DOI: 10.1007/s10272-009-0311-1

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Why Europe Needs a Policy on Inequality

Economic inequality within EU countries is characterised by large and persistent differences. In the mid-2000s the distances between nations were of a very significant magnitude, with a clear divide, for example, between Northern and Mediterranean countries. More precisely, in Germany, Spain, Greece, Ireland, UK, Italy, Poland and Portugal the Gini coefficient on disposable income was around or well above the threshold of 0.30. Denmark and Sweden, on the other hand, remained the least unequal advanced countries, with Gini values of around 0.23.[1]

Despite these differences and in line with worldwide tendencies, almost all EU countries have experienced a worsening of economic inequality over the last 25 years. The preceding general tendency towards a narrowing of disposable income distribution started to be interrupted in the early 1980s giving way to a generalised increase in inequality. This increase, although characterised by differences in timing and magnitude and often a consequence of abrupt but unreversed changes, has been particularly strong in Finland, Norway, Germany, Portugal and Italy, as well as in the USA. A rise in income shares by the top quintile of the income distribution (the richest 20% of households) has been a key determinant of greater inequalities over the last decade in Finland, Norway, Sweden, Denmark, Germany, Austria and Italy, as well as in the USA and Canada. In the last twenty years, the average annual growth of the real income of the top quintile has been twice as large as that of the bottom quintile (the poorest 20% of households) in Finland, Sweden, the UK, Germany and Italy, as well as in the USA.[2]

The recession that followed the international financial crisis of 2008 is likely to further exacerbate income inequalities and increase the problems of unemployment and poverty in many European countries, making even higher the already high social costs of inequality.[3]

Inequalities in disposable income are the result of extremely complex processes involving all the markets, the redistributive activity of the welfare state and a series of social variables, including the composition of households, gender disparities, ageing of the population and immigration. It is not easy to evaluate the effect of each of these variables but they should be taken into account both in explaining overall inequality and in policymaking. As regards markets different from the labour market, a positive contribution to greater inequality has come in many countries from more concentrated capital and self-employment incomes. However, in order to understand recent developments, special attention has to be paid to the labour market and the redistributive activity of the welfare state, also because of their implications for crucial policy issues at the EU level.

In the last decade wage dispersion among workers increased in many countries. This tendency is mainly due to two key phenomena. The first is the pronounced increase, in several countries, in the earnings of the richest workers, to which top managers also belong. More generally, there has been a marked but not uniform increase across nations of the share of income going to a very small number of rich people (the top incomes) who can be classified as workers (even if of a special type) and not capitalists. This is a new phenomenon and under several aspects a very interesting one.

The second phenomenon concerns atypical workers, i.e. part-time, temporary and outsourced workers, earning low and intermittent wages, who significantly contributed to widening inequality especially in those countries where they are the greatest in number (Italy, Spain, Ireland and Germany). Such workers are also responsible, at least partially, for the quite disturbing presence of working people in the lower tails of the distribution, the "working poor". More than disturbing is the consideration that such workers are often well endowed with human capital.

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[1] These data are taken from OECD: Growing Unequal? Income distribution and poverty in OECD countries, Paris 2008. Other studies obtain very similar results using different datasets: A. Brandolini, T. M. Smeeding: Inequality: International Evidence, in: S. N. Durlauf, L. E. Blume: The New Palgrave Dictionary of Economics, Basingstoke 2008, Palgrave Macmillan; M. Giammatteo: Economic Inequality of Europe, mimeo, March 2009.

[2] OECD, op. cit., pp. 27-31.

[3] ILO: World of Work Report 2008, Income Inequalities in the Age of Financial Globalization, Geneva 2009.

Both these and other tendencies have made for a pattern of changing distribution in labour income much different and more complex than the story told by the Skill Biased Technical Change hypothesis, which simply predicts a widening gap between skilled and unskilled workers.[4]

The overall effect has been a substantial stability of the average labour compensation in many countries while a growing share of European workers has experienced a decline in real wages. The proportion of the European workforce with a labour compensation per hour (wages plus social contributions) declining in real terms was 16.5% in the years 1996-1999 and 33% in 2003-2006. Moreover, 48% of the workforce during 1996-1999 and 61% during 2003-2006 saw their labour compensation per hour growing, on average, less than their labour productivity per hour. In the latter period, 23% of the workforce faced declining compensation with increasing labour productivity in their industry.[5]

Coupled with the low dynamics of labour productivity or the limited ability of labour to appropriate a significant share of productivity gains, such tendencies have resulted in a sharp increase of the profit share in the functional distribution of income. This change itself had an impact upon personal distribution of income. Since profits are usually less evenly distributed than wages, when their share in national income increases personal income inequality tends to increase as well.

Higher wage dispersion in the labour market has very likely weakened the positive effect of growing employment which several countries experienced in the years preceding the 2008 crisis. Higher employment usually reduces disposable income inequality especially when it is coincident with an increase in the number of workers in relatively poor households. However, due to the counteracting effects of greater wage dispersion, the inequality reducing effect of employment has not been significant in many EU countries.

The state, acting through taxation, social transfers and the provision of in-kind services can exert a strong influence upon disposable income distribution. To estimate how much such activities reduce the Gini coefficient is not an easy task. In particular, it is a really big problem to establish the redistributive effect of in-kind services. Anyhow, according to the most accurate studies, national experiences differ widely: Nordic welfare states are very effective in reducing market income inequality while a much weaker redistribution takes place in Mediterranean countries. In the last two decades the general tendency seems to have been towards a reduced redistributive effectiveness of national welfare states, despite significant differences across countries and over time.[6] A rather general conclusion could be that inequality first worsened because of adverse market developments and then it remained high because of weaker or not compensating redistributive policies.

Inequality in Europe as a Whole

In the above we have analysed inequality "within" EU countries. This inequality is an important element but not the only determinant of inequality in Europe as a whole. Indeed, the latter also depends on inequality "between" countries or "between" EU regions.

The best way to capture both these effects is to measure inequality in Europe as if it were a single country. Unlike "within countries" inequality, there are very few attempts to estimate overall inequality in Europe. This is easy to explain. The measurement of inequality at a supernational level poses several difficult problems: how to convert various national incomes to a common currency, how to compare purchasing power, which equivalence scales to make use of and so on.

The solution adopted may influence the results. According to one study[7] inequality in the EU is quite high but lower than in the USA: the Gini index is (with reference to data around 2000) 0.33 in the EU25, while it was 0.37 in USA.

A more recent estimate based on a different methodology and on more recent data (2005) concludes that inequality in Europe is significantly higher, and not much different from that of the USA: the EU-wide Gini coefficient is 0.369, not very far from the US level of 0.372.[8]

Even if such figures need further refinements, they still support the conclusion that Europe as a whole, and not only some specific country within Europe with Anglo-Saxon features, is characterised by high inequality. It is therefore very difficult, on this ground, to

[4] L. Nascia, M. Pianta: Skill bias or polarisation? Innovation and job growth in Europe, paper for the EAEPE conference, 6-8 November 2008.

[5] F. Bogliacino: Poorer Workers. The Determinants of Wage Formation in Europe, in: International Review of Applied Economics, Vol. 23, No.3, 2009.

[6] OECD, op.cit., ch. 4.

[7] A. Brandolini: Measurement of income distribution in supranational entities: the case of the European union, Temi di discussione n. 623, Bank of Italy, April 2007.

[8] M. Giammatteo, op. cit.

identify a clear-cut difference with respect to the USA, despite frequent claims to the contrary.

There are several reasons for arguing that inequality should be looked at from an EU-wide perspective rather than from national ones.

First of all, even if inequality within each country falls, the overall inequality at EU-level may very well increase. This happens if average national incomes tend to diverge so that a reduction in the dispersion of incomes around the national averages is not conducive to less overall inequality. In other words, higher between-countries inequality may cancel out the positive effects of a lower within-countries inequality. By adopting an EU-wide perspective it is possible to take both types of inequality into account. Indeed, in order to reduce inequality in Europe as a whole it is necessary to lessen the distance between the richest and poorest in the whole area, not only between rich and poor in each country.

Targeting inequality in Europe as a whole allows the treatment of two of the most important EU policies in a much more integrated way: social policies aimed at reducing within-countries inequality and regional policies concerned with disparities between countries.[9] In more general terms, as inequality is affected by many factors, a much larger set of EU policies could be evaluated with regard to their effects on overall inequality in Europe. Today, the implemented policies are likely to have a negative impact, though unintentionally, on EU inequality.

A second reason in favour of a unified European perspective on inequality is its symbolic as well as practical implications for a deeper economic and social integration. It could strongly enhance the view of Europe as a single entity and of the EU as a body with a special concern for social cohesion in the area as a whole. Indeed, it is rather disappointing that EU-wide inequality does not play a leading role in the evaluation of EU policies on social cohesion. The national approach to these issues should be corrected so as to make it clear that Europe cares about social cohesion on a truly European supernational level. A less unequal Europe, different by far from less unequal European countries, is an important political objective as well as a condition for the achievement of other well-established policy objectives. A less heterogeneous Europe seems to be both a condition for, and a result of, deeper economic and social integration.

The above considerations show how the emphasis put on EU-wide inequality may have important implications, independently of extensive institutional changes. Inequality at a supernational level can be reduced even without a stronger supernational policy, provided that proper relevance to policymaking is given. However, and this is the third reason in favour of a European approach to inequality, a more coordinated policy could strongly enhance the effectiveness of a large set of measures against inequality.

A closer coordination among decision centres at both national and supernational levels may help to strike a better balance between institutional competition and harmonised policies. As far as inequality is concerned the need for harmonised policies looks quite strong – stronger than with respect to economic growth – and the EU could play a crucial role in favouring such policies. Our analysis above suggests that the effectiveness of welfare state redistribution may take advantage of a better harmonisation of fiscal policies limiting tax competition inside Europe. Also with respect to those evolutions in the labour market that have negatively affected wage dispersion, a more coordinated policy could have positive effects. However, as stated repeatedly, inequality depends on a vast array of factors and policies and not only on labour and welfare policies. A well-designed set of country-specific and supernational policies may, above all, enable the achievement of lower inequality without sacrificing other important economic and social objectives.

How Much Inequality?

Making EU-wide inequality a policy objective can be justified on the ground that such inequality is high, that a coordinated approach is more effective and, finally, that it can positively interact with the process of constructing a more integrated and homogeneous Europe. However, in order to give priority to a policy against inequality other issues have to be faced. Why is inequality so important? How does it relate to other desirable objectives and in particular to economic growth? Such questions need convincing answers whatever the government level in charge of the policy.

It is not easy to say which level of income inequality is "fair" (and which is the best statistical measure to capture it). However, the present level of inequality in several EU countries seems to be in conflict with the values shared by a majority of European citizens.[10] An

[9] T. Fahey, C. T. Whelan, B. Maître: First European Quality of Life Survey: Income inequalities and deprivation, European Foundation for the Improvement of Living and Working Conditions, Luxembourg 2005, Office for Official Publications of the European Communities; A. Brandolini, op. cit., 2007.

[10] OECD, op. cit.

interesting question is why this apparent intolerance of inequality does not find an institutional and political echo. This issue involves political economy arguments as well as an analysis of the role played by civil society organisations and social movements. Maybe allowing this "voice" to be properly formed and listened to in political and policymaking circles can also help to develop a kind of ethical and institutionalised discourse, making possible a democratic solution to the problem of how much inequality is "fair" inequality.

But in order to establish what is a "fair" level of inequality it is also important to consider some of its implications. Of course, high inequality prevents a significant part of the population from having access to a "decent life"; moreover, too much inequality produces segregation and polarisation which put the "cement of society" in jeopardy, raising misgivings with regards to social sustainability.

Recent studies, going beyond these more direct effects, have argued that inequality is positively correlated to several negative social phenomena (health, crime and so on) in a strong and significant way. Such a generalisation should be taken with caution; inequality, however, seems a much better predictor of these phenomena than average income; in other words many social "bads" are much less frequent where societies are homogenously rich or poor. First explanations of the channels linking these various phenomena to inequality *per se* are being provided.[11]

Another important element to be taken into account is the relationship between high inequality and persistent inequality. The latter can be considered at both intra- and intergenerational level. Focusing on the latter, i.e. on the transmission of inequality from parents to their children, recent research shows that income disparities across generations seem to be correlated to current inequalities, indicating a persistence stronger than expected by the advocates of social mobility through "equal opportunities" and market processes. More precisely, where current income inequality is higher, parents' income also has a greater influence on their sons' labour income. A full explanation of this phenomenon is not available. However, there are some proofs that many economic institutions, not only the education system, are influenced in their functioning by the degree of current inequality, making them more amenable to the intergenerational transmission both of advantages and disadvantages. In particular, there are reasons to believe that the working of the labour markets can be influenced by current inequalities, with better opportunities, given other conditions, for young people coming from richer families.[12] This evidence casts some doubts on the soundness of the common view according to which policies should care only for the intergenerational transmission of inequality, which clashes with the much praised "equality of opportunities", without worrying too much about current inequalities. In fact, if current inequality also influences the mechanisms upon which its persistence across generations depends, the above policy suggestion is doomed to failure. Current inequality seems to be much more important than hitherto believed, also in this respect.

Lower inequality is commonly considered an enemy of economic growth. This is indeed one of the most popular reasons for suspicion of egalitarian programmes. However popular this conviction may be, it does not rest on solid ground. Where inequality is greater, economic growth is not systematically faster. Indeed, we have no clear evidence that a wider economic inequality is favourable to economic growth or that reducing inequality is conducive to slower growth. Nor can we rely on a positive automatic effect of reduced inequality on economic growth. On the other hand, economic growth is not an infallible strategy for reducing inequality. Trickle-down effects are too weak to make a policy aiming for sustainable growth also a policy favourable to the reduction of inequalities.[13] The conclusion to be drawn – which is at odds with the more common opinions on this issue, on both sides of the debate – is that inequality and growth should be considered relatively independent phenomena. A large number of institutions and policies, as well as the structural characteristics of the process of growth, through various complementarities and interconnections, play a crucial role in shaping the growth-inequality nexus. Policies aiming at reducing inequality without hampering growth are, therefore, possible: the problem consists in identifying and positively exploiting these complementarities and interconnections.

Conclusion

Inequality is about the distances that separate individuals and groups living in a society and conveys the idea that societies, at any level, should be concerned with such distances – not only with the worst off. In-

[11] R. Wilkinson, K. Pickett: The Spirit Level, London 2009, Penguin Books.

[12] M. Franzini, M. Raitano: Persistence of Inequality in Europe: the Role of Family Economic Conditions, in: International Review of Applied Economics, Vol. 23, No. 3, 2009.

[13] On the relationship between inequality and growth, see, among others, S. Voitchovsky: Inequality and Economic Growth, in: W. Salverda, B. Nolan, T. M. Smeeding (eds.): The Oxford Handbook of Economic Inequality, Oxford 2009, Oxford University Press.

equality has many dimensions, not only the economic one – predominantly captured by the distribution of income – which has been the focus of the present paper. However, even if we concentrate on the economic dimension, we can identify a series of arguments calling for an explicit and unified European policy against inequality.

Such arguments refer not only to the high level of inequality within several European countries, but also, and primarily, to the high level of inequality in Europe as a whole. Looking at Europe as if it were a single country has several advantages when dealing with inequalities: the effectiveness of existing policies can be enhanced through joint consideration of within-countries and between-countries inequality; further policies based on a better degree of coordination can be devised, and economic and social integration can positively interact with policies targeted to reduce EU-wide inequality.

On the other hand, there are several good reasons for making the reduction of inequality a priority of European policies. High inequality is positively related to a series of social "bads" and may also make the intergenerational transmission of advantages and disadvantages easier. The alleged negative effect of lesser inequality on economic growth is not well corroborated by existing evidence. For all these reasons inequality reduction (and more generally, inequality control) should rate high on the political agenda of Europe as a whole.