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How Basic Income is Moving up the Policy Agenda: News from the Future

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1. Introduction

One morning some years in the future you, a citizen of Europe, wake up to the sound of the radio news. “The Government has just announced the introduction of a basic income.” You doze off back to sleep, and then suddenly re-awake, having absorbed the news. “How ever did we get to this situation?” you ask yourself. What scenario has led to the achievement of the dream of so many people, from Tom Paine to the Basic Income European Network? Is there some crucial detail that you have missed?

As Walter Van Trier (1995) has aptly described, the idea of a basic income has had a cyclical history, going through periods of enthusiastic discovery followed by sceptical evaluation, and then fading away. There were for example the social dividend proposals made in the United Kingdom during and immediately after the Second World War. At that time, people had in mind a new beginning. The basic income, or social dividend, would have been a clean break with the past. Social policy was a greenfield site. Here however I am concerned with how the basic income idea may emerge through a natural evolution of existing policy, with how basic income may be moving up the policy agenda. In planning terms, I am concerned with a brownfield, rather than a greenfield, development.

In the paper I describe three possible answers to the question asked by the hypothetical radio listener. Looking back from the introduction of a basic income, how did we get there? The key lessons to be learned from this exercise in fictional history are summarized in the concluding section.

2. The inexorable rise of in-work benefits

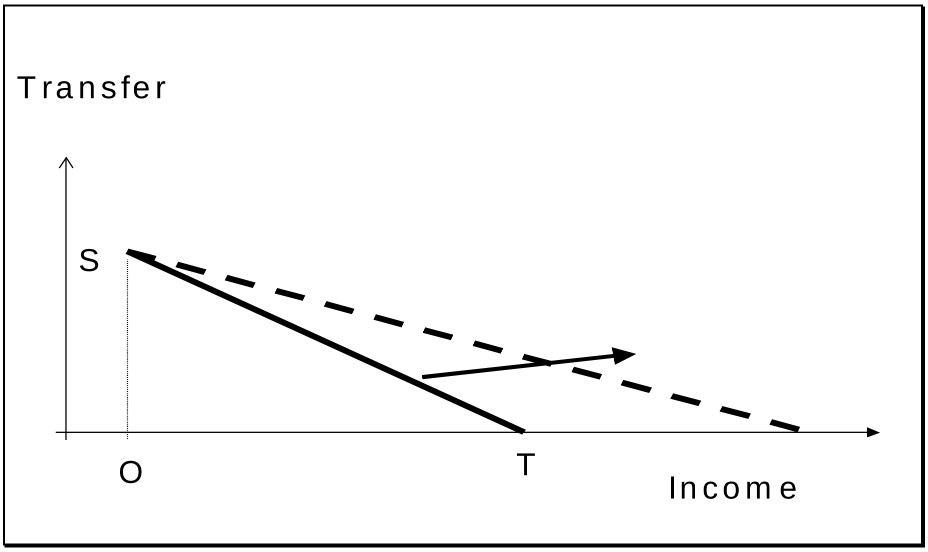
Each of the scenarios begins with a policy position that is well known to us today. We start from familiar territory, and from territory not apparently directly related to the final destination of a basic income (BI).

The first is the widespread drive towards ***in-work benefits***. In a sense this ***is*** related to BI. One of the merits consistently claimed for BI is that it is paid to all, regardless of their labour market status. The fact that it cannot be said to distort the work/leisure choice is one of the planks on which BI supporters have campaigned. The influential book by Hermione Parker (1989) is called *Instead of the Dole*. In this respect, BI is seen as superior to social transfers paid conditional on people not being in work. Social insurance forms the backbone of social protection in most European countries, and has been designed in such a way as to minimize the distortionary impact (for example by requiring job search activity and by disqualification in the case of voluntary job leaving). By insuring people against risk of job loss, social insurance has a positive function in attracting people into the labour force and in underwriting the modern employment relationship (Atkinson, 1999). But to the extent that these transfers have been generalized, and contribution conditions weakened, via the use of social assistance rather than social insurance, the impact on employment may become negative. Fears that this is the case have been one of the reasons for proposals for in-work benefits. The first Report on the European Economy by the European Economic Advisory Group at CESifo argued that "traditional social programmes ... have concentrated on replacing the earnings which are not enjoyed by those without jobs. [We propose an alternative] in which tax credits are used to supplement the wages available to low productivity workers "(Sinn et al, 2002, page 5).

The classic in-work benefit is child benefit, paid at a uniform rate for all children of a given age irrespective of the income or labour market status of their parents. Child benefit is in essence a BI for children. There has been a wide range of agreement among social security analysts and campaigners that child benefit should be the cornerstone of anti-poverty policy. Yet there have been two main problems. The first is that the level of the benefit has been too low. Beveridge (1942) proposed that child benefit should cover the "subsistence" needs of a child. Applying the EU risk of poverty criterion, and the OECD scale, this requires that child benefit be some quarter of mean equivalent disposable income. Most, if not all, countries fall short. The second problem is that this strategy does not provide for the needs of adults or for households with no children.

The standard response to the first problem has been to seek a "cheaper" solution by targeting transfers for children to those in families with low incomes. Selectivity has been the watchword. This principle underlay the introduction of the Family Income Supplement in the UK in 1971, which paid a sizeable transfer to families where at least one parent was in paid work but tapered the transfer with total family income. In other countries, benefits are paid via the income declared for income tax, but the effect is the same: the benefit is scaled-down with income. If there is a minimum hours condition, and a minimum hourly wage, generating a minimum monthly level of earnings, then a government can set the payment at this "origin" (point O in Figure 1) sufficient to meet its poverty objective, S, but limit the benefit to those families with an income less than T (see the solid line in Figure 1). This is a process that began with families with children but which the UK government plans to extend to other family types with the Working Tax Credit due to come into operation in 2003 (Brewer, Clark, and Myck, 2001).

Figure 1. In work income-tested benefit



But targeting comes at a cost. We have now had enough experience to know that there are two major shortcomings. First, the administration of the income test means that some people do not receive the benefit to which they are entitled: "even in the most well regulated countries, studies have shown means-tested schemes have take-up rates as low as 20 per cent" (Standing, 2002, page 98). Where its operation requires people to make a claim on the basis of their income, a proportion fail to do so. There is none of the automaticity associated with paying a BI each month into a person's bank account. Where the employer administers the scheme, some workers are deterred from claiming since they do not wish their employer to know their personal circumstances.

The second problem is the high marginal tax rate on earnings. The withdrawal of the transfer inevitably involves an increase in the total tax rate, whether the withdrawal is applied to gross earnings or to earnings net of income tax and social security contributions. The marginal tax rate with the present UK Working Families Tax Credit is, for a taxpayer, 69.4 per cent. This is substantially higher than the rate for top earners, which is 40 per cent. Can it not be expected that such a marginal tax rate, combined with the positive income effect of the transfer, discourages people from working longer hours or changing to a better paid job? Of course, the conditionality provides a positive incentive, in that people may come back to work, or increase their hours to the minimum required to qualify, but once in receipt the targeting acts as a disincentive.

The effect of high marginal tax rates has been extensively analysed (Blundell, 2001), but this literature concentrates almost exclusively on the reaction of individual workers. Yet there are two other important players in the labour market: employers and trade unions. They too may react to the high marginal tax rates. Suppose that output depends on worker effort, which is continuously variable and is fully observable. Employers have a pay policy that relates wages in part to productivity. Workers determine their effort level taking account of the benefit to them in terms of the productivity bonus, but this is reduced by the marginal tax rate. Employers in turn take account of the worker reaction when designing their remuneration policy. If the marginal tax rate is increased by the introduction of in-work income-related benefits, then the power of the bonus incentive is reduced, and the employer may react by reducing the productivity bonus proportion. The final effect, taking account of the employer reaction, may be a more marked reduction in effort and hence output. There are adverse consequences for productivity.

Introduction of the employers is important not only because they are separate actors, but also because it highlights how the effect of selective in-work benefits depends on the *proportion of the work force covered.* An employer has to devise a pay policy for the labour force as a whole. The fact that a small fraction of workers are receiving in-work benefits will not cause employers to change policy. With the extension of transfers up the income scale, it begins to have an effect. There is therefore a possibly unstable dynamic. Concerns about high marginal tax rates lead governments to amend the scheme. The point S is fixed, as it is necessary to meet the anti-poverty objective, so that the government swings the line round anti-clockwise. The new scheme is the dashed line in Figure 1, lowering the marginal tax rate but bringing more families into the benefit area. More employers find that their workers are affected, and more adjust their policies, generating a further reaction.

The reaction of employers to the high marginal tax rate is to reduce wages paid, and this may be seen as moderating wage pressure (see Lockwood, Sløk and Tranæs, 2000). The same applies to trade unions. It has been argued that progressive taxation reduces the marginal pay-off to a wage increase, giving unions less of an incentive to pursue wage increases at the expense of employment (Hersoug, 1984). On the other hand, the effect of the income-related transfer scheme is to raise the take-home-pay of the non-unionized workers as well as the unionized, and in the simplest case these effects cancel.[1] Moreover, the union objective may be different from the U (wage, employment) utility function assumed in this literature. Unions may have a target net real wage (see Malcomson and Sartor, 1987, although it should be noted that their empirical evidence for Italy rejects this formulation). If workers keep only a third of their net increase, this means that the union has to secure a • 30 increase to get a • 10 increase in take home pay. Here again the proportion covered by the tax credit scheme is important. Unions are negotiating on behalf of all their members. The fact that a few are receiving tax credits makes no difference, but once they begin to be a significant, and vocal, proportion, then the union will take account of the marginal tax rate.

It is here that we find the first possible explanation of the shock radio announcement. For we have to look at collective bargaining in the context of European monetary union (I am assuming that by this time the UK will have joined). With a common interest rate policy, and constraints on fiscal policy, member state governments are going increasingly to have resort to old-fashioned measures. They are deeply worried that wage demands will make their goods uncompetitive, so that they intervene explicitly or implicitly in wage setting. Using a tried and tested approach, they offer union leaders a deal: you moderate wage demands, and we will compensate you through the fiscal system. One consequence may well be the anti-clockwise swing in the in-work benefit

[1] The key element is the elasticity of net union gain with respect to changes in the gross wage. The derivative is reduced by (1-t), where t is the implicit tax rate, but with a constant taper the net gain versus the non-union wage is also reduced by the same amount.

schedule. This increases the net incomes of all recipients, so allowing union leaders to claim increased take-home pay. But the implied extension of coverage also means that the marginal tax rate (while lower) figures more prominently next time in wage demands. The dynamic is unstable, and the end result is likely to be a situation where virtually everyone is receiving a guaranteed payment of S and facing an increased tax rate. Which is how the BI came about.[2]

Is there a catch? Yes. The payment is conditional on working a minimum number of hours, or else of qualifying for the out-of-work benefits (which means being available for work unless another condition is satisfied). In other words, the announcement was of a Participation Income, rather than an unconditional BI. The government has listened to Tony Atkinson rather than to Phillipe van Parijs. Surfers are not to be fed.

3. Crumbling pension pillars

The second possible starting point of our journey from the present to the hypothetical future is the well-known World Bank proposal for a three-pillar approach to pension provision. The study *Averting the Old Age Crisis* (World Bank, 1994) advocated a limited public pillar, modest in size, with the goal of alleviating poverty, combined with a second mandatory pillar based on fully funded and privately managed pensions, coupled with a third voluntary pillar. The move from funded to unfunded pensions has been seen as offering a solution to the problems of an ageing population via improved economic performance (Holzmann, 1999).

Again this has no direct link with BI, but we can see how a connection may emerge if we consider the design of the first pillar. The World Bank described at

[2] After this was written, I received the *Citizen's Income Newsletter*, 2002, number 2, reprinting Professor Patrick Minford's article from the *Daily Telegraph* (13 May 2002), in which he argues "basic income could prove an escape route from the benefits trap".

least three options: (a) a means-tested programme, (b) a minimum pension guarantee, and (c) a flat-rate insurance benefit. The main emphasis has been on the first. Concern with restraining public sector costs has led governments to use means testing as a way of maximising the contribution from other forms of support. The UK Labour Government elected in 1997 decided to give priority to the Minimum Income Guarantee (MIG), subject to both income and assets tests. This meant that the budget constraint facing people, as they consider saving for old age, has a horizontal segment, where an increase in the income from saving yields no benefit in terms of net income, as the MIG payment is reduced £1 for £1. See the heavy line in Figure 2. (In fact the implicit tax rate was over 100% in view of the fact that the assumed income from capital exceeded that obtainable by the typical small saver.)

This generates a "savings trap". People who do not expect to save enough to clear the minimum guarantee in effect face a 100 per cent tax rate on their income. As a result, "if people realize that they will face this position in advance, they may decide there is little point in saving or building up pension rights below a threshold" (Hills, 1993, p 29). Again the impact depends on the numbers affected. For as long as a relatively small proportion of relatively less well-off pensioners faced the severe disincentive, then the issue received little attention. The raising of the MIG has however brought more people prospectively into the trap, and in the UK it has received extensive media coverage, making people more aware of the way in which "if you've got your own private pensions, then you're penalized" (respondent to Financial Services Authority survey, quoted in *Citizen's Income Newsletter*, 2002, number 2, page 7).

Figure 2. Pensioner credit in the United Kingdom

The savings trap undermines the third, voluntary pillar of pension provision. What about the second, mandatory pillar? The replacement of state pay-as-you-go pensions by a private funded scheme may appear straightforward. Suppose that the employer administers the private scheme. Assuming that the mandatory second tier offers workers terms no less favourable than private savings, at worst it displaces savings under the third pillar. But this ignores the fact that the savings trap still operates. A worker who sees no personal gain from the savings will regard the mandatory pension as a reduction in the net wage, and part of the burden will be shifted to the employer. Employers will see their wage costs increased, just as they are increased by state scheme contributions.[3] Again the crucial feature is the percentage of the work force potentially affected by the savings trap. The generalization of means-tested pensions will cause into question the acceptability of the second, mandatory tier.

[3] With the state scheme, the contributions are handed over at once; with the mandatory second tier pension, the process is less direct. The employer pays the contribution into a fund that becomes the property of the worker on retirement, who then hands it back to the government in the form of a reduced MIG supplement.

To this one must add the declining confidence in funded pensions. The arguments for replacing pay-as-you-go pensions were in essence based on the rate of return to capital, r, exceeding the rate of growth of the wage bill, n. It is true that, in the early days of pay-as-you-go pensions, the extension of coverage allowed n to exceed its long-run value. Recognition that, in the future, n will be relatively low led to the enthusiasm for funding. But r has also been overstated in recent decades as a result of the revaluation of equities. There has been a fall in prospective returns, as competition has increased following globalisation and market liberalisation. It is now less evident that funding offers a panacea. In the same way, the ageing of the population has been seen as a problem for pay-as-you-go pensions, with the rise in the dependency ratio, but it also raises problems for funded pensions, as is evidenced by the increased funding requirements for defined benefit plans and by the worsening annuity rates for those with defined contribution funds.

More generally, there is increasing anxiety about pensions. This is not just a question of risk. Small savers have become accustomed to being told that "investments can go down as well as up" or that there is a 10 per cent risk that the portfolio will not meet their target yield. Now, however, they have to come to terms with *uncertainty*, to use the phrase of Frank Knight (1921). Put crudely, uncertainty means that we cannot even list the events over which we need to form probabilities. It concerns the truly unexpected. For example, it would have been a particularly perspicacious investment adviser who warned you in the year 2000 that one ought to investigate the accounting practices of corporations. For most people, the accounting scandals came quite out of the blue.

All of this may lead us back to basic income, providing a second possible explanation for the radio announcement. The title of this Congress is "Income Security as a Right". How can this be assured for the elderly? For the reasons I have described, the World Bank's three pillars each look distinctly shaky, and governments may turn instead to an Old Age Basic Income (OABI). Payment of a basic income to all persons over a specified age, with no means testing, only taxation as under the income tax, would provide a secure base. It would allow people to make supplementary provision, either privately or via employer schemes or state schemes. The "catch" is that the scheme would apply only to the elderly. Our hypothetical listener missed the first two words in the name of the new scheme. We would have child benefit for those aged under 18 and OABI for the elderly, but nothing for those aged 18-64.

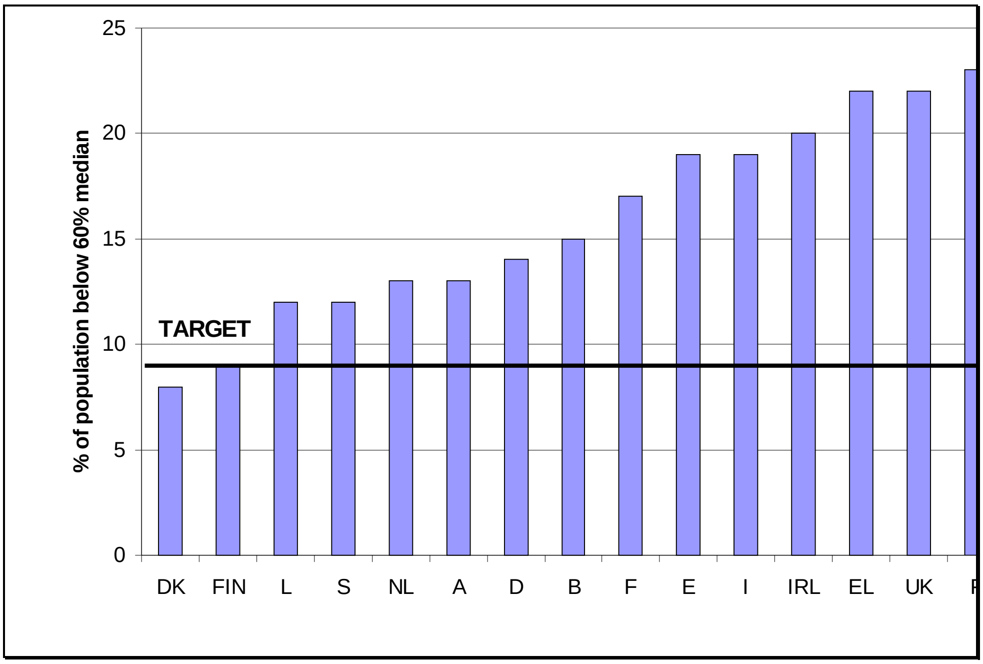
4. Taking social Europe seriously

The third point of departure is again one that is not directly linked with BI. The story begins in March 2000 at the European Summit in Lisbon, where EU Heads of State and Government decided that the Union should adopt the strategic goal for the next decade not only of becoming "the most competitive and dynamic knowledge-based economy", but also of achieving "greater social cohesion". This reflected the feeling of many people that the social dimension of Europe deserved more priority. Later in 2000, at the Nice Summit, it was agreed to advance social policy on the basis of an open method of coordination, an approach that recognizes that, under the principle of subsidiarity, social policy remains the responsibility of Member States (which is why the announcement of the introduction of a BI came from the national government, not Brussels). It was decided that each Member State should implement a national two-year action plan for combating poverty and social exclusion, setting specific targets. The first National Action Plans on Social Inclusion were submitted in June 2001, and a further round is due next year.

As part of this process, the EU has developed a set of social indicators, embodying the commonly agreed objectives (see Atkinson et al, 2002). The Social Protection Committee established a Sub-Group on Social Indicators, whose report (Social Protection Committee, 2001) was accepted by the Employment and Social Affairs Council in December 2001, and now forms the basis for European Union policy-making. The indicators encompass financial poverty, income inequality, and regional variation in employment rates, long-term unemployment, joblessness, low educational qualifications, low life expectancy and poor health. A range of indicators was reported in the *Joint Report on Social Inclusion* (European Commission, 2002).

A key indicator is the number of Europe's citizens living in financial poverty. Measured in terms of the proportion living below 60 per cent of the median equivalent disposable household income, as shown for individual Member States in Figure 3, the overall EU income poverty rate was 18 per cent in 1997. In its Communication to the Spring European Council in Barcelona, the European Commission proposed that the European Council should set the target of halving the poverty rate to 9% by 2010 (European Commission, 2002a, page 16)[4]

Figure 3. Poverty rate in EU, 1997



Here we find a third possible explanation for the radio news announcement, and indeed for the first time an indication as to *when* it may happen. The

[4] The Presidency Conclusions refer to Member States "being invited to set targets, in their National Action Plans, for significantly reducing the number of people at risk of poverty and social exclusion by 2010" (European Commission, 2002b, page 5).

Commission documents show the EU poverty rate as 18 per cent in 1997 and a series of blank entries until the target of 9 per cent in 2010. The aspiration is to reduce the numbers over the decade. In their National Action Plans, Member States have set out a variety of policy initiatives (see Atkinson et al, 2002, Ruxton and Bennett, 2002 and Atkinson, 2002). In a number of countries, these build on policies already in force. Ireland initiated its National Anti-Poverty Strategy (NAPS) in 1997, in response to the 1995 UN Social Summit in Copenhagen. In the UK in 1999 a high-profile commitment was made to eradicating child poverty in twenty years and halving it in ten (Blair, 1999).

The policies set in train by Member States may well have significant effects, but many of them are long-term in their impact. Investment in human capital takes time to yield its full return. Many of the children benefiting from current policies will not enter the labour force until after 2010. Measures to activate those not currently in the labour force will require changes in social attitudes and culture that take time to bring about. Regional policies may involve investment in infrastructure. It is therefore quite possible that, as 2010 approaches, Europe's leaders will find themselves contemplating the need for more rapid action – or else have to admit that the aspiration is unattainable in the indicated timescale.

It is here that we find the third possible origin of the radio announcement. The most rapid effect can be achieved via cash transfers, and the introduction of a European BI provides for European leaders the lifeline they need. Each Member State will be required to ensure a minimum basic income, related to average equivalent disposable income in their country. It is to be provided without test of means, since otherwise the impact may be undermined by incomplete take-up, but the form is to be determined, under subsidiarity, by Member States. It could take the form of a minimum state payment, rolling up existing state payments. In the case of the elderly, for instance, additional payments would only be made where the existing pension income fell short of the minimum (see Atkinson et al, 2002a, for an analysis of a European minimum pension). It could be household-based, reflecting the form of the poverty calculation. This would mean that a single man living with his parents would receive nothing if their existing state benefits, divided by the equivalence scale, were above the minimum.

The European BI would therefore be playing a clear political role, and this dictates its form. The "catch" in this case is that it would be a *partial* BI. The rate would be set, not by an independent assessment of the income needed, but by a calculation of the figure required to achieve the target poverty reduction.

5. What have we learned?

From these three stories, I draw two main conclusions – apart from the obvious moral that campaigners should not give up. The first is that BI may be introduced in a less than ideal form. There may be a "catch" in the government announcement, so that one has to listen to the details. But each of the incomplete BI schemes described here would be a step on the road. The second is the importance of exploiting existing trends in policy-making. Politicians may not be persuaded by the pure logic of a BI but may support its introduction because it is the logical terminus of policies already in train (in-work benefits), because it resolves a policy dilemma (the pensions crisis), or because it advances the European agenda (poverty targets). One has to work with, not against, the flow, harnessing the economic and social situation to one's advantage. Otherwise, BI may remain simply a dream.

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