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POLICY PAPER

Income Inequality and Public Policy

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Abstract: This paper briefly summarises the evidence that Ireland has a relatively high level of income inequality, which has been rather stable over time and reflects institutional legacies and choices made in the past. A comparative and over time perspective suggests that modest reductions in income inequality are achievable within the framework of Ireland's current socio-economic model, but bringing it below the (EU or OECD) average may well be beyond the capacity of that model. The current financial, fiscal and economic crises require very substantial increases in tax revenue and reductions in state spending. The imperative to close the fiscal deficit provides a window of opportunity to restructure the tax system in a fashion that is not only more economically efficient but also more equitable. Another core aim should be to minimise the number experiencing long-term unemployment and thus the long-term impact of the recession on labour market careers. Once the most immediate needs of the situation are met, this context may provide an opportunity to debate fundamental questions about the role of the state, the extent and nature of social provision and its financing, and the broader relationship between economic performance, the Welfare State, and the underlying goals of Ireland's socio-economic policy.

I INTRODUCTION

The onset of deep recession after a decade of unprecedented economic growth, and the emergence of an enormous fiscal deficit, have brought concerns about fairness to the fore in Irish public debate. What is a fair distribution of the burden of closing that fiscal deficit via tax increases and expenditure reductions? To what extent can or should those who fared best during the boom contribute proportionately to extrication from the "bust"? Were the reward structures that emerged during the boom – the differentials between top executives and average earners, between average earnings and

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the low paid, between public and private sectors, between different occupations – fair, how have they changed, and would we want to restore them if we could? If a reduction in national living standards is required to restore competitiveness, should that be shared equally or should certain groups – pensioners, social welfare recipients, the low paid – be afforded special protection?

In thinking about these very current concerns, some perspective is helpful – on where we are, how we got here, and how we compare with other countries. This paper seeks to provide that background by briefly characterising income inequality in Ireland in comparative perspective, and sketching out some explanatory factors. It then looks at current policy choices and how these might be framed by reference to medium to longer-term considerations and objectives. While some might consider distributional issues to be overshadowed by the financial, economic and fiscal crises, the paper argues that they are in fact central to thinking through options in responding to those crises effectively.

II WHY SHOULD PUBLIC POLICY BE CONCERNED WITH INCOME INEQUALITY?

We start by considering why income inequality should be a concern for public policy in the first place. The extensive research literature on the concept of equality has devoted a great deal of attention to the question "equality of what?" – of opportunities, welfare, resources, or capabilities, to mention just some of the candidates advanced (see for example the contributions by Sen, 1980; Dworkin, 1981a, b; and the survey by Roemer, 2009). Equality of opportunity has certainly come to be seen as an important social goal in Western democracies, and inherited privilege as in some important sense unfair. If everyone actually got the same start in life, unequal rewards might then be regarded as merited rather than unfair – as well as, from an economic perspective, central to promoting effort and economic activity (on which see for example Welch, 1999; Glaeser, 2006). It turns out to be difficult to define and agree on what equality of opportunity and having "the same start in life" actually means, though, and what factors are consequently to be considered as fair versus unfair advantages.[1] In practice, it

[1] To give just one example, for certain social backgrounds or ethnic groups working hard in school is the cultural norm: should the rewards to a hard-working student coming from such a background be seen as reflecting individual effort or an accident of birth? See for example Roemer (1998).

has also been very hard to find ways of effectively offsetting the advantages associated with coming from a "privileged" background, even in societies that have invested a great deal of effort into doing so. This means that it is also necessary to focus on outcomes as well as opportunities in relation to economic resources, while keeping to the forefront that inequalities in resources may be regarded as fair or unfair, and indeed economically functional versus harmful, depending on the sources from which they spring.

Income is a key component of economic resources but not the only one, with wealth also a central element. Unfortunately, the distribution of wealth is even more difficult to capture empirically than that of income, which makes it difficult to incorporate in the Irish case. There have been some cross-sectional estimates for Ireland (Nolan, 1991; 1999), and the study of wealth distributions across countries is advancing (see for example, Jäntti *et al.*, 2008, on the developing Luxembourg Wealth Study database), but we are not in a position to reliably place Ireland in comparative perspective or assess trends over time here.

Focusing on income as an indicator of economic resources, then, it is worth distinguishing between a number of distinct reasons why inequality might be a significant concern for public policy. The first is that people tend to have some sense of whether certain income differences are fair or unfair: current debates in Ireland and elsewhere about the rewards to top executives serve to illustrate that this is something people care about, at least in certain circumstances and settings. Views about income inequality and how to respond to it are complex and difficult to capture and interpret empirically,[2] but public policy has to be responsive to social goals, and attitudes towards inequality per se will influence how these goals are framed. (This is not to say that differences in inequality across countries simply reflect such differences in attitudes, for reasons we discuss below.)

The second reason is that income inequality may be a key factor in producing or exacerbating a wide range of social ills such as educational disadvantage, health inequalities and crime, and undermining social cohesion. There is now a substantial research literature documenting the extent to which childhood disadvantage underpins poor adult outcomes across various domains, such as educational attainment and adult earnings (Danziger and Waldfogel, 2000, Duncan and Brooks-Gunn, 1997; Cunha and Heckman, 2007). Heckman's work has been particularly influential in demonstrating

[2] Recent research on public attitudes to income inequality in the UK for the Joseph Rowntree Foundation, for example, found that most people think the income gap between top and bottom is too large, but far fewer explicitly support redistribution to address that gap, with public attitudes to redistribution described as complex, ambiguous and apparently contradictory (Orton and Rowlinson, 2007).

that certain early childhood development programmes had a pronounced positive impact on school achievement and other outcomes that substantially outweighed the costs. The extent to which such relationships operating at the level of the individual and household lead to a strong aggregate causal relationship between overall income inequality and such social "bads" is less clear. For example, the recent study by Wilkinson and Pickett (2008) posits the centrality of income inequality in underpinning health inequalities, whereas Leigh, Jencks and Smeeding (2009) interpret the evidence as suggesting a relationship between income inequality and health is fragile or non-existent. More generally, though, Jencks (2002) concludes from his review of the evidence on the social consequences of economic inequality that these are sometimes negative, sometimes neutral, but seldom positive. This may at least potentially provide a rationale for reducing inequality on instrumental grounds, as part of a strategy for tackling what are universally regarded as social ills.

The third reason is that if equality of opportunity is the core concern, income inequality may well be a key influence. While measures of intergenerational mobility in earnings and income are available only for a small number of countries, its variation across these is reasonably well aligned with the variation in income inequality – with the USA, for example, registering as having a relatively low degree of mobility alongside high cross-sectional income inequality. At a theoretical level, one can also point to models that predict such a relationship, on the basis for example that a more unequal distribution of earnings and higher returns to education give better-off parents a greater incentive to invest in their children's human capital (see for example Solon, 2004). As the OECD concludes in the recent comparative study *Growing Unequal*, the evidence "… is not conclusive but is suggestive of a consistent cross-country pattern of low intergenerational mobility and high income inequality" (OECD, 2008, p. 215).

The final reason, which is only recently receiving the attention it deserves, is that income inequality and economic performance may be intimately related, that inequality may undermine economic performance, and that in certain circumstances promoting equality may enhance economic growth. This runs counter to the conventional notion (among economists) of a straight trade-off in which more equality can be achieved only be at the cost of less economic growth or lower living standards. This reflects an emphasis on the central role of differential rewards in the labour market in bringing forth work effort and entrepreneurship: blunting those differentials runs the risk of choking off growth. However, recent theoretical and empirical research highlights that the transmission channels involved are numerous, including for example, the effects of inequality (combined with credit constraints) on

investment in education, on rent-seeking, and on politics, social capital and trust. Voitchovsky's (2009) review brings out that inequality can both facilitate and retard growth, and that for example inequality towards the top may have a different impact to inequality towards the bottom. Empirical efforts to capture the overall effect of inequality on growth covering developing and developed countries have generally proven inconclusive, while Jencks (2002) concludes that across developed countries the evidence for the claim that inequality promotes efficiency is also thin. Krueger (2004) argues that the degree of income inequality now reached in the USA may be "… too much of a good thing", due primarily to associated negative externalities of various kinds. So from a purely economic perspective there is a clear rationale for focusing on income inequality, even if we cannot say a priori how much is likely to be "too much".

III CHARACTERISING INCOME INEQUALITY IN IRELAND

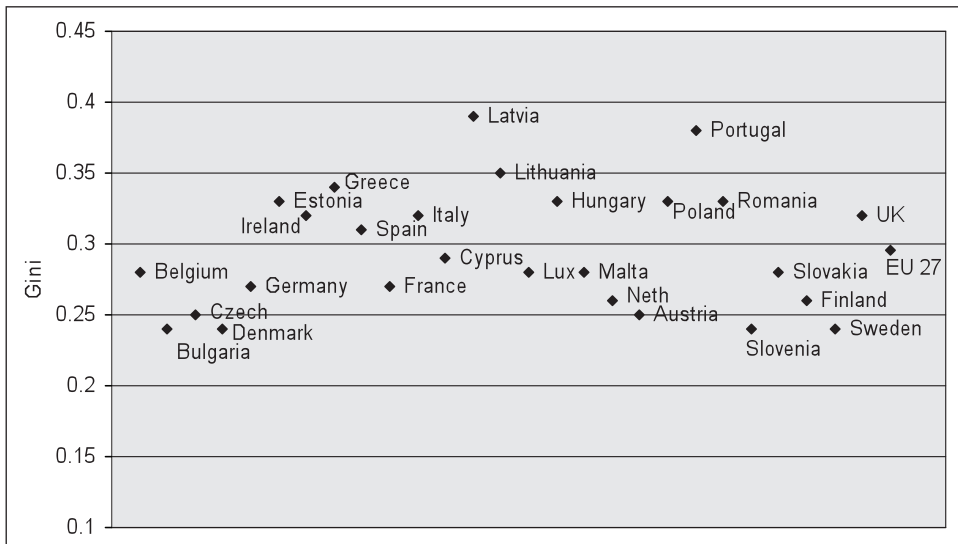
Against this background, where does Ireland fit comparatively in terms of income inequality, how should we characterise and then seek to explain Ireland's ranking compared with other advanced societies and what has been happening to the distribution in recent years? The degree of income inequality can be summarised using measures such as the Gini coefficient, Atkinson's inequality measure, the Theil coefficient, and the ratio of the 90th to the 10th percentile (for a discussion see Cowell, 2008). When the most widely-used summary measures are calculated from household survey data, Ireland ranks:

- 10-12th within the EU-15
- 17-18th within the EU-27
- 18-22nd within the OECD[3]

Focusing on the most popular of these measures, the Gini coefficient, which ranges from 0 to 1 and where a higher figure means more inequality, Figure 1 shows that in 2007 this ranges from 0.24 to 0.38 within the enlarged EU-27; the average is 0.30 and the median 0.29. The figure for Ireland is 0.32, so Ireland is clearly above average, but at a level that is similar to eight other countries (e.g. Spain, Italy, UK, Poland) and markedly below two – Portugal

[3] These rankings are based on the income inequality figures for the EU Member States produced by Eurostat, and those for the OECD discussed in Forster and Mira d'Ercole (2005) and OECD (2008). Different sources and years, and different equivalence scales used to adjust for household size, produce modest differences in rankings which is why a range is shown.

Figure 1: *Gini Inequality Measure, EU-27*



and Lithuania. Among OECD countries the picture is quite similar, with Australia, Canada and New Zealand also around Ireland's figure.

One regularly reads, in the media and in scholarly publications that Ireland is one of the most unequal countries in the industrialised world. A better description would be "… among the rich countries with significantly above-average levels of income inequality". The distinction to be highlighted is between seeing Ireland as *sui generis*, one of a kind, with a distinctively high level of inequality attributable to some specific features of its economy and society, or as one of a group of countries that share a set of institutional features that – however great the differences between them – underpin their relatively high levels of income inequality.

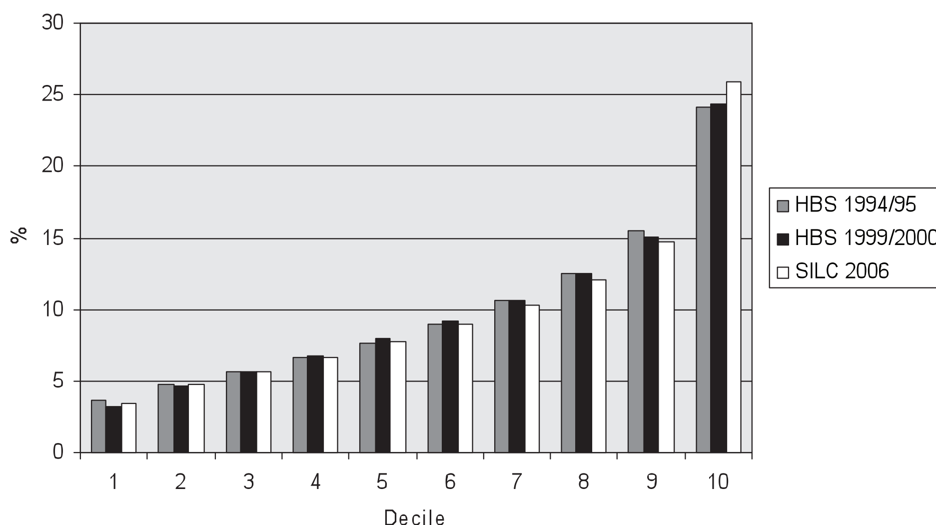
Turning to trends in inequality for Ireland over time, there is some variation across the available surveys, but broadly speaking summary inequality measures have been rather stable going back to the late 1980s.[4] (One can contrast this with the increase in inequality seen in the UK and the USA: from about 1980 the Gini coefficient for the US rose by 17 per cent, while in the UK it went up by over one-third.) This means that Ireland's position

[4] See Nolan and Smeeding (2005), Nolan *et al.* (2000), and the Central Statistics Office's releases on data from EU-SILC, most recently CSO (2009). The figures available for Ireland over time are from different sources and sometimes on different bases, and need careful interpretation; an in-depth treatment of these issues is beyond the scope of this paper but see Nolan and Smeeding (2005).

relative to other EU and OECD countries has also been broadly stable over the past quarter-century, insofar as comparative data allow that to be reliably assessed. Summary measures may mask important changes occurring in different parts of the income distribution, so one can also look at decile shares – the share of total income going to those in the bottom 10 per cent, next 10 per cent etc. Figure 2 shows that over the boom years some increase is seen in the share going to the top 10 per cent, but mostly balanced by a decline for others in the top half rather than further down the distribution.[5]

How would one reconcile this with the common belief that inequality increased sharply over the boom? The first point is that household surveys may not capture the full picture, and may have particular difficulty right at the top of the income distribution where the most pronounced effects from such a boom might be felt. Data produced by the Revenue Commissioners can be used to estimate the share of total income going to the top 1 per cent, and estimates in Nolan (2007) show a sharp increase from about 6 per cent to 10 per cent over the 1990s. Even larger increases in top income shares in countries such as the USA and the UK have been revealed by similar studies and widely commented on. In the Irish case, though, it is particularly difficult

Figure 2: *Income Distribution: Decile Shares 1994–2006*



[5] The figures for 1994-95 and 1999-2000 are from the Household Budget Survey, whereas those for 2006 are from the EU-SILC survey. All these are carried out by the CSO, but EU-SILC data shows a slightly higher level of inequality, so this comparison may overstate the increase in inequality from 2000 to 2006.

to disentangle the effects of changes in reporting behaviour vis-à-vis the tax authorities from changes in actual incomes – both are probably contributing to the observed trend.

Another factor is that even if the distribution is not changing in relative terms – if everyone experienced the same proportional increase in their incomes, which would leave conventional inequality measures unchanged – widening absolute gaps in incomes could dominate popular perceptions. (There is some experimental evidence that perceptions or views about inequality often focus on absolute gaps rather than just on shares.) When incomes are rising as rapidly as they did during the boom, such widening gaps will be particularly striking.

As far as shares are concerned, though, some of the effects of economic growth may be less obvious than others. The impact via profits towards the top may be more obvious than the no less real impact of much lower unemployment towards the bottom. Another important feature of the boom was the increase in married women's labour force participation. While in some countries this has been concentrated among women married to higher-earning men, in the Irish case it was as common for those married to lower-earning men, and thus did not have a disequalising effect on the household income distribution. It also seems that at least up to 2000 the boom was not accompanied by the pronounced increase in earnings inequality and widening gap between high versus low levels of education seen in the USA and the UK (Barrett, Fitz Gerald and Nolan, 2002; McGuinness, McGinnity and O'Connell, 2008). Strong demand for low-skilled employees appears to have kept up their returns, while increasing numbers of highly-educated, leaving college and returning from abroad kept theirs down.[6] As far as social welfare is concerned, rates initially lagged behind average earnings but subsequently made up much of the ground, although not increasing by as much as average household income boosted by increasing numbers at work.

Data are not yet available to allow us to track the impact of the recession on income inequality, but we return in Section V to what one might expect the key features of that impact to be. First, though, we discuss the factors that may underpin differences in income inequality across advanced countries and Ireland's ranking in those terms.

[6] It is worth noting that earnings inequality did rise substantially in the earlier period from 1987 to 1994 (Barrett, Callan and Nolan, 1999; Nolan and Maître, 2000), which saw significant economic growth; household income inequality remained steady, however, because of the offsetting effects of falling unemployment and relatively rapid increases in the lowest social welfare rates.

IV EXPLAINING DIFFERENCES IN INCOME INEQUALITY

Overall income inequality reflects the complex interaction of various factors: the way earnings are distributed among individuals, the extent and nature of labour force participation, how earners and non-earners are grouped together in households, the distribution of wealth and the returns to it, and "factor shares" – the division of returns between capital and labour. All these influence the shape of the distribution in one country versus another. However, what appears to be the single most important factor underlying differences among rich countries – and the one that is most amenable to influence via public policy – is the extent and nature of the Welfare State.

The first and most obvious way that the Welfare State influences income inequality is through redistribution via income transfers and direct taxes – income tax and social insurance contributions. There are striking differences across EU and OECD countries in the measured difference between inequality in income from the market versus disposable income, when transfers are included and direct tax deducted. For example, when one goes from market to disposable income the Gini coefficient is reduced by less than 30 per cent in the case of Italy, Spain and Portugal, compared to 45-50 per cent in Austria, Denmark, Belgium, France and Sweden. This overall redistributive impact can be decomposed into the separate effects of income transfers and direct taxes on inequality, and broadly speaking there is more variation across EU or OECD countries in the effects of transfers than taxes.[7]

However, the impact of the Welfare State goes beyond income support to encompass social provision much more broadly. Overall "welfare effort" is often measured by aggregate public social expenditure, which also includes healthcare and housing subsidies. Relating summary inequality measures to total social protection spending as a percentage of national income, low spenders generally have high levels of income inequality and vice versa – as Glaeser (2006) concludes, there is a strong negative relationship between inequality and social welfare spending. However, social protection spending alone is not a very good predictor of income inequality (though probably still better than any other single factor). This is clearer if the set of countries examined is the EU-27 or the OECD rather than the narrower EU-15. Quite a few countries have much lower inequality than their social spending would predict – e.g. Finland or Slovakia – and others have much higher – e.g. Portugal and Italy. Variations in social spending do not suffice to explain

[7] See for example Sutherland and Levy (2005).

where countries rank in terms of inequality, though they do clearly contribute, nor is higher social spending guaranteed to produce low inequality.[8]

The Welfare State remains central, though, because in addition to the direct effect of social protection spending it encompasses education and training, the way the labour market is structured and how it interacts with social protection. It is not simply the extent of redistribution of income at a point in time that matters, the extent to which higher taxes are used to develop the human capital of the population and reduce the degree of dispersion in skills may be key. Institutions (including collective bargaining structures and broader corporatist/partnership arrangements) also play a central role in the way the labour market operates to produce more or less dispersion in rewards given the distribution of skills.

This is where the notion of welfare "regime" is helpful, with the now-customary categorisation into:

- Social Democratic – Denmark, Finland, Norway, Sweden
- Corporatist – Germany, Belgium, France
- Liberal – UK, USA, Australia, New Zealand, Canada
- Residual/"Southern" – Spain, Portugal, Greece, Italy.

These groupings are distinguished not just in terms of how much their social security systems rely on means-testing versus contributory or universal payments, but also on the basis of social rights independent of the market, social stratification, and the public-private mix.[9] There are clear and consistent differences between these groupings in terms of levels of income inequality, with inequality lowest for the social democratic countries, higher but still relatively low for the corporatist ones, above average for the liberal regime with the USA an outlier, and as high or higher for the "Southern" regime, with Portugal again an outlier. (The former Communist countries of Eastern Europe cannot be placed in this schema and cover a very wide range in terms of inequality, from the Czech Republic at the low end to Lithuania at the other.)[10]

This lens proves helpful in understanding Ireland's income distribution. We saw in Section III that Ireland's relative position in terms of income inequality has been quite stable over time, despite substantial variation in

[8] See for example the discussion in Marlier, Atkinson, Cantillon and Nolan (2006).
[9] The seminal discussion is Esping-Andersen (1990).
[10] See for example the income inequality figures for the Member States produced by Eurostat and included in the EU's social inclusion indicators, available on the Eurostat website under data/living conditions and welfare/income distribution and monetary poverty. See also OECD (2008).

social spending as a proportion of national income. Ireland currently ranks lowest in the EU-15 in terms of social spending as a share of GDP. That includes profits repatriated abroad, however, expressed as a proportion of Gross National Income Ireland is one of the low spenders but not such an outlier. When social spending is plotted against summary inequality measures, for the EU or the OECD, Ireland is right on the regression line: the level of inequality is what one would predict given current social protection spending. Focusing on income transfers to and direct taxes on households, their "redistributive impact" in the Irish case to reduce the Gini coefficient for market income by 32 per cent. This is substantially below the EU average and similar to Greece and the UK, but as noted earlier countries such as Italy, Spain and Portugal reduce market inequality by less.[11] When this overall redistributive impact is decomposed into the effects of income transfers versus direct taxes, it is the former that is particularly modest for Ireland. This relates in particular to the limited redistributive impact of public pensions, reflecting their flat-rate nature with reliance on private pensions for an earnings-related component, as in the UK but unlike many other EU countries. More generally, though, in terms of the institutional structure of not just taxation and social transfers but social protection and the labour market more broadly, Ireland's structures fit us in the Liberal welfare regime. It is not then surprising that we have a level of income inequality similar to most of the other countries in that grouping.

V THE IMPLICATIONS

This focus on Welfare State institutions highlights not only the importance of adopting a comparative framework, but also of a historical perspective on understanding how we have arrived here, how core features of our institutional landscape have evolved. A key question then is the extent to which policy is constrained by this institutional legacy. Is Ireland locked into a relatively high level of inequality by institutional legacies and choices made in the past?

Posing the question that way of course begs what might be seen as a logically prior one: perhaps we are where we are because that is where we want to be? Depending on what one believes about the way the political system translates voters' preferences into public policy, that could be simply a

[11] See the income inequality measures produced by Eurostat from EU-SILC, mentioned earlier, and Sutherland and Levy (2005).

tautology: where we are must reflect at least the majority's preferences. Some cross-country research on inequality does see it as simply reflecting differences in attitudes, values and preferences, with voters in some countries being much less concerned about inequality than others – the question of interest then becomes why attitudes differ. Without dismissing this entirely, it seems simplistically reductionist, for at least two reasons.

The first is that the path from attitudes and values – and their distribution among different groups in society – to public policy and institutional change is a long and tortuous one: while most economists are still happy to infer individual preferences from what people do and spend, it seems quite a stretch to infer societal preferences from outcomes as complex and multifaceted as inequality. The second is that attitudes, values and preferences are not independent of context – they cannot simply be seen as exogenous. One illustration is the fact that many Americans are suspicious of "socialised medicine" but are as attached as any European to the public old-age pensions ("social security") which Roosevelt's New Deal succeeded in embedding during the Great Depression. So while there may be deep-seated differences across countries in general attitudes towards the state and "Big Government", when it comes to the more specific areas in which policy is actually made there is a dynamic relationship between attitudes/preferences and institutions/policies: attitudes do not simply shape and constrain institutional change, they also reflect it.

Does it make more sense to see societies as choosing different combinations of inequality and growth – different points on a stable underlying growth-equality trade-off curve? This is certainly a significant ingredient in the way public policy is debated. The first objection that will be raised to most social expenditures is that they will have a negative impact on economic growth and employment, either directly because they interfere with the free functioning of markets, or via the distortionary impact of the taxation required to finance them. Both in debate and in reality this is intimately tied up with our economic growth/development model – captured in the "Boston or Berlin" way our choices have been framed. In simple textbook models of supply and demand, taxes and transfers produce deadweight losses, which hinder economic growth. However, Lindert's (2004) magisterial cross-country study of social spending and economic growth since the 18th century finds little evidence for such a negative relationship. Recent research has highlighted the scope for social spending to itself be an underpinning to economic growth in a variety of different ways. This is most obvious in its impact on the health and productivity of the labour force, but extends well beyond that to include, for example, the provision of income security allowing economic agents to take risks, and helping create an environment where trust and social cohesion are

high which in turn facilitates investment and growth. This awareness has now percolated through to the way in which the role of social spending is debated at EU level, including by its Social Protection Committee, in terms of the potential role of social protection as a "productive factor".

The broader relationship between inequality and economic growth has also been the subject of recent theoretical and empirical research, which has brought out the numerous transmission channels through which inequality may affect growth. As Voitchovsky's (2009) review brings out, this literature suggests that inequality can either facilitate or retard growth, and that inequality towards the top may have a different impact to inequality towards the bottom. What is clear is that some countries have sustained low levels of inequality with impressive levels of economic growth – indeed, they include some of the richest in the world in terms of income per head. But realising that the Welfare State may in some circumstances and respects underpin economic performance does not mean we can go to the other extreme and believe with Dr Pangloss that "… all is for the best in the best of all possible worlds". Just labeling something as "social investment" does not mean it will have a net positive impact on economic performance. Poorly-designed welfare institutions and policies, and financing them, can damage growth and jobs. Countries that spend more on welfare policies, Lindert suggests, take greater care in designing efficient taxes and transfers. On the other hand, a central problem with systems that emphasise targeting of transfers on those who need them most, as Ireland does, is that poverty and unemployment traps – whereby recipients have little incentive to increase their earnings – are rife, and extremely difficult to address without substantially increasing spending.

VI INEQUALITY, THE RECESSION AND CURRENT POLICY DILEMMAS

While we do not yet have survey data showing the impact on income inequality of the recession which has replaced economic growth so rapidly and comprehensively, it is clear that the complex set of channels of influence noted during the boom is equally relevant in the "bust". Rapidly increasing unemployment will have a negative impact towards the bottom of the distribution – while all occupational levels are being affected, as in the past it is the less skilled who will experience most of the unemployment. Much depends on the reaction of migration flows, with the prospects for substantial out-migration by first-time job seekers and recent immigrants particularly hard to predict. At the other end of the distribution, sharply declining profits may reduce the share of total income going there. The return on capital

invested in property or shares will be much lower than over the past decade, and wider ownership of shares and property means that falling investment incomes have a wider impact than they would in the past – while those affected are disproportionately in the upper reaches of the income distribution, some pensioners relying on that source to supplement the state pension will also be hit. The impact of the financial crisis on the position and sustainability of occupational pension funds is also a potentially very serious issue for future retirees. The unprecedented extent of household debt at the onset of the recession is also a critical factor in its impact on living standards.

Much depends, as in the period of growth, on how the relationship between incomes from work and social welfare support evolves. The effect of increasing unemployment and inactivity on household incomes depends on the impact on the individual incomes of those affected, as well as on the extent to which joblessness is concentrated in particular households versus more widely spread across households where someone stays in work. For many older persons, the level of the social insurance and means-tested pensions is crucial: again, how this evolves in relation to average income as that average declines rather than increases will be key to the distributional impact. In the shorter term, social welfare rates were increased for 2009 in the expectation of continued inflation but falling price levels have actually been seen over the past year. Not all prices have fallen uniformly, with the greatest falls in mortgages, clothing/footwear and cars while prices of some other items have continued to rise. This means that older people and many social welfare recipients (who are mostly not paying back a mortgage) have benefitted least, but the fact that even for them there has been some decline in prices on average is important none the less. The taxation measures already introduced to cope with the fiscal crisis brought on by the recession will also have had a marked impact on the distribution of disposable income. Analysis by Tim Callan using the ESRI's *SWITCH* tax-benefit simulation model shows that the net impact of increases in social welfare and in income tax in 2009 is to have redistributed from the top 40 per cent towards social welfare recipients – though of course those moving from work onto welfare will have lost out.

So, like the economic boom, the financial crisis and the recession it has sparked will impact on the income distribution through a very complex set of channels, with the effects varying especially with the sources of income coming into the household. It will also be impacting on the distribution of wealth, though once again this will be a complex process. Wealth held in forms other than housing is highly concentrated, so the effects of the collapse on the value of financial assets and non-residential property will be felt disproportionately towards the top. However, this fall on average has not necessarily been greater than the decline in average house values (at least if

one takes the reported decline in wealth among the *Sunday Times* Irish "Rich List" of 25 per cent as a rough guide). With housing the main asset for most wealth-holders, one cannot, therefore, assume that the distribution of wealth among those who hold some has become more equal – although the gap between those with and without wealth has undoubtedly narrowed. Those who bought property towards the height of the boom with borrowed money and are now in negative equity, and small shareholders invested only in financial shares, have clearly been particularly hard hit.

How should policy respond, given the constraints on spending imposed by the fiscal crisis and with an eye to both short and longer-term distributional implications? The first point to make is that effectively addressing that crisis is critically important for everyone, not least for those most severely hit by the recession. Ireland's experience during the 1980s suggests that protracted fiscal crisis and associated uncertainty can delay recovery in economic growth and job creation. Any expectation that fiscal contraction might have an expansionary impact on the economy in current circumstances would be fanciful, but that does not mean that postponing the pain is costless. A central concern being expressed in current debates about closing the fiscal gap, as well as its timing, is how the burden of doing so is distributed. The core point to stress there, though, is that addressing the fiscal deficit is embedded in the wider macroeconomic challenge, of restoring competitiveness. If one accepts the analysis that the cost base of the Irish economy has become significantly out of line with international competition in recent years, and that restoring competitiveness is the key to medium-term growth prospects, the corollary is that a fall in living standards has to be accepted in the shorter term to achieve this. Given the fixed exchange rate regime under which we are operating, in a time of falling rather than rising prices this requires that nominal incomes come down faster than prices (see for example Fitz Gerald, 2009; Honohan, 2009).

This would be extremely difficult to bring about in any circumstances, but is likely to be impossible if not done in a manner that is seen to be fair. Fairness might reasonably be expected to entail significant and sustained reductions in earnings (including for the self-employed) across private and public sectors, across the traded and protected sectors of the economy, and across different occupations including the professions. The extent to which government can influence earnings clearly varies across this spectrum, and the imperative to close the fiscal deficit means that the public sector pay bill has to be substantially reduced anyway: the more this comes through reductions in (real) pay per head, the less the reduction in numbers will have to be. The minimum wage is intended to put a floor under the wage distribution, and if the rest of that distribution has to come down then keeping

the minimum where it is would risk pricing the low-skilled out of jobs in a way that it did not before the recession (see for example Nolan, 2008). The evidence with respect to the evolution of earnings in the private sector during the recession is patchy, but does not suggest that reductions on anything like the scale required from a competitiveness perspective have taken place so far: leaving the minimum wage unchanged while waiting for those wage reductions to occur (or become clear in the statistics) may however be hazardous. As far as social welfare is concerned, some reduction in support rates to offset the fall in the prices faced by recipients (not that in the overall CPI) could be justified, despite the straitened circumstances in which many of these recipients live and the fact that the recently unemployed will already have seen their incomes fall markedly. (Introducing a carbon tax without compensation for those on low incomes would be an alternative strategy, in effect regarding the unanticipated increase in the real value of social welfare payments in 2009 as "pre-compensation" – as suggested by Callan, Keane and Walsh, 2009). Looking beyond the Budget for 2010, it would be unrealistic to think that those relying on social welfare can be sheltered completely from the decline in national living standards from their artificial peak at the height of the boom: painful measures in the short term would be more easily accepted if set in a medium-to-long term framework including the desired relationship between social welfare support rates and average incomes or earnings.

As well as before-tax earnings, living standards will be hit by the unavoidable rise in taxation to restore a sustainable structure to a system that was allowed to become unbalanced during the property boom. A number of elements which could contribute have been widely discussed, including in the Report of the Commission on Taxation, and these include a carbon tax, a property tax, restructuring support for private pensions, and eliminating the range of exemptions and reliefs that still cost the Exchequer a very substantial amount in lost revenue. These can be justified purely in terms of reducing the distortionary effects of the tax system on economic behaviour, but equity considerations certainly also come into play and add considerably to those efficiency arguments. It is only if these measures are implemented that there is likely to be acceptance of the need for those on much more moderate incomes to pay more income tax by reducing the personal allowances for all taxpayers and bringing substantially more of those on low income into the tax net: the income tax base has been eroded both by special allowances and reliefs and by extension of general allowances and exemptions during the boom, and paying for adequate public services requires that this be reversed. (The ways in which a property tax could be structured to protect those on low incomes are discussed in Callan, Keane and Walsh, 2009, while Callan, Nolan and Walsh, 2007, discuss the scope for redirecting tax incentives for private pension

provision.) Universal Child Benefit could also be better targeted by making it taxable, and the administrative difficulties involved cannot be regarded as insurmountable: the case for a universal payment assisting all families with children remains strong. The imperative to close the fiscal deficit provides a window of opportunity to restructure the tax system in a fashion that is not only more economically efficient but also more equitable.

The other central focus in ensuring that the response to recession is seen as fair is the strategy adopted in relation to unemployment. Simply aiming to restore the economic environment in which job creation takes place will not be enough, more active intervention is called for. A minimal aim should be to try to ensure the burden of unemployment is as widely shared as possible, thus minimising the scope for "scarring" of individuals who then risk being trapped in long-term unemployment even when recovery takes place. This may involve not only investing more in activation and training for those at risk of becoming long-term unemployed, but also providing incentives for employers to take on these individuals rather than others when vacancies occur. Focusing on young workers, structured work experience schemes at minimal cost to employers may have a role, supported and monitored by the state to avoid abuse. For those made redundant after working for many years, re-training is likely to provide only part of the solution: Heckman (2000) for example argues that for older workers wage subsidies may in some cases be a more efficient option. The experience with incentives for job creation in recession in the past have not been hopeful in terms of their overall impact on unemployment, but these may be much less susceptible to deadweight costs if the core criterion for success is instead that the number experiencing long-term unemployment is reduced substantially below what it would otherwise be. "Sharing the unemployment around" may seem like a modest objective but it is an important one in terms of the long-term legacy of the recession.

While restoring competitiveness and achieving sustainable economic growth will undoubtedly dominate the policy agenda for the next number of years, followed by dealing with the legacy of the recession, in addressing those challenges a longer time horizon is also helpful as we struggle to set and maintain a course. Renewed job creation is certainly necessary, but there is no reason to believe it would be sufficient to bring Ireland's level of income inequality down to the EU average, if that were a target. In that perspective, it is notable that countries that achieve a below-average level of inequality tend to see social protection as part of the solution not as the problem. The National Economic and Social Council (2005), in its report on the "Developmental Welfare State", sought to recast the debate on social versus economic policy to highlight the intimate linkages between them, and to move away from the notion that social policy simply redistributes "the cake" that

economic growth produces. A high employment rate (for both men and women) is certainly an important ingredient, but has to be combined with effective social protection – which of course is easier to support when employment levels are high. The comparative evidence shows that work-friendly social security is critical, but moving towards a 'flexicurity' model requires less rather than more reliance on means-testing. At the other end of the distribution, it may be that recent experience has brought about a sea-change in attitudes to top pay: the notion that the market was appropriately rewarding the activities involved from an economic perspective seems even less plausible now than it did before the crash, before one even thinks about fairness. The way these rewards are set, like other aspects of the way markets operate, is a social as well as economic process open to influence by the state.

VII CONCLUSION

Ireland has a relatively high level of income inequality, which has been rather stable over time and reflects institutional legacies and choices made in the past. The evidence summarised here and presented in detail elsewhere suggests that modest reductions in income inequality are achievable within the framework of Ireland's current socio-economic model. On the other hand, bringing the level of income inequality below the (EU or OECD) average, much less close to the lowest levels among them, may well be beyond the capacity of that model. The current financial, fiscal and economic crises have to be addressed as a matter of extreme urgency, and will require very substantial increases in tax revenue and reductions in state spending. The imperative to close the fiscal deficit provides a window of opportunity to restructure the tax system in a fashion that is not only more economically efficient but also more equitable – and that may be essential in ensuring its acceptability. The other central focus in ensuring that the response to recession is seen as fair is the strategy adopted in relation to unemployment: a core aim should be to minimise the number experiencing long-term unemployment and thus the long-term impact on labour market careers. Once the most immediate needs of the situation are met, like the mid-1980s this context may provide an opportunity to debate fundamental questions about the role of the state, the extent and nature of social provision and its financing, and the broader relationship between economic performance, the Welfare State, and the underlying goals of Ireland's socio-economic policy.

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