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Veröffentlichungsversion / Published Version

Zeitschriftenartikel / journal article

Empfohlene Zitierung / Suggested Citation:

Skuciene, D., & Lazutka, R. (2019). Redistribution of income through social benefits over the life course in the Baltic States. *Studies of Transition States and Societies*, 11(2), 47-59. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-69178-6>

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Redistribution of Income through Social Benefits over the Life Course in the Baltic States

Daiva Skuciene* and Romas Lazutka

Abstract:

Vertical redistribution refers to the transfer of income from those who have more than they need to those who are in need and is related to the levelling of income inequality and poverty. Vertical redistribution throughout the life course is indicative of the capacity of the welfare state to protect against social risks over the life course. Studies that explore such redistributions often rely on the life-course perspective and use secondary cross-sectional rather than primary data.

The goal of the current study is to analyse the impact of social benefits on income inequality and poverty over the life course in the Baltic States. The paper focuses on the three Baltic countries commonly characterised by successful economic performance, low income redistribution and high income inequality. With this aim, analyses were conducted of micro-level data from the 2015 EU-SILC. To evaluate inequality changes across the life course, the study used a decomposition of the Gini index. The evaluation of poverty in different cohorts rested on the poverty rate gap between different groups and the average poverty rate in the country. The findings of our study suggest that the impact of social benefits on the reduction of income inequality is modest. The highest poverty rates are linked to periods of childhood, working age when unemployed and old age. Overall, a context laden with high levels of inequality and poverty cannot ensure adequate protection against social risks over the life course and create a “buffer” for the development of human capital.

Keywords: redistribution, life course, income inequality, poverty, the Baltic States

Introduction

Discussions about spending in the welfare state and its burden on the country's budget are never-ending in political and academic agendas. Welfare expenditure indicates how much the state redistributes through social benefits. The benefits of the welfare state should ensure protection against social risks and adequate income guarantees through the redistribution of income from the rich to those in need. Higher income guarantees for people with insufficient resources and income smoothing during different stages of the life course ensure lower income inequality and poverty. There are different levels of redistribution, income inequality and poverty among European countries, and the reduction of poverty has been put on the EU political agenda. One of the targets of Europe 2020 is getting 20 million people out of poverty (European Commission, 2010). National targets defining the level of poverty that member states should reduce were also set up in the Europe 2020 strategy, the three Baltic States among them. Therefore, the question is, what are the capacities for redistribution in the Baltic welfare states? Redistribution and income inequality in the Baltic welfare states have recently been analysed by Laurinavicius (2012), Masso et al. (2012), Lazutka et al. (2018) and others. Therefore, this study contributes to the literature by providing an analysis of the impact of social benefits on income inequality and poverty over the life course in the Baltic States.

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Our focus on the Baltic States is driven by the specific pattern of the development of Baltic welfare, which is characterised by low income redistribution and high income inequality, while also exhibiting successful economic performance. The main objectives for the implementation of the aim are as follows: first, to review the literature on welfare state redistribution; second, to explore the impact of social benefits on income inequality over the life course and investigate the impact of social benefits on poverty rates over the life course in the Baltic States.

Literature review

The role of social security systems in reducing income inequality and poverty has been thoroughly explored in the discourse on the welfare state. Indeed, the welfare state regime, social justice and social investment perspectives explain the patterns of redistribution undertaken by the welfare state. The theory of the welfare state regime encompasses the element of stratification and the scope of redistribution, which is the result of historical and political legacies (Esping-Andersen, 1990). Institutional structures of the welfare state redistribute benefits differently due to different roles of the market and state and different degrees of risk homogenisation (Korpi & Palme, 1998). Korpi and Palme (1998) contend that the residual social security model redistributes income the least, meaning that income will be distributed unevenly. The basic social protection model maintains the degree of stratification in the market, and the corporate social protection model maintains professional segmentation, which does not include economically inactive and high-earning people. Yet another voluntary state-subsidised model retains pre-retirement socioeconomic disparities and it is apparent that benefits are distributed most equally across the universal coverage model (Korpi & Palme, 1998).

Therefore, the welfare state establishes a general level of equality in society as it redistributes the outcomes of uneven market performance (Korpi, 2000). Prus (2000) focuses on old age inequality and notes that universal and high minimum-level public pension benefits can level old age income inequality. On the other hand, the least efficient in eradicating poverty are systems based on means testing in which the redistributive consequences are directed solely at the poorest in society (Ritakallio, 2002). On the basis of the types of social benefits, unemployment benefits and old age and survivor pensions have a statistically significant impact on income inequality, whereas social exclusion benefits have been found to result in an insignificant reduction in income inequality (Niehues, 2010).

Redistribution in social policy also implies external risks (Mares, 2005). Mares (2005) notes that in many less developed countries, characterised by weak and ineffective states, an increase in the level of external risk will not necessarily culminate in the expansion of social insurance coverage despite the increased demand for social insurance for workers. On the other hand, Mello and Tionsong (2006) argue that governments of more unequal societies are less likely to spend on redistributive programmes and redistribution herein may be inefficient because the benefits of public spending may be captured by the non-poor. Similarly, governments are often not able to shape the distribution of certain forms of income that are sheltered from direct government intervention (Beramendi & Cusack, 2009). They found growth in inequality in the overall market income. Ferrarini et al. (2016) argue that in countries where the size of income transfer is higher, poverty risks tend to be lower across the population as well as among the elderly. Chzhen (2017) states that children are significantly less likely to be poor in countries with higher levels of spending on social protection. Indeed, the findings of Chzhen (2017) show the importance of social transfers during an economic crisis.

Cantillon (2011) criticises the decreased generosity of traditional income support suggesting that adequate minimum income protection should be a priority, and the redistributive capacity of social programmes should be reinforced. Cantillon (2011) notes that even in rich societies, living at risk of poverty remains a handicap for achieving success at school, in the workplace and within family life.

As stated by Joumard et al. (2012) and Wang et al. (2012), social benefits have a higher impact on income inequality reduction than taxes in OECD countries. Almost three quarters of income inequality reduction depend on social benefits, while the remainder on taxes.

Plagerson and Ulriksen (2016) critically observe that social insurance schemes preserve inequality rather than combat it, all because social insurance schemes reward effort and maintain previous inequality in the labour market.

Redistribution patterns in the welfare state are explained by Alcock (2016). Alcock (2016) states that distribution and redistribution of resources are at the centre of the welfare state. As resources are not equally distributed in the market, redistribution makes it possible to pass resources to those who have less. According to Alcock (2016), vertical redistribution happens when resources are transferred from those who currently have more than they need to those who do not have enough. Vertical redistribution can help reduce inequality. Meanwhile, horizontal redistribution is the transfer of resources across the life cycle for the same person, from some points in their lives when they have sufficient resources to other points in time when they do not have enough. Horizontal redistribution means the transfer of resources across different age groups within a population, collecting contributions from those who work and providing benefits to those at risk. Child benefit and retirement income are the main examples.

Alcock (2016) notes that horizontal redistribution is more important than vertical; it requires a long-term commitment to a collective approach to the transfer of resources across generations as well as investment in collective resources. Individuals cannot meet these long-term challenges themselves. Importantly, among all the sources of welfare, the welfare state plays a crucial role in consumption smoothing through different stages of the life course, mostly because of market failure (Barr, 2012).

Redistribution is also inseparable from theories of social justice. The popular theory from Rawls (1999) stresses the provision of the greatest benefits to the least advantaged in society and seeking more equality, while equality and life-course perspectives are also related to the social investment perspective, albeit differently. The aim of social investment is to enhance equality of opportunities through investment in human capital. As Esping-Andersen and Sarasa (2002) put it, the well-being of the would-be elderly will depend on the welfare of the future labour force. And since children are the future labour force, social investment in children and youth is the best direction of social policy. Although the social investment perspective focuses on investments in human capital, it recognises the importance of compensatory welfare over the life course as a “buffer” (Hemerijck, 2017). Hemerijck (2017) states that good “stocks” (human capital) develop in the context of strong “buffers”. Esping-Andersen (2002) also argues that adequate income maintenance and children’s cognitive abilities could create more equal opportunities for underprivileged children, while Vandenbroucke and Vleminckx (2011) and Vaalavuo (2013) stress the importance of the redistribution of income within the framework of the social investment paradigm. Vandenbroucke and Vleminckx (2011) conclude that the redistributive impact of services depends on the overall context. Hence, the reduction of the proportion of work-poor households is crucial if childcare is to play its social investment role adequately. Similarly, Vaalavuo (2013) states that despite the fact that a major priority of social investment is the redistribution of opportunities, it is clear that old cash benefits continue to make up the most important source of income for all income classes. According to Vaalavuo (2013), even if vertical redistribution may be but one rationale for social action, it should not be overlooked when directing the shift from insurance to investment.

Method and results

The present study explores the vertical redistribution of social benefits over the life course. For the evaluation of outcomes of such redistribution, we used the Gini coefficient and AROPR indicator (see the explanation below).

In order to evaluate the ability of social protection to mitigate income inequality, a change of Gini was measured before and after social transfers for all groups during their life course. In addition, a measure of Gini decomposition was used to evaluate the dynamics of income inequality between different groups across the life course. The Gini decomposition coefficient (G_u) is based on the following formula:

$$G_u = G_b + \sum_{i=1}^n s_i G_i O_i$$

G_b is labeled *Gbetween* and G_i is labeled *Gwithin* in the original image.

S_i- income share of *i* group;

G_i-income inequality of *i* group

O_i- overlap of *i* group

Decomposition measured using the Gini index includes two components: within-group inequality and between-group inequality. Between-group inequality is always lower than within-group inequality. In this analysis the focus is placed on between-group inequality and its change moving across the groups after the payment of social transfers (see Table 1) in order to evaluate the role of social protection in the mitigation of income inequality over the life course.

For the evaluation of poverty, we introduced the AROPR gap indicator. This indicator shows the difference of the at-risk-of-poverty rate of the total population and a portion of the population within a specific bracket (children, unemployed, retirees, etc.). The gap is expressed as a difference in percentage points. A gap with a negative sign means a higher risk of poverty for the target group compared with the total population. Conversely, a gap with a positive sign means successful social protection for a given portion of the population. It must be noted that this research also employed the OECD equivalency scale.

Our analysis of income inequality over the life course is based on four stages of the life course: formal learning, family formation, working life and retirement. Furthermore, only the role of social benefits is evaluated during these life-course stages. We distinguished children (aged less than 18), students (by status), employees without children and employees with children (combining their status and the composition of the household) and, finally, retirees (by status).

We used the micro-level data of the 2015 EU-SILC to analyse Gini inequality, while the AROPR calculation was based on Eurostat data from 2015. We also conducted a secondary analysis of the Eurostat data (2007–2016) as a contextual review of social spending, overall income inequality and poverty rates in the Baltic States. Lastly, MISSOC data (10/01/2015) were used to perform comparisons for the three Baltic States.

The impact of social benefits on income inequality

Ferrarini et al. (2016) note that in countries where the size of transfer income is higher, poverty risks tend to be lower, while the spending on social protection in the Baltic States was lower by more than 10% compared with the EU average for the last ten years (the average in 2007-2016: 27.9% in EU, 17.3% in EE, 16.3% in LV, 18.4% in LT). The low spending on social protection is a cause

of the low redistribution in the region and, consequently, high income inequality and poverty. In 2015, the Gini inequality score in EE was 34.8%, in LV 35.4%, in LT 37.9%, while the EU score was 31%. The at-risk-of-poverty rate in EE was 21.6%, in LV 22.5%, in LT 22.2%, while the EU rate was 17.3% (source: Eurostat).

The findings of previous research by Lazutka et al. (2018) revealed that social benefits make up on average only about 20% of the primary household income. That is the lowest in the EU, where the average is between 30% and 50% (Lazutka et al, 2018).

The findings of our study show that social benefits reduce income inequality for all age groups over the life course in the Baltic States (see Figure 1). However, reduction of income inequality after social benefits is modest during the life course up until retirement.

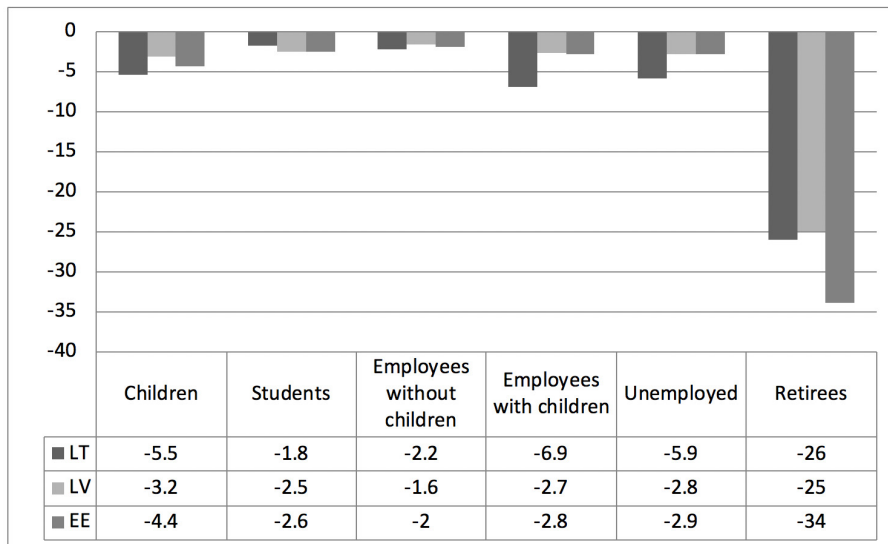


Figure 1: Impact of social benefits on Gini inequality (difference in percentage points before and after social transfers), 2015

Source: EU-SILC 2015, authors' calculations

The impact of social benefits on the reduction of income inequality for children was about 3–5% for all three Baltic States. The highest reduction of income inequality after social transfers for children was in Lithuania (5.5 percentage points (pp)) and lowest in Latvia (see Figure 1). Different schemes for the provision of child benefits in the Baltic States in 2015 can account for the differences in their impact. In 2015, Estonia and Latvia had universal child benefits (€45 per month up to 19 years and €11.38 up to 19 years respectively), while Lithuania had a means-tested benefit (1.5 SSI up to 18 years). Despite the lower generosity of child benefits in Lithuania, their importance for inequality reduction reveals a relatively poor financial standing on the part of children before social benefits.

Despite the differences in the effect of social benefits on income inequality, income inequality after social transfers for children remains high and almost the same (about 35%) in all of the Baltic States (see Appendix Table 1). The highest impact of social benefits on income inequality in Lithuania compared with Latvia and Estonia is not related to the same poverty rates. The highest AROPR gap for children was in Lithuania, while in Estonia it was the lowest (see Figure 2). In Lithuania and Latvia the AROPR gap for children aged 6–17 years was higher than the EU average. The means-tested benefits were not effective for poverty reduction in Lithuania because their level was below the at-risk-of-poverty threshold. Therefore, such benefits were unable to lift the incomes of poor families above the poverty level. From the social investment perspective, children from the Baltic States do not have adequate income for the development of their human capital because

poverty is a complex phenomenon related to the cumulative disadvantages of income, education and health. As stated by Esping-Andersen (2002), cognitive inequalities are strongly correlated with poverty and income inequalities. From the point of view of horizontal redistribution it is clear that the previous stages of life (those that are inactive) lack sufficient resources.

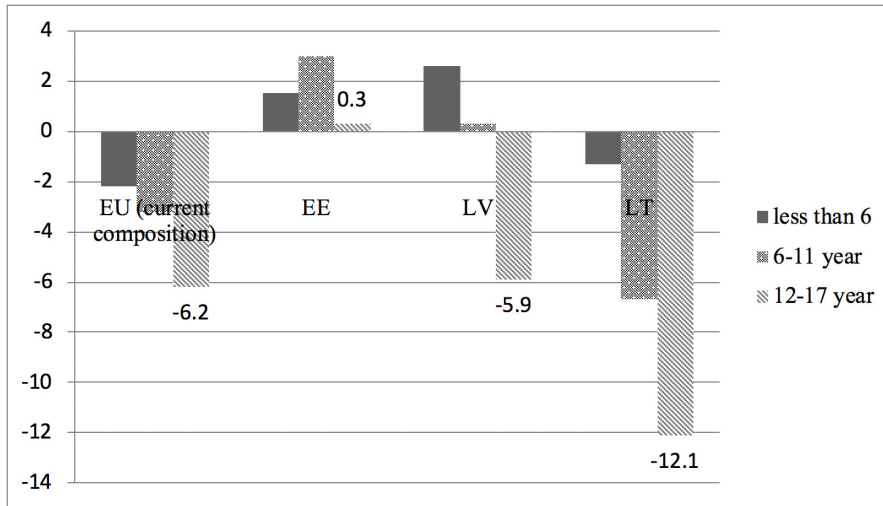


Figure 2: AROPR gap for people ≤ 17 (the at-risk-of-poverty rate total by age) in percentage points, 2015
 Source: Eurostat, authors' calculations

The next group explored in our study moving along the life course is students. The role of social benefits in the reduction of income inequality for students was one of the lowest over the life course and made up 1.8–2.6%. Income inequality after social benefits was high, especially in Lithuania (35%) and Estonia (36.4%) (See Appendix Table 1). As noted earlier, the right to receive child benefits extends to 18–19 years. Therefore, the period of studying only relates to social protection through orphan's pensions, which are provided in all Baltic States during full-time studies, and disability benefits for disabled students.

About one fifth of the individuals aged 18–24 in 2015 lived in poverty (19.5% in EE, 22.1% in LV, 21.2% in LT, source: Eurostat). It must be noted that the 18–24-year-old age group is not homogenous, as part of them are employees and part of them are students. High income inequality continues from childhood throughout the period of studies in all Baltic States. Admittedly, such a background generates social exclusion for tomorrow.

A modest reduction in income inequality is also apparent for employees without children. Income inequality after social transfers for this group compared to students was slightly higher in Lithuania and lower in Estonia (see Figure 1).

According to horizontal redistribution, the productive period of life is usually characterised by payments of contributions and less by the consumption of social benefits (Alcock, 2016). The welfare benefits most frequently related to this period of life are sickness, parental leave and unemployment benefits. Sickness benefits are short term and compensate for 70% of the loss of income in Estonia and 80% in Latvia and Lithuania. Therefore, the reduction in income inequality is very low for employees without children (see Figure 1).

The positive impact of social transfers on income inequality for employees with children was also highest in Lithuania (6.9 pp) (see Figure 1). The conditions of social protection are not very favourable for this group in Lithuania compared with the other two Baltic States and the greater reduction in income inequality can be related to the distribution of other social risks in this group;

for example, disability or sickness. This explains the level of income inequality after social benefits, which was the same in all Baltic States (see Appendix Table 1). Nevertheless, income inequality for this group was lowest after social benefits from the beginning of the life course (see Appendix Table 1).

During a period of unemployment, the role of social benefits in reducing income inequality was almost the same in Latvia and Estonia (see Figure 1), while the highest reduction in income inequality was observed for the unemployed in Lithuania, all because of social benefits (5.9 pp) (see Figure 1). Unfortunately, income inequality for the unemployed after social transfers was also highest in Lithuania compared with Latvia and Estonia. Indeed, the degree of inequality after social benefits over the life course is especially high for the unemployed in all Baltic States.

The schemes that provide unemployment benefit are quite similar in Latvia and Lithuania and less generous in Estonia: 100% of the reference earnings are provided for the first three months in LT and LV and 50% in EE. However, the reference earnings in Latvia depend on insurance duration, whereby the maximum is 30 years, and makes up 65% of the average contribution rate. This can explain the differences in the role of social benefits for income inequality reduction. Despite the differences in social benefits to reduce income inequality among the unemployed, the rate of poverty was high among the Baltic States compared with the EU average (see Figure 3). The highest indicator of the AROPR gap for unemployed persons was in Lithuania compared with Estonia and Latvia. In Lithuania, the at-risk-of-poverty rate for the unemployed was almost twice the total poverty rate or that for the employed. Despite the fact that unemployment benefits had a higher impact on the reduction of inequality for the unemployed, the financial situation of the unemployed in comparison with the poverty line remains the worst in Lithuania compared with Latvia and Estonia. From a social investment perspective, individuals are weakly protected against unemployment in the Baltic States, and poverty cannot ensure sufficient basis for developing the necessary skills for reintegration into the labour market.

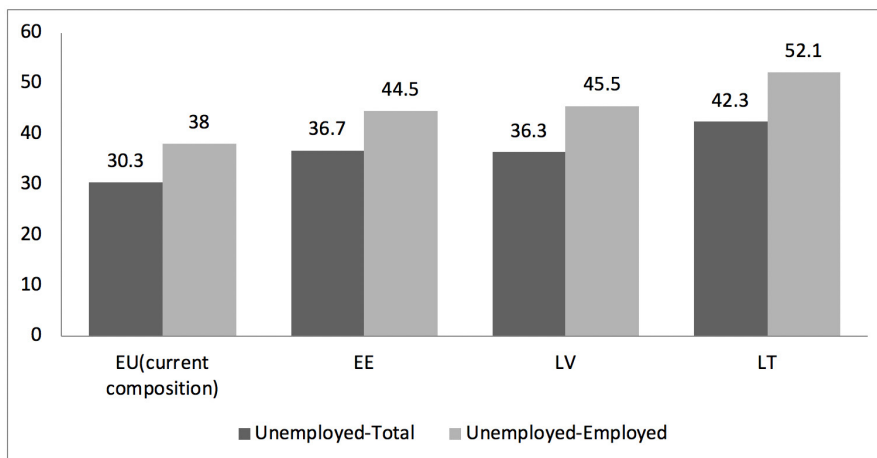


Figure 3: AROPR gap for the unemployed in percentage points, 2015

Source: Eurostat. Authors' calculations

Retirement, from the horizontal redistribution perspective, is related to the consumption of social security benefits as a right obtained from payment of contributions during the period of employment.

Retirement pensions have the greatest impact on income inequality: they reduce income inequality for Lithuanians by 26 pp; for Latvians by 25 pp and for Estonians by 34 pp (see Figure 1). This impact is several times stronger than those of any of the other stages of life. Retirement pensions cover a large part of the population and account for a significant portion of their disposable income in the Baltic States. However, income inequality after social benefits for pensioners remains rather high

(27.5% in LT, 29.2% in LV, 24.4% in EE, see Appendix Table 1). Importantly, the AROPR gap indicators were higher compared with the EU average in all Baltic States (see Figure 4). The state social insurance pensions as the main source of income for retirees cannot ensure higher protection against poverty. In addition, we observe a significant increase in poverty after retirement compared with the period of employment in the Baltic States as the poverty rate increases by 25–30 percentage points (see Figure 4). It appears that social protection during retirement is not able to ensure a smooth transition from the labour market in the Baltic States.



Figure 4: AROPR gap for retired individuals in percentage points, 2015

Source: Eurostat. Authors' calculations

Inequality reduction after social benefits was modest prior to retirement in all Baltic States and high poverty rates were observed during the periods of childhood and unemployment. Our comparison of the role of social benefits on income inequality among the Baltic States reveals that unemployment benefits and social benefits for employees with children had a higher impact on income inequality reduction in Lithuania, while in Estonia the impact of retirement pensions was greater.

The Gini decomposition allows us to evaluate the inequality structure and the impact of its components on inequality. The between-group inequality component shows a vertical inequality fluctuation during the stylised individual (as constructed on the basis of different groups) life course.

Table 1: Gini decomposition. Between-group inequality components, 2015

Groups	Components	Lithuania	Latvia	Estonia
Children and students	G between before	0.025	0.009	0.007
	G between after	0.023	0.007	0.006
	Change	-0.002	-0.002	-0.001
	Overlap before	-0.072	-0.046	-0.449
	Overlap after	-0.065	-0.034	-0.041
Students and employees without children	G between before	0.001	0.002	0.001
	G between after	0.001	0.003	0.001
	Change	0	+0.001	0
	Overlap before	-0.023	-0.054	-0.025
	Overlap after	-0.032	-0.060	-0.029
Employees without children and with children	G between before	0.006	0.004	0.002
	G between after	0.006	0.003	0.002
	Change	0	-0.001	0
	Overlap before	-0.093	-0.079	-0.043
	Overlap after	-0.091	-0.070	
Employees and unemployed	G between before	0.025	0.027	0.013
	G between after	0.030	0.027	0.013
	Change	+0.005	0	0
	Overlap before	-0.137	-0.138	-0.119
	Overlap after	-0.133	-0.128	-0.115
Employees and retirees	G between before	0.049	0.070	0.062
	G between after	0.051	0.056	0.065
	Change	+0.002	-0.014	+0.003
	Overlap before	-0.155	-0.143	-0.172
	Overlap after	-0.083	-0.077	-0.084

Note: The effect of overlapping on the between-group component occurs only if the expected values of the subpopulation are not all equal. This is always non-positive because overlapping reduces the ability to distinguish between the groups. It reaches zero if the ranges occupied by the different groups do not overlap (Liberati, 2012) before social benefits and after social benefits
Source: Authors' calculations on EU-SILC, 2015

The impact of social benefits on income inequality between groups was negligible. The between-group inequality after social benefits was lower among almost all groups; however, in a few cases we can observe a slightly higher income inequality (see Table 2). Income inequality was slightly higher after social benefits between the employed and the unemployed in Lithuania. Lastly, the same inequality increase was also observed between employees and retirees after social benefits in Lithuania and Estonia. All in all, the between-group element confirms the results of other analyses presented in this paper.

Conclusions

The phenomenon of redistribution lies at the heart of the welfare state as it ensures income for those who are at risk. Vertical redistribution is related to levelling income inequality and poverty, while horizontal or life-course redistribution means that resources pass from those life stages where income is higher to those periods of life when resources are inadequate.

Low spending on social protection produces a modest impact on the reduction of income inequality and poverty in the Baltic States. We identify low vertical redistribution during the stages of childhood, unemployment and retirement. Commonly, the effect of social benefits on income inequality and poverty is very similar in all Baltic States.

As individuals progress through the life course, not only does intergroup inequality after social benefits diminish very little but it also remains higher after the payment of social benefits among employees and the unemployed (LT) and employees and retirees (LT and EE).

There is a much higher probability of becoming afflicted by poverty moving through the life course in the Baltic countries than in the EU. The spread of poverty does not demonstrate adequate income maintenance for preventive or remedial strategies of welfare. The high poverty rates after social benefits for children means that the Baltic States can increase social exclusion tomorrow and that currently they do not ensure an adequate buffer for the development of human capital for the younger generation. The spread of poverty after retirement cannot ensure a sustainable transition from the working life stage to retirement.

Therefore, seeking to adopt the guidelines of social investment of the EC Package on social investment (SIP, 2013), the challenge for the Baltic States remains the resolution of the insufficient funding of compensatory welfare as a basis for human capital development.

A major limitation of our research is that it draws on the analysis of the hypothetically constructed life course using cross-sectional data from EU-SILC and not original data collected about the income of individuals over the life course. Hence, it would be advisable for further research to analyse real life courses. Similarly, a more detailed distribution of children by age group and young persons by occupation might make it possible to examine a possible combination of compensatory welfare within the social investment perspective.

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Acknowledgements

The research was funded by a grant (No.Ger-009/2017) from the Research Council of Lithuania.

Appendix 1

Table 1: Gini before and after social benefits among groups over the life course in 2015

	Gini before social benefits			Gini after social benefits		
	LT	LV	EE	LT	LV	EE
Children	0.423	0.421	0.397	0.351	0.351	0.343
Students	0.389	0.342	0.403	0.350	0.299	0.364
Employees without children	0.376	0.350	0.351	0.338	0.313	0.307
Employees with children	0.395	0.363	0.353	0.315	0.315	0.314
Unemployed	0.532	0.458	0.453	0.448	0.393	0.406
Retirees	0.539	0.538	0.582	0.275	0.292	0.244

Source: Authors' calculations based on 2015 EU-SILC.