BETTER POLICIES FOR BETTER LIVES

Income support for working-age individuals and their families

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The cost of living is climbing at an exceptionally fast pace across the OECD, with inflation in several countries reaching levels not seen in 40 years or longer. As steep increases in the prices of energy and food cause hardship for low-income people in particular, labour market and social policies have a crucial role in protecting living standards. They are also needed to share the burdens from high inflation between households, employers and governments. This policy brief discusses the resulting challenges of providing timely and targeted supporting for working-age individuals and their families. The roles of minimum wages and of old-age pensions are the focus of two further OECD policy briefs (OECD, 2022[1]; OECD, 2022[2]).

Key findings

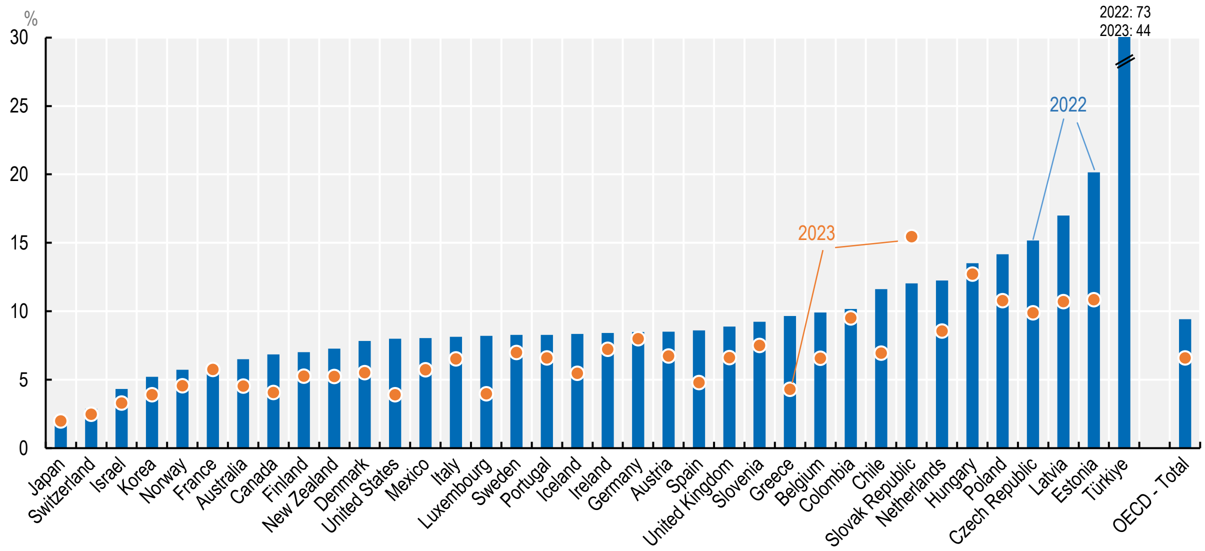
- Across OECD countries, targeted cash benefits were already in place prior to the cost of living crisis and these existing social protection measures have a crucial role in bolstering societies' resilience to economic turbulences, including from high inflation. A key question in this context is how governments can leverage social policies for cushioning the impact of soaring prices. How can social protection remain effective during times of high inflation? And what can be done to reinforce and scale up support when established social transfers are either not sufficient, or not readily accessible for those whose livelihoods are at risk?
- The recent and likely protracted period of high inflation has translated into a cost of living crisis. Price increases have been particularly steep for necessities such as heating and food. These and other essential items account for a large share of spending in low-income households, sometimes twice that of higher-income groups. While inflation raises living costs for everybody, support needs are greatest for low-income households, which raises a number of design challenges for tax-benefit policies.
- Government transfers lessen the impact of the cost of living crisis for selected population groups. They can, however, not altogether and sustainably shield households from losses due to high inflation and, in many countries, deteriorating terms of trade.
- Untargeted support measures risk providing insufficient assistance to those who need it most. They can also raise fiscal concerns and feed future inflation. Targeted transfers have key advantages but there have nevertheless been calls for across-the-board measures. Although countries are increasingly moving towards targeted cost of living support, most support to date has, in fact, been untargeted.
- Unlike price regulation and subsidies, income support maintains price signals that are needed for easing supply bottlenecks and rebalancing consumption towards greener energy sources. Higher prices for carbon-intensive products are a key pillar of national and international commitments towards a sustainable economy. Yet, a period of rapidly escalating energy prices, combined with a public perception of inadequate cost of living support, could risk a backlash against vital climate-change mitigation, and a further delay of urgent measures, such as carbon pricing. This highlights the need for carefully designed support measures, and clear communication of short-term priorities and medium-term policy strategies.

Higher prices, lower living standards

Prices have risen at an exceptional pace everywhere, and while efforts are underway to curb inflation, it is currently expected to remain above 6% in half of OECD countries through 2023 (Figure 1). In spite of government support, people's purchasing power is eroding, as wages have been slow to adjust and fell in real terms in most OECD countries, sometimes sharply so (OECD, 2022[3]; OECD, 2022[2]).

Figure 1. Inflation has risen sharply and is projected to remain high in 2023

Annual inflation, projections



Source: OECD (2022) OECD *Economic Outlook, Volume 2022 Issue 2: Preliminary version*, https://doi.org/10.1787/f6da2159-en.

Some countries are nevertheless in a better position than others to counter the detrimental effects of inflation on living standards. First, current inflation spikes are linked to deteriorating terms of trade and resulting aggregate income losses in most OECD countries, but especially so in countries that meet most of their energy needs through imports. Second, where public finances are sound, there is more fiscal space to support households through government transfers. Third, pre-existing inequities, driven by longer-term inequality trends and the impact of the COVID-19 pandemic, differed across countries and shaped inclusiveness challenges already before inflation started to accelerate. For instance, Gallup data for 2021 show that 5 to 6% of respondents in Israel, Netherlands and Sweden reported not having enough money to buy needed food, whereas the shares were 18 to 19% in Chile, Greece, Korea and the United States, and above 40% in Türkiye and in Latin American OECD members.

Although high inflation has now spread to a growing share of products, the surge in food and energy prices since early 2022 is disproportionately affecting low-income households, whose spending shares on these items exceed those of higher-income households by 50% or more (OECD, 2022[4]). Low-income groups also spend bigger parts of their incomes overall and their budgets are therefore hit harder, and more directly, than those of the better-off. Poorer households also have less savings to tap into, and they spend little to nothing on luxuries. Their scope for adapting to fast-rising prices, and doing so without compromising livelihoods, is therefore limited.

Inflation, and the associated loss in purchasing power, is therefore always harder to manage for those who earn and own little. Without support, some of them need to cut back on food and other essentials, and this is already reflected in emerging data (Giner and Placzek, 2022[5]; Eurofound, 2022[6]). Among countries already included in the 2022 release of Gallup data, several show that food affordability problems were more common than in 2021 (Denmark, Finland, France, Netherlands, Portugal, Slovenia, Spain).

Timely and targeted? Protecting livelihoods through the tax-transfer system

As efforts to contain inflation continue, government support has been central to alleviating the associated drop in living standards. As part of strategies to share the burdens of higher living costs across households, employers and government, direct transfers may also curb upwards pressures on wages.

Countries follow different approaches to cushion cost of living increases through the tax-transfer system. Some benefit entitlements are automatically uprated in line with prices but practices, and the extent and timeliness of any adjustments, vary considerably. Even during periods of low-to-moderate inflation, those adjustment provisions have a significant impact on government budgets, and on inequality and poverty trends (Immervoll, 2005[7]; Sutherland et al., 2008[8]; Paulus, Sutherland and Tasseva, 2019[9]).

In recent decades, and prior to 2022, rising price levels have, however, not been a primary focus of tax-benefit policy debates or reforms in the OECD area. Indeed, a central objective of working-age benefit programmes has been to alleviate employment and income shocks. Responding to income losses was the focus in the wake of recessions triggered by the global financial crisis and the COVID-19 pandemic. Income stabilisation is also central in the context of social policy responses to global mega-trends, including automation, and the reallocation of jobs from declining to growing sectors that accompanies these trends. Unlike unemployment, price shocks do not result in a sudden and possibly complete loss of income. But their impact is felt much more widely as inflation affects all households.

With losses spread across the population, suitable targeting is arguably more difficult, but it is also more critical. To be effective, cost of living support should be timely and focused on those facing the biggest affordability challenges. Workers' support needs depend on how, and when, wages respond to increasing prices. By contrast, jobless people, and those with little income from work, are mostly reliant on government transfers. Targeted support is aimed at households that require it most, consistent with a complementary role of government support. Timely support provides assistance quickly when it is needed, e.g. to provide relief for heating costs during cold winter months, and it is temporary to avoid raising public expenditure commitments beyond levels that are fiscally sustainable.[1]

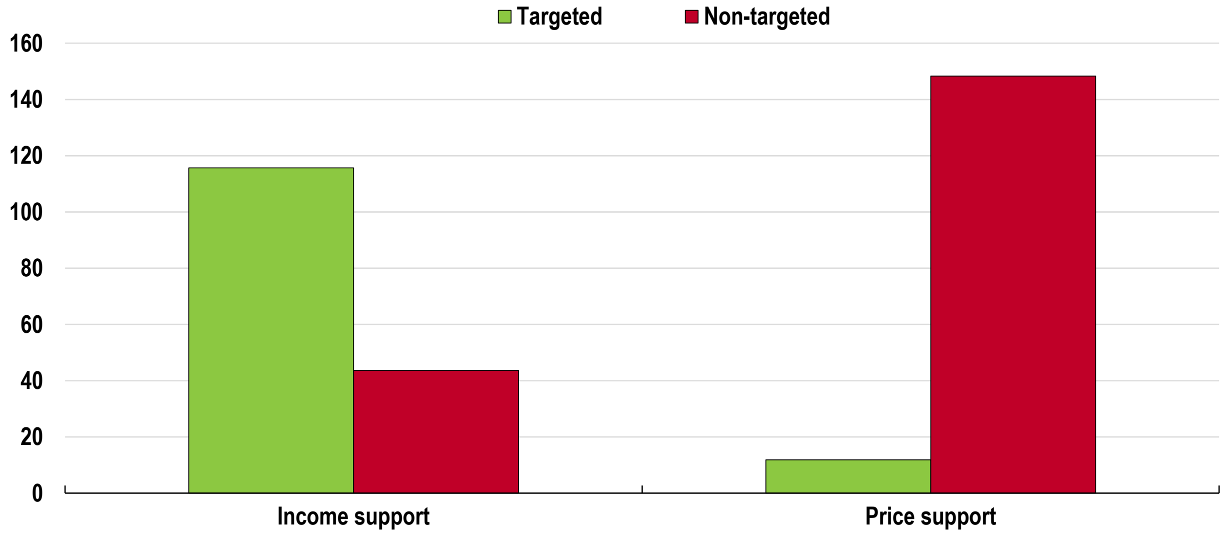
Substantial support measures, delivered through multiple channels

In practice, and to date, the discretionary support made available to counter higher energy prices has been poorly targeted, especially when considering total support provisions across countries (Figure 2). In part, this may simply be due to cost of living shocks being felt more widely than other economic crises, leading to prominent calls for broad-based assistance. Relatedly, the swift and exceptionally large support packages adopted in the context of the COVID-19 crisis may have raised expectations that households and employers can, once again, be shielded from the negative consequences of a cost of living crisis.

[1] For instance, IMF (2022[1]) warns that "facing a shifting landscape, policy makers must stay agile to be able to respond appropriately to the unexpected. Long commitments are not more than a pretence of certainty and can quickly become unaffordable."

Figure 2. Discretionary measures to counter price increases were poorly targeted

Support commitments across 35 countries, October 2021 to December 2022, billion USD



Note: 32 OECD countries (except Iceland, Lithuania, Luxembourg, Mexico, Switzerland and Türkiye) and 3 non-OECD economies (Bulgaria, India and South Africa). Income support provides direct transfers to energy consumers to help alleviate energy cost increases. Price support reduces the post-tax energy price, and includes price subsidies, price regulation and reductions in indirect taxes. Targeted support is provided to specific groups, such as vulnerable households or businesses. Non-targeted support applies to all consumers with no eligibility conditions. Includes government plans that are not yet legislated but have been announced and remain on track to be implemented. Loans, guarantees, and capital transfers that do not immediately change government net lending were excluded. Data as of September 2022.
Source: OECD (2022), *OECD Economic Outlook, Interim Report September 2022: Paying the Price of War*, https://doi.org/10.1787/ae8c39ec-en.

There can also be trade-offs between targeting and timeliness. Indeed, untargeted price subsidies were introduced quickly, and featured among countries' earliest support measures (e.g. for electricity or gas in Belgium, Germany, Greece, Ireland, Norway and for fuel in France, Germany, Hungary, Luxembourg, Portugal, Spain), as were reductions of energy tax burdens (e.g. lower VAT in Belgium and the Netherlands, reduced tax on electricity and/or gas in Denmark and Ireland). Hungary also introduced price caps for basic food items. Austria delayed the introduction of a previously planned carbon price measure (while keeping on schedule a lump-sum transfer that was designed to offset some of its impact on household budgets). Slovenia and Hungary operated price caps on fuel (Aumayr-Pintar and Cantero Guerro, 2022[10]).

In principle, some degree of targeting is possible with either price support or income transfers. For instance, price discounts can take the form of lump-sum payments and, as in the case of the German subsidies mentioned above, they can be made taxable to ensure that they are worth more to low-income households. Yet, available information on initial support provisions in Figure 2 indicates that income transfers are more readily channelled to groups with greater support needs. In fact, most price support measures have not only been untargeted but potentially regressive, with greater benefits for high-income groups, who consume more.

A further key advantage of targeted income support is that it maintains incentives for reducing demand for expensive goods, including those with a high carbon footprint. By contrast, price subsidies distort price signals and can further exacerbate supply bottlenecks that have triggered or reinforced inflationary pressures in the first place. Indeed, when many countries implement energy pricing subsidies at the same time, this tends to bid up prices and benefit energy exporters, rather than households (IMF, 2022[11]).

Income transfers, or targeted cuts of taxes on income therefore have advantages over other types of assistance. But not all tax-benefit measures are equally well-suited, targeted or timely. Broadly, cost of living support through direct income transfers can take the form of regular or automatic adjustments of existing benefits, through some form of price indexation. Alternatively, or in addition, support can also be provided through discretionary transfers. The remainder of this brief explores these approaches and provides illustrations of recent policy initiatives in selected countries.

Maintaining the value of existing social transfers

Most transfers are not immediately responsive to price shocks as experienced by individual households. Exceptions are those that cover certain proportions of actual expenditures, including in-kind transfers and “social tariffs” for housing or other forms of committed expenditures, such as utilities or public transport. Other income transfers may respond by linking relevant entitlements to prices.

Automatic or regular price adjustments are not universal, however. Where some form of indexation does exist, the additional support is typically subject to significant delays, even if it happens automatically and does not require the passing of new laws. This is because benefit amounts are typically uprated annually or at less frequent intervals. Relatedly, adjustments are “backward looking” and therefore lag behind the prices of goods and services. Delays between 12 and 24 months are typical in this respect. The result is that transfer recipients experience declining purchasing power during periods when inflation accelerates.

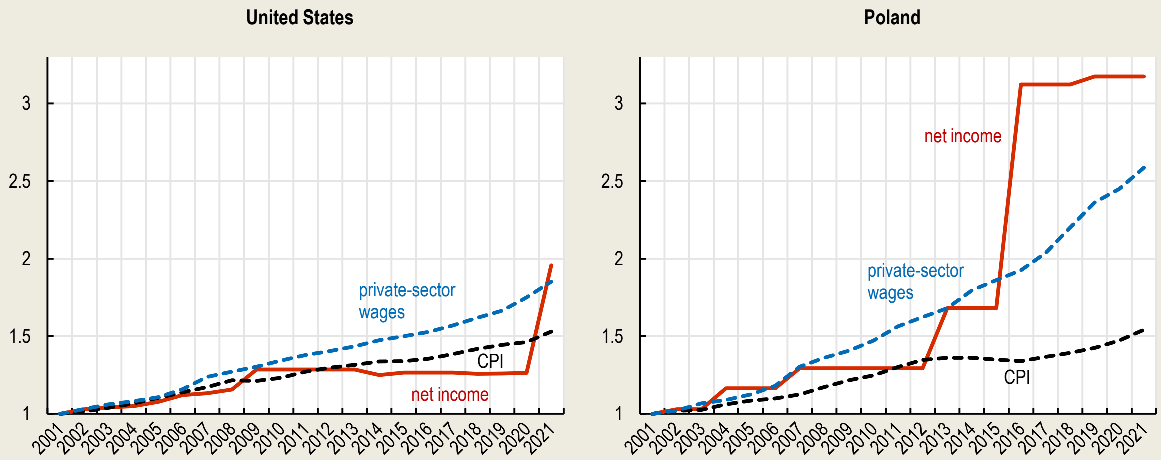
There exists a multitude of approaches for uprating tax and benefit provisions. Indeed, adjustment mechanisms vary not only between countries but also between programmes in the same country. Tracking the changes of policy parameters over longer time periods can give a good indication of different practices and how they affect households’ purchasing power over time (Box 1).

Box 1. Support for low-income families: Did it keep up with prices in the past?

The OECD tax-benefit models go back to 2001 and allow gauging the extent to which de-facto adjustments across a range of tax and benefit programmes have kept pace with price levels, and what this meant for household incomes. The figure below illustrates the evolution of statutory benefit entitlements in two countries, Poland and the United States, and for a lone parent who depends entirely on social transfers, with no incomes from other sources.

Results illustrate the consequences of infrequent or ad-hoc adjustments. At around 50%, overall inflation over the 2001-21 period was at comparable levels in the two countries, with the pace of price increases much slower than in recent months. Wages increased faster, and much more so in Poland than in the United States. In both countries, benefit entitlements for people without any other resources were left largely unchanged in nominal terms over extended periods. Their real value therefore declined during several multi-year episodes. For instance, real-term loss was about 17% in Poland during 2007-12, and about 19% in the United States during 2009-20. Interestingly, in both countries, infrequent but sizeable discretionary benefit changes meant that levels broadly kept pace with *wages* at specific points in time, despite falling behind *prices* in the intervening years. In Poland, the introduction of a new family benefit in 2016 stands out and resulted in large real-term gains. Over the period as a whole, the lack of regular or automatic adjustments meant that the income floor provided by safety net benefits varied markedly between years, and so did recipient families’ ability to meet essential expenditures.

Figure 3. Transfer entitlements prior to the cost of living crisis, nominal values, relative to 2001



Note: Lone parent (two children) with no entitlement to contribution-based unemployment benefits. Net income accounts for cash and near-cash benefits (such as the Supplemental Nutrition Assistance Programme, SNAP, in the United States), as well as any income taxes, tax credits and social contributions. Private sector wages are the OECD's Average Wage measure. Updates to 2022 are in progress and similar results can be produced for families in 40+ OECD and EU countries, for a range of different family and labour-market situations.
Source: OECD tax-benefit models, http://oe.cd/TaxBEN.

For recipients of government transfers, a combination of rising prices and a lack of regular benefit adjustments is felt most acutely in the case of flat-rate or means-tested assistance benefits (and, hence, in countries relying strongly on these types of support). By contrast, entitlements to earnings-related insurance benefits respond to changes in the earnings base. When employment incomes grow in line with prices or faster, an earnings link therefore provides protection from inflation-induced losses for new recipients. Yet, even in the case of earnings-related benefits, inflation can erode the real value of any benefit floors or ceilings, and this can produce losses for people with entitlements close to those thresholds. In addition, for recipients whose entitlements started *prior* to a specific inflationary episode, benefits in payment require adjustments if they are to keep pace with prices. This is most apparent in the case of pensions (OECD, 2022[1]), but it is also relevant for working-age benefits, especially when receipt durations are long, e.g. in the case of benefits available to the long-term unemployed.

In practice, and partly reflecting actuarial principles, regular adjustments of benefit amounts and thresholds tend to be more widespread or systematic for insurance benefits than for categorical transfers (such as child benefits) or mean-tested support (such as minimum-income programmes). For minimum-income benefits, available summaries of adjustment rules in European countries before the current cost of living crisis suggests that most of them had some type of indexation in place.[2] But the specifics of these adjustments, and their frequency, again varied considerably. Indexation considered a mix of prices and wages in Germany, a mix of prices and GDP growth in Belgium (Walloon region and German-speaking community), while it can account for changes in the statutory minimum wage in the Netherlands. Several countries indicated that no regular indexation was in place for either minimum-income benefits or family benefits (the Czech Republic, Estonia, Greece, Ireland, Latvia and Poland).

When prices are volatile, partial or irregular adjustments of policy parameters introduce a degree of unpredictability into key tax-benefit provisions. The difficulty of aligning such variability with transparent policy making can be the subject of long-standing national policy debates. But greater attention to these

[2] https://www.missoc.org/missoc-database/comparative-tables/

debates can lead countries to review adjustment mechanisms during high-inflation periods. For instance, from 2023, Austria will price index a number of transfers (e.g. child benefits) that had not featured automatic uprating provisions previously. Notably, the initiative also extends inflation adjustments to the income tax schedule (and tax credits), aiming to significantly limit inflation-induced bracket creep, and the resulting annual revenue boost, through annual adjustments (some automatic, some discretionary). In countries that provide significant social support through tax provisions, tax indexation rules can play a sizeable role in tackling cost of living pressures for some low-income families. For instance, in the past, price indexation in the US income tax has been more systematic and comprehensive than those applied to social benefits for the poorest, see Box 1 and (IRS, 2022[12]).

Regular adjustments of transfers and income-related taxes commonly account for changes in the consumer price index (CPI), or for some related index that tracks the price of average consumption baskets. Yet, spending priorities for benefit recipients can differ significantly from those of an average consumer, and low-income groups spend larger parts of their budgets on necessities. While linking transfer payments to the CPI therefore keeps the value of benefits constant in real terms, it does not account for the circumstances of households whose budgets and well-being are especially sensitive to price swings affecting necessities, such as food, energy, housing and transport.

Defining benefit levels with respect to “reference budgets” provides an alternative that can be attractive in the context of sizeable movements in relative prices. Reference budgets are based on baskets of goods and services that seek to represent an acceptable standard of living for specific low-income households (subject to characteristics such as housing situation, place of residence, number of children). They can be determined using spending data, essentially define targets for adequate consumption, and make it possible to account for the specific needs and spending patterns of low-income households. This can also facilitate benefit adjustments that respond to price-level changes. Prior to the cost of living crisis, seven OECD countries in the European Union have made use of such tailored consumption baskets as a basis for setting minimum-income levels in one way or another: Estonia, Germany, Lithuania, Luxembourg, Poland, Slovenia, Sweden (European Commission, 2022[13]).

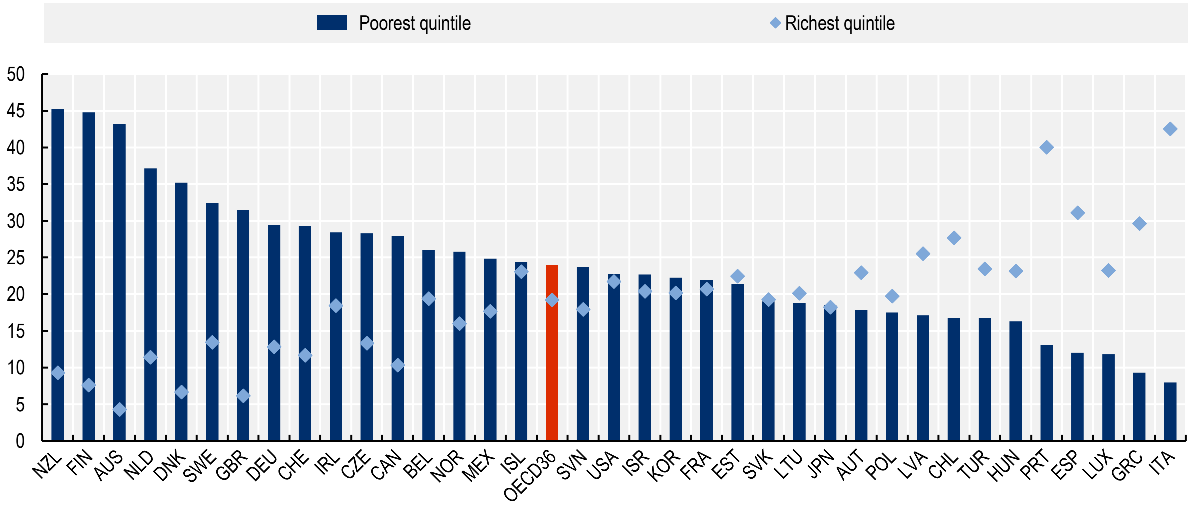
Discretionary reinforcements of social benefits

Where benefits mainly support lower-income groups, channelling cost of living support through existing transfers will provide support for many of those who need it most. In countries towards the left of Figure 4, low-income groups indeed receive higher transfers that high-income earners. When transfers are well-targeted, regularly adjusting them for inflation can then go a long way towards helping households make ends meet when prices go up. Where automatic adjustments are seen as insufficient (e.g. because they are not comprehensive or too slow), existing benefits can be scaled up in a more ad-hoc manner but building on existing targeting mechanisms. Indeed, using the benefit system as a vehicle for additional support can be done quickly, and can be significantly more cost-effective than unfocussed payments to everyone, or price subsidies that provide more help to better-off households.

A number of countries have indeed leveraged existing targeting mechanisms for discretionary benefit boosts. For instance, Finland raised child-related entitlements for a range of social benefits and proposed an across-the-board increase (+3.5%) of a number of transfers, including pensions, unemployment payments and student allowances. Austria, Czech Republic, Denmark, Finland, Germany, Greece, Ireland, Italy and Japan provided one-off payments or temporary benefit increases for recipients of unemployment, minimum-income or child benefits, while Luxembourg, Netherlands and Slovenia tied specific energy-cost relief measures to eligibility for various social benefits. Canada increased benefits for low-income working families, while Ireland added a one-off payment for recipients of in-work benefits. Canada, Finland and Norway supplemented cash housing support on a temporary basis, and the Czech Republic simplified the application process for housing benefits. Norway now accounts for electricity bills, and disregards child benefits, when assessing entitlements to social assistance.

Figure 4. Well targeted? Transfers received by low and high-income groups

Percentage of average cash transfers, working-age individuals, latest year available



Note: Ages 18-65. All public social cash transfers at the household level. Income groups refer to disposable incomes. All incomes are adjusted for household size.
Source: OECD Income Distribution Database, http://oe.cd/idd.

In countries positioned towards the right-hand side of Figure 4, higher-income groups are the main beneficiaries of social benefits. In part, this can be because benefits are not based on needs but, e.g. on past earnings histories. In addition, there are also significant social protection gaps for the poorest. A limited accessibility of support for low-income groups can signal a need to review whether targeting works as intended, and support for those with no or very low earned incomes are sufficiently developed and accessible. Coverage gaps can indeed be sizeable for key transfer programmes, including minimum-income transfers and unemployment benefits (Hyee et al., 2020[14]; Immervoll et al., 2022[15]; OECD, 2018[16]). Addressing structural targeting challenges and unintended coverage gaps for low-income groups requires careful reforms in different parts of the tax-transfer system. In some contexts, it may be possible to quickly reinforce specific support elements to alleviate pressures for vulnerable groups. For instance, Spain increased minimum-income benefits by 15% on a temporary basis, and Estonia raised the income ceiling for entitlement to minimum-income benefits, and now accounts for the cost of mortgage payments as part of the eligibility assessment.

However, implementing broader reforms in a timely fashion can be difficult in the midst of a cost of living crisis, and it may come too late to help those who need support right now or in the coming months. In countries where existing social transfers do not reach the poor, temporary ad-hoc support payments may then be among the only options for reaching vulnerable groups. But when untargeted, such ad-hoc measures are likely to be markedly more costly than complementing / increasing existing benefits.

The pros and cons of broad-based versus targeted cost of living support are not unlike those put forward in debates around a Basic Income (Browne and Immervoll, 2017[17]). In fact, even broad-based measures (such as one-off payments to most or all households) can still be targeted to some extent. For instance, several countries, including Austria, Estonia, Germany and Greece, have provided cost of living support to (most or all) families with children. Lump-sum payments can also be made taxable (as in Germany), resulting in greater support for low-income groups. In the context of high energy prices, subsidies could also be varied with household characteristics that are associated with specific patterns of energy use. For instance, Denmark provided for lump-sum subsidies to residents in areas with a high reliance on gas or electricity as a primary heat source (Aumayr-Pintar and Cantero Guerro, 2022[10]).

Implications for policy

The discussion in this brief points to a number of policy implications and directions, as governments balance significant demands for support in the context of medium-term economic, social and environmental objectives.

- A key advantage of targeted income support measures is that they maintain incentives for reducing demand for expensive goods, including those that are subject to supply bottlenecks, and those with a high carbon footprint. This contrasts with general price subsidies, which distort price signals and can further exacerbate supply shortages that have triggered or reinforced inflationary pressures in the first place. Some countries have sought to design price support measures in a way that maintains incentives. For instance, some reduced (or "capped") prices only for a basic amount of energy that households will need in any case (e.g. in Austria, Germany, Norway, United Kingdom), while maintaining market prices for consumption above these ceilings. Several countries have also brought in measures to support spending on items that are substitutes for fossil energy, such as heat pumps, insulation and retrofitting.
- Cash transfers to working-age individuals and families are well-targeted in a majority of OECD countries. A key priority during periods of high inflation is to maintain effective and predictable support and ensure that transfers operate as they were intended to. In particular, this can be achieved through regular adjustments that reflect the spending pressures of low-income households. It can be useful in this context to review whether existing adjustment mechanisms are sufficiently timely and frequent, drawing also on the experience of countries that undertake them more often than once a year (e.g. Australia, Netherlands and, on an exceptional basis, Norway). A related question is whether adjustments are comprehensive and whether they can be made more consistent across programmes.
- For broad-based transfer programmes that cover large shares of the population (such as tax rebates or child benefits), there is a good case for linking adjustments to the CPI, which is well-established and readily available. However, for highly targeted programmes, such as minimum-income benefits, adjustments may need to account for the specific consumption needs and priorities of the intended target groups, notably their higher spending on food, energy or other essentials. A feasible pragmatic approach may be to combine occasional detailed and group-specific assessments of spending patterns (as in the case of the German minimum-income programme) with CPI-based adjustments in the intervening years.
- In a few countries, and prior to the onset of the cost of living crisis, working-age transfers were difficult to access for some vulnerable groups. In these cases, straight inflation adjustments of existing benefits can be insufficient as they will be as weakly targeted (or as regressive) as the underlying transfer programme. Since introducing new targeted programmes can take time, a preferred option for addressing coverage gaps is to work through existing targeted measures, such as minimum-income benefits, by expanding eligibility and making them more easily accessible.
- In some countries, additional revenues from energy and value-added taxes, or from elevated profits in the energy sector can create meaningful additional budgetary room. Any additional fiscal space can facilitate the provision of targeted and temporary additional support measures when needed. In countries where existing cash transfers reach most vulnerable groups, administering such additional support through the existing tax-benefit system (e.g. by temporarily increasing payment rates) can be a cost-effective and simple way of providing targeted relief.
- The cost of living crisis is evolving, and so are governments' responses to it. Price subsidies or regulations that were put in place early on may have limited the initial budget crunch for households, including those with low incomes, who spend large shares on energy and food. But price measures are very expensive and typically time-limited, and their withdrawal may need to be paired with targeted income support. In general, a multitude of initiatives in different policy domains

raises the possibility of redundant or overlapping measures, e.g. if untargeted cost of living relief is combined with price-indexed benefits. It will be important to keep monitoring the total effects of support measures on different groups, and to adjust the scale and targeting of cost of living aid accordingly. Systematic distributional impact assessments, as undertaken in some countries and recommended recently by the European Commission, play an important role in this respect (European Commission, 2022[18]).

- Depending on countries' fiscal positions after the COVID-19 crisis, financing constraints can prompt a review of spending priorities. Regular inflation adjustments keep government spending broadly constant in real terms, but transfer spending increases when real wages decline and benefit entitlements grow faster than earnings. Revenues from progressive income taxes may also decline in the short term if tax schedules are fully indexed for inflation and wage agreements lag behind prices. Where reductions in real-term spending are unavoidable, they should consider the higher support needs of low-income households, as well as those of other groups who are particularly hard-hit by the cost of living crisis, or by the pandemic that preceded it.

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