Briefing

July 2016

ECONOMIC AND MONETARY AFFAIRS
EMPLOYMENT AND SOCIAL AFFAIRS

ECONOMIC INEQUALITY

BACKGROUND

In Europe, income and wealth inequality has been rising since the 1970s. Although overall, globalisation has reduced the income and wealth gaps between countries, inequality has often risen within countries. Not only do the top 10% of households earn 31% of total income, but the top 10% also own over 50% of the total wealth. Wealth has grown faster than gross domestic product in many countries, leading to larger inequalities. These economic inequalities have severe economic, social and political repercussions, and also raise ethical concerns, and calls to policy makers to address this issue are getting louder.

INSIDE

This leaflet provides the main points on economic inequality and the take-home messages from the ECON/EMPL hearing on 21 June 2016. It has been prepared by the European Parliament's Policy Department A on Economic and Scientific Policy (covering the ECON - ENVI - EMPL - IMCO - ITRE - TAXE- PANA committees). Contact us:

poldep-economy-science@ep.europa.eu

WHAT IS "ECONOMIC INEQUALITY"?

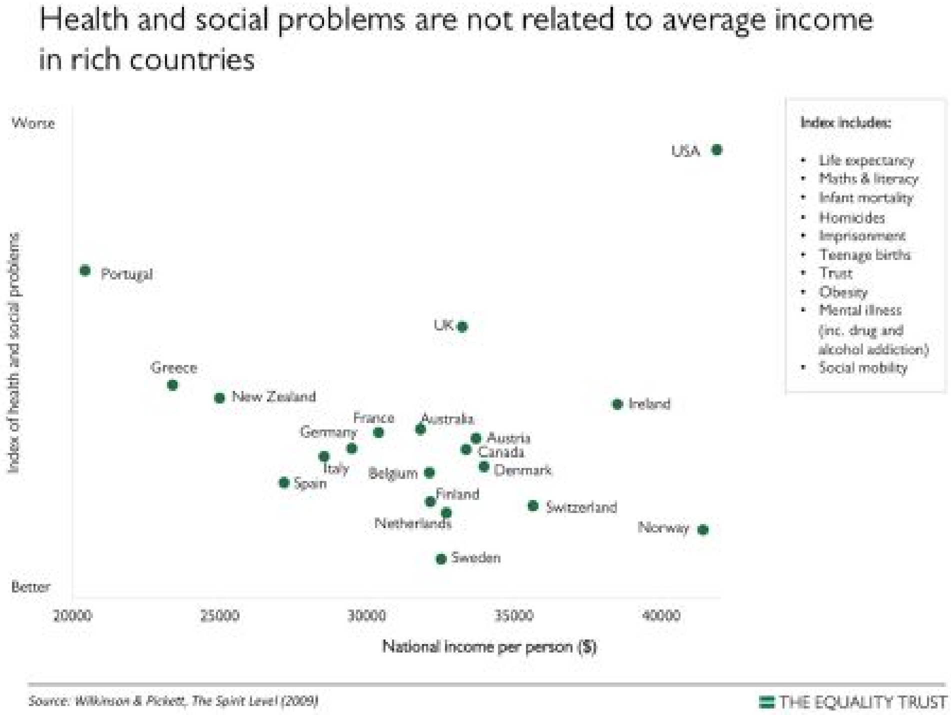
Economic inequality: "Economic inequality" specifically addresses the gap between the well-off and the less well-off in the overall economic distribution, and most commonly refers to inequality of income and wealth.

Income inequality (flow): "Income inequality" refers to the extent to which income is distributed in an uneven manner among a population. "Income" is usually defined as individual or household disposable income in a particular year. It covers any revenue stream coming from wages, interest on savings, dividends but also public cash transfers like pensions, after taxes and social security contributions have been deducted and can be either consumed or saved. When reading material on income inequality, it has to be kept in mind different sources may use different concepts of income inequality: **Market income inequality** (inequality in pre-tax and -benefit income) differs markedly from **disposable income inequality** (i.e. income after tax and benefits). One of the most common indicators to measure income inequality is the Gini index, which measures the degree of inequality in the distribution of family income in a country. If all households had the same income, the index would be zero; if only one household received all the income, the index would be 1.

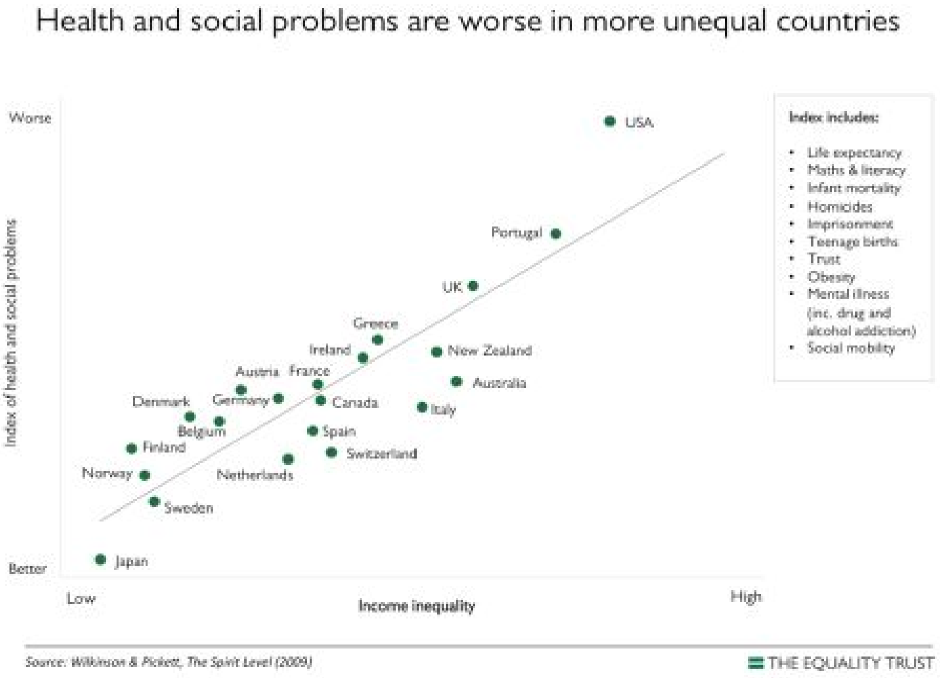
Wealth inequality (stock): "Wealth" refers to cumulated savings, i.e. the income stream which is not consumed. This corresponds to the total amount of assets owned by an individual or household, which includes both real assets (such as building or land), and financial assets (such as bonds, stocks and private pension rights). "Wealth inequality" therefore refers to the unequal distribution of assets in a group of people. As high income households save a higher proportion of their income compared to poor families, wealth inequality is larger than income inequality. Wealth is also accumulating faster than labour income as interest rates tend to outpace the growth rate.

Aren't health and social wellbeing connected to GDP levels?

Within a society, richer people tend to be healthier and happier than poorer people. But looking at the picture *between* societies, it makes no difference in health and happiness if on average people in one society are almost twice as rich as people in the other.



Instead, health and social problems are more common in countries with bigger income inequalities. Thus, people living in countries with a similar average income are typically worse off when they live in a more unequal country, as the following graph (for more see here) shows:



So is it about poverty?

Although both poverty and inequality are income and wealth related concepts, economic inequality concerns the bottom 40% of many societies and thus large population groups, which would not fall under the current poverty definitions. The lever to change something rests with economic and sectoral policy, not with social policy like anti-poverty programmes (which have made little overall impact on poverty levels): Without tackling economic inequality, attempts to reduce poverty are like mopping up water from the floor without closing the faucet.

Why does economic inequality matter?

Indicators for life expectancy and health (like infant mortality, obesity, mental illness) and social problems (as homicides and imprisonment, teenage births) are worse in more unequal countries.

But economic inequality is also bad for social cohesion, women's status and democracy, as recognised by Barack Obama, 4 December 2013: "*Rising inequality and declining [social] mobility are also bad for our families and social cohesion - we [....] trust our institutions less [and] trust each other less when there's greater inequality*."

Finally, in view of preserving the world for future generations, more equal societies promote the common good more (more recycling, more foreign aid, higher score on the Global Peace Index) and are more vocal for international environmental agreements.

Why would I care - I belong to the richer part of the population!

The effects of inequality are not confined to the poor - they affect the vast majority of the population: It has been shown that Sweden, as a relatively equal country, has lower death rates in its lowest occupational classes than the more unequal England and Wales have in their highest occupational classes. This means that, while the effect of inequalities are felt hardest by the poorest, outcomes as compared to more equal countries with a similar GDP are worse even among the better off: Inequality damages the whole fabric of a society, by increasing social divisions, status anxiety and status competition. Although the scale of differences varies from one outcome or social problem to the other, all of them are between twice to ten times as common in more unequal societies as compared to more equal ones.

Is economic inequality somehow connected to growth?

For a long time, policy makers assumed that economic growth would take care of economic inequality. However, in the last decades, growth in advanced economies has disproportionally been benefitting higher income groups at the expense of lower income households. In addition, it is getting clearer that higher economic inequality is also bad for future economic growth (for a more in-depth discussion see this briefing).

Higher inequality may be related to higher household debt levels, which may first lead to large financial instability and later adversely affect investment, consumption and overall growth. Further, higher inequality also hurts the long term potential of an economy. One reason is that poorer members of a society are less able to invest in their education (a key driver of growth), thus wasting their potential and lowering social mobility. Finally, higher inequality goes along with higher unemployment levels, which are also bad for growth potential: the unemployed do not contribute to the productive process but rather increase pressure on the fewer working; they consume less; and the longer their unemployment patches, the higher their skills loss, which is determinant of future poverty.

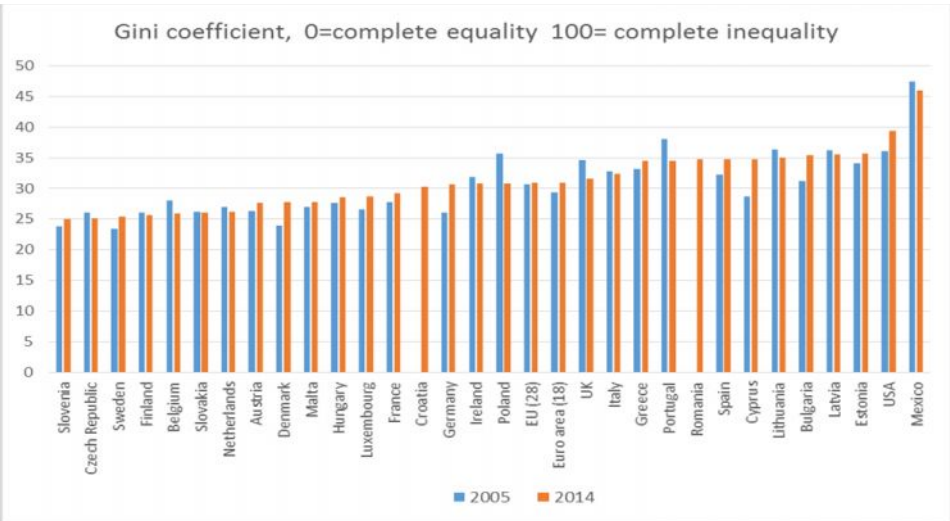
RECENT DEVELOPMENTS

How big is inequality really today?

The widening income inequality in the last decades is showcased by the increase in the Gini coefficient, which rose on average across OECD countries from 0.29 in the mid-1980s to 0.32 in 2013, because of the increase in income inequality in most OECD countries.

However, inequality varies considerably across developed countries, and looking only at figures for the EU as a whole can be misleading as the practically stagnant EU Gini coefficient hides considerable differential developments in EU Member States.

The following figure depicts the change in the Gini index between 2005 and 2014 in the EU Member States, the EU as a whole and the Euro area, as well as the US and Mexico for comparison, in order of rising level on inequality in 2014.



For other graphical depictions of the state of inequality, see Robert Reich (on the USA, which is a more unequal country than any EU Member State), or these two graphs from Pavlina Tcherneva comparing the distribution of income growth in the USA and Sweden.

A concrete example about the growing gap between the rich and the poor can be gleaned from a 2015 Oxfam report, which showcases that in highly equal Denmark, between 2003 and 2012, the average wage of a CEO increased by 23.3 percent. Over the same period, workers (both skilled and unskilled) received wage increases of only 0.5 percent. In the US, between 1976 and 2007, the top 1% have absorbed 60% of income growth.

Why has the gap grown so wide in the last decades?

There have been factors narrowing the gap such as

- an **increase in education**
- a **growing female employment participation**,

but other factors have rather widened the gap, such as

- **Changes in employment** patterns, working conditions (gradual decline of standard full-time jobs) and collective bargaining,
- **Weaker redistribution** via the tax/benefit system,
- A **skill-biased technological change** through crowding out routinized work (e.g. through replacement of manual labour by capital-intensive machines) due to globalisation and technological development. In addition, the sectors which have grown most in the last decade, namely health, education and social services, are confronted with the "cost disease" phenomenon. When trying to get them to operate more efficienty, there are basically three options. Either reducing quality (bigger classes in school, less time for each patient in hospital), or requiring tax payers to pay more for these services, or adding more technology. Adding more technology requires hiring more skilled personnel, which puts the less skilled people out of work. All of these solutions are in their way bad for inequality.

To a lesser degree, **changing family structures** have also widened the gap through people's tendency to marry within their socio-economic group ("assortative mating") and more single parents.

Wasn't the economic and financial crisis the main driver of current economic inequalities?

Economic inequality has been rising since the 1970s and is thus a long-term trend; it has risen not only in bad, but also in good economic times. While in the decade before the crisis, market income inequality has stabilised, redistribution was weakening: the rich benefited most from tax reforms since the 1990s but the mass income groups only gained marginally. The rising of economic inequalities at the beginning of the crisis was partially cushioned by redistributive measures ("social safety net"), but these last years market income inequality has kept rising while this cushioning effect has become weaker due to fiscal consolidation measures (e.g. cuts in expenditure on social services, which had a worsening impact for achieving more equality). We are currently at a crossroads because if the root causes of inequality are not addressed, fiscal consolidation measures resulting from the economic crisis could only result in higher levels of inequality, given that the drop in income during the crisis was larger for individuals at the bottom of the distribution than for those at the top.

WHAT TO DO ABOUT ECONOMIC INEQUALITY?

Doesn't growth take care of inequality?

The problem is that if growth occurs, it does not trickle down to the bottom 40% in an unequal society: newly created jobs are typically not in the bottom of the distribution. Put differently, the more equal a society is, the more probable it is that all parts of its population will gain from economic growth. Reducing inequality and bolstering long-term economic growth are thus two sides of the same coin.

Isn't it enough to strive for equality of opportunity?

While most people agree that everybody should have equal opportunities in life, i.e. the same chance to move up the social ladder through education and employment, the reality is that parents' educational background and their wealth predetermine their children's school outcomes, and also influence their chances for finding stable, long-term jobs. Therefore, the myth of equal opportunities is not enough to combat current levels of inequalities, but there is a need to also strive for equality of outcome (i.e. we have to narrow gaps in income and wealth). Some authors even hold that it works the other way round - tackling inequality of outcome is a good way to tackle inequality of opportunity: By helping a parent to get a stable job, his/her kid will have a better chance of climbing out of poverty.

Won't redistribution policies hamper growth?

The OECD and the IMF confirm that in developed countries, redistribution through taxes and transfers does not hamper growth. Policy makers should therefore not jump to the conclusion that the treatment for inequalities is worse for growth than the disease itself.

What is already being done to change the current high level of economic inequality?

Reducing inequalities has been included as Goal 10 in the 2015 Global Goals for Sustainable Development: Target 10.1 foresees to progressively achieve and sustain income growth of the bottom 40 per cent of the population at a rate higher than the national average.

Is there a magic bullet for reducing inequality?

No, as many factors are in play and only a policy mix can be successful. As to approaches to prefer, international evidence suggests that it does not matter whether income differences are reduced through a redistribution of taxes and benefits (disposable income equality) or by reducing differences in pre-tax incomes (market income equality).

What else can be done to change the situation?

One important thing to keep in mind is that worsening inequality is not "an act of God or nature" but depend on policy decision and laws made in the past (e.g. on trade unions, banks, wages, tax rates...), which in turn are passed by legislators, which in turn are elected. So things can also be changed again through government or legislative action. The most often called for measures are the following:

- **Promote employment and good-quality jobs,** as "having a job" is no protection against poverty any more, given that the higher levels of growth could only be achieved at the cost of a large low-paid sector and thus increasing in-work-poverty. Here, introducing minimum wages would act as a protection mechanism for the bottom part of the distribution, but, at given minimum wage levels, this would neither provide protection against low wages nor suffice to eradicate in-work poverty. Further, more and more people are in non-standard work, which is associated with substantial wage penalties at the bottom part of the distribution, which should be addressed. Further, while labour market segmentation rather entrenches inequality by cementing the position of "insiders" and "outsiders", an ideal policy mix in labour market regulation should not focus on making only the hiring process more flexible, but should also enable easier moves e.g. from temporary to permanent jobs during the career. It should further target workers faring poorly across several dimensions (earnings quality, labour market security, quality of the work environment), namely young and low-skilled workers.

- **Improving social dialogue and industrial relations,** because declining Trade Union coverage has a disequalising effect on wage distribution, and because countries with more centralised wage-bargaining systems report lower inequality indices.

- **Foster women's participation in economic life,** as women's lower labour force participation, the typical sectors they are employed in, the higher likeliness to interrupt their career due to childbearing, their propensity to work in non-standard work (e.g. temporary or part-time jobs) and their earlier retirement lead to a severe gender pension gap of 39%, which is significantly larger than the gender pay gap of 16%. Policies should thus focus on including more women into the labour market in general, and more specifically on increasing the earnings potential of lower-paid women to reinforce the equalising effect of women's labour market integration, as well as an even repartition of unpaid work between men and women through e.g. more equal parental leave provisions.
- **Strengthen quality education and skills development,** starting from early childhood through secondary education (as compulsory education reduces poverty by 5% as compared to 0,5% through tertiary education), complemented by incentives for workers and employers to further invest in skills throughout the career. Access to education has to be made more equal, by opening education systems and sorting students at a much later stage.
- **Improve the design of the tax/benefit system for a more efficient redistribution,** through addressing tax havens to curb tax avoidance (which does not only increase inequality but also engenders a higher proportion of public expenditure to be funded by tax payers in the lower income group). Further approaches consist of broadening the tax base and increasing the progressivity of the tax system for both income and wealth, especially inherited wealth, so wealthier individuals and multinationals contribute their share. However, policy makers have to be aware that the redistributive policies of the mid-20th century are more difficult to implement nowadays because globalisation has made it harder to tax mobile capital and people.
- It also entails a **rethinking of social budgets**, which should not be curtailed in times of crisis but rather be counter-cyclical, because the objective need for support is bigger during a downturn and income losses need to be prevented from becoming entrenched. Introducing a basic social income is a further suggestion, although some experts fear that this could rather exacerbate inequality.
- **Support forms of economic democracy** such as employee ownership, employee representation on boards, mutuals and cooperatives.
- **Integrate immigrants better**, as the problems faced even by second and third generation immigrants are telling. EU Member States have to learn from the best performers here, on one side for coordinating the flux better (criteria for immigration), on the other hand for managing immigration downstream, notably to get immigrants out of specific schemes and to integrate them as quickly as possible in the regular labour market.
- **The European Semester Macroeconomic Imbalance Procedure Scoreboard could include an indicator on income inequality** with corresponding recommendations for fiscal, investment and sectoral policy, to keep an eye on the situation. The corresponding indicators in the Joint Employment Report and the Social Protection Committee's list of social indicators (income quintile ratio S80/S20) could thus be "upgraded" to an economic indicator with consequences for economic policy making.
- **Structural policies for more growth** have to be complemented by a better distribution of the growth-dividend than in the past in order to implement policies which are growth-friendly at the same time than reducing inequalities because the position of the bottom 40% matters most for economic growth. Policy thus needs to be directed towards the bottom 40%.

Policy makers should keep in mind that reversing inequality is not only a question of fairness, but vital for people's health, the cohesion of our societies, for the survival of democracy and, last but not least, it makes countries richer.

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CONTACTS

Policy Department A: Economic and Scientific Policy
ECON - ENVI - EMPL - IMCO - ITRE - TAXE
poldep-economy-science@ep.europa.eu

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