Economic Security Series: Part 1
Pursuing income adequacy

Research InBrief No. 86

March 2024

Tom McDonnell

Summary:
Income adequacy is fundamental to economic security. Labour market inequalities and barriers are such that welfare support will always be a key component of income policy. This InBrief argues for a set of needed reforms to welfare policy. In particular, it proposes shifting towards an integrated and holistic system of supports based on the principles of adequacy, benchmarking and tapering.

Introduction

Labour market dynamics will never in themselves be fully able to ensure adequate incomes for everyone. For an individual this may be due to caring responsibilities, it could be age related, linked to a disability, to skills mismatch, to the take-up of education and education opportunities, or it may simply be that not enough jobs exist to meet labour supply, or even that jobs are badly paid. Direct income support from the state will therefore always be an essential component of public policy.

Unfortunately, Irish welfare policy does not appear to be fully rooted in an evidence-based process. Budgetary decisions can often seem to rely more on optics and a desire for political credit than on any systematic analysis of need. This institutional weakness was always present but was brought to prominence during the recent cost of living crisis. The debate was exemplified by sound bites of '€5 or €10 on the pension' and by an overreliance on temporary universal supports when prices were structurally increasing across the economy but impacting people differentially. The political system proved either unwilling or unable to design supports to offset the cost of living pressures on those most in need.

Most welfare states deploy a mix of means-tested, insurance based and universalist income supports and service arrangements. The social protection budget makes up almost 27% of voted public spending in the Republic of Ireland in 2024 and is the most expensive component of public spending (see O'Connor, 2024, forthcoming). The *state pension* alone costs almost €10.7 billion, with *illness, disability and carers'* income supports costing €6 billion and *working age* income supports over €4.1 billion. The scale of working age income supports tends to be the most volatile from year-to-year as it fluctuates depending on the underlying performance of the economy and the level of unemployment.

The core purpose and counting failure

What is the core purpose of the system of income supports and subsidised public services? One test through which we can grade a welfare system is ***the extent to which individuals do, or do not, have incomes adequate to their basic needs***. Enforced deprivation rates can be thought of as proxies for the extent of income inadequacy in a population or in a population sub-set. They are, therefore, measures of policy failure in protecting households and a way of identifying which groups are being failed.

Deprivation arises from the mismatch between income and the cost of living. In addition to incomes policy, governments can decide to directly reduce the cost of living for households via the provision of subsidised universal public services and through price regulation and tax and competition policies. In practice, no government and no system has ever achieved a deprivation rate of zero. The proportion of people living in enforced deprivation in the Republic was 17.3% in 2023. Deprivation rates vary significantly by age. Children have a more than one in five probability of deprivation (21.4%), or double that of the older age 65+ group (10.7%). Certain cohorts are particularly vulnerable. Lone parents have a 41.4% probability; persons unable to work due to health problems are at 44.7%, while renters are at 36.5%. The low pay problem in the economy is illustrated by the 11.6% of households with two persons working that are nonetheless experiencing deprivation.

Evidence-based benchmarking of incomes

Discussions and decisions about income sufficiency and poverty reduction need to be evidence based and transparent. What is ultimately required is ***a regular benchmarking exercise*** undertaken to establish minimum income adequacy floors for households of various types and with differential needs. Such an analysis would in turn anchor minimum requirements in respect of all working-age and other income supports including supports for the unemployed, people experiencing disabilities, pensioners, and people parenting alone. Benchmarking has been variously recommended by a range of bodies including NERI, the ESRI, the Commission on Tax and Welfare (COTW), the Pensions Commission and indeed many others. Ideally, an on-going evidence-led process would be established with sufficient resources provided to an independent body. Its analysis, while remaining advisory, should then feed into the annual budgetary process with its recommendations and methodologies helping to underpin a set of multi-annual targets made public in advance of the budget.

What are appropriate benchmarks?

What should the various payments be benchmarked against? There are a number of plausible options. For example, A) percentages of the median wage, B) percentages of the median income, C) indexing to consumer price inflation or to the personal consumption deflator, or even D) derived values linked to an individual or household's minimum essential standard of living (e.g. see MESL). A composite set of indicators or multiple indicators could also be used. The value of the relevant income support could then be set at a percentage or narrow range of percentages against the indicator.

Benchmarking to price changes alone is unsuitable as the value of the income support would increasingly fall below that of wages over time. Wage growth outstrips price growth in most years and relative living standards for those reliant on income supports would therefore deteriorate over time. Benchmarking against wages has a number of advantages. It ensures rates are set cognisant of employment impacts; that rates are indirectly linked to productivity and output growth, in so far as wages are themselves linked to productivity over the medium-term, and that households on fixed incomes don't fall further behind average living standards. On the other hand, the main argument for a MESL approach to benchmarking is that cost of living - not wages - is what actually determines an *adequate* income level. The logic goes that only the cost of living can be a meaningful benchmark for adequacy.

Technical questions

There are other important questions. How best to cater for different household compositions and household economies of scale? Assessment of adequacy thresholds will require data on cost of living and household consumption patterns for different cohorts. Whether benchmarking should be backward looking or forward looking is another important question. A backward-looking process may not be suitable in a period of high inflation, whereas forward looking estimates will invariably prove somewhat inaccurate.

Income tapering of supports

While benchmarking is fundamental to adequacy there are other welfare reforms that would enhance the functioning of the overall system and that could support other policy goals such as the minimisation of employment disincentives. For example, the 2022 Commission on Taxation and Welfare report proposed a new and tapered working age payment available to all households. In essence, ***a tapered system of payments based on household income***. The value of the support would taper down gradually from a 100% support for the lowest income households, eventually reaching 0% at a higher income level.

Such a payment would replace supports based on employment status or any other arbitrary threshold, for example days or hours worked. Removing welfare supports is functionally the same from a household income perspective as introducing a tax. Thus, the gradual tapering down of supports helps minimise employment disincentives by ensuring that marginal effective tax rates are kept low and achieves this without meaningfully compromising the proper targeting of income inadequacy. Other policy goals, could be approached in a similar way. For example, eliminating child poverty could be tackled via a tapered 2nd tier of child income support that diminishes as household income increases.

From a fragmented system to a coherent system

The welfare system needs to be reformed to make it simpler and more coherent. In particular, all cliff edges and step-effects, of which the system contains numerous examples should be eliminated. These are often arbitrary and can distort individual, household and employer incentives. Crucially, the entire system including all secondary benefits and non-cash supports (e.g. housing and health supports) should be designed holistically on a cross-departmental basis in order to ensure the ***system of supports is internally integrated, coherent and based on appropriate and necessary data gathering and analysis***. To achieve this a single department or cross-departmental body should be given final responsibility for and control over all design issues related to income and other supports.