

Income inequality and growth in Europe: key role for national policies

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Key messages

1. The literature is inconclusive whether income inequality is good or bad for growth and job creation
2. Offering opportunity for all segments of the population is crucial and income inequality might reduce social mobility
3. Income inequality in the EU is at a much lower level than in most other parts of the world, but there are differences between the member states
4. National policies for fostering social mobility and more efficient redistribution are crucial
5. EU can do little, beyond highlighting best practices

What is inclusive growth?

- OECD (2014) defines **inclusive growth** as: *“economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society”*
- Measurement of inclusive growth **goes beyond** one-dimensional **GDP** growth
- Jobs, skills, education, health, the environment and active participation in the economy and society also matter
- Inequality of **outcomes** (such as income, wealth, health and education) and **opportunities** (access to education, jobs, finance and the judicial system) are central to understanding how inclusive growth is

Inequality and growth

- **Greater inequality could reduce economic growth:**
 - Greater inequality and financial market imperfections might reduce the capacity of low-income households to invest in education, lowering economic growth
 - Under-investment in human capital by poorer segments of society might reduce social mobility and adequate allocation of talent across occupations
 - Greater inequality might also reduce growth if it leads to political instability and social unrest
- **Greater inequality could increase growth:**
 - If it provides incentives to work harder and take risks in order to capitalise on high rates of return
 - High differences in rates of return for education might encourage more people to seek education
 - Higher inequality could foster aggregate savings and capital accumulation, because the rich consume relatively less
- **The empirical evidence for the impact of inequality on growth is inconclusive**

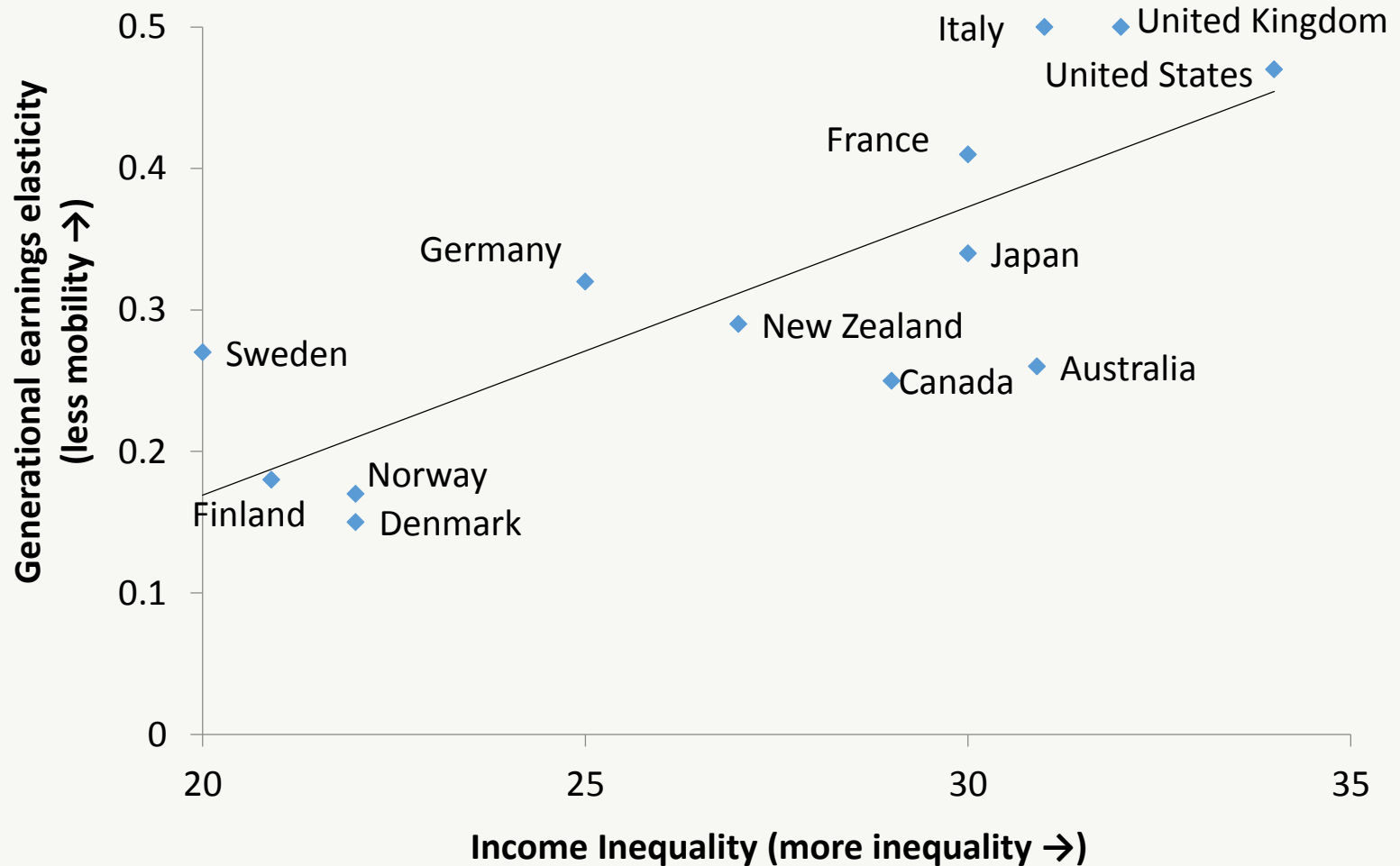
Inequality and protest votes in referenda and elections

- Our econometric estimates confirm that
 - In the United Kingdom's Brexit referendum on 23 June 2016
 - In the United States presidential elections on 8 November 2016
- **greater inequality supported Brexit/Trump votes** beyond socio-economic and geographic factors, such as:
 - Age
 - Level of education
 - Income
 - Unemployment
 - Race
 - Share of immigrants in resident population
 - Geography (in the UK: London, Scotland, Northern Ireland)

Social (or intergenerational) mobility

- Higher inequality is found to be associated with less inter-generational mobility: the children of poor families tend to stay poor, while the children of rich families tend to stay rich
- This association is described by the so-called 'Great Gatsby Curve' – see next slide

The Great Gatsby Curve: more inequality is associated with less mobility across generations



Source: Corak (2013), Figure 1.

Poverty and income inequality around the world

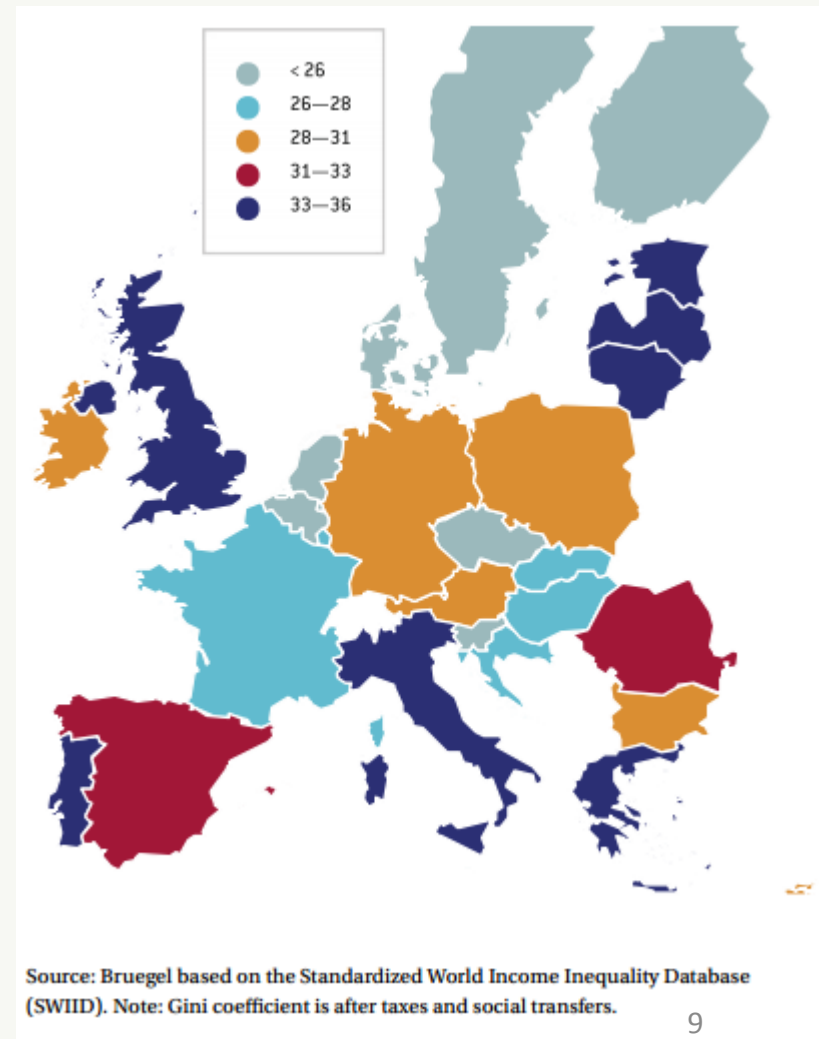
		No. countries	Poverty (%)	Income inequality	Unemployment rate (%)
EU	EU15 (ex. south & UK)	10	0.5	27	7.8
	Southern EU	4	2.3	34	19.4
	United Kingdom	1	0.5	35	6.2
	Baltics	3	1.5	34	9.6
	Other newer EU members	10	1.7	30	10.3
Non-EU	United States	1	1.3	37	6.1
	Non-EU advanced (ex. US)	7	0.3	29	4.8
	China	1	19.3	53	4.1
	Asia (ex. China & CIS)	19	23.6	40	4.5
	Latin America	19	12.1	44	6.9
	Africa	36	72.5	44	12.0
	CIS (former USSR)	10	19.3	35	6.9

Source: Bruegel based on World Bank World Development indicators (poverty), the Standardised World Income Inequality Dataset (income inequality), International Monetary Fund World Economic Outlook (unemployment rate). Note: Poverty refers to the percent of population living below \$2.50 a day. Income inequality refers to the Gini coefficient after taxes and transfers. For each country and indicator, the latest available data is used, which is typically available for 2012 or 2013 for poverty and income inequality and 2015 for the unemployment rate.

Inequality in EU countries

- EU countries, tend to be characterised by *lower income inequality than the US and most emerging/developing countries*;
- Mediterranean countries, Baltic countries and the United Kingdom exhibit relatively high Gini coefficients, while Nordic countries and 'core' continental EU countries are characterised by lower income inequality levels;
- *Europe's social problems widened* with the increase in unemployment and material deprivation in some parts of Europe;
- Polarisation between the *south and the north* of the EU has increased, as well as between the *young and the old*;
- There was *increasing intergenerational polarisation* during the economic crisis years.

Inequality in the EU, average 2000-2014



National policies for fostering inclusive growth

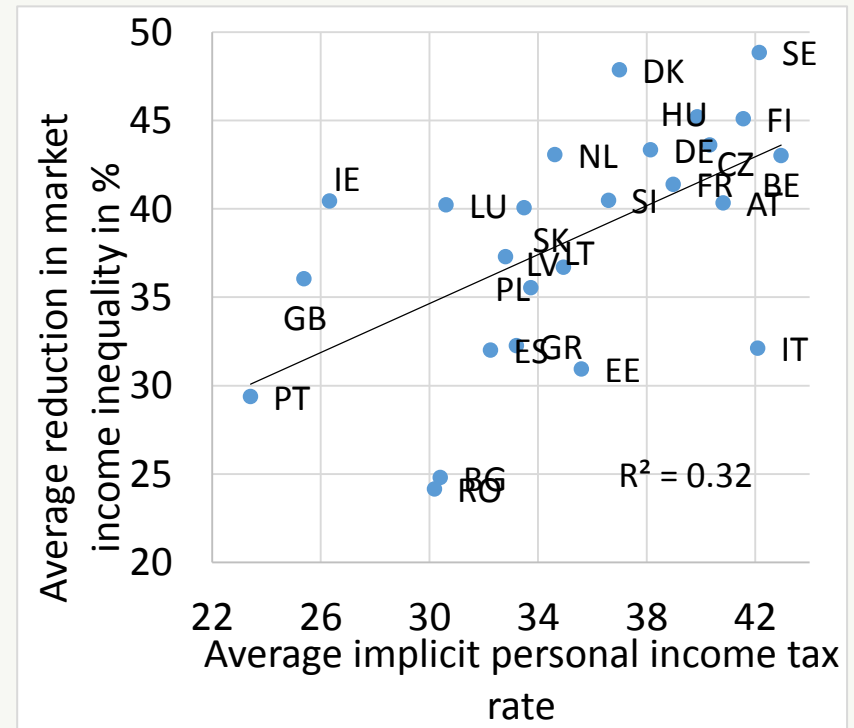
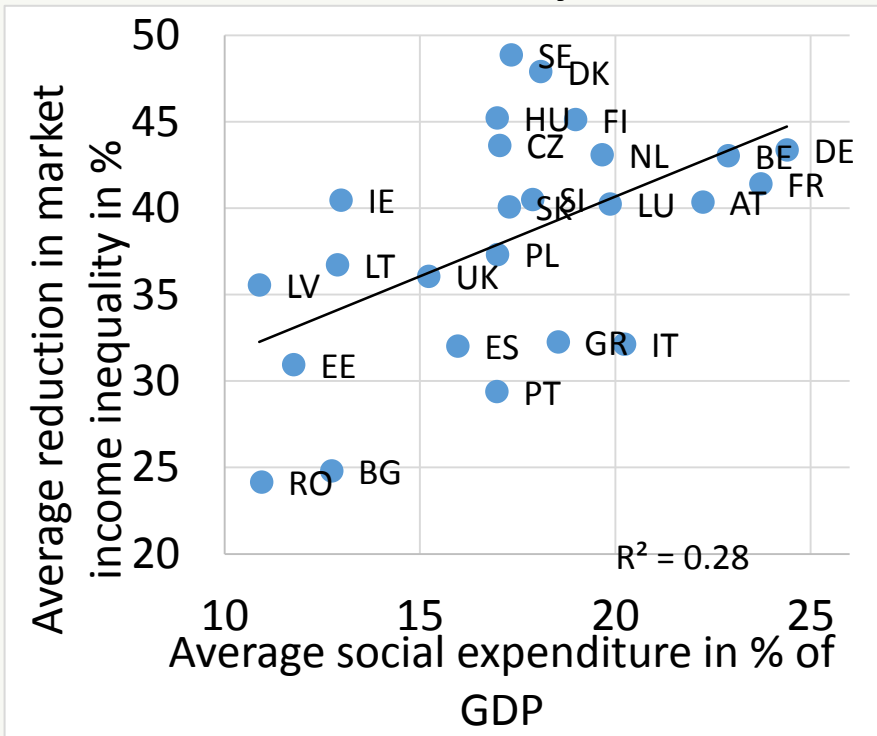
- Tax policy, social policy, labour laws or education policies are almost exclusively national competences in the EU
- National policies:
 1. Adequacy of national policies for fostering social mobility (e.g. education: early childhood education, tertiary education, challenges by robotisation)
 2. Efficiency of national redistribution systems (see next slide)
 3. Extent of redistribution and progressiveness of tax systems
 4. Protection of different sectors / rent seeking
 5. Recent economic policy decisions in the EU and in particular, fiscal adjustment strategies during the recent crisis (see table)
 6. Addressing unemployment

Policies to address inequality and mobility

Efficiency of the redistribution system

Given level of social expenditure can lead to very different reductions of inequality in a cross-section of EU countries. Similarly, taxes on labour income reduce income inequality to different degrees. This suggests that the efficiency of national redistribution schemes varies widely.

Correlation between the reduction of market income inequality thanks to the social redistribution system and two fiscal indicators, average for 2000-14



Fiscal consolidation: Old-age spending increased/preserved, education and family spending cut

General government expenditure by function, % change 2009-2012 (in current prices and constant exchange rates)

	Share EU24	Percent change in current prices, 2009-2012					
		EU24	Greece, Ireland, Portugal	Italy, Spain	9 other EU15	Baltics 3	7 other NMS
Total general government expenditures	100	4	-12	1	6	-3	7
Interest payments	5	23	14	32	19	164	22
Broad services	17	-2	-12	-11	2	-15	-1
Economic affairs	9	-5	-45	5	-6	-20	-4
Environment protection	2	-5	-26	-8	-4	-6	21
Health, recreation	17	4	-20	-7	8	-6	12
Education	11	2	-14	-10	5	-7	8
Old age	20	10	0	8	10	15	13
Family and children	4	0	-19	-10	3	-14	1
Housing	1	12	-30	6	13	23	20
Unemployment	4	0	11	14	-5	13	-11
Sickness and disability	6	7	-7	-1	9	-5	12
Other social protection	5	7	-11	5	9	26	8
Memorandum: inflation		8	6	8	7	12	10

Source: Bruegel using Eurostat's 'General government expenditure by function' (COFOG) database. Note: Belgium, Croatia, Slovakia and Romania are not included because of lack of data; we report data for the aggregate of the remaining 24 countries of the EU (EU24). For the Baltic States, the 2008-12 period is shown, because fiscal consolidation started earlier in these countries. The aggregates for countries with different currencies were calculated using constant exchange rates (the average of 2009-13) and therefore exchange rate fluctuations do not affect the values shown. Broad services include: general public services except interest payments, defence, public order and safety and community amenities.