Designing a universal income support mechanism for Italy. An exploratory tour*

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1. Introduction

Differently from most European countries and despite the recommendations on the part of the EC, Italy still misses a sufficiently systematic and nationwide mechanism of income support, although various selective or conditional income maintenance policies are operating and some local authorities are experimenting forms of minimum income policy. However, the current economic recession has put much stress on the current income support policies, thus revealing their shortcomings with respect to both efficiency and equity: the evidence about the undesirable implications of the current policies might produce a more favourable climate for debating about the redesign of the income support mechanisms with a universalistic approach.

In this paper we empirically explore the feasibility and the "optimal" features of a universal policy of income support in Italy. We aim at designing an income support mechanism that replaces the actual policies and has desirable properties in terms of households' welfare and incentives, subject to a public budget constraints and taking into account the households' new choices *vis-a-vis* the new opportunities and constraints introduced by the reforms.[1]

2. The current system and the reforms

Current Italian income support policies can be classified as contingent interventions (such as unemployment benefits) and structural (or anti-poverty) interventions. The contingent interventions suffer from three main undesirable features: (a) being they more aimed at

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[1] More detailed or technical presentations of this exercise can be downloaded from my homepage (Colombino 2011a, 2011b, 2012).

preserving the job rather than the worker's income and opportunities, the labour reallocation from unprofitable jobs to more promising ones is severely discouraged; (b) they are limited to certain sector and types of contract, thus generating social exclusion and processes of the insider-outsider type; (c) often some of the contingent interventions have to go through a bargaining process involving firms, unions and local or central authorities, thus adding more sources of potential inequities.

The anti-poverty interventions are mainly aimed at supporting low pensions, disabled people and low-income families with a mean-tested transfer (*Assegno per il Nucleo Familiare*) which is however limited to wage employees. Embodied in the personal income taxation system there are also tax credits and child benefits that can be classified as anti-poverty policies. It has been observed that the design of the mean-tested tax credits and child benefits create distortions and bad incentives for labour market participations of married women (Colonna and Marcassa, 2011).

Overall, the empirical evidence suggests that the current Italian system of income support policies, although costly, is defective with respect to both efficiency goals (e.g. minimizing distortions and supporting labour mobility) and equity goals (e.g. reducing poverty and economic insecurity).[2]

In this paper we will consider various versions of hypothetical income support policies that – differently from the current policies described above – are universal, meaning that they are not conditional upon professional or occupational categories or on bargaining or contingent

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[2] See for example Baldini et al. (2002), Boeri and Perotti (2002) and Sacchi (2005). In June 2012 the Italian Parliament has approved a reform of the income support institutions that features some measures inspired by more universalistic principles although the basic characteristic of the system are not affected.

financial constraints. As it is typically the case with universal policies, they are financed by general taxes. These reforms are stylized cases representative of the different scenarios that are discussed or even actually implemented in many countries.[3] In the following description of the policies there appears a "threshold" G: it is a fraction (alternatively, 50%, 75%, 100%) of the poverty line adjusted for the household's size.[4]

Guaranteed Minimum Income (GMI). Each individual receives a transfer equal to $G - I$ (if single) or $G/2 - I$ (if partner in a couple) provided $I < G$ (or $I < G/2$), where I denotes individual taxable income and G is some fraction of the poverty level (0.50, 0.75, 1.00). This is a simple version the standard conditional guaranteed basic income, implemented in many countries. Expected drawbacks: poverty trap, high monitoring ad administration costs. Expected benefits: targeting the deserving population.

Unconditional Basic Income (UBI). Each individual receives an unconditional transfer equal to G (if single) or $G/2$ (if partner in a couple). This is the pure version of Basic Income, implemented in Alaska, expected to be implemented in Brazil, currently experimented in local areas of Africa, India and South America. Expected drawbacks: high taxes. Expected benefits: no poverty trap, low monitoring and administration costs.

Wage Subsidy (WS). Each individual receives a 10% subsidy on the gross hourly wage and her/his income is not taxed as long as her/his gross income (including the subsidy) does not

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[3] Examples of other recent contributions that address specific reforms are: Aaberge et al. (2004), Fumagalli (2006), De Vincenti and Paladini (2009), Colombino et al. (2010), Figari (2011), De Luca et al. (2012).

[4] The poverty line for an individual is defined here as ½ of the median of the distribution of individual incomes.

exceed *G* if single or *G/2* if partner in a couple. Close to currently fashionable policies such as Earned Income Tax Credit and In-Work Benefits (USA, UK, Sweden). Expected drawbacks: little impact on poverty of "hard" non-participants. Expected benefits: incentives to participate, reduction of welfare dependence.

GMI + WS and **UBI + WS** are mixed mechanisms where the transfer is coupled with the wage subsidy and the threshold *G* is halved with respect to the pure types. They might be interpreted as an attempt to merge the benefits and cancelling the drawbacks of the transfer-based (GMI and UBI) and the subsidy-based (WS) policies.[5]

For each one of the above five types of mechanisms, we consider three versions where G is alternatively defined as 50%, 75% or 100% of the poverty line. Altogether we have therefore 15 reforms.

The income support mechanism is complemented by a progressive tax that replicates the current system: the marginal tax rates are applied to the whole income exceeding *G* (or *G/2*) and proportionally adjusted in the simulation in order to fulfil the public budget constraint.

3. Simulation

In order to simulate and evaluate the effects of the reforms we have developed and estimated a microeconometric model of household labour supply using a sample of Italian couples and singles. The model makes it possible to simulate the new labour supply choices made by the households given the new incentives and constraints implied by the different hypothetical

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[5] A mixed system close to GMI+WS has been proposed in Italy by De Vincenti and Paladini (2009).

reforms. The estimation and the simulation are based on a dataset generated by the EUROMOD algorithm[6] from a sample of couple and single households of the Bank-of-Italy's Survey of Household Income and Wealth (SHIW) for the year 1998.[7] Both partners of couple households and heads of single households are aged 20 – 55 and are wage employed, self-employed, unemployed or inactive (but students and disabled are excluded). As a result of the above selection criteria we are left with 2955 couples, 366 single females and 291 single males.[8]

Each reform defines a new budget constraint for each household. The simulation consists of running the model after replacing the current budget constraint with the reformed one. The procedure adopted in this paper has two distinctive features that are not common in the tax reform literature. First, the reforms are simulated under the constraint of being fiscally neutral, i.e. they generate the same total net tax revenue as the current system. Second, the simulation is conducted under market equilibrium conditions. In general the reforms induce a shift of the labour supply curve. Equilibrium in the labour market then requires an adjustment of the wage

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[6] EUROMOD is a tax-benefit microsimulation model for the European Union that enables researchers and policy analysts to calculate, in a comparable manner, the effects of taxes and benefits on household incomes and work incentives for the population of each country and for the EU as a whole. EUROMOD was originally designed by a research team under the direction of Holly Sutherland at the Department of Economics in Cambridge, UK. It is now developed and updated at the Microsimulation Unit at ISER (University of Essex, UK).

[7] More recent surveys are of course available. However, the years following 2000 envisage a more turbulent macroeconomic scenario with respect 1998. In any case, the analysis presented in this paper is a comparative statics exercise: it concerns the evaluation and design of institutions, i.e. policies that should be assumed to stay for a relatively long period; as a counterpart, preferences should be assumed to be stable.

[8] The microeconometric model is similar to the one used in Colombino et al. (2010) and it is fully explained in Colombino (2011a, 2011b, 2012).

rates. We adopt a procedure that is specifically appropriate for our microeconometric model (Colombino 2012). [9]

The model allows us to compute an index of household welfare, i.e. how well-off is each household given a specific reform. Then we can compute the Gini Social Welfare (GSW) index as follows:

(*Average Household Welfare*) × (1 − *Gini index of the distribution of Household Welfare*).

Intuitively, each household gets a slice of the "cake"; the first term is the average size of the slice and can be interpreted as a measure of efficiency; the second term tells us how equal the slices are. Therefore social welfare is measured as the product of efficiency and equality. [10]

4. Results and concluding remarks

Table 1 reports some results of the simulations. The policies are ranked in descending order (the best one at the top) according to the GSW index defined in Section 3. The reforms are identified by the content of the first two columns: the income support mechanism (GMI etc.) and the coverage, i.e. the value of G (defined in Section 2) as a percentage of the poverty line. For example, (UBI+WS, 75) denotes a policy where the income support mechanism is UBI+WS and G is 75% of the poverty line.

The best policy – according to the GSW criterion – turns out to be UBI+WS with a 75% coverage. It pays an average monthly transfer equal 721 Euros (comprehensive of the

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[9] The results reported here are those obtained under the assumption that the labour demand elasticity is equal to -1.

[10] A similar intuitive idea was originally introduced by Sen (1976). A formal treatment of a more general classo f social welfare indexes is provided by Aaberge (2007).

unconditional transfer and of the wage subsidy). It leads to reduction of the head count poverty rate from 4.33% to 0.95%. Under this reform, 69% of the households would be better-off. The reform requires a 50.2% top marginal tax rate (and an analogous increase in the other marginal tax rates as well). Of course the reform could be financed through different channels such as taxes on consumption, property taxes, taxes on capital etc.

All the simulated reforms turn out to dominate the current system in terms of social welfare gain: therefore we have a large set of alternatives to choose among according to different criteria. For example, reforms of the GMI, WS or GMI+WS type on the one hand require a lower marginal tax burden, on the other hand are less effective (with respect to UBI or UBI+WS) in reducing poverty.

The mechanisms envisaging unconditional transfers (UBI or UBI+WS) rank better than the mean-tested systems. The greater generosity of the unconditional transfers is compensated by the lack of poverty-trap effects, so that both the conditional and the unconditional systems imply very modest reductions in labour supply; however, the unconditional systems perform better in favouring distributional equity and reducing poverty.

The typical objections against universalistic policies of income support are based on the expectation of strong disincentive effects on labour supply and high tax rates required by the public budget constraint. The first expectation (strong disincentive effects on labour supply) is not supported by our results. We observe a modest reduction of male labour supply and actually an increase in female labour supply.[11] The second expectation (high marginal tax rates) instead is

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[11] An increase in female labour supply in response to the introduction of minimum income policies is not infrequent in policy simulation results and was also observed in Negative Income Tax experiments implanted in the USA during

confirmed by our results. UBI+WS_P_0.75 would require a top marginal tax rate equal to 50.2%, to be compared with the 43.7% required by the current system. It should be noticed however that these figures are high but not at all unrealistic, particularly when compared to the top marginal tax rates in the Scandinavian countries. Even if the above tax rates were judged for some reasons not feasible (possibly from the point of view of political consensus), it must be remembered that the *menu* of welfare improving reforms is very large and contains policies requiring lower marginal tax rates. Moreover, instead of increasing the marginal tax rates on income, one might think of a different structure of taxation e.g. increasing taxes on wealth and on (selected) consumption expenditures.

In conclusion, a universal income support for Italy appears to be feasible and beneficial, with a large menu of choices available to the policy makers. According to the GSW criterion, the best policy is a combination of an unconditional transfer (UBI) with a wage subsidy (WS).

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the 70s. There are many possible explanations: among not employed women, leisure might be an inferior good; the minimum income policy might give access to opportunities that are complementary to labour market work; etc.

Table 1

Income Support Mechanism	Coverage(*)	Percentage of Winners(***)	Annual Average Hours of Work (Women)	Annual Average Hours of Work (Men)	Top Marginal Tax Rate (%)	Monthly Average Transfer (Euro)	Head Count Poverty Ratio (%)
UBI+WS	0.75	69	1011	2043	50.2	721	0.95
UBI+WS	0.5	66	1014	2045	49.2	599	2.52
WS	0.75	61	1021	2046	46.5	353	3.66
WS	0.5	72	1021	2047	46.6	353	4.14
GMI+WS	0.5	70	1013	2046	47.6	406	3.40
GMI+WS	0.75	70	1010	2045	48.3	435	2.38
WS	1	57	1020	2046	47.9	352	3.04
UBI	0.5	68	1003	2041	50.8	568	0.52
UBI	0.75	67	994	2038	55.2	814	0.04
UBI+WS	1	68	1005	2040	52.9	842	0.20
UBI	1	64	985	2034	59.7	1060	0.00
GMI	0.5	58	1005	2044	45.7	193	2.48
GMI+WS	1	57	1005	2043	50.6	467	0.79
GMI	0.75	60	997	2042	47.2	268	0.81
GMI	1	48	988	2039	51.1	355	0.01
Current	---		945	2063	43.7	107	4.33

(*) Coverage = Policy threshold *G* as a percentage of the Poverty Level.

(**) Annual Average Welfare Gain = Change in Gini-Sen SWF divided by the number of households.

(***) Percentage of winners = Percentage of households who are better-off after the reform.

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