Income redistribution through taxes and transfers across OECD countries: A focus on the bottom 40 per cent

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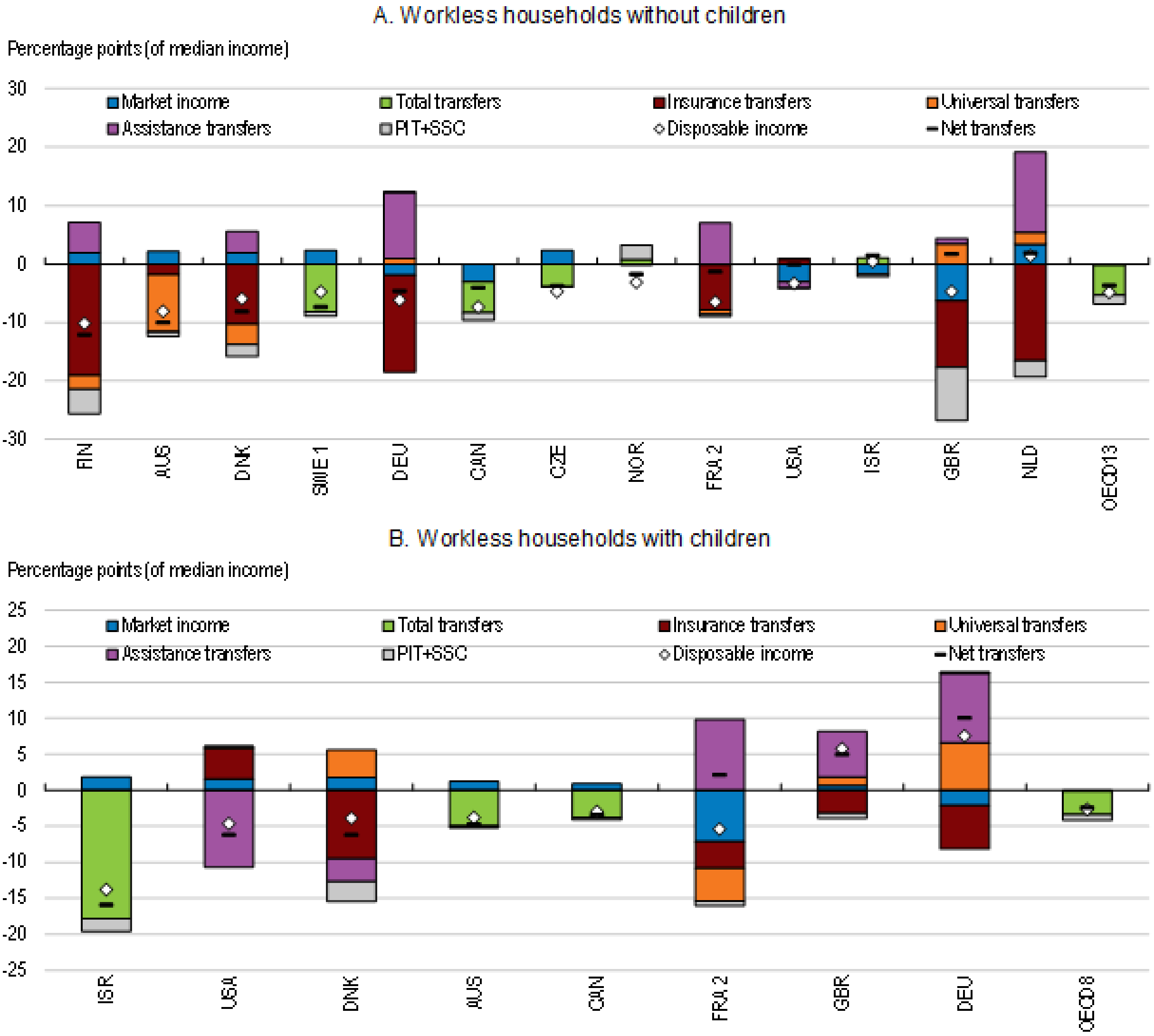
Tax and transfer systems are fundamental pillars of an inclusive growth policy agenda that aims at sharing the benefits of growth more equally and securing decent living standards for those in most need. A new OECD report by Causa and Hermansen (2017) ("[Income redistribution through taxes and transfers across OECD countries]()") documents that redistribution through taxes and transfers has tended to decline across OECD countries since the mid-1990s. By and large, the decline in overall redistribution across OECD countries over the last decades has been primarily driven by a decline in redistribution by cash transfers. This is not surprising insofar as cash transfers account for the bulk of redistribution.

While the analysis cannot disentangle between policy and non-policy drivers of such decline in redistribution, this picture raises the concern that welfare systems are becoming less effective at ensuring income adequacy among vulnerable households. This question can be addressed by focusing on developments in market (or pre-tax and transfer) income and redistribution among households in "the bottom 40%" of the distribution. In order to isolate the effect of changes in population structure within that group, the composition of households is adjusted according to the working status of adults and the presence of children, two key parameters affecting the "need" for redistribution. This delivers the following insights, focusing on developments over the last two decades:

- Income support provided by social transfers to bottom 40% workless households has declined in the majority of countries for which data are available (Figure 1). Given the overwhelming weight of transfers relative to market income among that group, their disposable income declined markedly relative to median income. In the majority of countries for which data are available, cash transfers have become increasingly ineffective at preventing workless households from falling into relative poverty, especially in the presence of children.

Figure 1. Income adequacy implied by taxes and transfers have become less supportive of bottom 40% workless households

Change in taxes and transfers in percentage of median household disposable income, from mid-1990s to 2013 or latest available year



1. Sweden only available for 1995-2005.

2. Social security contributions not available for France.

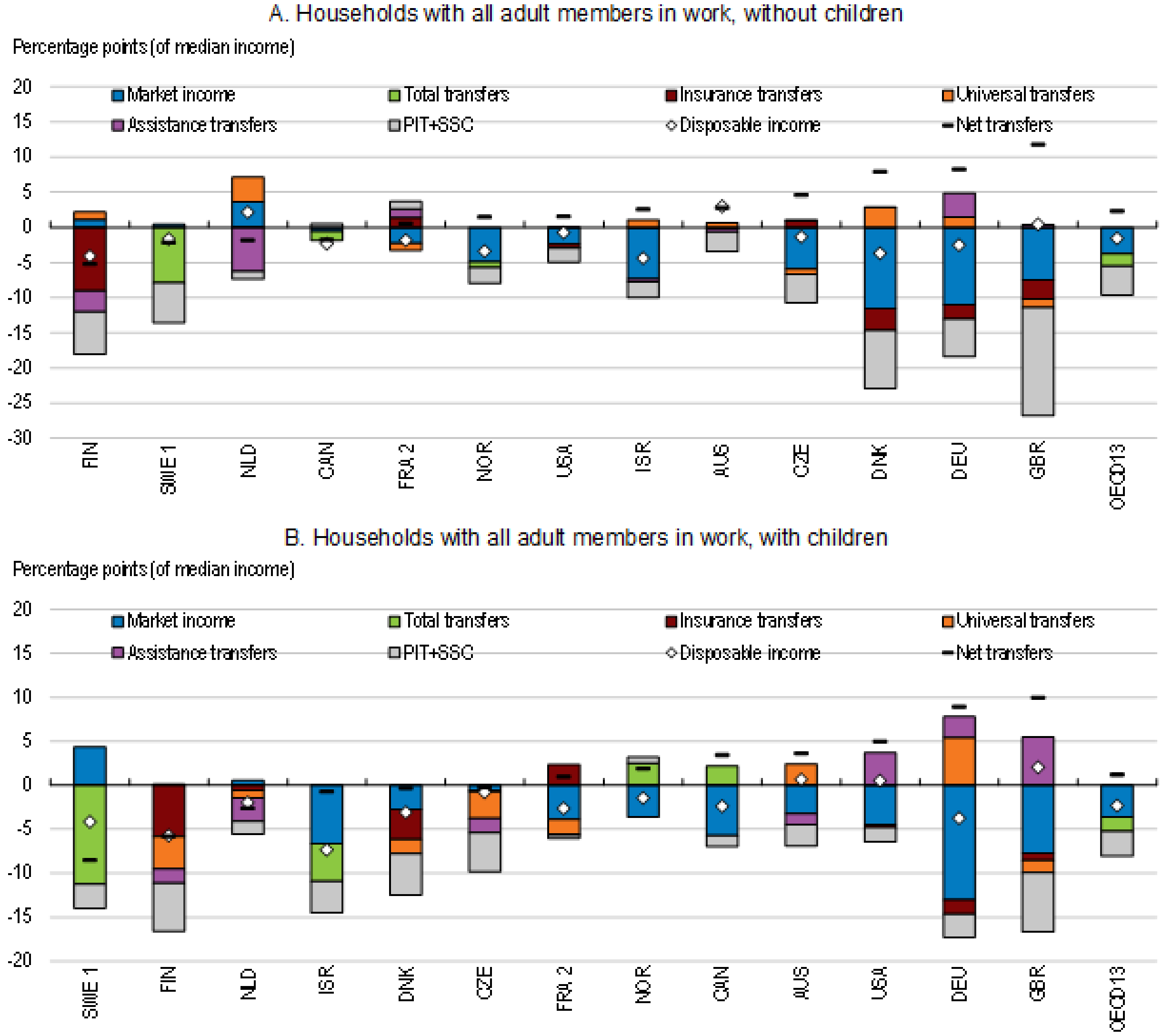
Note: Countries are sorted by net transfers received. The sample comprises all households among the bottom 40% (ranked by disposable incomes) with zero labour income. Countries with sample sizes less than 100 households have been excluded in Panel B. See note to Figure 5 for country-year coverage.

Source: OECD staff calculations based on the Luxembourg Income Study.

- By contrast with workless households, income support provided by taxes and transfers to bottom 40% working households has increased in the majority of countries for which data are available (Figure 2). The increase in net transfer support was largely driven by declines in income taxes and social security contributions that tended to mitigate widespread declines in market incomes.

Figure 2. Taxes and transfers have become more supportive of bottom 40% working households, but their incomes still fell behind the median

Change in taxes and transfers in percentage of median household disposable income, from mid-1990s to 2013 or latest available year



1. Sweden only available for 1995-2005.

2. Social security contributions not available for France.

Note: Countries are sorted by net transfers received. The sample comprises households among the bottom 40% (ranked by disposable incomes) for which all adult household members have positive labour income. See note to Figure 5 for country-year coverage.

Source: OECD staff calculations based on the Luxembourg Income Study.

The decline in redistribution may to some extent reflect the effects of tax and transfer reforms to make work pay for individuals with low earnings potential and weak labour market attachment. Concluding from this that such reforms were inappropriate would fail to consider redistribution policies as part of broader policy packages to make growth more inclusive. For example well-designed policy packages should combine tax and transfer policies to make work pay and boost jobs with policies to improve employability, skill adaptability and wage prospects. In other words, to raise job quality for less-skilled and at-risk individuals such as disadvantaged youth and immigrants, but also for older workers facing displacement in declining sectors. The policy implication is that tax and transfer reforms should be designed within an array of complementary policy instruments to address equity and efficiency objectives, taking into account country-specific context, constraints and social preferences.

References

Causa, O. and M. Hermansen (2017), "Income redistribution through taxes and transfers across OECD countries", *OECD Economics Department Working Papers*, No. 1453, OECD Publishing, Paris, http://dx.doi.org/10.1787/bc7569c6-en.

Income redistribution through taxes and transfers across OECD countries

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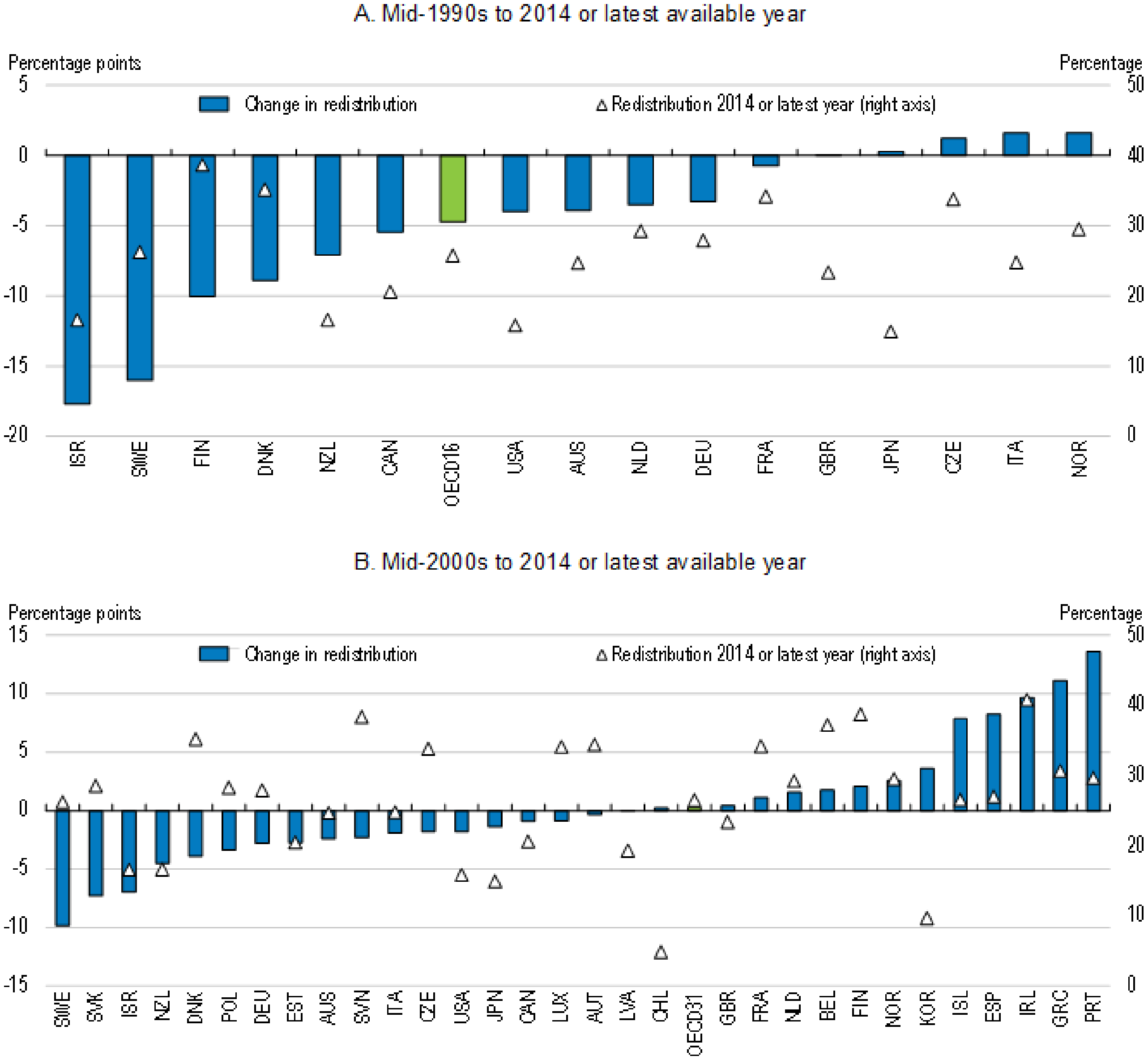
Many OECD countries have been facing a prolonged period of low growth and stagnating income of the poorest. This challenges governments' fiscal redistribution, all the more so in a context where new forms of work are calling into question the effectiveness of traditional social safety nets and population ageing is putting pressure on public finances. Yet, the system of taxes and transfers that underpins social protection is a fundamental pillar of an inclusive growth policy agenda that aims at sharing the benefits of growth more equally. A new OECD report by Causa and Hermansen (2017) ("Income redistribution through taxes and transfers across OECD countries") takes stock of the extent to which tax and transfer systems mitigate market income inequality today, and how this has changed over a period of rising globalisation and rapid technological change.

Redistribution through taxes and transfers has tended to decline across OECD countries since the mid-1990s

Since the mid-1990s, the redistributive effect of taxes and transfers has declined in the majority of OECD countries for which data are available (Figure 1, Panel A). The trend towards less redistribution was most pronounced over the pre-crisis period, and was temporarily reversed during the first phase of the crisis, reflecting the cushioning impact of automatic stabilisers and fiscal discretionary measures. The decline in redistribution was particularly pronounced in some Nordic countries, which are among the most egalitarian OECD countries. Admittedly, the extent of the decline observed in these countries was amplified by high levels of redistribution prevailing in the mid-1990s due to high unemployment. The steadily improving labour market outlook during the subsequent decade reduced the need for redistribution. The inequality-reducing effect of redistribution also declined among the least egalitarian of OECD countries, especially Israel, but also Australia and Canada. Trends in redistribution were more heterogeneous over the most recent decade, with increases in around half of OECD countries, in particular those hardest hit by the crisis (Figure 1, Panel B).

Figure 1. A widespread decline in redistribution across advanced OECD countries since the mid-1990s

Change in redistribution for the working-age population



Note: For Panel A data refer to 1994-2015 for the United Kingdom; 1995-2012 for Japan; 1995-2015 for Finland, Israel, the Netherlands and the United States; 1996-2014 for Czech Republic and France; and 1995-2014 for the rest. For Panel B data refer to 2003-2012 for Japan; 2003-2014 for New Zealand; 2004-2015 for Finland and the United Kingdom; 2005-2014 for Denmark, France and Poland; 2005-2015 for Israel, the Netherlands and the United States; 2006-2015 for Chile and Korea; and 2004-2014 for the rest. See note to Figure 1 for further details on redistribution measure and working-age population.

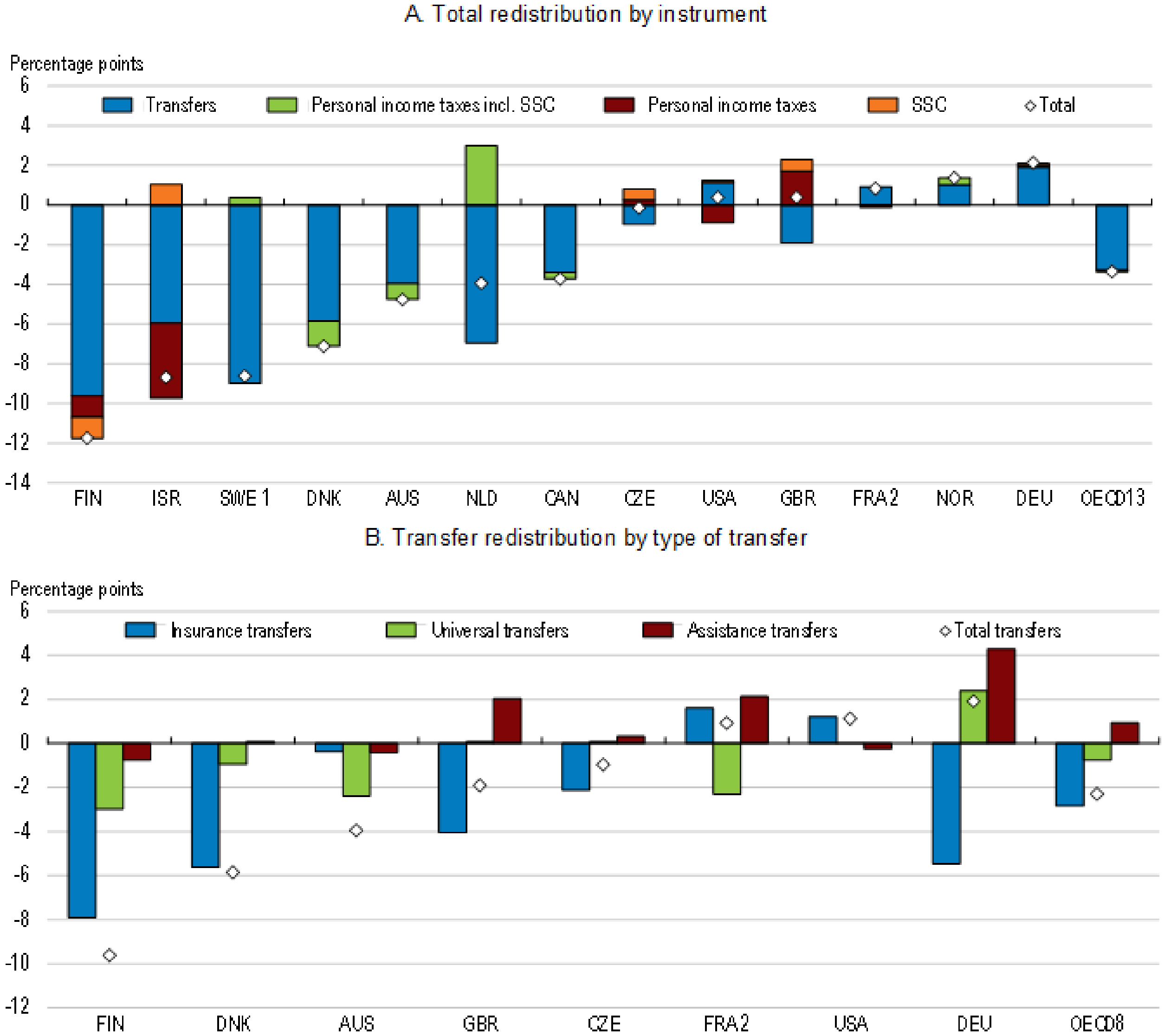
Source: OECD Income Distribution Database.

The decline in redistribution was largely driven by insurance transfers to working-age households

By and large, the decline in redistribution across OECD countries has been primarily driven by a decline in redistribution by cash transfers, which is not surprising insofar as cash transfers account for the bulk of redistribution. Personal income taxes also contributed but played a less important and more heterogeneous role across countries (Figure 2, Panel A). In turn, the decline in transfer redistribution was largely driven by insurance transfers (e.g. unemployment insurance, work-related sickness and disability benefits). This was partly mitigated by more redistributive assistance transfers (e.g. minimum income transfers, means- or income-tested social safety net) in some countries such as Germany and the United Kingdom (Figure 2, Panel B). Assistance transfers are in many OECD countries less redistributive than insurance transfers, for instance due to low take-up but also due to relatively low benefit amounts, so that their size is generally smaller than insurance transfers.

Figure 2. The redistributive effect of transfers has declined markedly across OECD countries

Change in redistribution for the working-age population, mid-1990s to 2013 or latest available year



1. Sweden only available for 1995-2005.
2. Social security contributions not available for France.

Note: See Box 4 for the approach to assess the redistributive impact of individual parts of the tax and transfer systems. Data refer to 1993-2013 for the Netherlands; 1994-2010 for Canada and France; 1994-2012 for Hungary; 1994-2013 for Germany, the United Kingdom and the United States; 1995-2000 for Belgium; 1995-2005 for Sweden; 1995-2010 for Australia; 1995-2013 for Denmark, Finland and Norway; 1996-2012 for Mexico; 1996-2013 for Czech Republic; 1997-2012 for Israel and Slovenia.

Source: OECD staff calculations based on the Luxembourg Income Study.

Policy implications

One finding highlighted in Causa and Hermansen (2017) is a fairly widespread shift in transfer policy from out-of-work to in-work support, at least partly driven by reforms to make work pay, especially for workers with weak labour market attachment. While this is likely to have mitigated market income inequalities by spurring employment growth, it could have contributed to the decline in redistribution. This should not lead to the conclusion that countries have no choice but to trade more efficiency for less equity. The reason is that redistribution policies should be considered as part of broader policy packages to make growth more inclusive. For example, well-designed inclusive growth packages should combine tax and transfer policies to make work pay and boost jobs with policies to improve employability, skill adaptability and wage prospects. To the extent that such packages have not been broadly deployed by OECD countries, potentially reflecting budgetary constraints, reductions in market income inequality induced by such reforms have not been sufficient to prevent disposable income inequality from rising.

References

Causa, O. and M. Hermansen (2017), “Income redistribution through taxes and transfers across OECD countries”, *OECD Economics Department Working Papers*, No. 1453, OECD Publishing, Paris, http://dx.doi.org/10.1787/bc7569c6-en.