December 6, 2017

Baltic Sea Region Report

Heart-warming growth is a poor excuse to postpone reforms

- Growth at its cyclical peak
- Productivity is the key to income convergence in the Baltics
- Sustainable development – where do we stand?
- Universal basic income – utopia or an urgent necessity?

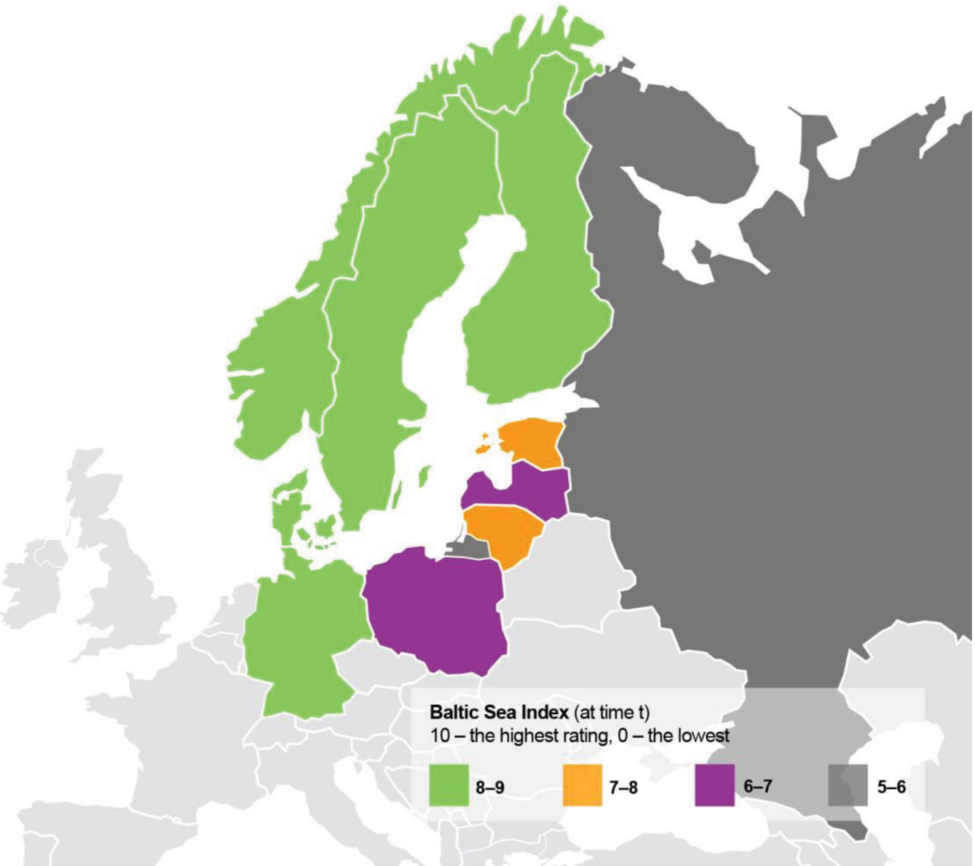
Growth at its cyclical peak
The upswing in global growth has lifted the Baltic See region's economies to their cyclical peaks. Growth will slow, but there are at least a few good years of strong growth down the road. Geopolitics and a resurgence of populism are the key risks. Strong growth is the time to reform, correct for imbalances, and invest in boosting long-term growth potential. In Sweden, housing market adjustment is in focus, while labour market tightening remains the hotspot in the Baltics.

The Baltic economies – productivity is the key to income convergence
All the Baltic countries have recovered from the recession and narrowed the relative income per capita gaps with the EU. Lithuania has been the front-runner and surpassed Estonia, benefitting from slower price convergence and a more pronounced population decline since the bottom of the recession. However, the effect from these factors is likely transitory. In the medium term, in addition to brain drain, the population decline will trigger employment reduction, negatively affecting economic activity. The relative price levels, adjusted for purchasing power, will start growing faster (already happening in 2017), slowing the pace of real income per capita convergence. The key to successful income convergence is productivity growth and structural improvements to the economy.

Sustainable development in the Baltics and Sweden – where do we stand?
There is an increased focus globally on sustainable development and the UN 2030 Agenda. Sweden scores better than the Baltic countries with regard to sustainability principles (i.e., environmental, social, and governance indicators); however, policy makers and companies in both Sweden and the Baltics have to do their homework to promote robust, socially inclusive, and environmentally friendly growth in the medium term and to contribute better to the UN Sustainable Development Goals.

Universal basic income – utopia or an urgent necessity?
The idea of universal basic income, or unconditional cash payments for all citizens or residents of a specific country was first expressed by Thomas More and almost implemented by Richard Nixon in the US in 1968. This idea has recently grown in popularity worldwide. In an EU-wide survey from 2016, 64% of respondents supported the idea, while Finland started experimenting with its implementation this year. The discussions on universal basic income are picking up steam also in the Baltics. We shed light on the pros and cons of UBI and conclude that full implementation of it in the Baltics is unaffordable, but elements of it can improve social inclusion and the efficiency of existing social security systems.

The Baltic Sea region and Swedbank Baltic Sea index 2017



The aim of the *Baltic Sea Report* is to assess the structural quality and strength of the Baltic Sea region economies from the point of the legal and business environment, and to provide analysis and suggest possible interventions by policymakers to support the swift and sustainable growth of their economies. The region includes 10 countries around the Baltic Sea: Germany, Denmark, Norway, Sweden, Finland, Russia, Estonia, Latvia, Lithuania, and Poland. Detailed analysis is provided for Swedbank's four home markets: Sweden, Estonia, Latvia, and Lithuania.

Contents

UBI – utopia or an urgent necessity?

What is common to the 16th century writer, Thomas More, a Republican President, Richard Nixon, and an entrepreneur, Mark Zuckerberg? Not much, at first glance. Dig deeper and you will find that they were all (or still are) proponents of basic income, or unconditional cash payments for all citizens or residents of a specific country. This idea, first expressed by Thomas More and almost implemented by Richard Nixon in the US in 1968, has recently grown in popularity worldwide. The idea resonates well also among EU voters – in an EU-wide survey from 2016, 64% of respondents supported the idea,[14] while Finland started experimenting with its implementation this year. The discussions on this concept, universal basic income (UBI), are picking up steam also in the Baltics. Here, we shed light on the pros and cons of UBI and try to estimate whether the Baltic countries could afford it.

Revival fuelled by fear and discontent

Fears of automation and globalisation behind the revival of UBI

The recent growing interest in UBI has been fuelled by rising fears of job losses due to automation and globalisation, as well as the growing inequality of income and opportunity across some advanced economies. The increasing discontent among citizens who have lost out to automation and globalisation and the rise of the precariat, the so-called new deprived social class facing insecurity and underemployment,[15] pose a considerable threat to political stability and democratic values, as indicated by the recent election outcomes in the US, the UK, and some other EU countries. The proponents of UBI argue that greater income security via this measure could be a possible solution to these problems and could help tame voter discontent and prevent them from supporting populists.

Current social support systems disrupt motivation to work and are out of date

However, there are additional arguments in favour of UBI related to the inefficiencies of the existing social support systems. There is a growing concern that the existing means-tested social support schemes disrupt people's motivation to seek employment and, thus, have a negative effect on the labour markets, economic development, and public finances. The disincentives to work emerge because people lose most of the benefits as they enter employment. For example, in 2015, in Latvia and Lithuania, over 80% - and, in Estonia, around 63% - of the gross earnings of a person moving into low-wage employment was taxed away by the combined effects of the withdrawal of benefits and higher tax and social security contributions. [16] Moreover, enrolment into social support schemes is often burdensome and time-consuming, and the conditions attached to the support are often viewed as degrading. The existing social protection systems also seem to be outdated and no longer meet the demands of the modern labour market, as evidenced by the growing popularity of "gig jobs" and self-employment, and thus may not be effective at reaching those in need of support.

Current systems have created armies of bureaucrats and are costly to sustain

Some also argue that the current complicated social protection systems have created armies of bureaucrats and the wasting of taxpayer money on non-productive activities, while simple UBI payments to all would eliminate the need for bureaucrats in the distribution process. This argument rings a bell also in the Baltic countries. However, data show that the administration costs of social spending in the Baltics are relatively small – in Latvia and Estonia, they account for 1.2-1.4%, and, in Lithuania, for 2.1%, of total expenditure on social protection--and are below the EU average. However, Lithuania is less efficient in managing and administering social support than the other two Baltic countries – in 2015, Lithuania spent EUR 46.7 per capita on administration of social support schemes, compared with EUR 26 in Latvia and EUR 27.6 in Estonia.[17] This could also be related to the fact that Lithuania has a somewhat larger share of social benefits that are means tested, which possibly complicates the administration of the system.

UBI would make the system simpler, more reliable and accessible

A UBI-based system would most likely be simpler, more reliable, and more accessible than the existing social protection systems. The proponents of UBI argue that it would also have a positive effect on the labour market by reducing the unemployment trap and the low-income trap, since, as support would not be phased out when incomes rise above a certain threshold, more people would thus be brought into employment. UBI would provide greater income security and thus people could more actively engage in activities that do not yield instant monetary gains, such as starting a business, retraining, and engaging in education – a very important positive aspect in an age when digitisation and automation are rapidly changing the requirements for workers' skill sets.

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[14] http://basicincome.org/news/2016/05/europe-eu-poll-basic-income-support/
[15] Guy Standing (2014), "The Precariat: The New Dangerous Class."
[16] Recently, steps have been taken in all three Baltic countries to lower taxation of low-income earners; thus, the unemployment traps should be smaller in 2016-2018.
[17] For Estonia, latest available data on administration costs are for 2014.

Utopia that would not work in practice?

Still little knowledge of possible side-effects of UBI

However, the expected positive effects of UBI on the labour market and the economy are by and large based on wishful thinking rather than hard facts. As there have been very few cases where UBI (or something similar) has actually been introduced, there is little knowledge of how it would change recipients' employment behaviour. The opponents of this idea argue that guaranteed income would reduce work incentives and thus have adverse effects on the labour market and the economy, and ultimately undermine the funding of UBI. This possible effect cannot be ruled out – research by Calnitsky and Latner (2017)[18] found that a basic income introduced as an experiment in Dauphin, Canada in 1975-1977 generated a reduction in labour market participation of 11.3 percentage points.

UBI may reduce participation – not necessarily bad for the economy over long run

However, the same study found that the incentives behind the participants leaving the labour force were largely related to other factors than simple leisure maximisation, such as limited employment opportunities, involvement in care work, disability, old age, illness, or educational investment. Thus, it is likely that, with basic needs secured outside the market, people would become more picky about jobs and work conditions, and would possibly choose to spend more time with family, or engage in non-paid care work or charitable activities. This outcome would not necessarily be bad for the economy over the long run. According to Calnitsky and Latner (2017, p. 20), "these alternate activities may be highly socially productive and may improve our collective well-being, even though, as sources of wealth, they are not tracked well by conventional income statistics."

Equal UBI for all could contribute to rising income inequality

Another argument often expressed by those opposing UBI is that equal transfers to all would make the system highly regressive, as those in greater need, e.g., the poor, the disabled, or the unemployed, would receive the same level of support as those in lesser or no need of support, which would contribute to rising inequality. Taxation of UBI alongside other incomes could alleviate some of these concerns; however, taxation of UBI could undermine the simplicity aspect of the idea. Guy Standing, an economist and a leading advocate of UBI, argues that, as UBI should be the right of every person, only income above UBI should be taxed. Moreover, he argues that this sum should be free of creditor or tax authorities' claims or of any fines.[19]

UBI could reduce incentives to pay taxes and undermine the funding of the system

The opponents also worry that uncoupling the social benefits and pensions from contributions may have adverse effects on incentives for paying taxes and could thus expand the shadow economy and encourage tax avoidance. The Baltic countries do not have to search long for evidence in favour of this argument – the Soviet slogan "from each according to his ability, to each according to his needs" did not work very well in practice. Thus, the risk of reduced incentives for paying taxes could be a serious drawback of such a system and could eventually undermine its funding.

No best practices to follow in implementing UBI

Some also worry that the idea looks good on paper but would be very difficult to implement in practice. Designing UBI would require making crucial decisions, which would be costly to reverse, and there are almost no best practices that could be followed in this process. First of all, who would be eligible for UBI – the citizens or the residents of a specific country? In the latter case, concerns may arise about how social migration would be controlled and whether this would be compatible with the free movement of people in the EU.

No easy answers for designing UBI system

Second, should UBI be distributed evenly to all, or should it be age dependent (e.g., less for children, more for the old)? How high should it be set? Some even question the very concept of "basic needs" that UBI should cover. This concept may evolve considerably over time, with pressures on financing the ever-larger basic needs mounting.[20] Should UBI be taxed or not? Should all social assistance programmes be replaced fully with UBI, or should there be additional benefits available to those with limited work capacity, e.g., the disabled or the old? The latter option would go against the arguments in favour of smaller government and cost saving.

Moreover, how would UBI payments evolve over time? Should UBI be automatically linked to some official indicators, e.g., inflation, median disposable income, or average wage developments? Or should the size of it be left to politicians to adjust regularly? The latter option would put a tool into politicians' hands that could be wielded in a populist manner and used to implement fiscally unsustainable decisions. These questions may seem technical, but the success of this measure would depend on these details, and reaching a political agreement on them would not be easy.

UBI would be low with current spending levels

Affordability of this measure is the most problematic aspect

But even if agreement is reached, affordability of this measure may still be problematic, especially in the Baltic countries, which tend to have relatively small social security budgets.

[18] C. Calnitsky and J.P. Latner, (2017), „Basic Income in a Small Town: Understanding the Ellusive Effects on Work."
[19] Guy Standing (2017), „Basic Income: And How Can We Make It Happen."
[20] https://www.bloomberg.com/view/articles/2017-06-04/universal-basic-income-is-neither-universal-nor-basic

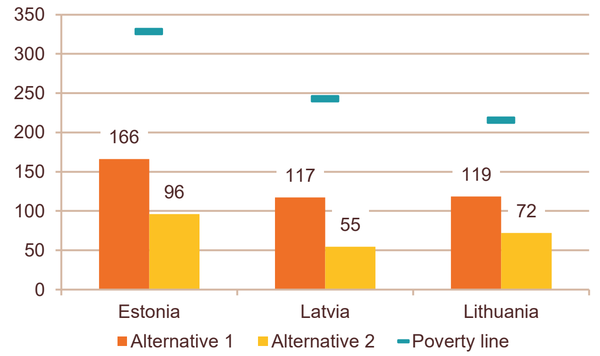
Thus, using 2015 data[21] on general government social protection spending, we conduct a simple thought experiment and try to evaluate how large the budget- neutral UBI could be in the three Baltic countries.

We do the calculations for the following two alternatives:

1. All government spending on social protection (spending on old age, survivors, family and children, unemployment, housing, social exclusion, and others) is replaced with UBI paid to all inhabitants.
2. All non-elderly government spending on social protection (excluding old-age-related spending) is replaced with UBI paid to all inhabitants below the age of 63 years (the approximate average statutory pension age in the Baltic countries). The elderly remain entitled to their old-age pensions.

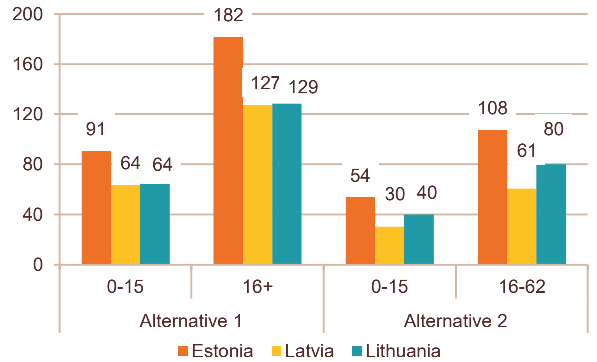
For each of these alternatives, we calculate the size of UBI for two scenarios: 1) UBI is paid to all inhabitants in equal amounts, and 2) children up to 16 years old receive 50% of UBI, and the remaining eligible recipients (16+ -year-olds in alternative No.1 and 16-62-year-olds in alternative No. 2) receive 100% of UBI. The at-risk-of-poverty threshold is set at 50% of the median equalised income for a single person. We assume that the introduction of UBI does not alter the tax revenue side.

Monthly UBI paid to all eligible recipients in equal amounts, EUR/ person, 2015



Source: Eurostat & Swedbank Research

Monthly UBI by age groups: children paid 50%, the rest 100%, EUR/ person, 2015



Source: Eurostat & Swedbank Research

With current budgets, monthly UBI payments would be considerably below poverty line

We find that, if all government social protection spending were distributed equally across the population, this would yield monthly UBI payments of only EUR 117-166, around 48-55% of the at-risk-of-poverty threshold. It is unlikely that the elderly would approve this kind of redistribution because their UBI would be less than half their old-age pensions. If only non-elderly spending were to be distributed in equal amounts to those below the retirement age, then the monthly UBI payments would be below EUR 100. In Latvia, this amount would be only EUR 55 – around one-fifth of the poverty line (see graph above).

Paying only half of UBI to children increases the UBI paid to those older than 16 only marginally--in the range of 9-12% for both alternatives – but UBI still remains significantly below the poverty line. This indicates that, with current social security budgets, UBI at socially and politically meaningful levels would be impossible.

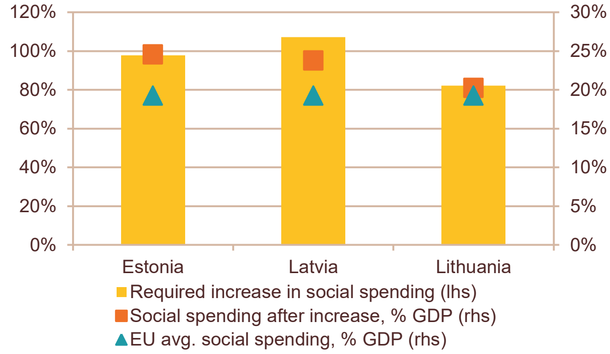
UBI at poverty line would require much higher budgets and additional tax revenues

Setting UBI at the poverty line and paying it to all inhabitants in equal amounts would require doubling the existing social protection budget in Latvia and Estonia and increasing it by 82% in Lithuania.[22] As a result, increased social spending in all three countries would amount to 20-25% of GDP and would be above the EU average, which stood at 19.2% in 2015.

This increase in UBI budget would open up a funding gap. If we assume that this funding gap would be financed solely by tax revenue, this would have to rise by around 30-40%, depending on the country. In such a case, tax revenues as a share of GDP would come close to the EU average in Lithuania and rise above it in Estonia and Latvia. The increases would most likely be even higher as the economies would probably be hit considerably by the tax hikes.

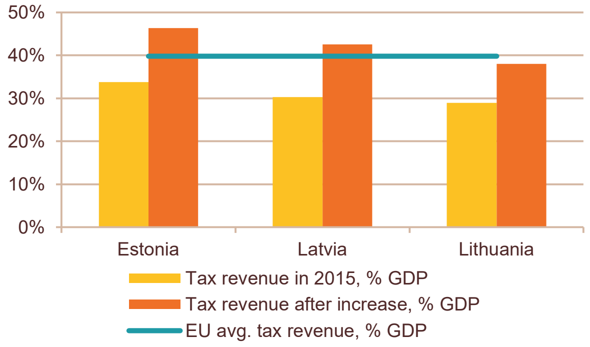
[21] The last year for which comparable data are available for all three Baltic countries.
[22] A smaller increase in Lithuania would be required because of the lower poverty threshold.

Increase in social protection budget if UBI set at poverty threshold, 2015



Source: Eurostat & Swedbank calculations

Increase in tax collections to finance UBI set at poverty threshold, 2015



Source: Eurostat & Swedbank Research

Towards better-functioning social security system

Full implementation of UBI is largely unaffordable; some parts of UBI could be used to improve current schemes

As the simplified calculations show, replacing the complicated social security system in the Baltics entirely with a flat basic income would be largely unaffordable. Not to mention that UBI is still uncharted territory, and more experiments are needed in order to see how it affects recipients' incentives and behaviour.

However, some parts of the basic income model could be used in simplifying and improving the efficiency of the existing social security systems. Governments could make the existing benefits more accessible by eliminating unnecessary conditions and means testing in order to reach those who fall outside the system. This could also help cut administrative costs. A more gradual phasing out of benefits would reduce the unemployment trap and increase the incentives for the unemployed to enter the labour market.

Governments could aim for "partial" UBI applied to new cohorts

In order to make the transition to basic income more gradual and limit the cost increases, governments, instead of implementing full-scale UBI, could consider a "partial" basic income that would apply only to new cohorts. Lithuania has taken a step in this direction by replacing the additional non-taxable income with lump-sum cash benefits paid to all children, without regard to family income.[23] Maybe, as a start, a similar basic income or, simply, a once- in- a-lifetime payout could be introduced to young adults, which would at least partly level the playing field for poorer youngsters. However, payments to young cohorts only may be met with resistance from the older ones.

Negative income tax is another option

Yet another alternative to UBI is a negative income tax, in which people earning below a certain amount receive supplemental pay from the government instead of paying taxes. This system would most likely be less fiscally demanding than UBI and would not exacerbate income inequality, but, at the same time, it would share some of UBI's benefits. Nevertheless, this measure, as well as others mentioned here, carry their own risks and potential side-effects; thus they require separate consideration, as well as separate estimations of their affordability.

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[23] However, it is unlikely to reduce bureaucracy, since families will need to file an official request to receive these benefits. This change is expected to take effect as of January 1, 2018.