowd out private provision or charity, whilst guarding against the danger of cultivating a dependency culture.

Social democratic welfare regimes give a much more prominent role to redistributive policy. Unlike the liberal regime, the underlying assumption is that the outcomes of unfettered capitalism are unfair and, therefore, social democrats are much more prepared to manipulate the market economy to social ends (e.g. via strong employment protection and minimum wage legislation) even at some cost to overall productivity. Redistribution is also to be achieved by taking certain goods and services, such as health, education, and housing out of the capitalist realm and ensuring they are distributed more equally than income or wealth ("decommodification"). Entitlement to certain state benefits is seen as part of the "rights of citizenship" and insurance systems are usually broad and universal. Benefits are typically graduated in proportion to accustomed earnings in order to ensure high replacement rates, even for relatively high earners. Since state services and benefits are tailored to the expectations of middle-income groups, the market is largely crowded out of the welfare sector.

Corporatist welfare regimes seek to preserve the existing order and the patterns of distribution within it, in contrast to the social democratic state's explicit attempt to alter the distribution between rich and poor. The corporatist approach to welfare relies on mutual aid to take care of those who fall upon hard times. Social programs are generous, but are funded largely by contributions made over recipients' own working lives. Social entitlements derive principally from employment rather than citizenship (as in the social democratic model) or proven need (as in the classic liberal model). The primary role of the state is to underwrite and facilitate group-based schemes of insurance and arrange residual insurance pools for those who are not part of an established occupational group. The state's emphasis on upholding status differentials dampens its distributional impact (over complete lifetimes, at least), though most corporatist systems contain some weakly redistributive elements.

Such differences are not only seen in the structures that emerged between different nations' welfare regimes in the third quarter of the twentieth century, but also in their responses to fiscal pressures at the end of the century. Such pressures—from aging and slower growth—may have been greater in the more extensive social democratic or corporatist regimes, but so was their political entrenchment, leading to varied responses (Pierson 2001).

Esping-Andersen and others have attempted to classify countries into one of these three regimes, using a whole range of indicators. In practice, few countries match these descriptions in every respect, though most countries tend towards one or other of them. The USA is the clearest example of a liberal welfare regime, the Scandinavian countries come closest to the social democratic model, and the continental European countries, including France, Germany, and Italy, are commonly cited as examples of corporatist regimes.

4.1 Universal versus Targeted Welfare

One of the key distinctions between the liberal and social democratic regimes is that the former favors targeted welfare on the poor, whereas the latter favors universal provision of welfare. In practice, however, all welfare states contain a mixture of targeted and universal welfare provision.

"Universalists" advance many reasons for regarding the targeting of welfare as bad policy. Means testing often involves an intrusive enquiry into people's personal and financial circumstances; it can stigmatize the recipients and may be socially divisive; targeted welfare payments may tend to become less generous to the poor over time, because they generally command less political support than universal programs; many of those in need may miss out, because need is often difficult to identify; non-take-up is a greater problem with means-tested benefits, in part because of the stigma or time cost attached to claiming these benefits; means-tested benefits are generally more difficult and expensive to administer; means testing can create a "poverty trap," because benefits are withdrawn as incomes rise; and, since means tests only make sense when applied to the family, they run counter to the desire to have a social security system that promotes greater independence for women (Atkinson 1983, 1993, 1995, part III; Cornia and Stewart 1995).

Supporters of more targeted welfare argue that it is a more efficient way of combating poverty and can be equally effective. By definition, a greater proportion of any expenditure goes towards helping those below the poverty line. Social transfers impose costs on the economy, which are minimized through better targeting. They also dispute or downplay some of the arguments against means testing. Mitchell, Harding, and Gruen (1994), for example, have argued that a well-designed means test need not be stigmatizing; that non-take-up is generally greatest among those entitled to only small amounts; and that the disincentive effects generated by means testing may not be as great as might be thought.

4.2 The Efficiency–Equity Trade-off

Another key distinction between liberal and other welfare regimes is that they are more concerned about the potential trade-off between equity and economic efficiency. The principal idea behind the neoclassical critique of the welfare state is that social programs with high replacement rates constitute a powerful disincentive for people to work and to save for old age or insure against other adverse events. These disincentives are expected to reduce employment rates and increase welfare dependency, which are in turn a drag on economic growth (cf. Goodin et al. 1999). At the same time, greater income inequality is a spur to economic growth, because it rewards innovation and effort and increases savings and investment as those with higher incomes tend to save a larger share of their income (see, for example, Welch 1999).

On the other hand, there are theoretical arguments for why greater equality may be good for economic growth. Higher tax rates can increase work effort if there is a large enough "income effect," whereby individuals have to work harder to achieve a given level of post-tax income. Some economists also argue that more equal pay can help to suppress unwanted (but unobservable) uncooperative behaviour at work, such as shirking. More generally, Haveman (1988) argues that the redistribution system reduces economic insecurity and uncertainty, increases economic stability, and facilitates economic change and the production of human capital. As he puts it, each of us feels better knowing we live in a society which protects the weak and moderates the extremes in income and economic power that accompany the operation of free markets. Though harder to quantify, these efficiency gains need to be set against the economic losses generated by any adverse incentives and distortions that the redistribution system creates.

Whilst it is a commonplace contention that high taxes and generous transfers produce work disincentives, a comprehensive review of research on Denmark, Sweden, Germany, and the UK demonstrates that the empirical evidence is much more mixed (Atkinson and Mogensen 1993). Generous early retirement pensions do appear to induce early exit from the labour market; otherwise, the negative effects on labour supply are generally small or insignificant and positive effects are not infrequent for some subgroups such as prime age men. Moreover, findings for one country do not necessarily hold for another, so it is hard to generalize.

Empirical evidence on the relationship between inequality and growth is also inconclusive. Some studies find that countries with more inequality tend to have slower rates of economic growth, whilst others find precisely the opposite, depending on the countries included in the study, the period covered, and the methodology used. Kenworthy (2004), for example, carries out a cross-country analysis and a cross-state analysis (for the USA) and shows that in both cases there is a possible negative effect of inequality on growth, but that the association is weak at best and very sensitive to one or two outliers. He concludes that "although there is surely a point at which the distribution of income might be too egalitarian to be compatible with desirable rates of economic growth, the experience of the past two decades suggests that such a point has yet to be reached." Particular institutions or policies may have growth-impeding effects, but there is no evidence of a general equity–efficiency trade-off over this period.

Similarly Atkinson reviews ten econometric studies of the relationship between the level of social spending in different countries and their economic performance. For comparability, he takes the results of each study to produce its prediction of what would be implied for a country's rate of economic growth if its social spending was smaller as a share of GDP. Four of the studies fitted suggestions that a smaller welfare state would be associated with faster growth. But two found no significant relationship, and four suggested that growth would be *slower* if social spending were reduced. He concludes, "studies of the aggregate relationship between economic performance and the size of the welfare state do not yield conclusive evidence" (Atkinson 1999, 84). The question itself may not be the right one to ask—instead we should be looking at the structure and design of the components of social spending: some may have positive effects on economic performance, for instance education and training; others may have negative effects, for instance because of damaging incentive effects.

5. Effectiveness of Redistributive Policy

The effectiveness of redistributive policy can be examined on two levels: macro-level comparisons of different welfare regimes across countries and micro-level analyses of individual social policies and programs within countries. These two strands of literature are discussed in turn.

5.1 Cross-country Comparisons

The effectiveness of different welfare regimes is usually judged in terms of their impact on inequality and poverty, though some of these analyses also take into account other criteria, such as economic efficiency.

Smeeding (2004) compares the level of inequality before and after taxes and benefits in thirteen OECD countries using the most recent data from the Luxembourg Income Study for 2000 (or the mid–late 1990s for some countries). His analysis shows that the high-spending countries in northern and central Europe and Scandinavia have the greatest impact on inequality—a reduction of between 40 and 48 per cent in the Gini coefficient. The Anglo-Saxon nations, excluding the USA, are next with reductions of 24 to 31 per cent; the USA with an 18 per cent reduction is the lowest of the rich OECD nations.

The anti-poverty effect of taxes and transfers shows a similar pattern. In all countries, taxes and transfers reduce income poverty, but the reduction is greater in both absolute and proportional terms in countries with high levels of social spending (as in Scandinavia and northern Europe) or more careful targeting of government transfers on the poor (as in Canada, for example). The USA shows the least anti-poverty effect of these countries—poverty is reduced by 28 per cent in 2000 (from 23.7 to 17.0 per cent), compared to an average reduction of more than 60 per cent for the eight countries included in this analysis.

The Dutch welfare regime—used in Goodin et al. (1999) as an "imperfect" example of a social democratic regime—is also more effective at reducing the length and recurrence of poverty spells through its public transfer program, as well as minimizing the number of such spells in the first place. On an annual basis, around 18 per cent of the US population were poor, whereas it was less than a third of that in the Netherlands (during the late 1980s and early 1990s). These differences are even greater when looked at over an extended time period. Dutch poverty rates dropped to around 1 per cent if incomes are averaged over a five-year period, whereas American rates remained at around 15 per cent. The US welfare regime has no impact (or even a slightly negative one) on working age households. The only sort of poverty the US regime helps to alleviate is among the elderly—and it removes only about half of that, compared to around 90 per cent in Germany and the Netherlands.

Hicks and Kenworthy (2003) use regression analysis to examine the relationship between the characteristics of welfare regimes and various outcome measures, including redistribution. They find that those characteristics associated with "progressive liberalism" (which broadly equates to Esping-Andersen's social democratic model) have a strong and positive effect on inequality and poverty reduction. The estimates for "traditional conservatism" (which broadly equates to Esping-Andersen's corporatist model) are also positive in both cases, but the impact on inequality is not statistically significant and its impact in reducing poverty is weaker than that of progressive liberalism.

5.2 Paradox of Redistribution

Contrary to common wisdom, it is now well established that systems which target narrowly to the most needy generally perform rather badly in terms of redistribution or poverty alleviation (Esping-Andersen 1996). Korpi and Palme (1998) called this the "paradox of redistribution:" the more benefits are targeted at the poor, the less likely this is to reduce poverty and inequality. While a targeted program may have greater redistributive effects per unit of money spent, other factors are likely to make universalistic programs more redistributive.

Korpi and Palme put forward several explanations for this counter-intuitive finding. First, an emphasis on targeting may over time undermine broad-based support for social security, because it largely benefits the politically weak poor, and may therefore lead to lower levels of social security expenditure and ultimately to more, not less inequality. Second, the institutional welfare state may "crowd out" even more inegalitarian private alternatives. This might explain, for example, why the lowest inequality in the incomes of older people occurs in the four countries with the most unequal public pensions—Finland, Sweden, Norway, and Germany. Third, most earnings-related social insurance programs have some, often a strong element of redistribution built into them. In a "pure" earnings-related scheme, contributions and benefits are both proportional to earnings, but in practice most schemes have a "floor" below which benefits are not allowed to fall and a "ceiling" above which the percentage of earnings replaced is gradually reduced, favouring lower earners.

Goodin et al. (1999) offer a slightly different explanation for why liberal welfare regimes are less effective at combating poverty. While liberals want their welfare state to help the poor and only the poor, they also want it to do so efficiently and at least cost to overall macroeconomic performance. This "big trade-off" causes them to temper their pursuit of poverty alleviation. Whereas social democratic welfare regimes "err on the side of kindness," the liberal US system is "lean and mean." US welfare programmes are over-tightly targeted, so many poor people receive less than they need and a substantial proportion do not receive any transfer payments.

5.3 Caveats

In summary, the evidence strongly suggests that comprehensive, universalistic, and more generous welfare states of the Scandinavian type are considerably more egalitarian in outcome than others. By contrast, the same studies invariably show that the USA, and to a lesser extent other more "liberal" regimes, perform relatively poorly in terms of reducing inequality or poverty compared to other OECD countries. However, there are several caveats which need to be borne in mind.

First, even in the USA, the tax-transfer system has been a powerful instrument for reducing poverty and inequality. Absolute poverty (as measured by the official US poverty line) was between 40 and 60 per cent lower in the mid- to late 1980s than it would have been in the absence of government transfers (Haveman 1988; Danziger 1988). Federal taxes are also progressive, though only mildly so (Pechman and Mazur 1984; Haveman 1988). In a historical context, the period 1960–80 saw the US government transformed from a traditional defense–transportation–natural resources enterprise to a major engine for poverty reduction. Social policies that are redistributional by nature grew from about a quarter to nearly half of federal activities over this period (Haveman 1988). Nevertheless, as he also points out, in spite of the massive increase in taxes and spending, inequality was no lower in 1988 (and is probably higher now) than it was in 1950, because of rising inequality in market incomes.

Secondly, as argued by Alesina and Angeletos (2003), redistribution from rich to poor is more limited in the USA than in continental Europe at least in part because of differences in public attitudes towards the source of income inequality. In a society like the USA, people are much more likely to believe that individual efforts determine income and that poverty is due to lack of effort rather than bad luck or social injustice. Americans accept a larger measure of inequality and choose less redistribution, because they believe that the distribution of incomes produced by the market is closer to what they consider to be a fair outcome. Schwabish, Smeeding, and Osberg (2003) offer a different perspective on the relationship between income inequality and social spending. They argue that cross-national differences in social expenditure are associated with and according to their theory, may be driven by the degree of inequality in the top half of the income distribution, because political influence is concentrated among the rich who stand to benefit less (or lose more) from social and welfare programs the more unequal the society.

Thirdly, and related to the previous point, many defenders of American economic and political institutions argue that inequality plays a crucial role in creating incentives for people to improve their situations through saving, hard work, and investment in education and training. According to this line of argument, wide income disparities may be in the best long-term interest of the poor themselves as the benefits of higher economic growth "trickle down" to the poor. However, Smeeding, Rainwater, and Burtless (2000) conclude that the supposed efficiency advantages of high inequality do not appear to have accrued to low-income residents of the USA, at least so far, but rather to those further up the income scale. Kenworthy (1998) assesses the relationship between the "extensiveness" of social welfare policies and overall poverty rates in fifteen developed countries over the period 1960–91, allowing for the possible impact on long-run economic growth. The results of his multivariate analysis, though not conclusive, suggest that social welfare policies do significantly help to reduce absolute and relative poverty, even when possible indirect, dynamic effects on long-term economic growth are taken into account.

Finally, there are various ways in which the methodology used in comparative studies may exaggerate the differences between countries, making simple comparisons of pre- and post-transfer poverty or inequality potentially misleading. This relates to the problem with establishing incidence discussed at the start. For example, in countries with generous earnings-related social insurance schemes, older people