

Income Transfers Alone Won't Eradicate Poverty

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Even in the current economic situation, in developed countries, rhetoric about cutting "poverty" is misleadingly outmoded—because it implicitly suggests that government income transfers can be the vehicle for achieving substantial reductions in poverty. Almost all Americans already live far above subsistence poverty: most because of their earnings, and the rest because of government transfer programs. This decline in material poverty is obscured by weaknesses in how the official U.S. poverty measure counts income. What is now called poverty is really "income inequality." Reducing income inequality is also a vitally important social goal, but it cannot be accomplished through income transfers alone. The authors argue that, although income transfers have a role to play in lessening the impact of material deprivation, real progress in raising incomes will require building the human capital of the economically disadvantaged. This means both increasing the earnings capacity of lower-income workers and reducing the number of female-headed families.

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Recently, major political figures in the United States and the United Kingdom have promised to make substantial reductions in poverty. In 1999, then British Prime Minister Tony Blair vowed to "be the first generation to end child poverty." He added that it would be "a 20-year mission but I believe it can be done" (Blair, 1999).¹ Although John Edwards was the American politician most identified with the issue, candidate Barack Obama promised to halve poverty within 10 years (The Compassion Forum, 2008).² And his Republican opponent, John McCain, vowed to "make the eradication of poverty a top priority of the McCain Administration" (McCain, 2008).

Even in the current economic situation, in developed countries, this kind of rhetoric about cutting "poverty" is misleadingly outmoded—because it implicitly suggests that government income transfers can be the vehicle for achieving substantial reductions in poverty. And, in fact, when concrete proposals are put forward to reduce poverty, they usually involve an increase in income transfers. For example, former presidential candidate John Edwards's Half in Ten campaign to halve American poverty in 10 years has, among its "immediate policy priorities," increases in the minimum wage, child tax credit, Earned Income Tax Credit, Unemployment Insurance, government-funded child care, and the creation of "Green Jobs." Lower on the

list of priorities are only three proposals designed to increase the human capital of low-income workers, specifically increase Pell Grants, “connecting” disadvantaged youth with school and work, and increasing employment opportunities of former prisoners.³

In the developed world, almost all citizens already live far above subsistence poverty: most because of their earnings, and the rest because of government transfer programs. In large measure, what is now called poverty is really “income inequality.” Reducing income inequality is also a vitally important social goal, but it cannot be accomplished through income transfers alone. Income transfers cost too much; create harmful disincentives to work and marriage; and must compete against other, much more politically popular programs (such as old-age pensions and health care).

This paper argues that, although income transfers have a role to play in lessening the impact of material deprivation, real progress in raising incomes will require building the human capital of the economically disadvantaged. This means both increasing the earnings capacity of lower-income workers and reducing the number of female-headed families. Neither are as easy as writing checks to low-income citizens, but both are essential to long-term progress.

Relative versus Absolute Poverty

Webster’s dictionary defines “poverty” as the “lack of means of subsistence,”⁴ with “subsistence” being “that which supplies the *means of living*.”⁵ By this definition, poverty has all but disappeared in wealthier nations (including the United States and the United Kingdom), where almost all citizens are free from life-threatening material want. This does not mean that the problems of low income and material deprivation have disappeared, just that subsistence (or better) levels of food, clothing, shelter, and medical care are now almost universal (Eberstadt, 2009)—thanks to expanded government transfers and higher earnings (even at the bottom).

Why, then, does poverty reduction command such political attention? And why would it take so long to eradicate poverty? Or even to halve it? The answer, of course, is that, as Western societies have become wealthier, the meaning of poverty has expanded. To oversimplify a complex and ongoing argument, the political argument is moving from “absolute poverty” to “relative poverty,” or more accurately “income inequality.”

“Absolute poverty,” the traditional way of measuring poverty, is calculated against a specific amount of income determined (accurately or not) as the amount needed to meet people’s physical needs. Of course, all absolute measures are to an extent, relative. Thus, reflecting the very low living standards in some countries, the World Bank measures poverty using an absolute measure of about \$1.25 in consumption per person per day (about \$456 annually) for low-income, developing countries; and about \$2.50 (about \$912 annually) for middle-income, developing countries (at 2005 international purchasing power parity) (Chen & Ravallion, 2008).

Even the U.S. absolute poverty measure is, in origin, a relative measure. It is based on the USDA’s “Thrifty Food Plan”⁶—not a subsistence diet—multiplied by three (to reflect food’s place in the overall household budget of average Americans).⁷

In 2007, the U.S. poverty threshold for a family of three was an annual income of \$16,705 (U.S. Census Bureau, 2008c). (All amounts are in 2007 dollars, unless otherwise specified.)

Based on the official U.S. poverty measure, in 2004, the poverty rate for American families was 12.7 percent. But this does not consider income from the Earned Income Tax Credit (EITC), let alone various noncash benefits (such as food stamps and housing assistance).⁸ Include the major types of income that are excluded (noncash benefits and tax-based transfers) and also correct the poverty threshold for past overstatements of inflation, and the official poverty rate falls to 8.6 percent—about a third lower.⁹ Other more controversial adjustments, such as including the value of Medicaid and Medicare or the imputed rental value of owner occupied housing, would lower poverty to as low as 5 percent (Besharov, 2006). Some advocates for the poor are willing to accept these adjustments, but only if the threshold itself is raised (which, of course, would negate the impact of counting a larger portion of household income) (National Academy of Sciences, 1995).

The current measure has been criticized by analysts on the right and the left. “Although there is widespread consensus that the current official measure in the United States is badly flawed, three decades of discussion and debate have not resulted in any change to this statistic,” laments Rebecca Blank of the Brookings Institution (Blank, 2008). The U.S. poverty measure has proven difficult to change because, besides the political implications of a rise or fall in poverty, it (or its variant) is used to determine eligibility for many means-tested, social assistance benefits. Change the measure, and tens of thousands of people gain or lose benefits—with government spending rising or falling commensurately.

Contemporary antipoverty rhetoric, however, suggests an informal yet substantial expansion of the U.S. poverty measure. Many liberal advocates now, for example, use the term “working poor” to denote persons in households (that have at least one person working at least part time) with incomes up to twice the official poverty line (Acs, Phillips, & McKenzie, 2000). And American journalists have tended to accept this construction, perhaps because they do not understand the difference or because they are sympathetic to the expansion. (Although rarely expressly stated as such, it is this “poverty” that has been the target of the American “make work pay” movement; Zedlewski, Chaudry, & Simms, 2008.) Hence, in the discussion that follows, as appropriate, we also present estimates at twice the official poverty line.

“Relative poverty,” the approach to poverty measurement most commonly used in Europe, is a calculation based on the income of a selected percentile of society (which rises or falls depending on changes in the distribution of income). Some consider this to be the amount of income needed to provide “decent living conditions” and to prevent the exclusion of people “from the goods and services that are customary in any given society” (Förster & Mira D’Ercole, 2005, p. 21).

Actually, some have argued that differences in consumption are a better, or at least a significant, additional measure of poverty and inequality. Using the Consumer Expenditure Survey, Dirk Krueger, a professor at the University of Pennsylvania, and Fabrizio Perri, a professor at New York University, concluded that between 1980 and 2003, consumption inequality in the United States was

substantially lower than income inequality under a variety of measures (Gini index, 90/10 ratio, 50/10 ratio), and that it increased at a markedly slower rate than income equality over the measured time period (Krueger & Perri, 2006).¹⁰ But because of the challenges to measuring consumption and interpreting its meaning in this context, this approach has enjoyed relatively little traction in the general media.

Relative poverty thresholds are usually set at either 50 or 60 percent of median disposable household income (and sometimes at 40 or 70 percent). “The preference towards the 60 percent of the median line has no theoretical grounds. . . . [The] 60 percent cut-off is as arbitrary a choice as 50 percent or 40 percent,” notes Asghar Zaidi, a senior economist at the OECD.¹¹

Prior to 2000, Eurostat calculated European poverty rates based on 50 percent of *mean* equivalized disposable household income.¹² In that year, however, Eurostat changed the basis of its poverty measure to *median* equivalized household disposable income and raised the threshold to 60 percent (based on the recommendations of the 1998 Eurostat Task Force on Poverty and Social Exclusion).¹³ In 2001, the European Union adopted this definition as its “at-risk-of poverty rate.”¹⁴

Hence, given the nature of these thresholds and the subjectivity in how they were selected,¹⁵ relative poverty, whether based on 50 or 60 percent of median income, is more accurately seen as a measure of income or economic “inequality.” Timothy Smeeding, former director of the Luxembourg Income Study (LIS), explains: “Relative poverty rates are often taken as a proxy for inequality, since a more spread-out income distribution will tend to have a larger share of the population that has less than half of median income” (Smeeding, 2005, p. 9).

In a series of calculations, Smeeding broadly shows the complex relationship between absolute and relative poverty rates. Using the OECD’s purchasing power parity exchange rates, he converted the 2000 U.S. absolute poverty threshold (adjusted for household size)¹⁶ into the currency of other OECD countries and then calculated what would be their poverty rates under the American regime. Combined with the OECD analyses described in his paper, the results are illuminating (see Table 1.)

- The United States is usually pictured as having a substantially higher poverty rate than most European nations, but that is mainly when relative measures are used—because European income assistance reaches higher in the income distribution and because there are so many more higher-income households in the United States (which moves the median income higher). When absolute measures are used, the difference narrows considerably, and all but disappears when the U.S. EITC and noncash benefits (such as food stamps and housing) are taken into account (especially at 125 percent of the poverty line).
- Poverty rates, and the relative poverty position of specific countries, are sharply dependent on the measure used. For example, in 2000 (or 1999 in two countries), in comparison to eight other OECD countries Smeeding studied, the United States had the second highest absolute poverty rate behind only the United Kingdom (12.4 percent). At 125 percent of the absolute poverty line (roughly 40

Table 1. Absolute and Relative Poverty Rates: Market Income and Disposable Cash Income Organisation for Economic Co-Operation and Development (OECD) and Luxembourg Income Study (LIS) 2000 (in 2007 dollars)

Country	Absolute Poverty Rate				Relative Poverty Rate											
	100%		125%		50% of Median Income		60% of Median Income									
	LIS	Disposable Cash Income (%)	LIS	Income Threshold (PPP)	Market Income (%)	LIS	Income Threshold (PPP)	LIS	Income Threshold (PPP)	OECD (%)	Income Threshold (PPP)	OECD (%)	Income Threshold (PPP)	OECD (%)	Income Threshold (PPP)	OECD (%)
Austria	5.2	11.6	\$9,971	31.8	7.7	9.3	\$11,965	14	16							
Belgium	6.3	12.8	\$9,975	34.6	8.0	7.8	\$11,969	14	13							
Canada	6.9	12.2	\$12,745	21.1	11.4	10.3	\$15,293	18	17							
Finland	6.7	17.0	\$8,589	17.8	5.4	6.4	\$10,307	12	14							
Germany	7.6	13.9	\$9,541	28.1	8.3	10.0	\$11,448	13	15							
Netherlands (1999)	7.2	13.2	\$8,974 ^a	21.0	7.3	6.0	\$10,769 ^a	13	12							
Sweden	7.5	15.4	\$10,374	28.8	6.5	5.3	\$12,449	12	11							
United Kingdom (1999)	12.4	23.0	\$11,305 ^a	31.1	12.4	11.4	\$13,566 ^a	21	19							
United States	8.7	13.9	\$14,421	23.1	17.0	17.1	\$17,305	24	24							
Unweighted average	7.6	14.8	\$10,655	26.4	9.3	9.3	\$12,785	15.7	15.7							

Sources: LIS: Timothy Smeeding, *Poor People in Rich Nations: The United States in Comparative Perspective*, Luxembourg Income Study Working Paper Series (Luxembourg: Luxembourg Income Study, October 2005), <http://www.lisproject.org/publications/LISwps/419.pdf> (accessed May 21, 2008); OECD: Michael Förster and Marco Mira D'Ercole, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment, and Migration Working Paper Series (Paris: OECD, 2005), <http://www.sourceoecd.org/10.1787/882106484586> (accessed May 21, 2008); Thresholds: Author's calculations from Michael Förster and Marco Mira D'Ercole, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment, and Migration Working Paper Series (Paris: OECD, 2005), <http://www.sourceoecd.org/10.1787/882106484586> (accessed June 11, 2008); European Commission, Eurostat Database, "Mean and Median Income by Age and Gender," http://epp.eurostat.ec.europa.eu/portal/page?_pageid=107346870091&_dad=portal&_schema=PORTAL&p_product_code=ILC_DI03 (accessed June 11, 2008); and Organisation for Economic Co-Operation and Development, "Purchasing Power Parities (PPPs) for OECD Countries Since 1980," <http://www.oecd.org/dataoecd/61/56/39653523.xls> (accessed June 11, 2008).

Note: ^aThreshold is from 2000. For absolute poverty, the 100 percent threshold is the U.S. poverty threshold converted to the currency of the other countries using OECD purchasing power parity exchange rates. Income in the LIS is defined as "all types of money income, minus direct income and payroll taxes and including all cash and near-cash transfers, such as food stamps and cash housing allowances, and refundable tax credits." Income in the OECD is defined as "earnings... self-employment income; capital income (rents, dividends, and interest); and current transfers received by households... Current transfers refer to cash transfers paid by government to individuals and households." For the United States, this includes the value of food stamps, housing, and the Earned Income Tax Credit

percent of the median income in the United States), however, the United States was tied with Germany for fourth highest at 13.9 percent, and lower than the United Kingdom, Sweden, and Finland (Smeeding, 2005).

- If the United States had relative poverty thresholds (at 50 or 60 percent of median income), they would be substantially higher than those in all other wealthy countries, partly because the United States has a wider dispersion of incomes and partly because a much higher proportion of its population has relatively higher incomes. For example, in comparison to 16 other wealthy OECD countries, a U.S. poverty threshold at 50 percent of median household income would be about 54 percent higher. The mean poverty gap in the United States, however, is substantially higher, suggesting that many of the U.S. poor have about the same income than the poor in these other countries (Table 5).
- Poverty rates under the U.S. absolute measure (as applied to OECD nations) are surprisingly close to relative poverty rates under the 50 percent of median income measure. But, as Table 1 shows, in many countries, the difference in the percent of the population considered “poor” using a 60 percent of median income measure compared to a 50 percent of median income measure is 70 percent or more higher—even though the income difference is often only about \$2,000 or less (see Figure 1).

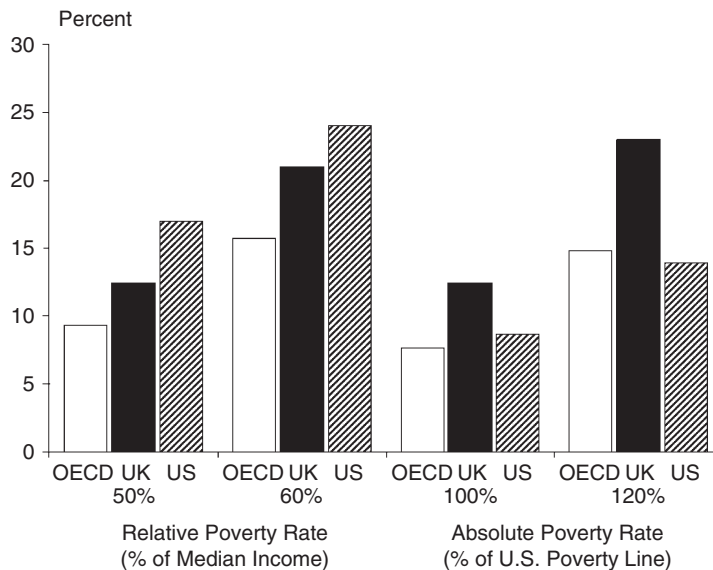


Figure 1. Poverty Rates, Relative vs. Absolute. Nine OECD Countries, United Kingdom, and United States (2000).

Sources: Timothy Smeeding, *Poor People in Rich Nations: The United States in Comparative Perspective*, Luxembourg Income Study Working Paper Series (Luxembourg: Luxembourg Income Study, October 2005), <http://www.lisproject.org/publications/LISwps/419.pdf> (accessed May 21, 2008); and Michael Förster and Marco Mira D'Ercole, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment, and Migration Working Paper Series (Paris: OECD, 2005), <http://www.sourceoecd.org/10.1787/882106484586> (accessed May 21, 2008).

Besides the degree of income dispersion, differences in relative poverty rates are largely driven by national demographic patterns and the level of income transfers (usually in that order). The high poverty rate in the United Kingdom, for example, can be attributed to “a high (growing) rate of lone parenthood, high lone parent poverty rates, high rate of workless households, high (and growing) earnings inequality and risk of in-work poverty, [and] a social transfer system that was less generous than in much of N. Europe (although more generous than S. Europe, US or Australia),” according to Holly Sutherland of the University of Essex (Sutherland, 2005).

Income Transfers

As suggested by Table 1, in most affluent countries, various cash and noncash transfers go a long way toward erasing the deep material deprivation that afflicted their poor in earlier times, and that still afflicts so many in developing countries. In 2000, for example, according to an OECD examination of 17 relatively wealthy countries (hereinafter, the “OECD-17”),¹⁷ government transfers and taxes more than halved the pretax/pretransfer poverty rate (at 50 percent of median income) for the working-age population (ages 18–65), taking it from 18.2 percent to 8.4 percent (Table 2). (The percent decline ranged from about 18.1 percent in Japan to about 80.7 percent in the Czech Republic.) Similar patterns are also found for children and the elderly (Förster & Mira D’Ercole, 2005).¹⁸

Such estimates, of course, have a false precision. There is nothing magical about any poverty line. The people just above the line are not necessarily better off than those just below. Conversely, even those substantially below the line see their material well-being improved by substantial income transfers, even if they are not large enough to raise them above poverty. Moreover, the very idea of reconstructing a pretax/pretransfer poverty rate is artificial, as many recipients probably adjusted their behavior in the presence of taxes and transfers (see Guio, 2005). Nevertheless, the exercise illuminates the significant impact of income transfers on financial well-being, and the important role they play in the modern social welfare state.

This decline in poverty and income inequality has been purchased at a high price. In 2003, 28 OECD nations (hereinafter, the “OECD-28”),¹⁹ spent an average of 7.4 percent of GDP on income transfers, including cash assistance, disability, housing, unemployment, and other income transfers. Income transfers ranged from a low of 1.3 percent of GDP in Korea to a high of 14.7 percent of GDP in Denmark.

Like many others, we adopt the convention that old-age pensions are not considered social transfers.²⁰ If we had, the total would be 14.6 percent of GDP for the OECD-28. (Survivors benefits are about 0.8 percent of GDP.) Health benefits would add another 6.1 percent of GDP to social spending, for a total of 21.4 percent of GDP spent on social welfare programs in the OECD-28. Total social expenditures (including income transfers) ranged from a low of 5.7 percent of GDP in Korea to a high of 31.3 percent of GDP in Sweden (Organisation for Economic Co-Operation and Development, 2008) (see Table 3).

Table 2. Impact of Transfers and Taxes in Selected OECD Countries: Relative Poverty Rates at 50 Percent of Median Income Ages 18–65, 2000

	Market Income Poverty Rate (%)	Disposable Cash Income Poverty Rate (%)	Percent Decline (%)
Austria	20.5	8.6	58.0
Canada	16.0	10.3	35.6
Czech Republic	19.5	3.8	80.7
Denmark	18.5	5.0	73.1
Finland	15.3	6.4	57.8
France	24.1	6.0	74.9
Germany	20.5	8.0	61.0
Ireland	18.8	11.9	36.8
Italy	21.8	11.5	47.2
Japan	16.5	13.5	18.1
Netherlands	14.9	5.9	60.3
New Zealand	18.3	9.5	48.2
Norway	14.5	6.0	58.7
Portugal	15.7	9.6	39.0
Sweden	16.2	5.1	68.2
United Kingdom	19.9	8.7	56.4
United States	18.1	13.7	24.0
Unweighted average	18.2	8.4	53.6

Sources: Asghar Zaidi, Organisation for Economic Co-Operation and Development, e-mail message to Douglas Call, June 5, 2008; Michael Förster, Organisation for Economic Co-Operation and Development, e-mail message to Douglas Call, May 15, 2008; and Michael Förster and Marco Mira D'Ercole, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment, and Migration Working Paper Series (Paris: OECD, 2005), <http://www.sourceoecd.org/10.1787/882106484586> (accessed May 21, 2008). Thresholds: Author's calculations from Michael Förster and Marco Mira D'Ercole, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment, and Migration Working Paper Series (Paris: OECD, 2005), <http://www.sourceoecd.org/10.1787/882106484586> (accessed June 11, 2008); European Commission, Eurostat Database, "Mean and Median Income by Age and Gender," http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1073,46870091&_dad=portal&_schema=PORTAL&p_product_code=ILC_DI03 (accessed June 11, 2008); and Organisation for Economic Co-Operation and Development, "Purchasing Power Parities (PPPs) for OECD Countries Since 1980," <http://www.oecd.org/dataoecd/61/56/39653523.xls> (accessed June 11, 2008).

Note: Income is defined as "earnings: . . . self-employment income; capital income (rents, dividends, and interest); and current transfers received by households. . . . Current transfers refer to cash transfers paid by government to individuals and households." For the United States, this includes the value of food stamps, housing, and the Earned Income Tax Credit.

The apparently higher total levels of social support in some countries are somewhat misleading, however, as they are often counterbalanced by higher levels of indirect taxes on benefits (that is, "taxes on goods and services bought by benefit recipients," essentially sales taxes; Adema & Ladaique, 2005). These countries may spend more on social welfare benefits, but also tax back a higher proportion of the benefits (see Figure 2).

Using income transfers to reduce poverty and income inequality even further, however, becomes progressively more expensive. Most income distributions form a bell curve. As one moves up the income ladder, many more people have to receive benefits to have a comparable impact on rates of poverty and income inequality. (Remember, in many countries, raising the poverty line from 50–60 percent of

Table 3. Revenues, Expenditures, and Surpluses/Deficits in Selected OECD Countries Percentage of GDP at Market Prices 2003

Country	Revenues			Defense	Expenditures								Other	Total (Pub. Only)	Surplus/Deficit
	Taxes	Oth.	Total		Social				Other						
					Old-Age Pensions		Health		Pub.		Pvt.				
Australia	30.7	5.6	36.3	2.8	3.9	2.5	6.2	0.7	7.8	0	17.9	3.2	13.9	34.6	1.7
Austria	43.1	6.2	49.3	0.8	12.8	0.6	5.1	0.6	8.2	0	26.1	1.2	24.1	51.1	-1.8
Belgium	44.6	6.5	51.1	1.3	7.2	2.3	7.2	0.3	12.1	1.3	26.5	3.9	23.4	51.2	0
Canada	33.7	7.3	41	1.1	4	4.2	6.8	1.2	6.5	0	17.3	5.4	22.7	41.1	-1
Czech Republic	37.3	3.2	40.5	2.1	7.8	0	6.8	0	6.5	0.1	21.1	0.1	23.9	47.1	-6.6
Denmark	48	7.2	55.2	1.6	5.8	2.2	5.6	0.1	14.8	0	27.6	2.3	26.1	55.3	-0.1
Finland	44	8.4	52.4	2	5.8	0.2	5.7	0.2	11	0.8	22.5	1.2	24.9	50	2.3
France	43.2	6	49.2	2.6	10.5	0.1	7.6	1.3	10.6	0.9	28.7	2.3	22	53.3	-4.1
Germany	35.5	8.9	44.4	1.5	11.3	0.7	8	1.1	8	0	27.3	1.8	19.6	48.4	-4
Greece	28.1	11.2	39.3	4.3	11.5	0.5	5	0.2	4.8	1.7	21.3	2.4	19.4	45	-5.7
Hungary	37.5	4.4	41.9	1.8	7.5	0	6	0	9.2	0	22.7	0	17.4	49.1	-7.2
Iceland	37.2	5.6	42.8	0	4.1	0	7.2	0	7.4	0	18.7	0	24.1	45.6	-2.8
Ireland	28.8	5	33.8	0.9	2.9	0	5.6	0.5	7.4	0	15.9	0.5	16.6	33.4	0.4
Italy	41.8	2.9	44.7	1.9	11.4	0.2	6.2	0.1	6.6	0.2	24.2	0.5	22.2	48.3	-3.5
Japan	25.7	4.8	30.5	1.0	8.0	2.6	6.1	0.0	3.6	0.0	17.7	2.6	19.7	38.4	-7.9
Korea	25.3	6.0	31.3	2.7	1.2	0.0	2.9	0.2	1.6	0.0	5.7	0.2	22.5	30.9	0.4
Luxembourg	38.5	3.9	42.4	0.9	4.5	0.0	6.2	0.1	11.5	0.0	22.2	0.1	18.8	41.9	0.5
Netherlands	36.9	7.0	43.9	1.6	5.4	3.2	5.8	1.6	9.5	2.2	20.7	7.0	24.8	47.1	-3.1
New Zealand	34.3	8.3	42.6	1.0	4.4	0.0	6.3	0.5	7.3	0.0	18.0	0.5	19.8	38.8	3.8
Norway	42.3	13.2	55.5	1.9	7.0	0.7	6.5	0.0	11.6	0.3	25.1	1.0	21.3	48.3	7.3
Poland	34.1	4.3	38.4	1.7	11.4	0.0	4.5	0.0	7.0	0.0	22.9	0.0	20.0	44.6	-6.3
Portugal	34.7	7.8	42.5	2.3	8.8	0.1	6.7	0.0	8.0	0.9	23.5	1.0	19.7	45.5	-3.0
Slovak Republic	33.2	4.5	37.7	1.9	6.4	0.3	5.2	0.0	5.7	0.8	17.3	1.1	21.3	40.5	-2.8
Spain	34.2	4.0	38.2	1.2	7.9	0.0	5.2	0.3	7.2	0.0	20.3	0.3	16.9	38.4	-0.2
Sweden	49.4	7.8	57.2	2.1	10.1	2.0	7.1	0.0	14.1	0.4	31.3	2.4	24.9	58.3	-1.1
Switzerland	29.4	5.8	35.2	1.0	6.8	0.0	6.0	1.0	7.7	0.1	20.5	1.1	14.9	36.4	-1.2
United Kingdom	35.2	4.3	39.5	2.4	5.2	4.2	6.7	0.6	8.0	1.2	20.6	6.0	19.8	42.8	-3.3
United States	25.9	6.0	31.9	3.9	5.5	3.8	6.7	5.6	4.0	0.3	16.2	9.7	16.7	36.8	-4.8
Unweighted average	36.2	6.3	42.5	1.8	7.2	1.1	6.1	0.6	8.1	0.4	21.4	2.1	20.8	44.4	-1.9

Sources: Revenues, total expenditures, and deficits: Organisation for Economic Co-Operation and Development, *OECD Economic Outlook 82* (Paris: OECD, December 2007); defense expenditures: Central Intelligence Agency, "The World Factbook: Rank order, military expenditures, percent of GDP," <http://www.umsl.edu/services/govdocs/wofact2004/rankorder/2034rank.html> (accessed June 18, 2008); social expenditures: Organisation for Economic Co-Operation and Development Social Expenditure Dataset (Aggregated Data) http://stats.oecd.org/brandedview/pilot/default.aspx?datasetcode=socx_agg (accessed June 18, 2008).

Note: For the social expenditures data, following convention, we use percent of GDP at market price as opposed to at fiscal cost. See Organisation for Economic Co-Operation and Development, *Social Expenditures 1980-2003: Interpretive Guide of SOCX* (Paris: OECD, November 2007), 81, <http://stats.oecd.org/OECDStatDownloadFiles/OECDSOCX2007InterpretiveGuide.En.pdf> (accessed June 18, 2008) stating: "As the construction of net social spending indicators involves adjusting for indirect taxation of consumption out of benefit income, net social expenditure is related to GDP at factor cost, as GDP at factor costs does not include the value of indirect taxation and government subsidies to private enterprises and public corporations. However, in order to facilitate comparison with gross social spending indicators which are usually related to GDP at market prices for international comparisons, Table A.3.1.a presents these indicators."

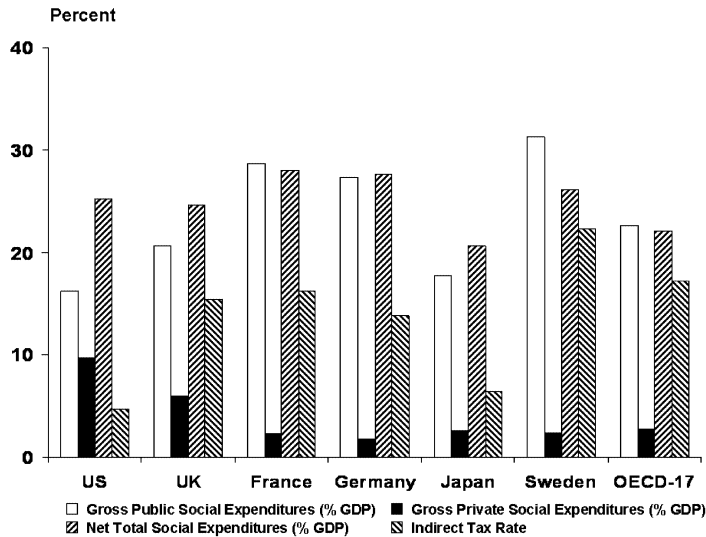


Figure 2. Social Expenditures. Public and Private (at Market Prices), Plus Indirect Taxes.

Source: Organisation for Economic Co-Operation and Development, *OECD Factbook 2008: Economic, Environmental, and Social Statistics* (Paris: OECD, 2008), <http://massetto.sourceoecd.org/vl=3786858/cl=50/nw=1/rpsv/factbook/> (accessed April 21, 2008).

Note: Net social expenditures are the sum of gross public and private expenditures minus direct and indirect government taxes.

median income increases the percent of the population considered “poor” by 70 percent or more.)

One measure used to gauge how much it would cost to erase poverty is the “aggregate poverty gap,” that is, the combined income shortfall of all of the poor compared to a poverty threshold (Hiilamo, Sallila, & Sund, 2004, p. 7). The size of the gap, of course, depends on the poverty measure used.

Under the official U.S. poverty measure, we calculate the 2003 aggregate poverty gap was about \$66 billion for families and about \$88 billion for households, or about 0.6 and 0.7 percent of GDP, respectively (University of Maryland, 2008). But that exaggerates the income shortfall, because, as mentioned, the official measure does not count many forms of income. Take them into consideration by counting all forms of disposable income or their equivalent (and also adjust for underreporting), and the U.S. poverty gap shrinks to about \$32.2 billion for families and \$48.2 billion for households, or about 0.3 and 0.4 percent of GDP, respectively.²¹

The aggregate poverty gap grows quite considerably when the official poverty measure is modified to reflect the emerging U.S. definition of the “working poor.” We calculate that this measure, with a threshold at twice the official poverty line, results in a 2003 aggregate poverty gap of about \$320 billion for families and about \$446 billion for households, or about 2.7 and 3.8 percent of GDP, respectively (University of Maryland, 2008). Taking into consideration total disposable income (and adjusting for underreporting) lowers the aggregate poverty gap to about \$271 billion for families and about \$393 billion for households, or about 2.3 and 3.3 percent of

GDP, respectively (see Table 4).²² To put these figures in perspective, consider that, in the same year, the United States spent about 16.2 percent of GDP on social expenditures, including about 6.7 percent on health care, 5.5 percent on Social Security/old-age pensions, 1.3 percent on disability, 0.7 on family assistance; 0.5 percent on unemployment; and about 1.5 percent on other social spending (Organisation for Economic Operation and Development, 2008).

By comparison, when aggregate poverty gaps are averaged and equivalized for household size, the mean equivalized poverty gaps in the other OECD-17 countries are substantially smaller compared to the United States, reflecting these countries' lower income thresholds, more compressed income distributions, and higher levels of income transfers. We calculate, for example, that the mean equivalized poverty gap in the United States was about \$5004 in 2000, almost twice the \$2582 of the other OECD-17 countries (ranging from a low of about \$997 in the Czech Republic to a high of about \$4078 in Canada.²³ (Dollar figures at 2000 international purchasing power parity.)

Along these lines, Michael Förster and Marco Mira D'Ercole, economists at the OECD, used mean equivalized poverty gaps as supplied by OECD member countries²⁴ to calculate the percent of total national disposable household income that would be needed to fill the countries' aggregate poverty gaps at 50 and 60 percent of median income. According to their calculations, the United States would need an income transfer of 5.9 percent of total national disposable household income at 50 percent of median income and 8.3 percent at 60 percent of median income to fill its aggregate poverty gaps. In comparison, the other OECD-17 countries would only need an income transfer of 2.6 percent of total national disposable household income at 50 percent of median income and 4.3 percent at 60 percent of median income (ranging from 0.8 percent in the Czech Republic to 5.5 percent in Japan, and 1.8 percent in the Czech Republic to 7.6 percent in Japan, respectively) (Förster & Mira D'Ercole, 2005) (see Table 5).

These figures are based on current economic and social conditions. For many developed countries, however, the poverty gap will likely grow substantially (and in some countries already has), as a result of increases in wealth and income dispersion as well as increases in immigration and female-headed families (described in the next section).

The aggregate poverty gap, however, understates how much it would cost to eliminate poverty because one cannot simply bring all incomes up to some particular threshold. To avoid the creation of high marginal tax rates that, in turn, create what many, including Anthony Atkinson, call "poverty and unemployment traps" (Atkinson, 2000, p. 6), there needs to be a phase out of benefits that reaches up to incomes substantially above the threshold. (Estimates of the wage elasticity vary. A reasonable estimate for the United States is that every 1 percent reduction in after-tax earnings reduces hours of work by the same percentage; Hotz & Scholz, 2003.)

Graduated phase-in and phase-out rates that reduce marginal tax rates are the most common method used to reduce work and marriage disincentives. If the phase-out is long enough, the negative consequences of income transfers can be

Table 4. U.S. Absolute and Relative Poverty Rates and Aggregate Poverty Gaps: Market Income and Disposable Cash Income by Families and Households 2003 (Billions of 2007 dollars)

	100% of Official Poverty Rate			200% of Official Poverty Rate			60% of Median Income					
	Families		Households (All Persons)	Families		Households (All Persons)	Families		Households (All Persons)			
	Poverty Rate (%)	Poverty Gap	Poverty Rate (%)	Poverty Rate (%)	Poverty Gap	Poverty Rate (%)	Poverty Rate (%)	Poverty Gap	Poverty Rate			
Official Census Bureau definition of income (pretax, postcash transfer)	12.5	\$66.0	10.8	\$88.1	31.0	\$317.9	29.0	\$446.1	24.4%	\$337.8	27.0%	\$395.4
Posttax/posttransfer income (cash and noncash) ^a	10.7	\$47.4	9.0	\$65.9	33.6	\$294.8	31.3	\$423.7	N/A	N/A	N/A	N/A
Posttax/posttransfer income (cash and noncash) partially adjusted for underreporting ^b	9.2	\$32.2	7.3	\$48.2	33.6	\$271.0	31.3	\$392.5	N/A	N/A	N/A	N/A

Source: UMD/AEI Poverty Tabulator: Software for Examining Historical Trends and Alternative Measurement Definitions, version 4.6.7, <http://www.aeimirror.org/poverty> (accessed May 22, 2008).

^aPosttax/transfer income includes all market income, all means- and non-means-tested cash and noncash government transfers, tax credits, and federal and state taxes (including payroll taxes).

^bPosttax/transfer income partially adjusted for underreporting of Temporary Assistance for Needy Families (TANF), food stamps, public housing, and Supplemental Security Income (SSI).

Table 5. Household Poverty Rates and Poverty Gaps: Household Disposable Cash Income 2000 (in 2007 Dollars)

	50% of Median Income (Dollars, PPP)	Poverty Rate (%)	Mean Poverty Gap (Dollars, PPP)	Aggregate Poverty Gap as % of Total Household Disposable Cash Income (50% of Median Income) (%)	Aggregate Poverty Gap as % of Total Household Disposable Cash Income (60% of Median Income)
Austria	\$9,971	9.3	\$2,991	2.8	4.4%
Canada	\$12,745	10.3	\$4,078	3.3	N/A
Czech Republic	\$5,333	4.3	\$997	0.8	1.8%
Denmark	\$11,925	4.3	\$2,874	1.0	2.1%
Finland	\$8,589	6.4	\$1,778	1.3	2.8%
France	\$9,033	7.0	\$2,367	1.8	N/A
Germany	\$9,541	8.9	\$3,072	2.9	4.3%
Ireland	\$7,581	15.4	\$1,819	3.7	6.3%
Italy	\$7,336	12.9	\$2,678	4.7	6.6%
Japan	\$10,720	15.3	\$3,870	5.5	7.6%
Netherlands	\$8,974	6.0	\$2,638	1.8	N/A
New Zealand	\$8,477	10.4	\$1,975	2.4	4.5%
Norway	\$13,134	6.3	\$3,704	1.8	3.0%
Portugal	\$4,863	13.7	\$1,202	3.4	5.7%
Sweden	\$10,374	5.3	\$2,708	1.4	2.4%
United Kingdom	\$11,305	11.4	\$2,589	2.6	N/A
United States	\$14,421	17.1	\$5,004	5.9	8.3%
Unweighted average	\$9,666	9.7	\$2,726	2.8	4.6%

Sources: Author's calculations from Organisation for Economic Co-Operation and Development database, "Demographics and Population," <http://stats.oecd.org/WBOS/Index.aspx?QueryName=254&QueryType=View> (accessed June 11, 2008); Michael Förster and Marco Mira D'Ercole, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment, and Migration Working Paper Series (Paris: OECD, 2005), <http://www.sourceoecd.org/10.1787/882106484586> (accessed May 21, 2008); European Commission, Eurostat Database, "Mean and Median Income by Age and Gender," http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1073_46870091&_dad=portal&_schema=PORTAL&p_product_code=ILC_DI03 (accessed June 11, 2008); Organisation for Economic Co-Operation and Development, "Purchasing Power Parities (PPPs) for OECD Countries Since 1980," <http://www.oecd.org/dataoecd/61/56/39653523.xls> (accessed June 11, 2008); and Michael Förster, Organisation for Economic Co-Operation and Development, e-mail message to Douglas Call, September 26, 2008.

reduced, but doing so raises the cost of income transfers immeasurably and can cause other socially unattractive results (Besharov & Sullivan, 1996).

That is the approach taken by the U.S. EITC. As a result, it seems to have a slightly positive overall effect on labor force participation (Eissa & Hoynes, 2005; Hotz & Scholz, 2003). But this is purchased at a high price. Of the EITC's total 2001 cost of \$33.3 billion, between \$13.3 billion and \$16.7 billion (or 40–50 percent of the total) is spent on those in the phase-out range (Eissa & Hoynes, 2005).

For another illustration of just how expensive these graduated phase-outs can be, consider the much ballyhooed recent experience in the United Kingdom. Between 1998/1999 and 2005/2006, the poverty rate (after housing costs²⁵ and using a 60 percent of median household income threshold) declined 12 percent, from about 34 percent in 1998/1999 to about 30 percent in 2005/2006.²⁶

Many applauded this decline, for example, Paul Krugman of *The New York Times*:

But there's no denying that the Blair government has done a lot for Britain's have-nots. Modern Britain isn't paradise on earth, but the Blair government has ensured that substantially fewer people are living in economic hell. Providing a strong social safety net requires a higher overall rate of taxation than Americans are accustomed to, but Britain's tax burden hasn't undermined the economy's growth.

What are the lessons to be learned from across the pond? First, government truly can be a force for good. Decades of propaganda have conditioned many Americans to assume that government is always incompetent—and the current administration has done its best to turn that into a self-fulfilling prophecy. But the Blair years have shown that a government that seriously tries to reduce poverty can achieve a lot. Second, it really helps to have politicians who are serious about governing, rather than devoting themselves entirely to amassing power and rewarding cronies. (Krugman, 2006)

Some have estimated, however, that almost a third of these children escaped poverty because of a growing economy in the United Kingdom, rather than because of the child tax credit.²⁷

In any event, because of the graduated phase out of benefits for those above poverty, this 12 percent decline in poverty was accompanied by an almost tripled annual expenditure on the U.K.'s child tax credit (from about £6.3 billion to £17.3 billion) (Hirsch, 2006; House of Commons, 2004). For many of these children, however, the improvement in income was minimal, perhaps £25 per week, moving them from a little below the poverty line to a little above. (The average benefit per child was about 33 pounds per week,²⁸ ranging between a low of 4 pounds per week to a high of 117 pounds per week;²⁹ see Figure 3.)

Reducing child poverty below 5 percent by 2020 would require spending an additional £30.5 billion (in 2006 pounds) in that year (more than twice what is now spent on the child credit), according to the Joseph Rowntree Foundation (Hirsch, 2006). (Interim year costs were not modeled.)^{30,31} And that is before housing costs are

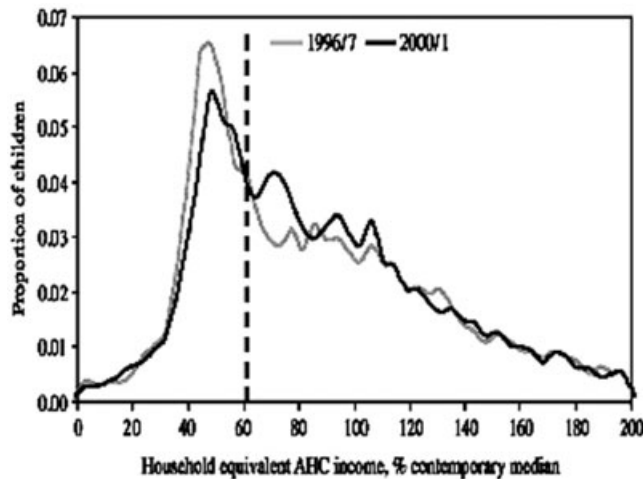


Figure 3. “Reducing” UK Child Poverty. Removing 600,000 Children from “Poverty” Costs about £18 Billion per Year But 3.8 Million Children Remain Poor.

Source: Mike Brewer, Tom Clark, and Alissa Goodman, “What Really Happened to Child Poverty in the UK under Labour’s First Term?” *The Economic Journal* 113 (June 2003): F240–F257, Figure 2 “The Distribution of Children’s Household Incomes in 1996/7 and 2000/1”, page F244.

subtracted from income. Subtract them, and the number of children in poverty increases from 2.8 million to 3.8 million, and the amount needed to reduce child poverty below 5 percent would be even higher (Department for Work and Pensions, 2007). Moreover, that is the cost only for families with children, who are just about 54 percent of the poor (Department for Work and Pensions, 2007). Raising the rest of the population above the poverty line would cost yet more.

The situation has worsened since the Rowntree calculations. In 2007, child poverty in the United Kingdom increased by an additional 100,000 children.³² According to the Institute for Fiscal Studies, child poverty rose not because low-income households had less money but because average income rose (and hence the poverty line) faster than increases in tax credits.³³ This exemplifies how relative measures can create an ever-receding target for policymakers attempting to alleviate poverty (at least in times of plenty).

And that does not even begin to solve the marriage penalty problem, that is, loss of income caused by a decline in benefits that result when two individuals marry (regardless of whether or not they were living together beforehand). Adam Carasso and Eugene Steuerle of the Urban Institute describe the effects of this marriage penalty in 2001: “For a typical household with two children, the value of the EITC drops 21.06 cents for every dollar of income a household receives above \$13,090. Suppose a head of household with two children earning \$10,000 marries someone earning \$15,000. At a household income of \$25,000, this couple loses 21.06 percent of the excess of \$25,000 over \$13,090, or \$2,508 of credit, simply because of the marriage” (Carasso & Steuerle, 2002).

Fixing the marriage penalty in the U.S. EITC and other means-tested programs would, according to well-respected economists, require extending the phase-out of

benefits to incomes as high as \$40,000 or \$50,000. Some have suggested that married couples file separately, so that tax liability would depend on each individual's earnings. But this would cost tens of billions of dollars³⁴ and would make eligible for benefits families with earnings above \$50,000 (Besharov, 2003).

Growing Income Dispersion

The foregoing calculations assume a static income distribution, but in many countries, median incomes will probably rise,³⁵ while incomes below the median will probably remain stagnant or even fall. Both will have the effect of increasing the cost of income transfers meant to raise incomes above a relative threshold. After all, "The very concept of relative poverty means that if somebody's income moves up, then to stay out of poverty somebody at the bottom needs more income" (Hiilamo et al., 2004, p. 5).

Income distributions are becoming less compressed around the world. Richard Burkhauser of Cornell University and Kenneth Couch of the University of Connecticut looked at the changes in income distribution in the United States, the United Kingdom, and Germany over two decades in the United States and one decade in both the United Kingdom and Germany. In the United States, they found that between 1979 and 1989, there was a substantial decrease in the middle of the distribution around the mode. Eighty-two percent of the decrease represented an increase in incomes, while only 18 percent represented a decline in incomes. Over the next decade, the shape of the income distribution in the United States remained the same, but the entire income distribution shifted to the right, indicating an increase in all income levels compared to the beginning of the decade. The experiences of the United Kingdom and Germany between 1990 and 2000, although not as pronounced, show the same tendency (Burkhauser & Couch, 2008) (see Figure 4). Incomes are rising in the upper part of income distribution for at least two reasons: higher levels of education (and increased returns to education) coupled with an increase in the proportion of two-earner households—partially driven by those same higher returns to education.

Returns to education have risen sharply in recent years, so that in most wealthy countries, those fortunate enough to have attended college or to have received other postsecondary education have seen their incomes rise faster than others. In the United States, for example, between 1970 and 1996, the earnings of college graduates, measured as a ratio of the earnings of high school graduates, rose from 124 percent to 154 percent; the earnings of those with some college rose slightly from 110 percent to 114 percent, but the earnings of males who do not have a high school diploma or GED fell from 81 percent to 69 percent. (This is an aggregate effect and a selection effect is implicit in higher college attendance. However, the underlying point remains valid;³⁶ see Figure 5.)

Until recently, however, compared to the United States, relatively few Europeans received additional schooling, let alone those in other countries. But in many places, this is changing rapidly. Figure 6 portrays the U.S.'s historic advantage in postsecondary education (with its higher proportion of graduates in the general population), but it also shows that the postsecondary graduation rates in other countries are now

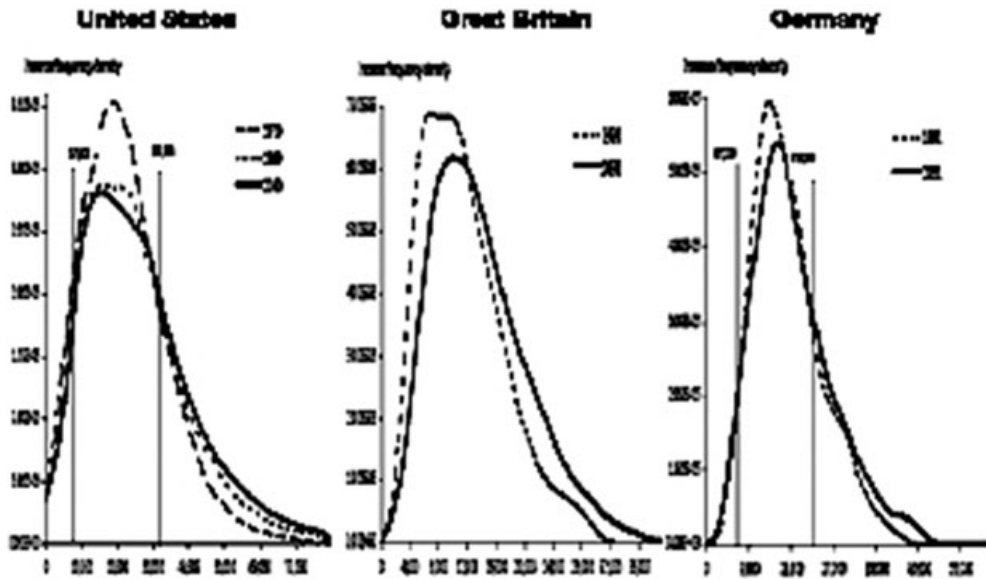


Figure 4. Income Differences Growing.

Source: Richard V. Burkhauser and Kenneth A. Couch, "How the Distribution of After-Tax Income Changed Over the 1990s Business Cycle: A Comparison of the United States, Great Britain, Germany, and Japan," *Journal of Income Distribution* 17 (1): 87-109, Figure 2, pp 98.

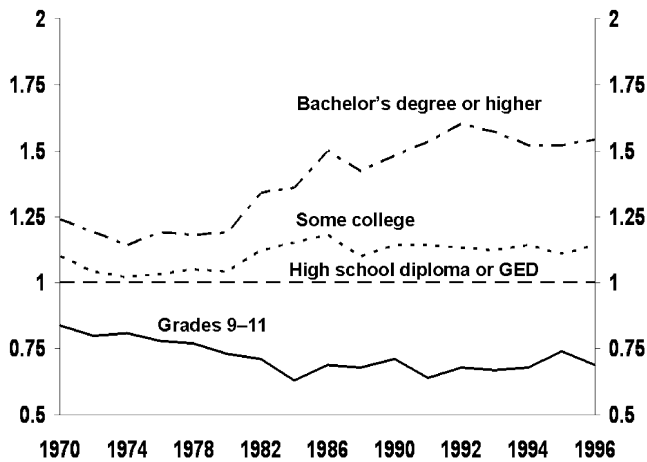


Figure 5. Returns to Education. Ratio to Earnings of Male High School Graduates.

Source: U.S. Department of Education, "Annual Earnings of Young Adults, by Educational Attainment," *Education Statistics Quarterly* 1, no. 3 (1998), http://nces.ed.gov/programs/quarterly/vol_1/1_3/5-esq13-a.asp (accessed April 21, 2008).

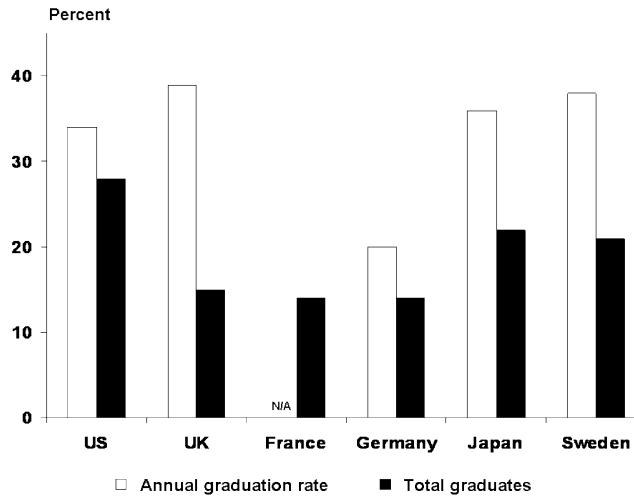


Figure 6. Postsecondary Education.

Sources: For 2005 educational attainment for 25- to 64-year-olds, see Organization for Economic Co-Operation and Development, *Education at a Glance 2007: OECD Indicators* (OECD, Paris: 2007), table A1.1a, 36, <http://www.oecd.org/dataoecd/4/55/39313286.pdf> (accessed April 21, 2008); for “Trends in tertiary graduation rates (1995–2005),” see Organization for Economic Co-Operation and Development, *Education at a Glance 2007: OECD Indicators* (OECD, Paris: 2007), table A3.2, 68, <http://www.oecd.org/dataoecd/4/55/39313286.pdf> (accessed April 21, 2008).

equal to or higher than those in the United States, so that they will eventually have the same (or higher) proportion of graduates. That, in turn, will increase income dispersion, as earlier happened in the United States.

As the returns to education have risen, and with them women’s rising earnings capacity, so too has the labor force participation of women.³⁷ Between 1980 and 2006, according to the U.S. Bureau of Labor Statistics (and based on the U.S. definition of labor force participation), the percentage of British women in the labor force rose from about 48.6 percent to 56.7 percent; the percentage of German women rose from about 40.3 percent to 51.2 percent; and the percentage of Dutch women rose from about 34.3 percent to 57.8 percent (U.S. Department of Labor, 2008). When these working women live with another worker, average household income rises. In the United States, for example, the median income for a household with two earners was \$76,635 in 2006; about 55 percent higher than that for all households (\$49,574); about 38 percent higher than that for one earner, married-couple households (\$55,372);³⁸ and about 90 percent higher than that for a household with one earner (\$40,429) (U.S. Census Bureau, 2008a).

At the same time that incomes above the median are rising, incomes below the median are being depressed. Two big reasons are higher rates of both nonmarital births and immigration. (Again, depending on the country.) Some would also include globalization and competition from low-cost labor in less wealthy countries.

Nonmarital birth rates are continuing to rise in most developed countries, sometimes being as much as half of all births (see Figure 7). Nonmarital birth

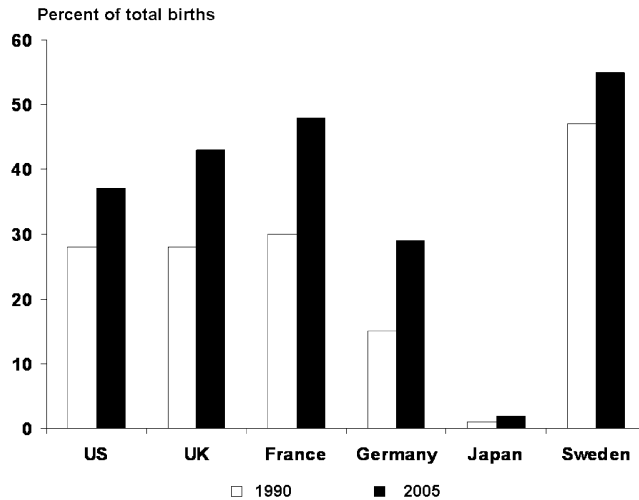


Figure 7. Nonmarital Births.

Sources: For nonmarital birth rates, see European Foundation for the Improvement of Living and Working Conditions, "Non-Marital Births" (Eurofound, Dublin: 2007), <http://epp.eurostat.ec.europa.eu> (accessed April 21, 2008); for the rate of nonmarital births in Japan, see National Institute of Population and Social Security Research, Population Statistics of Japan, "Number of Illegitimate Births and Proportion: 1925–2004 m," table 4.16, 38, <http://www.ipss.go.jp/p-info/e/PSJ2006.pdf> (accessed April 21, 2008); and for the rate of nonmarital births in the United States, see U.S. Centers for Disease Control and Prevention, "Number and Percentage of Births to Unmarried Women, All Ages and Women under Age 20 Years: United States, Final 2004 and Preliminary 2005," table 3, http://www.cdc.gov/nchs/data/hestat/prelimbirths05_tables.pdf#3 (accessed April 21, 2008); and U.S. Centers for Disease Control and Prevention, "Births to Unmarried Mothers: United States, 1980–1992" (Washington, DC: CDC, June 1995), http://www.cdc.gov/nchs/data/series/sr_21/sr21_053.pdf (accessed April 21, 2008).

rates depress household incomes (especially at the bottom of the income distribution) because families with two parents (and particularly two earners) are more economically viable.³⁹ In the United States, for example, the median income of never-married mothers is about 20 percent of married-couple families.⁴⁰ Teasing out cause and effect is difficult, of course, because various social and economic factors interact.⁴¹

Stronger families and fewer nonmarital births are important not just for their economic effect but also for their probable benefits for children and social cohesion. Paul Amato, a sociologist at Pennsylvania State University, writes: "Research clearly demonstrates that children growing up with two continuously married parents are less likely than other children to experience a wide range of cognitive, emotional, and social problems, not only during childhood, but also in adulthood" (Amato, 2005, p. 89).

Some argue that increased rates of nonmarital cohabitation ameliorate the impact of the decline in marriage. In many European countries, cohabitation is often more like marriage, that is, it tends to be a relatively stable relationship.⁴² Certainly, this makes a difference, but it is difficult to see how the economic strength of these relationships equals that of traditional marriages.

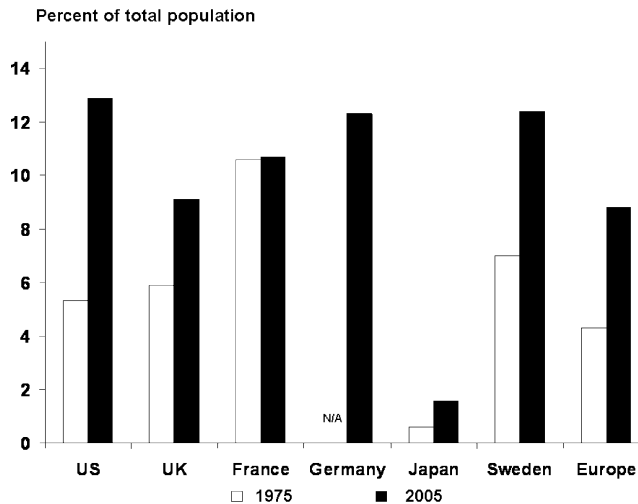


Figure 8. Large (and Growing?) Immigrant Populations.

Source: World Migrant Stock: The 2005 Revision Population Database (United Nations, Department of Economic and Social Affairs, Population Division), <http://esa.un.org/migration/index.asp?panel=1> (accessed April 21, 2008).

Immigration is further depressing incomes at the lower part of distribution in many countries. Between 1975 and 2005, for example, the proportion of immigrants in the United States increased from about 5.3 percent of the total population to about 12.9 percent; in Sweden, it rose from about 7 percent to about 12.4 percent;⁴³ and in France, it started high and stayed there (about 10 percent) (see Figure 8).

However one feels about immigration, the plain fact is that most new arrivals have low skills and limited earnings capacity. At least initially, they add to the number of low-income households. In the United States, for example, if the proportion of Hispanics in the population in 2006 had been the same as it was in 1975, then the overall American poverty rate in 2006 would have been 7 percent lower (about 2.4 million fewer people) (Besharov, 2007). (Of course, an increase in the number of low-income households tends to lower a relative poverty line, but, unless there are much higher levels of immigration, not nearly as much as middle-class gains will push it upward.)

Competing Social Welfare Needs and Massive Long-Term Deficits

Even without these trends, there is simply not enough money in the government's cupboard to make a meaningful dent in income inequality. The financial demands of other social programs are huge and growing.

In 2003, total taxes across the OECD-28 averaged 36.2 percent of GDP, ranging from a low of 25.3 percent of GDP in Korea to a high of 49.4 percent of GDP in Sweden. Taxes are not the only source of funds for governments. In addition to taxes, revenues derive from "property income (including dividends and other transfers from public enterprises), fees, charges, sales, fines, capital transfers received by the

general government, etc.” These raised average total revenues to about 42.5 percent of GDP (Organisation for Economic Co-Operation and Development, 2007a, p. 246).

Total government expenditures averaged 44.4 percent of GDP, ranging from a low 30.9 percent of GDP in Korea to a high of 58.3 percent of GDP in Sweden. Social welfare already makes up a substantial portion of total government spending—about half for OECD-17 countries. Across the OECD-28, in 2003, social welfare spending across the OECD-28 averaged about 21.4 percent of GDP, including about 7.2 percent of GDP on old-age pensions, about 6.1 percent on health, about 5.1 percent on income support (mostly disability, unemployment, and family-related cash benefits), and about 3.0 percent on other social services.⁴⁴

U.S. taxes and government spending are on the low side compared to other OECD nations, and especially compared to other OECD-17 nations. In 2003, U.S. taxes (federal, state, and local) were about 25.9 percent of GDP and total government spending was about 36.8 percent of GDP (the United States spent about 16.2 percent of GDP on social welfare) (Organisation for Economic Co-Operation and Development, 2008). But when private expenditures are also considered, total U.S. social expenditures are much closer to typical levels in other OECD nations, with the difference coming largely from employer contributions (see Figure 2).

Compared to other OECD countries, the United States spent proportionately more on health (about 6.7 percent of GDP and more than twice that when private expenditures are included), less on pensions (about 5.5 percent but, again, about 60 percent more if private expenditures are included), less on social services (about 2.1 percent), and less on income support (about 1.9 percent). All told, including private expenditures brings the U.S. total to 27 percent of GDP (Organisation for Economic Co-Operation and Development, 2008) (see Figure 9).

With only modest oversimplification, one can say that, from the 1970s onward, many nations raised tax rates to pay for increased social spending (especially for pensions and health care). But sometime in the 1990s, the rate of tax growth slowed, if not plateaued (see Figure 10). The explanations are manifold: globalization and increased international trade competition, the requirements of the Maastricht Treaty, concerns about disincentives to work caused by high marginal tax rates, and taxpayer revolts.

Whether for these or other reasons, a combination of relatively static tax rates combined with large future obligations mean that most countries face mounting and ultimately debilitating budget deficits and, hence, national debts. Their actual size is difficult to predict because so many factors are involved, but all estimates tell a story similar to that portrayed in Figure 11, in which future deficits will dwarf current ones, greatly increasing overall debt which will in some cases be several multiples of annual GDP (European Union, 2003).

Many factors feed these growing budget deficits. The easiest to understand (and the most certain to occur) is the aging of the population, which, under present policies, will lead to higher pension and medical costs. Over several decades, the European population will become progressively more top-heavy. For example, according to an estimate by the International Monetary Fund (IMF), between 2004

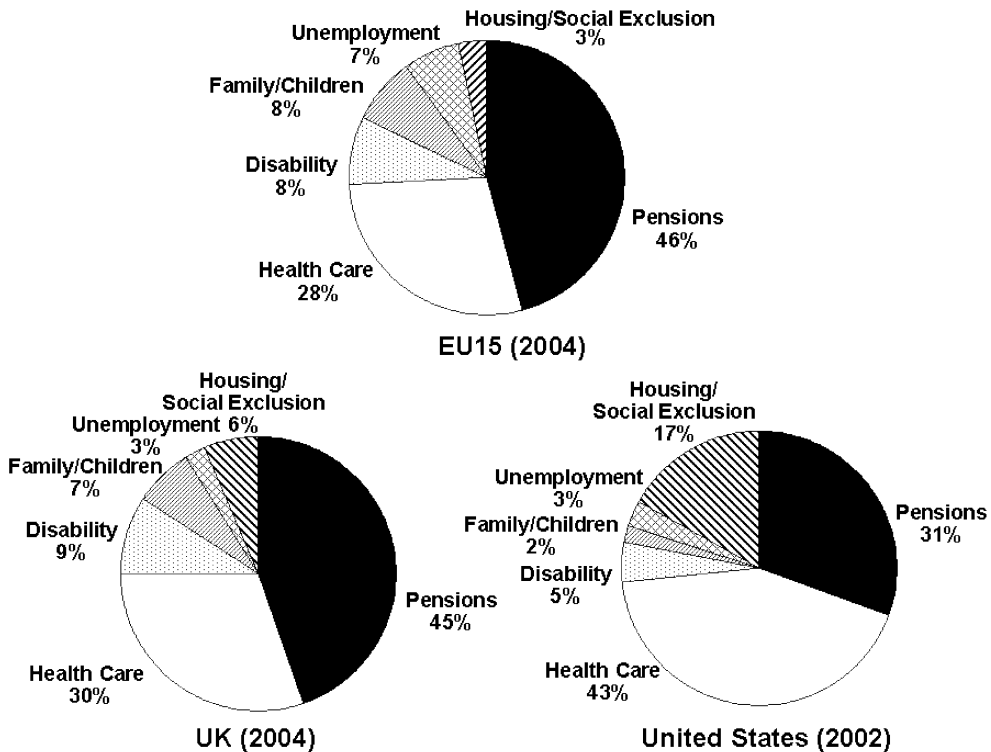


Figure 9. Public Social Expenditures.

Sources: Alexandra Petrásová, *Social Protection in the European Union*, Statistics in Focus, Population and Social Conditions (Luxembourg: European Commission, 2007), http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-07-099/EN/KS-SF-07-099-EN.PDF (accessed April 21, 2008).

and 2050, the EU-25's ratio of people age 15–64 to people 65 and older will fall by more than half, from about 4.1:1–1.8:1 (Carone & Costello, 2006). (For the United States, between 2000 and 2050, the decline will not be nearly as great, going from 5.26:1–3.13:1, largely because of its higher birthrate; Bongaarts, 2004; see Figure 12.)

Human Capital Remedies versus Income Transfers

Some believe that these long-term budget deficits will be eased through political actions that result in a combination of sharply higher taxes, deep cuts in health and pension benefits,⁴⁵ and higher levels of immigration (that bring more younger, tax-paying workers into the economy). But after taking such painful steps, few, if any countries, would probably have the appetite for substantial increases in income transfers to low-income citizens.

Moreover, for whatever new spending will be possible, politicians will be tempted to skew benefit structures to maximize the decline in measured

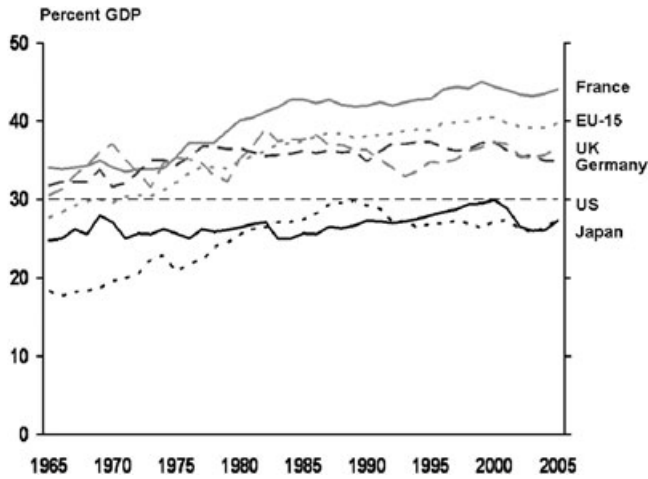


Figure 10. Tax Rates Plateaued in the 1990s.

Source: Organisation for Economic Co-Operation and Development, *Taxing Wages: 2006/2007* (Paris: OECD, 2008), http://www.oecd.org/document/57/0,3343,fr_2649_201185_40233913_1_1_1_1,00.html (accessed April 21, 2008).

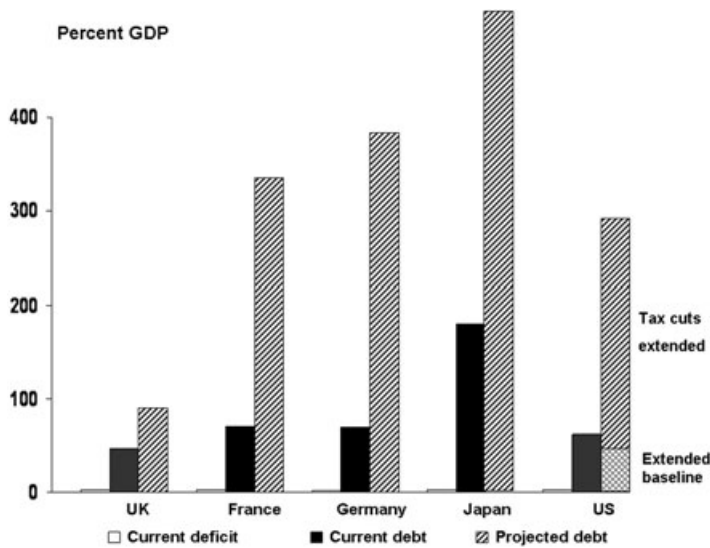


Figure 11. Current Deficits & Debts (2006); and Projected Debts (2050).

Sources: For Europe: European Union, Economic Policy Committee, *The Impact of Ageing Populations on Public Finances: Overview of Analysis Carried Out at EU level and Proposals for a Future Work Programme* (Brussels: European Union, 2003), http://ec.europa.eu/economy_finance/epc/documents/2003/pensionmaster_en.pdf (accessed April 21, 2008); for the United States: Congressional Budget Office, *The Long-Term Budget Outlook* (Washington, DC: CBO, December 2007), <http://www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf> (accessed April 21, 2008); and for Japan: Moritz Kraemer and Luc Marchand, *Western Europe Past Its Prime—Sovereign Rating Perspectives in the Context of Ageing Populations* (London: Standard and Poor's, 2002), http://www.actuaries.org.uk/_data/assets/pdf_file/0004/19282/kraemer_paper.pdf (accessed April 21, 2008).

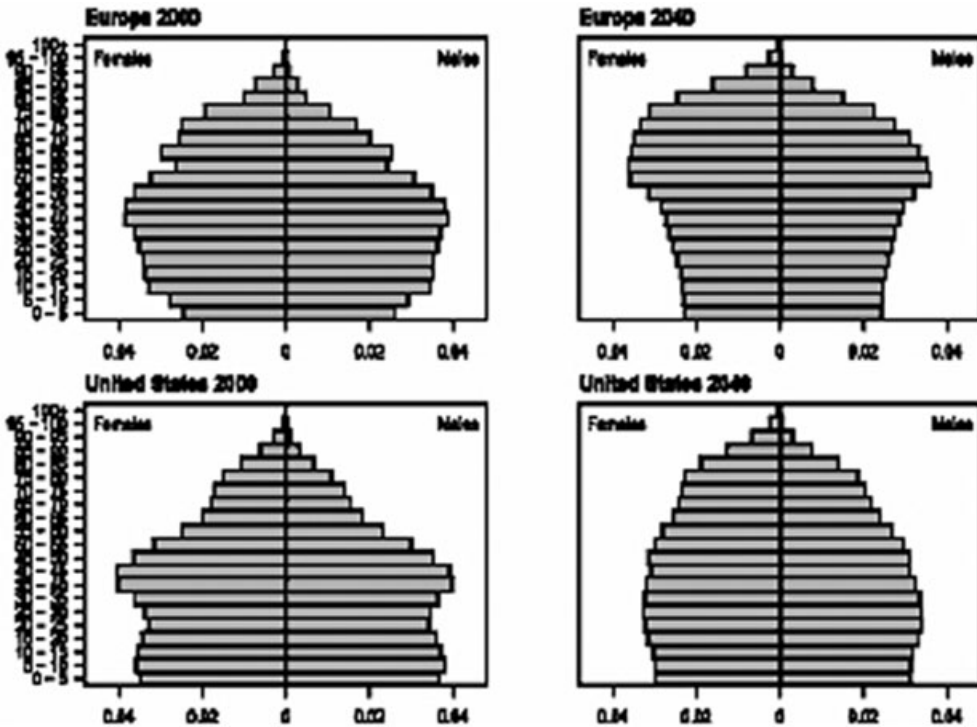


Figure 12. Our Aging Populations.

Source: Hans-Peter Kohler, Francesco C. Billari, and José Antonio Ortega. 2006. "Low Fertility in Europe: Causes, Implications and Policy Options." In *The Baby Bust: Who Will Do the Work? Who Will Pay the Taxes?*, ed. F.R. Harris. Lanham, MD: Rowman & Littlefield Publishers, 48–109. Figure 4, "Population age pyramids based on the UN medium projections: Europe, United States, Bulgaria and Denmark."

poverty—even if that means concentrating funds on those just below poverty to move them just above. This is a major problem with measuring progress against a particular threshold, because that progress is usually measured by how many are raised above it, which creates the political temptation to help those just below the line. As a Luxembourg Income Study Working Paper explains:

Changes in the head-count ratio based on median incomes depend solely on which direction and how many people are crossing the poverty line, and it does not indicate how poor the poor are, and does not change if people below the poverty line become poorer. . . . The easiest way to reduce the head-count ratio is to target benefits to those people just below the poverty line, because they are the cheapest ones to move across the line. (Hiilamo et al., 2004, p. 6)

To discourage this tendency, or at least reveal its impact, it could be helpful to keep track of changes in aggregate poverty and what in the United States is called "deep poverty," number of persons with incomes at or below 50 percent of poverty.⁴⁶

Even more troubling, as Anthony Atkinson points out: “Simply stated, concentration of benefits on those in need comes very often at the expense of creating poverty and unemployment traps” (Atkinson, 2000, p. 6). According to Nicholas Boys Smith, a researcher at the British think tank Reform, only 18 percent of tax credit spending in the United Kingdom goes to the poorest 10 percent of earners, over 80 percent of social expenditures in the United Kingdom are entitlements, and the marginal tax rate for parents with children who are moving from part-time to full-time work is over 80 percent (Boys Smith, 2006). Atkinson notes that the problem worsens as income supports have increased:

In the UK, under the Working Families Tax Credit (WFTC), the tax credit is reduced at the rate of 55% as net income rises. If the person increases his or her earnings by £100 a month, then the government takes £33 in income tax and social insurance contributions, and then the remaining £67 is reduced by 55%, leaving £30. In other words, the marginal tax rate is 70% [in the phase out range of assistance]—which is much higher than the top income tax rate (40%). With the expansion of the Working Families Tax Credit necessary to reduce poverty by a half or more, a much larger fraction of the population face high marginal rates. This tax rate applies not only to additional earnings by existing workers (for example, the disincentive to seek a better-paid job), but also to the earnings of other family members if they seek employment. It is not just a poverty trap but also an unemployment trap for additional earners. (Atkinson, 2000, p. 6)

In the end, therefore, making real progress against low income will require increasing the earnings capacities of citizens in modern societies and strengthening the ability of families to provide for their children, as recognized by analysts on the left and right. Here is Benjamin Bernanke, Chairman of the U.S. Federal Reserve System:

In the short-term, the better approach is to adopt policies that help those who are displaced by economic change. By doing so, we not only provide assistance to those who need it but help to secure public support for the economic flexibility that is essential for prosperity. In the long term, however, the best way by far to improve economic opportunity and to reduce inequality is to increase the educational attainment and skills of American workers. (Bernanke, 2008)

From the other side of the political spectrum, here is Atkinson on the same point:

There are clearly many policies that national governments can invoke in order to reduce poverty. The Lisbon Summit stressed investment in people and building an active welfare state. There is general agreement on the importance of measures, such as learning opportunities, which increase the capacity of people to raise themselves above the poverty line. These are likely to be doubly rewarding in that they reduce poverty and reduce dependence on state benefits. But social investment is not a complete substitute for social spending. (Atkinson, 2000, p. 4)

For example, in a study published by the Federal Reserve Bank of New York, Jaison Abel, an economist at the Federal Reserve Bank of New York, and Todd Gabe, a professor at the University of Maine, used a simple regression analysis to determine the relationship between a metropolitan area's per-capita GDP and the percent of the working population with a college degree. They found that "a one-percentage point increase in the proportion of a metropolitan area's working age population with a college degree is associated with a 2.3 percent increase in GDP per capita" (Abel & Gabe, 2008, p. 10). They also found that a one-standard deviation increase in a metropolitan area's percent of the working population with a college degree increased per-capita GDP by 17 percent, the largest increase of the variables they measured (Abel & Gabe, 2008).

The problem, of course, is that writing a check to fund an income transfer is much simpler than developing and operating successful active welfare state programs that build human capital. The track record for remedial job training programs is not inspiring. Few make more than a small improvement in earnings, and even the successful ones have proven difficult to replicate.⁴⁷ And so far, despite the rhetoric about strengthening families, no one has proposed a credible strategy for achieving either stronger families or fewer nonmarital births.⁴⁸

Worried that the needed investment in education and family policies will not be made—or that such approaches will not work—many social welfare advocates have been reluctant to focus their energies on the "active welfare state." As a matter of short-term political strategy, perhaps they are right. But in the long run, it is difficult to see an alternative to human capital and family-based strategies. Despite the daunting challenges, if that is where the solution lies, we should redouble our efforts to develop policies and programs to accomplish both.

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Notes

1. See also United Kingdom HM Treasury (2002), stating as the specific goals to "[r]educe the number of children in low-income households by at least a quarter by 2004, as a contribution towards the broader target of halving child poverty by 2010 and eradicating it by 2020." See, generally, Minoff (2006).
2. Hillary Clinton promised to create a cabinet-level position of "poverty czar" that would be "solely and fully devoted to ending poverty as we know it, that will focus the attention of our nation on this issue and never let it go" (Bumiller & Broder, 2008).
3. Half in Ten (2009a, b).
4. *Webster's Universal Unabridged Dictionary*, 2nd ed., s.v. "Poverty."

5. *Webster's Universal Unabridged Dictionary*, 2nd ed., s.v. "Subsistence" (emphasis added).
6. The U.S. poverty line was originally based on the USDA's Economy Food Plan.
7. See generally, Besharov & Germanis (2004).
8. For a discussion of the arbitrary rules surrounding what income is and is not counted in the official U.S. poverty measure, see Besharov & Germanis (2004).
9. Adjusting for inflation using the chained CPI (an alternative inflation measure from the Bureau of Labor Statistics which accounts for adjustments in consumption patterns to avoid the burden of inflation) would lower the poverty rate to 7.6 percent.
10. See also Hanson & Ooms (1991). Using Consumer Expenditure Survey data from the early 1980s, the authors, both then of Catholic University, compared the average income and consumption of one-earner and two-earner married couples with children under 18, and found that while two-earner couples had both higher levels of income and consumption, the differences in consumption levels between one-earner and two-earner couples were much smaller than the differences in income across all income levels.
11. Asghar Zaidi, Organisation for Economic Co-Operation and Development, e-mail message to author, May 13, 2008.
12. See Hiilamo et al. (2004), p. 5, stating: "Using a median threshold is also subject to well-grounded criticism. A median income threshold, as a standard, comes closer to the definitions of absolute poverty, which does not take account of the changes in the economic and social context of the upper half of the income distribution. On the other hand, the threshold defined by the mean reflects income equalities caused by changes in the upper end of the distribution, and it may well be criticized for obscuring the difference between inequality and poverty measures. However, the difference is already blurred as poverty measures correlate with inequality measures to a large degree. This does not mean that the measures should be kept in different categories. Actually, they focus on more or less the same phenomenon, though from a slightly different perspective (Yitzhaki, 2002)."
13. The 1998 Eurostat Task Force on Poverty and Social Exclusion recommended the change from mean to median income because, due to the "special features of the income distributions (asymmetry, long tails, etc.)," the median "is less affected by the extreme values of the income distribution and is less affected by sampling fluctuations" compared to the mean (European Statistical Systems, 1998). The recommendation of 60 percent of median income (as opposed to 40, 50, or 70 percent) was apparently not designed to raise the poverty threshold or poverty rates, rather, it was chosen because the poverty rate at 60 percent of median income was, for most EU countries, about equal to the then-current poverty rate at 50 percent of mean income, so that there was no substantial change in poverty rates for most countries.
14. See Atkinson, Marlier, and Nolan (2004) and Nolan (2003).
15. See also Hiilamo et al. (2004, p. 4), stating "Eurostat measures the risk of poverty as 60 percent of median incomes (<http://europa.eu.int/comm/eurostat/>). The OECD has used 50 percent of median incomes as an indicator of income poverty. However, the scientific justification for the use of 60 percent of the median equivalent income threshold or any other relative threshold based on the mean or median is not very convincing (Bradshaw, 2001). As a matter of fact, there is no evidence that gives ground to a particular income threshold. Any fraction of incomes is nothing more than an agreement on the level of resources which guarantee the least amount of income for 'normal life.' A kind of synthesis for different poverty line definitions is given in Hagenaaers and Van Praag (1985). However, in practice, the most popular choices for poverty lines are given in terms of certain percentages of mean or median incomes of the population. The pragmatic question is whether median or mean income is more effective in capturing the middle class's changing perception of basic necessities."
16. When determining overall poverty rates, household incomes are adjusted by the size and composition of the household using equivalency scales. Equivalency scales assign a different weight to each additional adult and child in the household, reflecting differences in consumption. These equivalency scales can skew absolute poverty rates. For example, if children are given similar weights as adults, then countries which have more children per household will have higher poverty rates compared to countries with fewer children per household. See Notten and de Neubourg (2007) and Smeeding (2005).
17. Although the OECD currently has 30 member nations, we found detailed income and poverty data for only 17 OECD nations, and it was for 2000. See Förster & Mira D'Ercole (2005).

18. See also Smeeding (2005) reporting similar findings in 11 OECD countries in 2000. He found that the number of people under 50 percent of the median disposable household cash income fell from about 27 percent to about 10 percent after social insurance (mainly old-age pensions, disability, and unemployment) and social assistance payments (mainly income support, noncash benefits, and tax credits).
19. Although the OECD has 30 member nations, only 28 member nations had social expenditure data available for 2003. See Organisation for Economic Co-Operation and Development (2008). The countries are Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, the United Kingdom, and the United States.
20. See Guio (2005, p. 4), stating: "It can be argued that the prime role of old age (and survivors') pensions is not to re-distribute income across individuals but rather over the life-cycle of individuals."
21. Without the adjustment for underreporting, the poverty gap is \$47.4 billion for families and \$65.9 billion for households, or about 0.4 and 0.6 percent of GDP, respectively.
22. Without the adjustment for underreporting, the poverty gap is about \$294.8 billion for families and about \$423.7 billion for households, or about 2.4 and 3.5 percent of GDP, respectively.
23. Author's calculations based on Förster and Mira D'Ercole (2005).
24. Michael Förster, Organisation for Economic Co-Operation and Development, telephone conversation, August 20, 2008.
25. Before subtracting housing costs, the child poverty decline was a bit larger, going from about 26 percent in 1998/1999 to about 22 percent in 2005/2006, a decline of about 15 percent. Author's calculations from New Policy Institute (2008).
26. New Policy Institute (2008).
27. See, for example, Chen and Corak (2005), estimating that of the 13.2 percentage point decline in child poverty in the United Kingdom between 1991 and 2001, about 9.7 percentage points of the decline were due to social transfers and about 3.5 percentage points of the decline were due to a stronger economy. (About 0.8 percentage points of the decline were due to other reasons.)
28. Author's calculation from National Audit Office (2007); and HM Revenues & Customs (2007).
29. HM Revenues & Customs (2008).
30. Mike Brewer, Institute for Fiscal Studies, e-mail to Douglas Call, May 13, 2008.
31. Housing costs include rent, mortgage interest payments, structural insurance premiums for homeowners, and water utility rates. Department for Work and Pensions (2007).
32. The number of poor children increased by 100,000 between 2005/2006 and 2006/2007, but leveled off between 2006/2007 and 2007/2008 (Department for Work and Pensions, 2009; New Policy Institute, 2008).
33. Spring (2007).
34. Janet Holtzblatt of the U.S. Department of the Treasury and Robert Rebelein of the University of Cincinnati estimate that, in 2000 (before some modest changes in the formula), the EITC imposed a total marriage penalty ranging from 3.6 billion to 9.9 billion dollars (within the context of a 32 billion dollar program) (Holtzblatt & Rebelein, 1999).
35. See Brewer, Goodman, Muriel, and Sibieta (2007), reporting that between 1996/1997 and 2005/2006, median income in the United Kingdom increased by 20 percent.
36. See, for example, Mankiw (2008), stating: "The cohort of workers born in 1950 had an average of 4.67 more years of schooling than the cohort born in 1900, representing an increase of 0.93 years in each decade. By contrast, the cohort born in 1975 had only 0.74 more years of schooling than that born in 1950, an increase of only 0.30 years a decade. Because growth in the supply of skilled workers has slowed, their wages have grown relative to those of the unskilled. This shows up in the estimates of the financial return to education made by Goldin and Katz. In 1980, each year of college raised a person's wage by 7.6 percent. In 2005, each year of college yielded an additional 12.9 percent. The rate of return from each year of graduate school has risen even more—from 7.3 to 14.2 percent."
37. See, generally, Gilbert (2002).
38. John Coder, Sentier Research, e-mail message to Douglas Call, June 6, 2008.

39. See Lerman (2002).
40. For 2006, the median income for married-couple families was \$76,158; for never-married mothers, the figure was \$15,427. For married-couple families, see U.S. Census Bureau (2007b); and for the 2006 median income of never-married mothers, U.S. Census Bureau (2007a).
41. See McLanahan and Sandefur (1994), showing that marital status is responsible for only about half the difference in the social and economic outcomes of the children of unwed mothers compared to those of married mothers.
42. See, for example, Wilson (2006) and Kiernan (2004).
43. In 2004, about 25 percent of all immigrants living in Sweden were from other Nordic countries (Bento, 2007, p. 337).
44. Author's calculation based on Organisation for Economic Co-Operation and Development (2008).
45. See Organisation for Economic Co-Operation and Development (2007b, p. 8), stating: "Nearly all the 30 OECD countries have made at least some changes to their pension systems since 1990. As a result, the average pension promise in the 16 countries—whose reforms are studied in this report—was cut by 22%." See also Dougherty (2008), reporting: "In recent months and years some Europeans have tried to defuse the time bomb posed by millions of retirees receiving government benefits. Italy gradually raised the retirement age to 59. France increased the tenure requirement for government workers to receive full pension benefits to 40 years of service. Germany curtailed annual government pension increases and raised the retirement age by two years, to 67."
46. Although the U.S. Census Bureau does not actually use the term "deep poverty," the term is used by others to describe its published estimates of the number of persons with incomes at or below 50 percent of poverty. See U.S. Census Bureau (2008b) and McKernan & Ratcliffe (2006).
47. See, for example, Friedlander and Burtless (1995).
48. See, for example, Amato (2007) and Furstenberg (2007).

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