Preliminary Draft

Political Economy and the Equity-Policy Agenda

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I. Introduction

The past 20 years have witnessed an increase in the inequality of income and the number of people suffering from poverty and social exclusion in many European countries (Atkinson, 1995). Some government policies have been severely criticized in terms of equity. They are generally considered to be ineffective and even exacerbate income distribution.

However, the individuals' preferences for a reduction of existing inequalities and for living in a fairer society have not diminished. Inquiries made in the European Union show that 80 percent of the individuals consider that the fight against poverty and social exclusion should rank among the highest government priorities.

The discussion and analysis of the orientations that should be taken into consideration and of the strategies for action that should be followed are issues of the greatest importance in designing government policies that may, in practice, lead to an effective reduction in income inequality and the achievement of a more equitable society.

When designing and implementing redistributive measures, it is necessary to pay attention to the environment of international liberalization, increasing globalization and economic integration, and technological changes in which they are going to operate.

On the other hand, political factors that may influence policy choices and implementation have to be taken into account. The main interest should be in those inequality-reducing measures that politicians are receptive to, rather than in those that, theoretically, should be chosen by governments but are politically infeasible in the real world. To be sure, policy advisors influence politicians' decisions. But economists who give advice to policymakers should make a real effort to understand the issues relevant to policymaking.

I shall discuss below the priority intervention areas which, in my view, policymakers can be persuaded to include in their agendas, so that the results, in terms of distributive equity over the next twenty years, will be better than those of the past two decades. The paper is structured as follows: Section II discusses equity as a policy agenda for European governments; Section III focuses on designing and implementing policies to reduce inequality; Section IV touches briefly on political and administrative concerns; and Section V presents concluding remarks.

II. Equity as a Policy Agenda for European Governments

A. Importance of Equity to European Governments

What can be a politically realistic equity policy agenda for the European governments? Equity is an important issue of politics—even in European industrial countries, those which are implicit in this paper.

In the European Union, 55 million people (15 percent of the population) have incomes below 50 percent of the national average; 18 million are unemployed (10.7 percent of the labor force), of which 50 percent are long-term unemployed; and 2.5 million are homeless. This situation is a matter of growing concern for political and social actors as well as for citizenry in general. Poverty is an issue of increasing political importance at both the national and community levels.

The objectives of reducing inequality in income distribution and combating social exclusion appear, normally, as a high priority in politicians' electoral proposals. The political speech generally gives more emphasis to the equity goal than to efficiency and economic growth. And when political proposals put greater emphasis on economic growth, it is usual to underscore the contribution of economic growth to the reduction of income inequalities and to the improvement of social justice.

B. Electoral Proposals Versus Concrete Actions

Politicians are convinced that voters dislike great income and wealth inequalities and situations of profound poverty. Politicians consider that expressing a high concern for social injustice is indispensable in winning the voters' support. This also reflects the attention paid by the media to specific situations of inequality and poverty and to social-exclusion phenomena.

However, in the 1980s and 1990s, the objective of reducing income inequality, compared to other objectives, seems to have lost weight in concrete European government action, moving to a lower priority than in the electoral proposals. This is independent of an incumbent party's position being more to the right or to the left. This downgrading of the equity objective by policymakers, when in office, may seem strange, assuming that politicians want to get the votes to be reelected. The following reasons may explain this.

Firstly, policymakers are not very optimistic about the possibility of achieving, during their mandates, positive and visible results in terms of equity that can electorally offset possible negative results, in terms of other objectives, such as growth, reducing unemployment, and lowering inflation.

Generally, politicians seem to believe that redistributional policies have an adverse effect on efficiency and growth, notwithstanding the wide diffusion of a contrary message by the World Bank (Chenery and others, 1974) that there could be no trade-offs between growth and efforts to improve equity. Politicians seem to accept that the linkage goes mainly from growth to equity—a positive growth result is viewed as indispensable in improving the distribution of income in the medium term.

On the other hand, politicians are convinced that the budget costs of a global policy designed to achieve a socially fair state of distribution are unsustainable and that financial resources would not be available to pursue other goals.

Secondly, the persistence, over time, of income inequality and poverty in almost all countries leads the electorate to believe that solving the problem is an extremely long and difficult task, and so voters tend to forgive incumbent politicians for the weak results achieved. As the problem is not exclusive to a limited number of countries, and its worsening is not obvious in a government's mandate, voters tend to absolve politicians. By the same token, voters have difficulty in detecting changes in the overall state of income distribution, and equity is likely to be an area where, from an electoral point of view, the political speech and promises are more important than concrete results.

In general, policymakers react when economic growth, employment, or inflation reduction are below the targets and announce additional measures which sometimes have an adverse effect on equity in the short run. The same does not happen when a clear failure occurs in the objective of income distribution. This is a behavior that economists seem to accept as rational. They often hypothesize that politicians, in their desire to be reelected, adjust economic policies to show a positive performance in terms of economic growth, employment, and inflation running up to the electoral periods, as the literature on political business cycles makes clear. Income distribution results are not viewed as a determinant factor for the behavior of politicians.

The downgrading of the equity objective by politicians in office compared to the electoral proposals does not mean that governments do not care about taking new measures to reduce existing income inequalities.

Policymakers reveal an increasing preference for specific expenditure programs directed at certain groups or situations, instead of a global income redistribution policy through the tax transfer system. Their electoral interests may be better served in this way.

III. Designing and Implementing Policies to reduce Inequality

A. Growth and Equity

Economic growth may have a positive effect on income distribution, as politicians appear to be convinced. However, the linkage only reveals itself in the long run and some measures directed to the growth objective may have, in the short run, adverse effects on equity. But it is sure that without sustainable economic growth it will be difficult to achieve a significant reduction in social inequalities.

It is well known that some redistributive measures may affect economic growth in a negative way. But a more equitable distribution may also be a positive factor in economic growth, as underlined by Chenery (1974) and as several other authors have emphasized more recently (Persson and Tabellini, 1994; Alesina and Rodrik, 1994; Bardhan, 1996). There are policy measures that clearly suit both objectives. Vito Tanzi (1998) asserts that often many of the policies that benefit the lowest-income groups are those with the highest social rate of return. Programs that promote the reduction of income inequality and are also beneficial to economic growth and employment have a better chance of acceptance by politicians than those where the latter objective is ignored. European politicians will not make major efforts to reduce income inequality if they are convinced that economic growth will be negatively affected.

B. Tax Transfer Policies

It is quite normal that politicians prefer programs that have high public visibility and impact on the media; those that produce results in the short run and concentrate on specific groups of voters, and those whose costs can be kept within budgetary restraints. Generally, politicians believe that, as far as equity is concerned, voters are influenced mainly by the poverty conditions of specific groups and by the programs adopted by the government to redress that situation. On the other hand, it is much easier for voters to identify the "beneficial" effects of government policies in the case of specific expenditure programs. Thus, politicians may prefer a social activism involving some sort of paternalism toward the choices of poor people, such as noncash subsidies, rather than universal cash transfers.

Regulatory measures which take aim at the market earnings distribution, such as the minimum wage, are also attractive to politicians, in spite of the severe criticism that international organizations have leveled at them. Politicians consider these to be measures that enjoy a high public profile, enjoy explicit support from workers and trade unions, and have low direct budgetary costs.

Here, the role of the economic advisor is to reduce the temptation for politicians to employ this type of market-distorting measures as these have a negative effect on both efficiency and equity objectives in the long term. These measures are likely to benefit current workers but are detrimental to the unemployed, the less skilled and younger people.

It is politically unrealistic to think that an effective improvement in income distribution can be achieved through higher tax progressivity.

At present, a great deal of demand is placed upon the tax system for nonequity purposes. European decision makers have been receptive to the concession of various tax incentives to stimulate savings, new investment, competitiveness, technological development, and other goals. Yet, a significant improvement in equity could be achieved in some countries through more efficient measures to combat tax fraud and evasion.

On the other hand, policymakers seem to be increasingly convinced that globalization and economic integration put a heavy constraint on a national redistributive tax policy. Governments have responded to high capital mobility by reducing capital income taxation, while the labor factor, which is less mobile due to cultural and linguistic reasons, is relatively burdened. Globalization helps to explain the reductions seen in several European countries in the rates of company taxation and the special tax concessions granted for new investments, as well as the cut in personal tax rates paid by taxpayers in the highest income brackets.

Tax competition in the European Union is now a matter of concern to the Commission and some member states. It has been publicly recognized that tax competition has led to tax structures that are unfavorable to job creation and to increased tax burden on labor compared to more mobile factors. To combat this situation, the European Union is now discussing the introduction of greater coordination—if not harmonization—of corporate taxes and savings taxes in the framework of a monetary union.

Social security transfers have made a crucial contribution to a fairer European society over the last 40 years. But at present, in most countries, it is unrealistic to think that progress in income redistribution can be achieved through the increase and enlargement of the benefits of the conventional social security system, which covers pensions, health, and unemployment. The costs of the system are increasingly recognized as budget-unsustainable, due mainly to demographic changes. The system is, to some extent, in crisis in all European Union member states. Governments are under strong pressure to reform the social security system and to cut benefits, with the aim of controlling public expenditure growth. On the other hand, it is widely recognized that the high social security contributions currently in place strongly discourage investment and job creation.

Thus, a strategy to improve equity, based on the traditional tax transfer system, appears politically unfeasible. In the near future, it is unlikely that income inequality will be reduced through radical changes in the tax system or in the state social security system. The exception lies in possible improvements in administration, which, in some cases, may allow for significant results.

C. Employment and Human Capital Formation

If, for purposes of government action, the equity goal is defined in terms of dispersion throughout the income scale, the results may be disappointing, given the difficulties in conducting a national redistribution policy. It is preferable that policymakers adopt a less ambitious definition of the equity goal and concentrate their attention on the lowest-income groups and the social exclusion situations. The developments above a poverty threshold, measured as a percentage of national median income, would not be a matter of great policy concern. It is likely that, by concentrating on the poorest groups, the tension between redistribution and growth objectives would be mitigated.

For policy purposes in the real world, an equity perspective focused more on the underprivileged might lead to better results. However, the policymaker cannot ignore distributional developments affecting the nonpoor groups if income disparities above the poverty line create strong social tensions or jeopardize the other policy goals.

Taking into consideration the political, economic, and budgetary constraints mentioned above, for European governments to achieve a more equal society, priority for action should be given to two interrelated areas: the fight against unemployment and the improvement of human capital. These are strategic interventions that have a good chance of being accepted by politicians and that, in the long run, may gain ground in terms of growth and the equity objective.

These areas for action are not new. They are normal elements of the policy proposals for improving income distribution which have been advanced by economists over the past 20 years. But the environment in which the measures can now be implemented has changed, and new emphasis is justified. Some measures appear today to be much more practicable than they were in the past.

Unemployment is, in many countries, a main factor of income inequality. The social security system does not cover all those who are unemployed and, sometimes, the benefits paid do not allow for an acceptable standard of living. Poor people are particularly hit by unemployment.

Long-term unemployment is a phenomenon that has spread considerably during the 1990s and is a key factor contributing to social exclusion. Thus, the fight against unemployment should be viewed by economic and social advisors as a strategic orientation for the promotion of a more equitable distribution of income.

European governments are genuinely concerned about the high level of unemployment. And pressures arising from economic globalization and monetary union are increasing the political feasibility of more effective measures to fight the structural component of unemployment. Since 1994 the OECD has proposed a set of policy recommendations aimed at reducing unemployment—known as "The OECD Jobs Strategy"—and by the end of last year it was decided, at the highest level of the European Union, to develop a strategy of coordination of employment policies to increase the employment level and to lower unemployment rates in member states.

Policy advisors should include in the equity area measures and structural reforms that are beneficial to job creation. And policymakers should be persuaded to make the necessary adjustments and adopt the accompanying actions appropriate to a concern for social justice.

In line with *The OECD Jobs Study* (1994), a greater flexibility in the labor market has been strongly recommended for the European Union, mainly with a view to promoting economic efficiency and competitiveness. This may widen wage dispersion and, in the short run, low-skilled workers may be hit. Thus, this policy measure is often regarded as being adverse to equity, engendering a negative reaction from social agents. Labor-market flexibility includes not only labor-cost flexibility, but also mobility, flexibility in work time and work organization, adaptability, and less strict employment protection legislation.

But, if for policy action the equity goal concentrates primarily on the poorest groups, as appears to be realistic, then labor-market flexibility will contribute to a less unequal society. By improving the performance of the labor market, some jobless or socially excluded individuals would have the opportunity to work and earn wages. In this equity perspective, the employment effects of labor market flexibility are considered to be more important than the possible widening of wage distribution. But it is crucial that greater flexibility is accompanied by an appropriate social safety net which protects those who are negatively affected in their well-being. This would also reduce the possible negative social reactions to the implementation of labor reforms.

Keeping current European labor-market rigidities unchanged in the new global economy might imply higher unemployment rates and worsening social exclusion and, consequently, a more unfair society in the long run. However, a radical change in European labor markets in the direction of the U.S. model would be politically infeasible.

Social consensus institutions, including government, employers, and trade unions, might both create more favorable conditions for implementing labor reforms and provide for the accompanying actions required by an equity concern, thereby preserving social cohesion. The risk lies in the trade unions requiring compensations that are beneficial mainly to those workers who are and will continue to be employed, and not to those who lose their jobs.

Other types of job creation incentives should also be viewed as positive equity measures. Such is the case of reduced taxes on the labor factor or on consumer services, which are intensive in low-skilled labor, or even the granting of subsidies for marginal job creation, mainly to younger people and long-term unemployed workers. The high nonwage labor costs in the European Union are a strong disincentive to job creation. Measures to promote employment should also include the reinforcement of entrepreneurship, the reduction of tax and administrative costs on small and medium-sized enterprises, or the promotion of local employment initiatives. In the European Union two-thirds of jobs are created by firms having fewer than 250 employees.

Up to now, European policymakers have not been receptive toward adopting expansionary macroeconomic policies in order to tackle the unemployment problem. However, it is likely that the labor-market reforms should be coupled with a more appropriate aggregate demand management, coordinated at the community level, as some authors have suggested (Modigliani, 1996). In some countries, a strong government intervention in housing and rehabilitation of urban areas, to benefit low-income families, would be very positive from the equity point of view.

Secondly, a policy advisor with a major concern about the reduction of income inequality in a growing globalized world should give special priority to the measures directed at improving human resources through education, vocational training, and apprenticeship schemes—in particular, to those at the lower level of income distribution.

In a world of rapid technological changes, measures that promote human capital formation, by increasing the income-earning capacity of the poor, are extremely important in promoting greater equality of income. They have a positive effect on efficiency, employment, and productivity and are economically and politically recognized as key factors for competitiveness and economic growth. This is the case of free basic education or education subsidies directed toward low-income families, programs against school failure or early school abandonment,or programs to promote the integration of truant children. Training programs for low-skilled workers, and unemployed and socially excluded individuals; social integration programs for single parents; or work and apprenticeship experiences are also relevant. It is well known that imperfections in capital markets are a severe constraint on human capital investment by poor individuals.

Existing social policies should be adjusted so that individuals are strongly encouraged to enhance their competencies and skills to get a job. Individuals should improve their employability conditions. This is a concept that has been increasingly emphasized in the European Union. There is a general understanding that a passive social policy, in which unemployed, socially excluded, single parents, and other needy groups have a right to receive cash benefits, should be replaced by a more active social policy. The beneficiaries may be asked to acquire new skills and may be given personal advice regarding job search and social integration. Those who refuse to improve their employability skills might be penalized with a reduction in social benefits. It has been widely recognized that the social protection schemes existing in some countries need to be reformed, as they are too generous, encourage a culture of dependency, and discourage work effort.

D. Reforming Public Assistance Programs

The above priority areas for government action are, in our view, those which, in the long term, may lead to a less unequal European society. However, this does not dispense with specific transfer programs directed toward vulnerable groups. For those living in conditions of deep poverty and for those to which measures to promote job creation or to enhance employability do not apply, special social assistance programs adapted to the specific situations will have to be designed. Such is the case of programs targeting poor pensioners, the homeless, drug users, disabled, or ethnic minorities.

In-kind or quasi-in-kind benefits, such as housing, food, transport, and health-care benefits may be more politically attractive than cash benefits, owing to their visibility and short-term impact. And in-kind benefits may produce better results in terms of well-being, as targeting is easier. Some economists may criticize the paternalism underlying noncash subsidies, but these seem to have the preference of the voters.

There is now greater realism in understanding that the public assistance programs in some European countries have to be reformed in order to confine the benefits to the right people—those who are really vulnerable. Universal benefits paid without means testing would likely be cut in a reform of social protection systems. A more effective targeting of benefits toward the most disadvantaged groups seems inevitable.

IV. Overcoming Political and Administrataive Constraints

Competitive pressures are now making European policymakers more willing to take measures to reduce social expenditures, as some proposals of Mr. Blair's government illustrate. Those expenditure cuts should not be roundly regarded as measures running against the equity objective. On the contrary, they may correct unjustified situations and free up money for the programs of job creation and human capital investment. Policy advisors should urge politicians to turn their efforts in that direction and put the reform of the social security and welfare programs on their policy agenda.

A policy action to improve income distribution requires clear and strong government leadership. The objective of reducing income inequality should be a commitment of the head of government himself or his inner cabinet. Because the necessary measures have to be prepared by several ministries, the center of government will have to supply the impetus to policy action and ensure the coordination and coherence between economic policy and sectoral social policies.

The inefficiency of public services responsible for administration of redistributive programs is often emphasized and an improvement in their capacity is normally viewed as indispensable in achieving satisfactory results.

Programs directed toward the more vulnerable groups tend to produce better results, at lower costs, if implemented by local authorities—with the active involvement of private social organizations—than those conducted by the central government.

Decentralization of social policy tends to increase responsibility in decision making and allows for beneficiaries to be accompanied on a personal basis and for a more active policy to be pursued. Individuals can be better oriented and encouraged to return to work and thus escape social exclusion. At the same time, local authorities have better information on the individual situations. This allows for reducing fraud, ensures that benefits reach those who really need them, and lowers administration costs. The involvement of private and voluntary institutions in the implementation of welfare programs helps to improve their quality and cost-effectiveness, mainly in support of children, the elderly, the disabled, and drug users.

V. Concluding Remarks

A persistent and determined action by European governments in the area of employment and human capital formation appears to be the effort that, in practice, may lead to better results in terms of equity in the long term. These two complementary areas should be addressed at the national level, but have acquired a community dimension, as well. The creation of jobs widens the employment opportunities of those who complete training programs and acquire new skills, while the improvement of employability allows for a better adjustment of labor supply to market needs. Policies that stimulate income generation are more effective in reducing inequality of income than do unconditional cash payments to needy groups. Besides, by increasing employment, savings are made in unemployment compensation and additional tax receipts are obtained from the new workers.

Simultaneously, social security and welfare programs will have to be reformed in several European countries. Existing disincentives to job creation and job search need to be reduced. Equally important, public assistance programs should be confined to the really vulnerable people. These reforms are not necessarily negative to the equity objective. A cut in social security expenditures may be indispensable to making budgetary room for policies which are more effective in reducing income inequality and in increasing the level of employment.

In the context of the European monetary union, the financing of job creation incentives and human capital investment will have to rely mainly on the change in the composition of government expenditures. The European Commission's White Paper on Growth, Competitiveness and Employment (1993) suggested the introduction of an energy tax or pollution taxes, as well. The opposition of some member states to this type of taxation has diminished and it is possible that an agreement will be reached in the future.

An equity policy agenda including priority areas for government action such as those outlined above now has a good chance of acceptance by politicians.

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