European Research Area

EUROPEAN POLICYBRIEF

Inequality: mechanisms, effects and policies

Ongoing

SUMMARY	
Objectives of the research	Main objectives: ➢ understanding the mechanisms and effects of inequality in EU countries; ➢ integrating the economic and social dimensions of inequality also to explain its persistence; ➢ suggesting policy measures to reduce inequality and its more negative effects.
Scientific approach / methodology	The analysis has been articulated in three stages: ➢ collection of the relevant data; ➢ elaboration of the data; ➢ theoretical interpretation with a special attention to the policy implications.
New knowledge and/or European added value	The project offers a broad and integrated view of economic and social inequalities. It allows a deep and extensive assessment of the effects of inequality and provides strong motivations for policy intervention. It delineates several policy measures and takes interaction among themselves into account.
Key messages for policy-makers, businesses, trade unions and civil society actors	Inequality cannot be tackled by redistributive policies only (Policy-makers); reducing inequality is not bound to have negative effects on growth and competitiveness (businesses); cultural attitudes making for inequality tolerance should change (civil society actors); sustaining innovation may reduce inequality (trade unions).

Objectives of the research

The general aim of the project was drawing together different dimensions of inequalities in a coherent framework that allows a deeper understanding of its complexity and helps to identify effective policy action. This in order to fill a major gap in the current debate, due to the fact that the economic and social mechanisms producing polarisation and inequality have been generally dealt with separately and paying limited attention to their interaction. More precisely, highlighting the role that economic and social variables, as well as political process, play in determining economic inequality and its persistence has been a major goal.

At the policy level, after clarifying why we need an inequality-reducing policies in many countries, the main objective has been to broaden the view as to the more appropriate measures. In particular the limitations of mere redistributive policies have been analysed. It has been advocated a more articulated and integrated approach paying attention to a whole set of economic and social policy tools that may be effective in making inequality a more tolerable phenomenon.

Scientific approach / methodology

The project has been developed both at theoretical and empirical levels. The basic methodology consisted of collection of data; use of appropriate quantitative techniques to highlight correlations and causal relationship between various phenomena; interpretation of the results on the basis of the best theoretical models available in the literature or, when needed, on the basis of models developed within the project; integration of the results and interpretations of various phenomena in a more general; working out of the policy implications, especially with reference to economic inequality.

As regards the collection of data we also produced some original dataset; for the elaboration we made use of several quantitative techniques – from micro and macro-econometric methods to cluster analysis. Theoretical analysis was carried on also on the basis of original models relatively to specific issues. In particular, we made use of a Computational General Equilibrium model to assess the influence of trade and technical progress on wage dispersion; we developed a political economy model in order to highlight some conditions on which welfare state policies may depend; we offered a theoretical explanation, based on individual behaviour, of how social networks may make inequality a persistent phenomenon.

New knowledge and European added value

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. Poverty and inequality are different phenomena. In this Policy Brief we address the latter. Inequality, however, is not a simple concept. Distances can be measured in several different dimensions and as a consequence inequality can refer to rights, capabilities, income, well-being and so on.

The INEQ project focussed mainly, but not only, on income inequality: Income is important but many relevant social distances are not reflected in, and do not depend on, income inequality. Nonetheless it is a dimension of inequality that cannot be neglected.

Usually, inequalities are measured at national level and the political debates are predominantly about "within countries" inequality. However, especially in an era of globalization, "between countries" inequality as well as direct measures of "global inequality" in interconnected areas are particularly meaningful. This applies not only to developed and developing countries but also to the advanced and emerging market economies of the EU, to which this Policy Brief is primarily addressed.

EU countries show large and persistent differences in economic inequality. The distance between Northern and Mediterranean countries are, almost without exception, of a very significant magnitude. In several countries (notably Germany, Spain, Greece, Ireland, Great Britain, Italy, Poland and Portugal) the Gini coefficient is around or well above the threshold of 0,30. Income inequality has widened in most European countries during the last two decades, according to almost any accepted measure. In no country has it significantly decreased. France, Ireland and Spain (up to 2000) experienced a limited reduction in their inequality as measured by the Gini coefficient. These findings look quite robust, despite limitations regarding the quality of the data. These developments raise deep preoccupations and the coming recession could make the picture even more worrisome.

It is not easy to say which level of income inequality is the "fair" (and which is the best statistical measure to capture it) nor do we know precisely how inequality influences other desirable economic goals, especially growth. However, the present level of inequality in several EU countries seems in conflict with the values shared by a majority of European citizens, as the recent OECD Report on *Growing Unequal* has also argued. Moreover, it prevents a significant share of the population from having access to a "decent life".

The possibility of arguing that observed income inequality in the more unequal countries is the result of processes which preserve the much praised equality of opportunity (and therefore it is compatible with this notion of equity) is practically nonexistent, as shown especially by the high measured degree of inequality transmitted from fathers to sons. Looking at current and intergenerational inequality a further reason for concern arises: the countries with higher current inequality seem to be the same where the intergenerational transmission of inequality is higher. This suggests that fighting current inequality may help to make social mobility a more concrete phenomenon and reduce a particularly disturbing feature of inequality: its persistence. Too much inequality produces segregation and polarization which put in jeopardy the “cement of society”. This implies the much debated disappearance of the middle class – which the data in many cases are not able to confirm – raising preoccupations precisely on the ground of its social sustainability.

For all these reasons inequality reduction (and more generally, inequality control) should rate high on the political agenda.

Concern for economic growth is not a good reason for rejecting this conclusion. Where inequality is larger, economic growth is not systematically faster. Indeed, we have no clear evidence that a wider economic inequality is favourable to economic growth, so that reducing inequality is conducive to slower growth. Nor can we rely on a positive automatic effect of reduced inequality on economic growth. The lack of a firm causal relationship between growth and inequality is also confirmed in the computer-based simulations conducted within our project. 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 at sustained growth also a policy favourable to the reduction of inequalities.

The conclusion to be drawn – which seems different from the more common opinions on this issue, on both sides of the debate - is that inequality and growth should be considered as relatively independent phenomena: other institutions and the structural characteristics of the process of growth may play a crucial role in shaping the growth-inequality nexus. Policies aiming at reducing inequality without hampering growth should be able to identify and positively exploit these complementarities and interconnections. This is their ideal starting point.

Economic and social inequalities are the outcome of complex mechanisms and processes. Those mechanisms cut across markets, society and policies.

Briefly, income inequality within a country is the result of mechanisms involving first of all labour markets. Here both the distribution of gross income between wages and profits and wage dispersion at individual level are determined. Other markets contribute to what is normally called market income inequality, which refers to households income before the redistributive action of the State: capital markets and self-employment are most important in this respect. Market income inequality depends also on social variables: how the households is composed of, the number of workers per households, gender disparities and so on. From market income we can go to disposable income inequality taking account of the Welfare State, acting through taxation and social expenditures, both monetary and in-kind expenditures. It is to be stressed that there are recursive effects among these abstract phases of the process that leads to disposable income inequality. For example, Welfare State expenditures in education may alter, in the medium run, the supply of skilled workers and this, in turn, may change the degree of wage dispersion in the labour market. Going back to this market we observe that in the last decade wage dispersion among full-time workers increased in many countries (France, Finland and Ireland are the exceptions) mainly as a consequence of rising earnings among the richest workers. This tendency is a manifestation, to some extent, of a distinguishing phenomenon of recent years: the very pronounced increase, in several countries, in the share of income going to a very small number of rich people (the top incomes) who, unprecedentedly, can be classified as labourers (even if of a special type) and not capitalists.

A complete picture of the level and the tendency of wage inequality should take account not only of full-time workers but also of atypical (part-time and temporary) workers. Such workers significantly contributed to enlarging inequality especially in those countries where they are greatest in number (Italy, Spain, Ireland and Germany). Such workers are, at least partially, responsible for the quite disturbing presence of working people in the lower tails of the distribution, the so-called working poor. More than disturbing is the consideration that such workers often embody a high level of human capital.

Employment is a crucial elements for the relationship between inequality in personal earnings and inequality in overall households income. Higher employment will reduce the latter type of inequality in so far as it is coincident with an increase in the number of workers in relatively poor households. In recent years the inequality reducing effect of employment has not been significant in many EU countries, therefore a large part of earnings disparities has translated into households income inequality. On the other hand, capital and self-employment income became more concentrated in the last decade in many countries. This made for a larger inequality in overall market incomes at households level.

As said above, other developments at social level that can impact upon market income disparities are: how households are composed of, gender disparities, ageing of the population, 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 policy making.

The last step to be considered is the redistributive activity by the Welfare state. Also in this respect national experiences differ widely: Nordic Welfare States are very effective in reducing market income inequality while much weaker effects seem to take place in Mediterranean countries. Recent tendencies are for a rather generalized weakening of the redistributive effectiveness of the Welfare State, but not in three major European countries: France, Germany and Italy. These results should be taken with special caution because of the substantial neglect – due to extremely complex computation problems – of in-kind transfers.

On the basis of this brief survey we come to the conclusion that from a general point of view inequality has been adversely affected by development taking place in all the relevant spheres and in all the markets. Which lies at the root of such developments?

Increasing wage dispersion is commonly traced back to globalization (trade effects, in particular), innovation (rising the skill premium) and new institutions in the labour market – especially those favouring higher flexibility – usually introduced as a necessary response to the new international scenario set by globalization. In our research we found that national experiences are not homogenous, with trade and FDI effects that seem to be more significant in some neighbouring countries. Although in general it is very difficult to disentangle these effects from each other, in some studies of our project we found evidence that “internal” factors of reforms – such as in particular price liberalisation and also privatisation – were more relevant than globalization factors in accounting for the rising trends of inequality in the EU neighbouring countries.

Moreover we found that the relationship between innovations and inequality is a much more complex story than the one told by the so called Skill Biased Technical Change (SBTC). It is misleading to think of technological change as an undifferentiated process and to expect a general upskilling to take place as a result of it. What we found, rather, is a strong increase in the polarisation of the professional structure of employment in Europe, jobs have been offered mainly to managers and professionals and to unskilled manual workers, while job losses have mainly concerned clerks and craft manual workers. Within European industries, higher wage polarisation is found in industries with strong innovation (in particular new products and new markets) and high shares of workers with university education. Wage compression is associated to the diffusion of new technologies (in particular the adoption of new machinery) and to high shares of workers with secondary education. Finally, a fast employment dynamics favours wage disparities. We also found that multinational strategies, especially in some countries, may exert an important influence on wage disparities.

We have explored the role of technological change in supporting the growth of wages and profits, beyond the role played by productivity growth; we have found that different types of innovation contribute in distinct ways to factor incomes; while profits benefit from both the market expansion provided by new products and the restructuring and cost-cutting resulting from new processes, wages are sustained by the innovative expenditure devoted to high skill researchers and technicians only.

In Europe, therefore, a major problem is found in the ability of labour to capture an adequate share of the productivity gains, often resulting from technological change or international production systems. In fact, 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. These patterns and the mechanisms identified in our research suggest that the role of technology and international production is embedded in particular labour market institutions and in the balance of forces between workers and employers. The combination of these factors has led to a reduced ability of wages to capture productivity gains and to a worrying diffusion of real wage decline in large parts of European economies. This is a major force behind increasing inequalities and social problems, and need to be addressed by national and European-level actions.

In order to understand developments in the labour markets of relevance to the generation of inequality attention is to be paid also to the significant reduction of the labour share in GDP, which took place in many countries over the last two decades (even though the phenomenon lessened and also reversed in more recent years in some countries). This change in the functional distribution of income can be the result of significant changes in labour relations. It has an impact upon overall inequality because usually profits are less evenly distributed than wages, so that when the share of the latter declines personal income increases, other things remaining unchanged.

The weak or declining redistributive effect of the Welfare State can be traced back, at least partially, to the rather successful idea that progressive taxation is an obstacle to economic growth in a globalized world. A reinforcing factor may have been the bad design of social expenditures and the adoption of not always effective selective measures, based on means-testing.

Key messages for policy-makers, businesses, trade unions and civil society actors

On the basis of the preceding analysis of the principal features of economic inequality and its mechanisms we can now identify a set of policy which can positively reduce inequality while hopefully not undermining the potential for growth in the economy.

Let us start with measures that can reduce market income inequality. The first measure to be considered is higher employment. As said above employment can, in principle, reduce inequality if the number of earners increases in poorer families. This is not an assured outcome. Moreover relying on employment only means that the phenomenon of the working poor is not addressed and the problems posed by atypical workers are overlooked. This is not to deny that employment is important. But employment that may raise the lower wages is definitely more important.

In this respect giving support to those innovations that may increase productivity and lift up – with the help of appropriate labour relations - the whole distribution of wages should be considered a priority also as an inequality-reducing policy. Our analysis offers more than one motivation to such policy. This proves too that inequality is the result of several factors falling in the realm of very different policies.

The emphasis we put on innovation along with the missing proof that globalization has definitely worsened wage inequality leads to disregard any form of protectionism as a useful policy against inequality. On the contrary, a closer scrutiny of the impact of certain types of "external" flexibility seems necessary in order to reduce some negative effects this flexibility may have had both on inequality and innovation. In many countries it has also created a kind of segmentation in labour markets which is hardly acceptable also independently from its effects on income inequality. Many workers bear a heavy burden in terms of economic risks and this may easily conflict with efficiency. More security should be introduced in several countries, but also the role and functions of flexibility may deserve a reconsideration, to magnify their positive effects and eliminate the negative ones, especially those related to segmentation.

It is also important to design a better system for allowing productivity increases to be shared among a larger set of individuals with positive effects on the share of wage on GDP which may favour a more equal distribution of personal incomes.

To make markets more friendly towards equality, we need also measures that reduce the degree of imperfections in the credit market which prevent deserving people from overcoming their liquidity constraints. This could also enhance social mobility, provided that risks are carefully scrutinized and shared.

Let us now consider redistributive policies which reverberate their effects also on the labour market. Personal taxation and family benefit system should be improved taking into account also the effects that the reform could exert on incentives to work and to save. In many countries, a more progressive tax rate profile combined with tax allowances and family benefits could help a lot in achieving a better mix of equality and growth.

Family benefits may have a key role in helping families cover maintainance and education costs of children and offering more equal opportunities to them (as the experience of some countries suggests). Negative income tax schemes can have a role to play in this context, because they can support low incomes without distorting too much the incentive to work.

On the social expenditures side the priority should be a careful restructuring which makes social policies more effective in improving the living conditions of a large number of families. In order to promote gender equality a number of services for citizens – especially children and the elderly – should be developed. In this realm a clear priority is a well designed housing program. In some cases, co-payments, carefully designed, could be considered so to avoid a too heavy financial burden that several countries may not be in a position to bear.

Pensions may be the object of measures, at least in some countries, that make them more in line with a conception of equality over the life cycle. In view of achieving an equitable and efficient risk sharing, pensions should not be significantly exposed to the vagaries of financial markets.

Unemployment subsidies should avoid any form of discrimination among workers (which are hardly tolerable in a few countries) and should be designed so to avoid negative incentive effects, which are the less likely the more attractive are the jobs offered in the labour market. Innovation policies may have a role to play also in this respect. The few European countries that have not yet introduced a universalistic measure of support to poor people should soon correct this unjustifiable deficiency.

A delicate issue is posed by the working poor. Should their income be integrated with a public subsidy? Would this not be translated into a lower wage paid by firms? Could a newly designed minimum wage offer a solution? An alternative solution could come from changes induced by labour market and industrial policies that help to reduce the number of jobs paying such low wages, especially when they are supported by atypical contracts subscribed by graduated workers.

Another thorny issue is whether social expenditures should become more selective by making a wider use of means-testing. While acceptable in principle selective measures face several practical problems at the implementation stage which are to be carefully considered on a case by case basis.

A further issue of concern for the Welfare State – which is indeed a very general policy issue - refers to immigrants, who are bound to become more and more important in determining the degree of economic inequality in Europe.

The education system plays a crucial role under several aspects and especially in ensuring equal opportunities in life. It is to be considered, however, that education – however well designed the system is – may not be sufficient to this end. We found that the family background seems to exert an influence on the economic future of the children which goes well beyond the pure education effect. This suggests that preventing child poverty is more important than trying to reduce its effects by means of an easy to access education system. Moreover, a further reason why education may fail as a social mobility vehicle is the very low income earned in several countries by people with high degrees. This phenomenon can be explained by the weak ability of several economic systems to create an adequate number of jobs for skilled workers. It is the task of industrial policy to rejuvenate such ability.

An encompassing policy directed to reduce inequality and poverty should also address the issue of social networks and their effects on individual behaviour. In many cases escaping from poverty is made difficult by membership in specific groups which may reveal itself as an obstacle to take up the opportunities offered by the Welfare State. This group-dominated behaviour in some cases may be the worse enemy of inequality reducing policies. Special educational programs may be the best response to this challenge.

In designing policies of migration, policy makers should also take into account that migrants from different countries neighbouring the EU appear to follow different patterns of migration and remittances. Often migrants make decisions within the context of the objectives of their household who often still reside in the home country. The analysis conducted shows that remittances are highly sensitive to macroeconomic conditions (e.g. exchange rates and interest rates).

The practical implementation of the suggested policies depends, as usual, on the ability to avoid that details become the devil but, more in general, it may be hampered by several obstacles. We list some of the most important, urging policy makers at various level to take them very seriously.

The first obstacle relates to the need of coordination among different policies.

All the policies we have advocated tend to interact with each other and have contrasting or reinforcing effects on several variables of relevance for inequality. Therefore the design of policies in one sector has to take into account all the possible complementarities and conflicts arising with other policies and should carefully evaluate the fall-out on other elements which are of crucial concern for the overall success of inequality reducing policies.

The second obstacle could be of a cultural or institutional nature. The level of inequality we observe is also the result of what we can call “tolerance” or limited aversion to “inequality”. The reasons why a number of countries exhibit such attitudes are not easy to identify. One reason could be that some people – including those who suffer from inequality - accept inequality as more or less inevitable, because they cannot identify an effective way to escape from it or believe that society is more mobile than it actually is. Another reason, more in line with the opinions expressed by a large number of European citizens, is that individuals' limited tolerance to inequality does not find institutional and political echo. This issue, which involves political economy arguments as well as analysis of the role played by civil society organizations and social movements, has been specifically considered within the INEQ project not only in relation to inequality in the EU but also inequality between the global North and South. Allowing this "voice" to be properly formed and listened to in political and policy-making circles may also help to develop a kind of ethical and institutionalized discourse that may offer a democratic solution to the problem, referred to in the opening of this *Policy Brief,* of "how much inequality is fair inequality".

A third obstacle could come from lack of coordination among decision centres at various level of government, both national and supernational. To overcome this obstacle, the right balance should be found, also at EU level, between institutional competition and harmonized policies. As far as inequality (within countries and between countries) is concerned the need for harmonized policies looks quite strong – stronger than with respect to economic growth - and the EU should play a crucial role in favouring such policies. In particular, programs should be designed so to meet specific and observable targets, and local and national governments should be clearly accountable with respect to them.

In conclusion, inequality depends on the interaction between markets, society and policies. These interactions help to understand why high inequality usually co-exists with persistent inequality and suggest that policy makers develop an integrated approach to inequality, paying special attention to the complementarities or the conflicts that may arise between different measures adopted even policy fields that are not particularly close.

At the European level the very different performances of countries (and regions) - in some cases extremely negative - call for an approach that makes the impact on inequality a more important element for assessing all types of policies. A general conclusion of the research is that in order to make inequality a tolerable – and less damaging – phenomenon redistributive policies only are insufficient. More structural policies - with a significant impact both on markets an society – are needed.

PROJECT IDENTITY

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Further reading	All the research papers and all the WP's Reports are available at www.criss-ineq.org. A number of papers are forthcoming on a special issue of the *International Review of Applied Economics* (May 2009); some papers have been published in Italian in the issue n. 59-60 of the journal *Meridiana;* two books are in preparation.
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