EU social policy beyond the crisis

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Introduction

I appreciate very much the fact that the Bank of Greece has organised this conference. The first reason is that it recognises the need to see economic and social policy in an integrated way. Such an integrated approach is very important and is not always followed. Indeed, economic and social policies are too commonly treated as separate. At the EU level, there are separate committees dealing with economic policy and with social protection. At a national level, these policies are typically handled by different ministers. However, in my view, we cannot resolve our economic problems without considering the social issues. It is essential to consider them in conjunction. It is not enough to focus on the bond markets and fiscal aggregates without considering what this means for individuals and their families. In order to obtain public support for macro-economic measures, governments have to be able to relate them to the wider impact on their societies.

This impact will extend well into the future, and this brings me to the second reason for welcoming this conference. It offers an opportunity to look beyond the immediate crisis. In my view, it is important to consider the longer-term as well as the short-term, since many of the decisions taken today will have long-run consequences. Put differently, when choosing between different responses to the crisis, we need to set these choices in the context of the longer-run goals of our societies. It is in terms of our longer-run ambitions that the present hard decisions can be justified to citizens and voters.

This need to set current crisis policy-making in a longer-term context has been recognised by the European Union, notably in the establishment of the Europe 2020 Agenda. It is easy to dismiss the Europe 2020 Agenda, and the headline targets adopted by the EU Heads of State and Government, as pure window-dressing or cheap talk with no policy relevance. However, I believe that would be a mistake. I have spent half of the last 2 years teaching at Harvard, and I have been struck by the contrast between the US and the EU. The US has nothing corresponding to the Europe 2020 Agenda and one senses that there is little agreement as to where the US is headed. For much of the post-war period, the US had a clear role as a leader of the "Free World", but it has not found a replacement. In contrast, the EU, as a new political construction, has had to give explicit consideration as to where it is headed.

Where the EU is headed is not defined in purely economic terms. The EU is not just a customs union. The euro zone is not just a monetary union. Right from the outset, the EU has had a social dimension. Member States made very clear way back in 1974, just as the UK was joining, their intention of forming "an economic *and social union*". It is on this European perspective that I shall be focusing in this talk. I shall not be attempting to discuss the specific case of the crisis in Greece; the rest of the programme contains a rich set of papers on this subject. But I hope that what I have to say will be of relevance to your current policy issues.

1. Debt, the Welfare State and the need for an intergenerational compact

The burden of the national debt and pensions

Indeed, I am going to start with the question of the national debt. One of the first essays that I wrote as a student in Cambridge in the 1960s was on the burden of the national debt, and later this became a chapter in my book with Joe Stiglitz. From my teachers in Cambridge I learned three key things about the national debt. The first is that the key economic variable is not the gross debt of the government – how much is outstanding in government securities – but the net worth of the public sector.

This key point tends to be overlooked. In the UK, the present government has been making a great deal of the high debt GDP ratio that it inherited from the Labour government – 150 per cent of GDP, but has ignored the asset side of the account. The UK response to the financial crisis – just like the responses of Norway and Sweden to their banking crises in the 1990s – was to nationalise a significant part of the banking sector. The ownership by the UK government of a substantial stake in the Royal Bank of Scotland, Lloyds Bank, Northern Rock, etc has a definite value to be set against the liabilities. In the Nordic case, the purchase and then re-sale generated a modest profit. If we look at the overall balance sheet, taking account of all government assets, then this shows the net worth of the UK state as being modestly positive.

This balance sheet is not however the complete picture. The second thing I learned about the national debt was that one has to take account not just of the explicit debt but also of the implicit debt in the form of obligations already entered into to pay state pensions. It is here that the welfare state enters our story. From James Meade, I learned that the state needed on this account to have a substantial positive net worth; and indeed successive UK governments over the post-war period did raise public sector net worth so that by 1979 it was broadly equal to the value of outstanding state pension rights. In 1979 we were broadly in balance. However there then came the Thatcher privatisations that sold off a significant part of state assets, such as the state ownership of housing, to finance tax cuts. The deficit was financed by asset sales.

As a result, today, rather than the UK state wealth being broadly zero, we have an implicit debt of some 100 per cent of GDP. This, it seems to me, is the real fiscal crisis. Moreover, it is a long-term crisis and it is a crisis that affects most countries. We do not collect internationally comparable figures on state net worth, but I suspect that the UK position is typical of many countries. The real fiscal crisis is the negative net worth of the public sector, taking account of pension liabilities, and this crisis is not confined to the countries currently in the headlines. It is not simply a euro zone problem.

Put differently, the problem of financing the welfare state needs to be tackled from the standpoint of the capital as well as the income account of the government. But is the problem of the welfare state only a problem of financing?

Inter-generational redistribution

This brings me to the third lesson that I learned about the national debt, which is that it is at heart an inter-generational issue. I should mention that one of my teachers at Cambridge was last year's Nobel Prize-winner Peter Diamond, who was, when he taught me, engaged in showing in a celebrated paper in the *American Economic Review,* 1965, how the burden of the national debt could be studied in the context of a model of overlapping generations. It is the *overlapping* that is crucial and often neglected. When we say that debt allows the burden to be transferred to a future date, say 2050, we tend to overlook the fact that many of those alive today will be alive in 2050 but others of us will not be. I belong to a 4 generation family, and 2 of these generations can reasonably hope to be here then, and 2, my own included, cannot. It therefore matters *who* would pay today and *who* would pay then. If it is my children who would pay both today and then, the issue of debt becomes a purely within-generation transaction. On the other hand, if it becomes a question of cutting my pension now or their pension in 2050, then it involves inter-generational redistribution.

The welfare state involves major elements of redistribution between generations. Pensions are the most evident, but much of family policy can be seen in the same light, so too can transfers related to the labour market. As governments consider cuts in government spending to meet their fiscal consolidation targets, they need to consider not just the vertical distribution between rich and poor but also the distribution between different stages of the life-cycle. The incidence is not always easy to identify, but in some cases it is clear. In the UK case, for instance, the government has recently abolished the educational maintenance allowance, which paid a benefit to 16-18 year-olds who stayed on at school or in further education. They may have spent it all on drink, but it definitely increased the proportion staying in education, with – one hopes – long-term benefits in terms of their lives and earnings.

The need for an inter-generational compact

The inter-generational dimension is very relevant to both economic and social policies, and is a major reason why they need to be seen in conjunction. Agreement on policy towards the national debt, and on the welfare state, involves an inter-generational compact. Such a compact involves agreement about, not just how much to reduce today's as opposed to future living standards, but also about who should bear the reduction in living standards today. This is not a new idea. In 2004 the report of a High-Level Group on the future of social policy in an enlarged European Union, of which I was a member, proposed such a new pact. Summarising the key messages of its report, the Group concluded that:

> "Through these different messages, the idea of a new intergenerational pact emerges. The present intergenerational pact is focused on the elderly and based on fears: fears of ageing and of its consequences on the pension system and on the labour force, fears of migration, and so on. The new intergenerational pact should be focused on the young and based on confidence. It is now time to turn all these fears into a win-win process based on a positive perception of the future and a new intergenerational balance" (European Commission, 2004, page 7).

A key feature of this pact is that it would encompass all areas of policy. For any individual there would not be wins on all dimensions. Taxes may rise and pensions may be cut (as in the UK at the present), but these may be balanced by gains on other dimensions. In this respect, putting everything on the table has advantages. At the same time, we have to accept that there will be certain generations that are net losers; there will be “a new intergenerational balance”. I believe that this would be socially just. Concretely, I believe that my own generation and the baby boom generation that followed should bear more of the cost of adjustment. To be even more concrete, I was shocked to discover that, when I reached the age of 65, I was no longer liable to pay social security taxes.

Now you may rightly say that this is a distributional judgment and depends on one’s views about social justice between generations. However, it seems to me that there is an argument that does not depend on ethical judgments. This is that, whatever the form of the social welfare function governing distribution between generations, it must be the case that we now expect future European generations to be less well off, relative to my generation, than we previously expected. We have adjusted downwards our view of future prospects – in the light, for example, of the costs of mitigating climate change and of increased international competition. This is an argument for making our generation bear more of the cost of fiscal adjustment that holds irrespective of one’s distributional values.

A second consideration is that an intergenerational compact allows people to weigh costs to themselves against the benefits to future generations. In a personal sense, this may well already happen in that individuals may be concerned not just with their own living standards but also with the living standards of their children, grandchildren and – possibly – parents. This is taken to an extreme form in macro-economic models that assume that people maximise the utility derived from the consumption of all future generations from now to infinity. If one were to accept such an assumption, then it could of course be argued that such dynastic decision-making renders my proposed inter-generational compact unnecessary: people do this naturally. Any re-adjustment, such as that occasioned by the reduced expectations of future generations, would be automatically carried out by my generation saving more to leave in bequests to our children. If the government decide to tax me more, then I simply reduce my children’s inheritance.

There may be an element of truth in this argument, but it is a limited one. To begin with, a significant number of people are not linked in this way, because they have no direct descendants. An even larger proportion leaves no significant wealth at death (over half of UK population leave negative, zero or minimal wealth at death). But, more generally, people are not only concerned with their immediate family. The abolition of the educational maintenance allowance concerns me, even though I have no children or grandchildren on the relevant age range. It remains the case, in my view, that the inter-generational compact would allow people to see that sacrifices they are making are to the benefit of other generations to whom they are linked not by kinship but by solidarity.

To this point, I have not discussed vertical redistribution, between rich and poor. It has however been below the surface. The case for the educational maintenance allowance, for example, is that it was paid to those with low incomes; the extension of social security taxes to those over 65 would tax more heavily the better off members of that age cohort. This vertical redistribution is important for the European dimension, to which I now turn.

2. The role of EU social policy and the case for a European basic income

Subsidiarity and Europe 2020

I have argued that economic and social policy need to be seen an integrated way, but there is a major difference in that, under the principle of subsidiarity, social policy remains largely within the competence of Member States, whereas economic policy has shifted to a significant degree towards the European level.

It is however important to be clear about the meaning of subsidiarity. This principle recognizes that action in the field is the responsibility of Member States, but within a framework of common objectives. The role of common objectives should be stressed, since it is a source of confusion. In the public finance literature on decentralization, there has been analysis of the allocation of functions to different levels of government, particularly between federal (the European Union in the present context) and local (in this case the Member States). Some have argued that functions such as income redistribution should be allocated to local governments where there are marked differences in preferences between local areas. Subsidiarity would then mean that a Member State was free to determine the extent of redistribution on the basis of the expressed preferences of its electorate. Some countries would choose a highly redistributive policy, with associated higher taxes, and another would provide less social protection. This is not, however, what is envisaged in the European Union, which refers to the best way of achieving agreed common objectives. In other words, it does not leave the lower level government free to determine the *objectives* of redistributive policy. The principle of subsidiarity is derived from the Catholic Church, and the Church does not delegate the determination of objectives.

It is here that the Europe 2020 Agenda is important. The function of the headline targets is to set the objectives, and in this sense the role of social policy has been elevated in that there is now an explicit goal of reducing the number at risk of poverty and social exclusion. There are not the financial penalties associated with the Excessive Deficit Procedure, but the performance of the Greek

Government, like the governments of other Member States, will be judged in part by its success or failure in achieving progress in this social dimension.

Protecting the most disadvantaged

However, how is this to be achieved? Greece is being asked to reduce its deficit and at the same time to tackle poverty (and reach the other Europe 2020 targets). This seems an impossible task. Moreover, the problem is not confined to Greece. I have argued earlier that other Member States – such as the UK - face fiscal problems of a long-standing and entrenched nature. More effort is being demanded in terms of social policy but the state balance sheet is not in a position to finance the achievement of social goals.

In part the resolution has to be via higher taxation. In the UK the decline in the net worth of the state was due to the government using the proceeds of privatisation to reduce taxes below their sustainable level. To their credit, the past Labour government and now the present one have recognised that taxes have to be raised. So the top personal income tax rate has gone up to 50 per cent, and VAT has increased from 17.5 to 20 per cent.

But there have also to be reductions in government spending, and these cuts risk increasing rather than decreasing the number suffering poverty and social exclusion. Here the formulation of the Europe 2020 objectives is providing some guidance. In effect it is saying that poverty and social exclusion should be the primary focus, and that this should take precedence over the other functions of the welfare state. In other words, vertical redistribution has to take place. The older generations should bear more of the burden, but that burden should be distributed in such a way as to protect the least well-off among the elderly.

Now this may appear to be simply a re-iteration of the age-old message that social policy needs to be better targeted. For decades the World Bank, the IMF and the OECD have been urging countries to concentrate their social spending on those at risk of poverty. Yet countries have been reluctant to follow this advice and, where they have followed the advice, the results have not always been very successful. It is important therefore to make clear that there are different forms of targeting and that I am arguing for a particular approach – different from that which has been typically advocated.

The difference may be illustrated by the case of benefits for children, where there has been a growth in income-tested schemes, where payments for children are not universal but are only made where the family income is below a specified level, the payment being phased out as income rises. The idea of taking child benefit away from the rich families and using the saving to pay higher benefits to those with low incomes may sound like a good policy. And an optimal tax analysis by Brewer, Saez and Shephard (2010), with a model of disincentives operating on the extensive work margin, does indeed show that a utilitarian social welfare function is maximised by a policy that limits child benefit to those with lower/middle income earning power. However, in my view, the analysis, though quite correct as far as it goes, is incomplete and leads to a potentially misleading policy conclusion.

To begin with, the Brewer, Saez and Shephard analysis is narrowly utilitarian. Their paper could have been written by Pigou or any other classical welfare economist. Even classical welfare economists, however, would have taken a wider perspective than simply maximising the sum of utilities. They would have recognised, for instance, that there are issues of horizontal, as well as vertical equity. The removal of child benefit from the wealthiest means that they are placed in the same position regardless of the number of children in their family. But many would regard it as unfair that a person with an income of €100,000 a year and 3 children should pay the same amount of tax net of benefits, as his counterpart with no children.

The idea of 'fairness' applies more broadly. The income-tested approach to family support entails withdrawing benefit as income rises and leads to high marginal tax rates for those on lower and middle incomes. For example, if we phase out child benefit of 15 percent of average income over the range from ½ to 3/2 of average income, then for a family with 2 children this means an additional marginal tax rate of 30 percent over this range, meaning that the overall marginal tax rate can easily reach 60 or 70 per cent. The implications for incentives are taken into account in the optimal tax analysis, but there are also issues of 'fairness'. On grounds of fairness, it could well be seen as 'unfair' that a person/family should retain so little of their additional earnings. Fairness requires a perceivable link between effort and reward.

Income-testing child benefit may therefore be seen as "unfair". But this is not the only objection. A second set of arguments concerns the means by which family support is delivered. The standard tax analysis is concerned only with the amount of income received; it is not concerned with the f*orm* in which it is received. Yet people value different forms of income differently. Earnings or interest on shares are perceived as merited, since they are based on a reciprocal relationship. Pensions are seen as merited, since they have been earned by past contributions. On the other hand, certain other transfers are seen as 'charity' and the receipt entails a loss of dignity. We have seen how this applies to means-tested 'assistance'. The UK has a long history of means-tested family payments, going back to the Family Income Supplement introduced in 1971. Regular statistical studies have shown that a significant minority of those entitled to these benefits do not claim them. Attention tends to be focused on false positives – on those not entitled but who nonetheless receive benefits – but false negatives are, I am convinced, more worrying, since they mean that many people on very low incomes are not receiving the benefit to which they are entitled. The UK family credit has been in operation for many years and yet approximately 20 percent of those entitled are still not claiming. In other words, income-tested benefits fail to deliver.

In my view, the above indicates the need to ensure that benefits are delivered without loss of dignity. Experience shows that this cannot be achieved by the kind of income-tested schemes used in the past. In his book *Les Exclus*, Rene Lenoir, the originator of the concept of social exclusion, went even further and argued that the state is itself a source of social exclusion. The very benefits that are intended to help the poor serve to isolate them from the rest of society. I have always felt that it was ironic that the scheme introduced in France to promote integration, the Revenue Minimum d'Insertion, led to the identification in the popular mind of a separate category of person, the RMIste.

For all these reasons I believe that we need to seek a new approach to targeting. Income-tested schemes fail to deliver – in that they do not reach all those below the poverty line – and they are in themselves a form of social exclusion.

The case for a European basic income

Translated into a European Union context, this means that I do not believe that the EU should base its strategy on a harmonisation of income-tested minimum income schemes. The route to meeting the Europe 2020 objectives is not via the RMI, now the RSA, of France or the Income Support of the UK. Such harmonisation would in any case be extremely difficult, given the wide diversity of schemes and legislative provisions.

Rather, I believe that we should adopt a new approach. Or, in fact, a very old idea – due originally to Thomas Paine, the 18th century writer and revolutionary. He proposed that all citizens should be entitled to a *basic income*, and the idea has been taken up in recent years by a wide variety of people. Under the basic income, everyone would be entitled to a minimum cash income, on an individual basis. It would not be income-tested, but would be conditional. The form of the conditions varies. For some proponents, the basic income would be paid on the basis of citizenship. This raises a number of tricky issues, not least because citizenship is defined differently in different Member States. For example, I understand that if I were to become a monk at Mount Athos, then I would automatically become a Greek citizen. Otherwise I would have to live here for seven years, which means that recently arrived immigrants would not be covered for a significant period, when they may be particularly at risk of poverty or social exclusion. For this reason, I would make the BI conditional, not on citizenship or residence, but on participation in the society, where "participation" is defined broadly to include all forms of paid employment, full-time education, active engagement in seeking employment, caring for children, the disabled or the elderly, and those below a certain age (say 18) or above another age (say 70).

What I would like to do, in the time that remains, is to explore the case for making a basic income the foundation for a European social policy. To be more concrete, I would begin with the young and the old. As I have argued before, and was indeed proposed in the report of the EU High Level Group to which I referred earlier, the first step should be a Child Basic Income (CBI). Here I have in mind a payment sufficient to meet the EU at-risk-of-poverty criterion, which for a child is 30 per cent of 60 percent of median income in each member state, or 18 per cent of median income, say 15 per cent of mean income. Or, alternatively, it could be defined in terms of a set of basic needs. This proposal, if accepted, would mean that each Member State guarantees that its provision for children reaches this level. A family whose current child-related transfers – whether in the form of child benefit, educational support payments, additional housing benefits - did not meet the target level, would be entitled to a payment, funded by the Member State government, which brings the total to this level. To this I would add a similar provision for those aged over 70. A person over that age whose existing state (and private where mandatory) pension did not reach the level would be entitled to a payment, funded by the Member State government, which brings the total to this level.

Now, you may immediately say that this is no different from income-testing. This is not a BI, but a guaranteed minimum income, more like a negative income tax. However, this is not the case. The proposed BI would be income-tested, certainly, but only on the total of social transfers with respect to children. If the Member State has a social assistance scheme with an explicit allowance for children, this payment would be taken into account for recipients, while the rest of the social assistance, and any other non-child-related income, that they received would be ignored. In the same way, the BI for the over 70s would be a guaranteed minimum pension, not a guaranteed minimum income. A person would be eligible if their total pension fell short of the target level, irrespective of any income from savings or work.

What I am proposing is an intermediate strategy, one that avoids the stigmatising effect of current income-testing, one which moderates the effect on the incentives to work and save, and which complements rather than replaces existing policy. At the same time, it would add to government spending, which is not what current Member State governments want to hear. The cost would not be trivial. A study by Levy, Lietz and Sutherland (2007) has simulated the effects of introducing child BI in what was then the EU15. The rate of child basic income proposed above would mean increases in all of EU15 Member states. Increases in Luxembourg would be relatively modest, but higher in the Netherlands, Italy, Portugal, Spain and Greece. The cost for the EU as a whole would be equal to a rise in the overall tax rate of 2 percentage points.

How would the BI be financed? In part it would be financed through redistribution between generations. I have already argued that my generation and the Baby Boom generation should pay more tax. For example, in the UK the special income tax exemption for those over 65 costs £2.8 billion, or some quarter of 1 per cent. Or to take another example, we currently tax income from savings either at zero or at rate 12 per cent less the rate on earned income. An investment income tax equal to 12 per cent would help finance the BI for those aged 70 plus. This tax on savings would fall more on the better-off, just as abolition of the age allowance would come at the expense of the middle income pensioners. This underlines the fact that the financing has to come from a mix of inter-generational and vertical redistribution.

The complementary nature of the BI proposed here makes it particularly relevant in an EU context and in relation to the Europe 2020 agenda. A person from Mars observing the agreement of the Heads of State and Government on this 2020 agenda could be forgiven for supposing that the EU Commission had already worked out a plan for how Member States, under subsidiarity, might achieve this goal. The programmes were to be negotiated with Member States, but the Martian might naively have expected the Commission to have a “fall-back plan” – that there was a costed programme which could meet the headline targets. We now know that the present national proposals fall significantly short in some countries of the desired reduction in poverty. The figures that I have seen for Greece suggest that it is an honourable exception – the planned reduction is close to 1/6th – but others, including some of the largest Member States, fall short.

The BI, with Child BI as a possible first step, offers one way forward. The establishment of such mandatory transfers to be implemented by Member States according to national circumstances could achieve the agreed result. The fact that it would represent a departure from the existing national systems, in all their different forms, is a positive advantage. There would be no question of the agenda being dominated by the “model” of any one Member State. It would make a reality of the inter-generational compact.

Conclusions

The principal conclusions may be summarised as follows:

- I have argued that economic and social policies need to be viewed as an integrated whole; they are inter-dependent and agreement is unlikely to be reached on economic measures unless the social impact is taken into consideration;
- I have argued that there *is* a fiscal crisis, but it is not the one on which attention tends to be focused; the crisis is that of the net worth of the state, which is a longer-standing and much more general problem; it is not confined to the euro area;
- We need an inter-generational compact, covering all dimensions of policy; this is likely to involve redistribution from older to younger generations;
- The Europe 2020 agenda is important in providing a medium-term context for current policy-making, and in highlighting the need to protect the most disadvantaged;
- A European basic income, operated by Member States under subsidiarity, offers a way forward that can meet both our social aspirations and our fiscal responsibilities;
- The basic income has to be financed by a mix of inter-generational and vertical redistribution; it will involve higher taxation.