

# INCOME INEQUALITIES AND (IN)EFFICIENCY OF THE EUROPEAN WELFARE REGIMES

Josifidis Kosta, Supic Novica and Beker Emilija<sup>1</sup>

**Abstract:** *This paper seeks to evaluate how well the different European welfare regimes perform in the terms of reducing income inequalities and what are the major factors of its (in)efficiency. The paper provides empirical findings on efficiency through the macroeconomic research of the relation between income inequality and the social protection expenditure in the countries of the EU 15 from 1994 to 2004. The countries with the higher social spending are not necessarily those with the lowest income inequality or where inequality have fallen the most. Conversely, the countries that allocate the fewest resources are not necessary those with the most income inequality or where inequality has increased the most. It implies that the different welfare regimes in Europe have achieved their social goals quite differently in the terms of efficiency. These variations across countries have to be taken into account in interpreting and using welfare theory and policy.*

**Key words:** *Income Inequality, Social Protection Expenditure, Efficiency, European Union*

**JEL:** *D31, H53, I38*

## Introduction

Among the various critiques addressed to the European welfare states, the decreasing economic performance due to increasing social spending and the problem of their efficiency are the most frequent. Over the past 50 years, the member states of EU have experienced important improvements in terms of the standards of living and social equality. Current levels of European welfare can be attributed to development of contemporary welfare state but also to several decades of continuous high economic growth.

However, over the last decade, most EU countries experienced declining economic growth and increasing unemployment rates. These trends lead to intensive reinvestigation of welfare state concepts in order to find solution for improving economic performance of European economies, especially compared to the United States and Japan. The positive benefits brought about by welfare

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state in terms of providing a higher social security are often neglected and a number of economists started questioning the desirability of an extensive welfare state.

The problem is not only in extent of social spending but also in their efficiency. Despite extensive government intervention and redistribution, there are still groups systematically excluded from the benefits of the welfare state and from valuable job opportunities. Although the possibility for shrinking of social spending is politically impeded, it is obviously that European welfare regimes need to be reformed in order to be more efficient.

## **1. Regimes and income inequalities**

The term welfare regime refers to “that larger constellation of socio-economic institutions, policies and programs all oriented toward promoting people’s welfare quite generally” (Goodin et al., 1999). The literature on comparative social policy abounds in classifications of welfare regimes. The one we prefer – and which draws on Ferrera (1998) defines at least four different welfare regimes in Europe: Nordic or Scandinavian (Denmark, Finland Sweden and plus the Netherlands which is a hybrid between the Scandinavian and the Continental models and has recently moved Northwards), Anglo-Saxon or Liberal (Ireland and the UK), Continental or Bismarckian (Austria, Belgium, France, Germany and Luxembourg) and Southern or Mediterranean (Greece, Italy, Spain and Portugal).

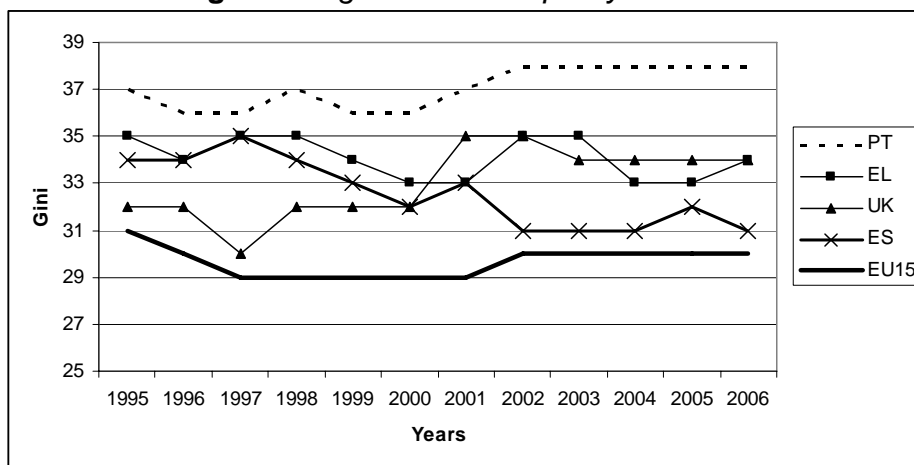
Even if there are similarities between countries belonging to the individual regime types, there are also differences and the regime types should therefore be merely regarded as ideal types. In the other words, it is important to recognize that these regimes must be viewed as ideal-types and there is not likely to be any country that fits perfectly in one type. Also, there is coincidence between classification of welfare regimes in developed capitalistic economies and typology of capitalism (Josifidis, Prekajac, 2000).

It is a well-known that the major task of welfare interventions is reducing income inequalities. The extent of income inequalities differs widely across European countries. Taxes and social security contributions have to be paid in order to finance these transfers differs internationally, too. Differences in the scope of redistribution are broadly in line with differences in the size of the welfare state. The interesting question is, however, whether or not social policy achieves more in terms of reducing inequality than what would be implied by the relative size of redistributive programmes. To give answer on this question, it is necessary to parallel compare the level of social inequalities and social spending i.e. to test efficiency of different welfare regimes.

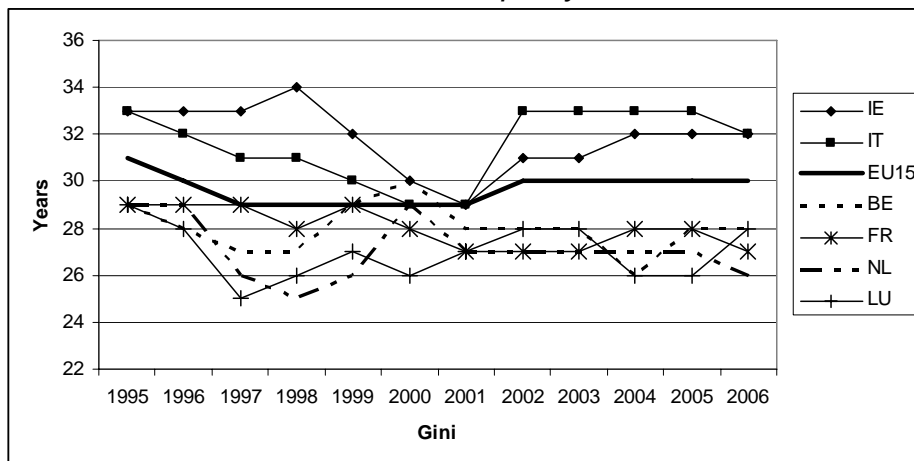
In the terms of level and dynamic of Gini coefficient (by far the most used measure of income inequalities) European welfare regimes can be categorized into three groups:

- High income inequality countries (Portugal, Greece, Great Britain and Spain) which have inequalities over the EU-15 average.
- Medium income inequality countries (Ireland, Italy, Belgium, France, Netherlands and Luxembourg). These groups followed the EU average in the terms of income inequalities.
- Low income inequality countries (Denmark, Austria, Finland, Sweden and Denmark). They have achieved the best results in the filed of reducing income inequalities.

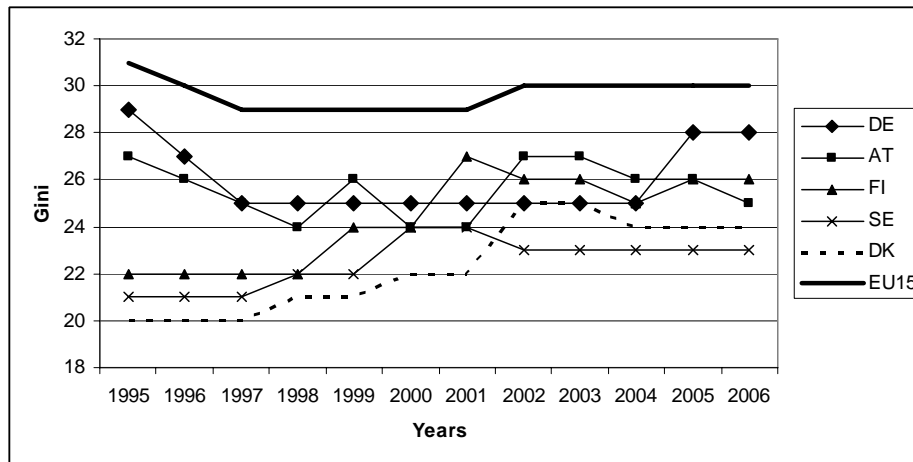
**Figure 1** High income inequality countries



*Medium income inequality countries*



### Low income inequality countries



Source: Developed by authors using data from Eurostat, at: [<http://epp.eurostat.cec.eu.int/>]

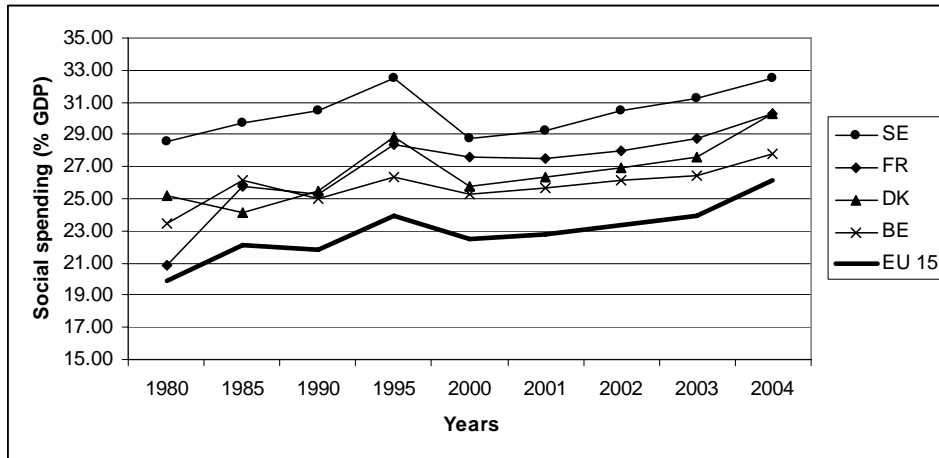
Income inequalities are strongly connected with the level of economic development, expressed by GDP per capita. Thus, the most developed countries have the least income inequalities while the least developed countries record the highest inequalities. But, it does not mean that most developed countries are, at the same time, the most efficient in reducing inequalities.

According to social spending, there are also significance differences among European welfare regimes. So, liberal model is characterized by dominance of means-tested social assistance. Social benefits accrue mainly to low income households. In countries that adopt this welfare model, entitlement rules are strict and often associated with stigmatization, while the benefits levels are modest. Conservative model is characterized by strong corporativisation of labour and social relationship. The model is above the market forces and leaves little room for private insurance. Scandinavian model is based on dominance of universal principle of social rights. It tends to be generous and redistributive but also with a heavy social service burden (Pestieau, 2004).

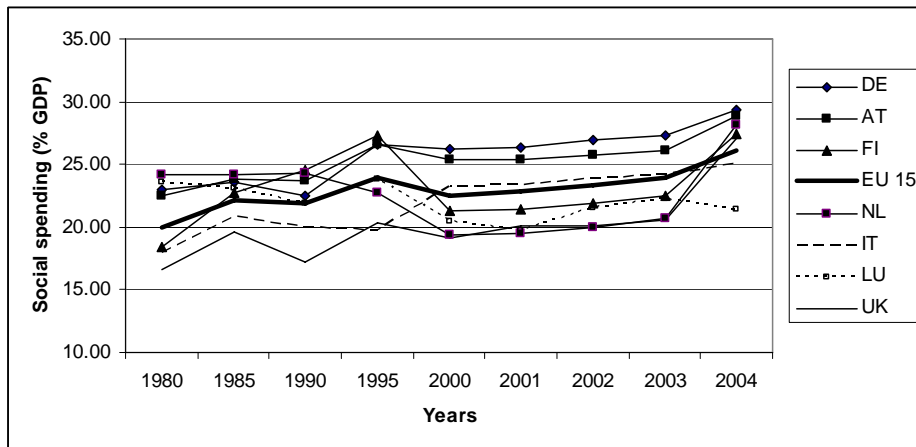
Generally, in terms of level and trend in social spending, it is possible to distinguish three relatively homogeneous groups in the EU-15:

- High spending countries (Sweden, France, Denmark and Belgium) reflect both the largest spending rates and per capita incomes of the EU-15, with the smallest changes in those indicators
- Medium spending countries (Germany, Austria, Finland, Netherland, Italy, Luxembourg, Great Britain) which lie halfway between high and low social spending countries, according to their economic and social characteristics
- Low spending countries (Greece, Spain, Portugal and Ireland) lagging in the terms of social protection and economic development, but experiencing high growth rate on both fronts.

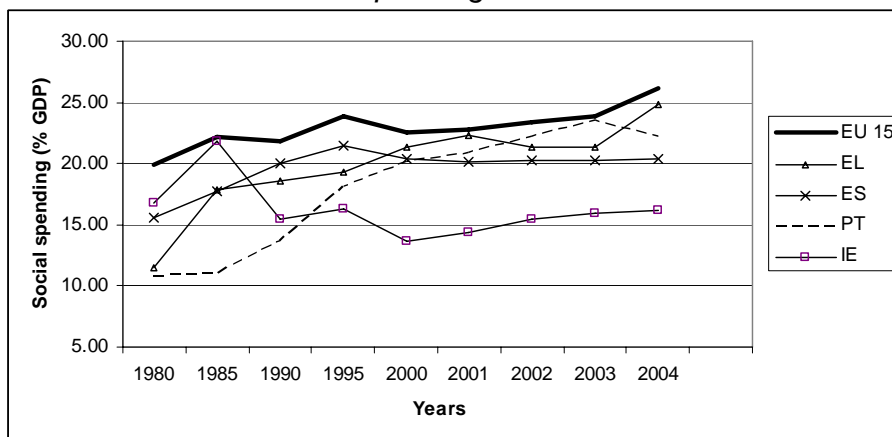
**Figure 2 High spending countries**



**Medium spending countries**



**Low spending countries**



**Source:** Developed by authors using data from OECD (2008)

The evolution of social spending in the EU has shown important differences between particular countries and social regimes. However, most of them are divided by a common characteristic – convergence towards a lower level of

social protection (Josifidis, Supic, 2008). Therefore, welfare regimes should be considered as a dynamic concept – and not a stable feature of a country’s socio-economic policy – that requires continuous scrutiny to test its current value.

### 3. Method

A number of different methodologies have been used to examine social spending efficiency. Generally, they may be classified as microeconomic, which focus individual behaviour, and macroeconomic, which analyze the influence of social protection on the whole economy. The subject of our paper is to research into the efficiency of social regimes from comparative perspective, so we emphasize the macroeconomic approach.

The most of aggregate methods for measuring (in) efficiency of welfare state are based on testing a macroeconomic relation by regression analysis. The selection variables for the model are specific problems because the modern welfare state encompasses a variety of activities ranging from pure financial intermediation (like social security) to the production of social services. For each of these activities we can use specific measure of performance. Moreover, aggregating these indicators is not easy, because they don’t express the same performance.

As was pointed out before, the modern welfare state has two main objectives: (i) to relieve poverty and (ii) to reduce economic inequality. In order to measure the efficiency of welfare state, it is necessary to test achievements of these objectives. Generally, poverty is measured by the percentage of households with adjusted income below the half the median adjusted income, while income inequality is measured by the Gini coefficient. If we achieved the lower poverty or inequality rate, with the same or lower social spending, the redistribution would be more efficient.

In order to assess the efficiency of public spending on social services we applied the method of efficiency frontier developed by Gouyette and Pestieau (1999). According to this method, efficiency is measured by regressing poverty or inequality measures on social spending and then shifting the regression line down to find the country with lowest poverty (inequality) conditional on social spending. The difference between the actual spending and its expected value on this frontier is their measure of the inefficiency in social spending.

Inefficient social spending is defined as a spending which has not direct or indirect effect on income inequality. Consequently, total social spending ( $S$ ) includes two components, efficient ( $S^E$ ) - that reduces inequality and inefficient ( $S^I$ ) - that does not.

$$S = S^E + S^I$$

The estimating regression line gives inequality as a decreasing function of the efficient social spending while inefficient social spending has no effect. So, actual poverty level in county  $i$  is given by

$$I_a = \alpha + \beta S_a^E + \varepsilon_a$$

Where  $\alpha + \beta S_a^E$  is expected level of inequality and  $\varepsilon_a$  is residual.

In order to estimate the social inefficiency for county  $a$ , it is necessary to compare it with the country  $b$  which is deemed to be on efficiency frontier. The possible level of inequality in country  $i$  is found by replacing its wasteful social spending with efficient social spending found in best country case, while holding all else factors constant. Thus, efficient social spending in country  $a$  rise from  $S_a^E$  to  $S_b^E$ .

The new level of poverty in country  $a$  is

$$I_a^* = \alpha + \beta S_b^E + \varepsilon_a$$

The extra poverty in country  $a$  due to inefficient social spending can be calculated as difference in inequality rates conditional on efficient social spending.

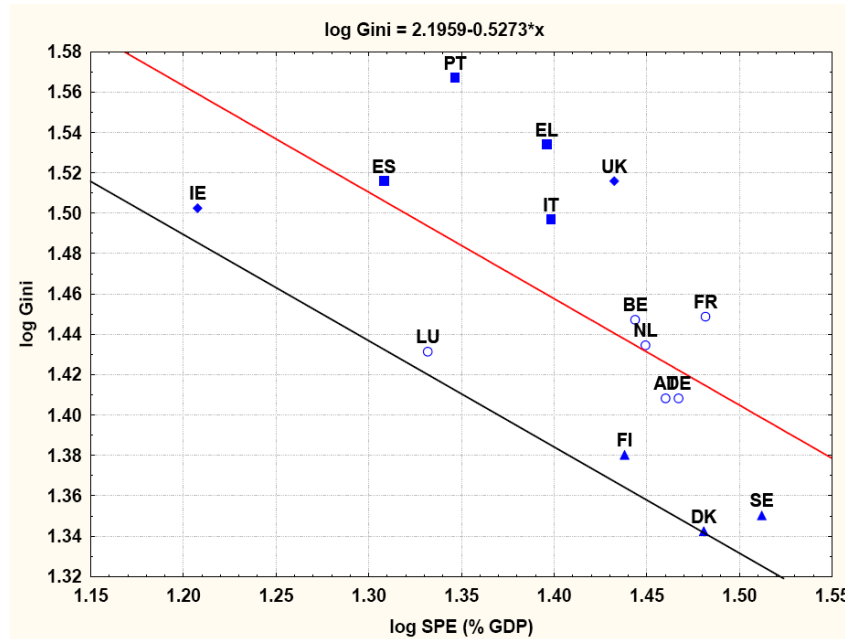
$$I_a - I_a^* = (I_a - I_b) - (\varepsilon_a - \varepsilon_b)$$

In the other words, this equation present the amount by which inequality in country  $a$  would fall if we eliminate inefficient social spending compared with country  $b$ .

## 4. Results

This section tests hypothesis concerning welfare regimes differences in the term of social spending efficiency. As was pointed out before, we expect these differences because the income inequalities and the extent to which the welfare state insures against acknowledged social risks differ widely across regimes. The present study uses income inequalities data from EUROSTAT for the years 1994 – 2004.

**Figure 3** Social protection expenditures and income inequality in EU-15, 1994 - 2004



**Source:** Developed by authors using data from Eurostat, at: [<http://epp.eurostat.cec.eu.int/>]

Figure 3 displays the link between Gini index and social protection expenditure for EU-15 countries, from 1994 to 2004. Increasing social transfers are followed by decreasing income inequality. The efficiency of each country is determined by comparing it with country which has the best results in reducing inequality. In our example, it is Denmark, country with highest negative value of residuals compare to assessed regression line. The results of analysis reveal the important variation in social spending efficiency among EU-15 countries. For example, Denmark and France spend about the same fraction of GDP on social protection, and yet in France income inequality is three times higher than in Denmark. Practically, if France had eliminated inefficiency in its social spending it could achieve three times lower income inequality.

Table 1 presents the share of social spending that is deemed inefficient in the terms of reducing income inequality. The average level of inefficient social spending is 2% of GDP for EU-15. However, there are considerable variations between countries. Thus, for Great Britain, about 4 percent of social spending is deemed inefficient, while for Denmark it is zero (efficiency frontier) and for Sweden, it is under 1%.

**Table 1** *Total social spending and estimated inefficient social spending by the Gouyette and Pestieau method, EU – 15, 1994 – 2004*

Member state	Social spending (% of GDP) 1995 – 2004 mean	Gini	Inefficient social spending (% of GDP)
DK	30.25	22	0.00
LU	21.47	27	0.22
IE	16.13	31.8	0.26
FI	27.42	24	0.42
SE	32.51	22.4	0.79
AT	28.85	25.6	1.59
ES	20.33	32.8	1.68
DE	29.32	25.6	1.72
NL	28.14	27.2	2.13
BE	27.78	28	2.37
IT	25.02	31.4	2.78
FR	30.32	28.1	3.24
PT	22.21	36.9	3.42
EL	24.88	34.2	3.65
UK	27.07	32.8	4.01
Mean	26.11	28.65	1.88

**Source:** Developed by authors using data from Eurostat, at: [<http://epp.eurostat.cec.eu.int/>]

Taking Table 1, we can conclude the following about efficiency of European welfare regimes:

- Scandinavian countries have the most efficient welfare regimes in reducing income inequality. The level of inefficient social spending is below the EU-15 average.
- Mediterranean countries have the most inefficient social regimes in reducing income inequality. The level of inefficient social spending is above the EU-15 average.
- Countries of conservative model have the efficiency of social spending on about the same as EU-15 average.
- Countries of liberal model do not have common characteristics in the field of social spending efficiency. Great Britain has the worst results while Ireland has the best together with Scandinavian countries.
- Countries that allocated the most resources to social protection expenditure are not necessarily those with the lowest income inequality. Conversely, countries that allocated the fewest resources are not necessarily those with the highest income inequality.

Tito Boeri (2002) found a similar ranking of countries when analyzing the performance of the four European welfare models in terms of reduction of income inequality and poverty by comparing Gini coefficients before and after taxes and transfers. He found that the extent of redistribution effected via taxes and transfers is highest in Scandinavian countries (with 42 per cent reduction of

inequality) and lowest in Mediterranean countries (35 per cent reduction), with Anglo-Saxon and continental countries in the middle (39 per cent reduction).

As revealed by table 1 Mediterranean and the Scandinavian groups come out as being respectively the least and the most successful in reducing income inequality. This holds also when we compare Gini coefficients before and after taxes and transfers. How can we explain that? Since the extent of redistribution, as percent of national GDP, is fairly equal in most countries it cannot be the major explanatory factor. One of the most appropriate explanations is the different regulations of social transfers according to family income.

In all welfare regimes, extent of social transfers for working age population depends on their income. In aggregate point of view, income level primarily depends on employment rate and human capital that individuals bring to the market. According to employment rate and education level, there are significant differences among European welfare regimes which can be used as an acceptable explanation for their variations in social spending efficiency.

**Table 2** *Employment rate in EU15, 2007*

Member state	Employment rate 15-64	Employment rate 15-24	Employment rate 55-64
DK	77,10	65,30	58,60
FI	70,30	44,60	55,00
SE	74,20	42,20	70,00
<b>SDWR</b>	<b>73,87</b>	<b>50,70</b>	<b>61,20</b>
UK	71,50	52,90	57,40
IE	69,10	49,90	53,80
<b>LWR</b>	<b>70,30</b>	<b>51,40</b>	<b>55,60</b>
AT	71,40	55,50	38,60
BE	62,00	62,00	34,40
FR	64,60	64,60	38,30
DE	69,40	45,30	51,50
LU	64,20	64,20	32,00
NL	76,00	68,40	50,90
<b>CWR</b>	<b>67,93</b>	<b>60,00</b>	<b>40,95</b>
EL	61,40	24,00	42,40
IT	58,70	58,70	33,80
ES	65,60	39,10	44,60
PT	67,80	34,90	50,90
<b>MWR</b>	<b>63,38</b>	<b>39,18</b>	<b>42,93</b>
<b>EU15</b>	<b>66,90</b>	<b>40,80</b>	<b>46,60</b>

**Source:** Developed by authors using data from Eurostat, at: [<http://epp.eurostat.ec.eu.int/>]

As is apparent from table 2, labour market participation varies a great deal across the four European welfare regimes. Employment rates are higher in Scandinavian and Anglo-Saxon countries (respectively 62 per cent and 59 per cent) than in continental and Mediterranean countries (respectively 56 per cent and 48 per cent). Furthermore, the gap is higher if we analyze the differences at

the two ends of the age spectrum. Thus, for workers aged 55–64, the employment rate is considerably higher in Scandinavian (61 per cent) and Anglo-Saxon (56 per cent) countries than in continental (41 per cent) and Mediterranean (42 per cent) countries. For workers aged 15–24, the employment rate is significantly higher in Scandinavian (74 per cent) and Anglo-Saxon (70 per cent) countries than in continental (67 per cent) and Mediterranean (63 per cent) countries.

Employment rate differences among European welfare regimes are mainly the consequence of using different instruments in order to protect workers from unemployment risk. Namely, there is a strong connection between the employment rate generated by a social system and the instrument it uses to protect workers from unemployment risk. Governments reduce job insecurity in two basic ways: (i) the provision of unemployment benefits and (ii) by making it hard to dismiss workers via employment protection legislation. Since employment protection legislation and unemployment benefits have a similar purpose, there is a trade off between them. EU Member States have chosen very different points in the trade-off between the employment protection legislation and unemployment benefits. The Mediterranean countries have very strict employment protection regulations and a rather low coverage of unemployment benefits. On the other side, the Scandinavian countries provide unemployment benefits which are both generous and comprehensive, but the strictness of their employment protection legislation is quite low. So, they relied more heavily on unemployment benefits than employment protection legislation.

Although employment protection legislation and unemployment benefits are two instruments designed to achieve a similar purpose, they have different influence on employment rate. The stricter the employment protection leads to the lower employment rate. On the other side, the generosity of unemployment plays only a secondary role. This means that protecting jobs with employment legislation is definitely detrimental to employment, whereas protecting workers with unemployment insurance is potentially useful for employment. (Sapir, 2007).

**Table 3** Educational attainment: adult population (2006) Distribution of the 25-to-64-year-old population, by highest level of education attained

Member state	Below upper secondary education			Upper secondary level of education			Tertiary education		
	Pre-primary and primary education	Lower secondary education	ISCED 3C (short programme)	ISCED 3C (long programme)/3B	ISCED 3A	Post-secondary non-tertiary education	Type B	Type A	Advanced research programmes
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
DK	1,00	16,00	2,00	43,00	4,00	n	8,00	27,00	1,00
FI	10,00	10,00	a	a	44,00	n	16,00	18,00	1,00
SE	6,00	10,00	a	x(5)	47,00	6,00	9,00	22,00	x(8)
<b>SDWR</b>	<b>5,67</b>	<b>12,00</b>	<b>2,00</b>	<b>43,00</b>	<b>31,67</b>	<b>6,00</b>	<b>11,00</b>	<b>22,33</b>	<b>1,00</b>
EL	28,00	11,00	3,00	3,00	26,00	8,00	7,00	15,00	n
IT	16,00	32,00	1,00	7,00	30,00	1,00	1,00	12,00	n
ES	23,00	27,00	a	8,00	13,00	n	9,00	19,00	1,00
PT	57,00	15,00	x(5)	x(5)	13,00	1,00	x(8)	13,00	1,00
<b>MWR</b>	<b>31,00</b>	<b>21,25</b>	<b>2,00</b>	<b>6,00</b>	<b>20,50</b>	<b>3,33</b>	<b>5,67</b>	<b>14,75</b>	<b>1,00</b>
AT	x(2)	18,00	2,00	47,00	6,00	10,00	7,00	10,00	x(8)
BE	15,00	18,00	a	9,00	24,00	2,00	18,00	14,00	1,00
FR	14,00	19,00	a	30,00	11,00	n	11,00	15,00	1,00
DE	3,00	14,00	a	49,00	3,00	7,00	9,00	14,00	1,00
LU	18,00	9,00	8,00	17,00	20,00	5,00	8,00	15,00	2,00
NL	7,00	20,00	x(4)	16,00	23,00	3,00	2,00	28,00	1,00
<b>CWR</b>	<b>11,40</b>	<b>16,33</b>	<b>5,00</b>	<b>28,00</b>	<b>14,50</b>	<b>5,40</b>	<b>9,17</b>	<b>16,00</b>	<b>1,20</b>
UK	n	14,00	17,00	23,00	16,00	n	9,00	21,00	n
IE	16,00	18,00	n	x(5)	25,00	11,00	11,00	19,00	n
<b>LWR</b>	<b>16,00</b>	<b>16,00</b>	<b>17,00</b>	<b>23,00</b>	<b>20,50</b>	<b>11,00</b>	<b>10,00</b>	<b>20,00</b>	<b>n</b>
<b>EU15</b>	<b>16,36</b>	<b>16,66</b>	<b>5,90</b>	<b>23,47</b>	<b>20,64</b>	<b>5,70</b>	<b>8,94</b>	<b>17,64</b>	<b>1,10</b>

Notes:

a Data is not applicable because the category does not apply.

n Magnitude is either negligible or zero.

x Data included in another category or column of the table (e.g. x(2) means that data are included in column 2 of the table).

**Source:** Developed by authors using data from OECD, at: [www.oecd.org/edu/eag2008]

Except employment rate, family income level is also determined by educational level. Educational attainment and labour market outcomes are strongly connected and low attainment in the educational sector lead to low positions in the labour market. The proportion of the population aged 25–64 with at least upper secondary education is highest in Scandinavian (about 80 per cent) and Anglo-Saxon (50 per cent) countries and lowest in continental (about 55 per cent) and Mediterranean (30 per cent) countries. This ranking matches the position of country groups in terms of social spending efficiency.

## **Conclusions**

This paper has shown interesting differences in social spending efficiency among European welfare regimes. The empirical findings, using Gouyette and Pestieau method, suggest that Scandinavian countries have the most efficient welfare regimes while Mediterranean countries have the most inefficient welfare regimes in reducing income inequalities. Countries of the conservative model have the efficiency of social spending on about the same level as the EU-15 average.

The different performance of the four European welfare models in terms of social spending efficiency is strongly connected with difference in employment rate and education level. Employment rates and the proportion of the population with at least upper secondary education are higher in Scandinavian and Anglo-Saxon countries than in continental and Mediterranean countries. These variations across regimes and countries have to be taken into account in interpreting social and economic situation in EU. Results, elsewhere in the literature, obtained using various macro approaches, mainly point to quite similar general conclusions with regard to efficiency of European welfare regimes.

These conclusions are based on the more or less rough macroeconomic approach to welfare regimes and their implications in European economies. For more detailed information on the efficiency of the various social policy models it is necessary analyze micro data, notably probability of receiving different types of cash transfers against family no economic characteristics.

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