'IN-WORK BENEFITS': A MORE EFFECTIVE WAY OF REDUCING INEQUALITY THAN TRADITIONAL REDISTRIBUTION POLICIES

'In-work benefits' like the UK's Working Families Tax Credit (WFTC), which target the working poor, are much more effective than traditional anti-poverty measures. In maintaining, and even strengthening, people's incentives to work, they make transferring money from rich to poor far less costly. These are among the central findings of a new study by **Herwig Immervoll, Henrik Kleven**, **Claus Kreiner** and **Emmanuel Saez**, which uses EUROMOD, a new simulation tool, managed by the Institute for Social and Economic Research.

Writing in the January 2007 *Economic Journal*, the researchers conclude that in-work benefits – sometimes referred to as 'Kombilohn' in German – represent a valuable policy option for enhancing the economic situation of many low-income families, especially in continental European countries where taxes are high and up to a third of the population draw most of their incomes from government transfers.

Reducing income inequality without increasing unemployment is tricky. Redistribution from rich to poor requires taxation but taxes cut into the payoff from work and tend to reduce work incentives, causing what economists call efficiency losses. The new study sheds light on this trade-off in 15 European Union countries. It turns out that the cost of redistribution varies both between policy instruments and between countries. Getting policy right is therefore of crucial importance. The authors start by asking how much it costs to redistribute a given amount, say one euro, from the rich to the poor. They use EUROMOD to calculate tax burdens and benefit entitlements for a representative set of households in each country, showing people's financial incentives to work as well as the cost of different types of social transfers.

The study finds that the design of redistributive policies matters hugely. Traditional anti-poverty programmes can be very expensive, with the rich paying far more than the poor receive. In contrast, in-work benefits, which target transfer payments to the working poor, are much more efficient. A one euro transfer delivered through in-work benefits costs the rich little more than one euro (and sometimes less).

In Nordic countries, for example, work incentives are already rather weak (many unemployed people lose as much as 70-80% of their gross earnings to higher taxes and reduced benefits if they move into work). Any further transfers to the poor make work even less attractive and are therefore very expensive: an additional one euro transfer would cost six euros and more.

In Belgium, France and Germany, the same transfer would cost the rich four to five euros. Hence, only 20-25% of the taxes paid by higher income Germans would actually reach the intended beneficiaries – the rest is lost in the process because higher taxes and benefits reduce work effort leaving fewer resources for redistribution.

Extending existing anti-poverty policies would therefore seem undesirable in these latter countries – unless the population is particularly committed to redistribution to the poor. This would be the case if, say, income gains of the poor in the Nordic countries were valued more than six times as much as losses suffered by the rich.

What, then, can governments do to make redistribution less costly? The study shows that 'rolling back the welfare state' is not the only possible response. Carefully designed redistribution policies can maintain, or even strengthen, work incentives. And such policies already exist. The best-known examples are the Earned Income Tax Credit in the United

States and the UK's WFTC. A number of continental European countries have recently introduced similar measures, although on a much smaller scale.

Like traditional anti-poverty programmes, these in-work benefits also redistribute from high- to low-income people and tax workers to finance the transfers. But importantly, benefit payments are conditional on having a job. In-work benefits therefore improve the incomes of the working poor *and* strengthen incentives to take up employment. As low-skilled people are particularly responsive to this type of incentive, in-work benefits can have large positive effects on employment, boosting people's incomes and reducing government expenditures on welfare benefits.

Of course, support for the poorest households, those without a job, is still required. Indeed, in Southern Europe, where many poor currently receive little support, anti-poverty transfers could be introduced at a relatively modest cost. But in high-tax countries where welfare benefits are already more generous, rebalancing the existing benefit system towards support for the working poor would make it more effective and less costly.

Would in-work benefits receive the necessary political support? The authors calculate that, in most countries, a majority would gain from increasing support to the working poor. So this is a policy that makes economic sense and is politically attractive.

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Notes for editors: 'Welfare Reform in European Countries: A Microsimulation Analysis' by Herwig Immervoll, Henrik Jacobsen Kleven, Claus Thustrup Kreiner and Emmanuel Saez is published in the January 2007 issue of the *Economic Journal*. Immervoll is at the OECD in Paris; Kleven and Kreiner are at the University of Copenhagen; and Saez is at the University of California, Berkeley.

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