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## EUROPE'S SOCIAL PROBLEM AND ITS IMPLICATIONS FOR ECONOMIC GROWTH

by Zsolt Darvas

Senior Fellow at Bruegel  
zsolt.darvas@bruegel.org

and Guntram B. Wolff

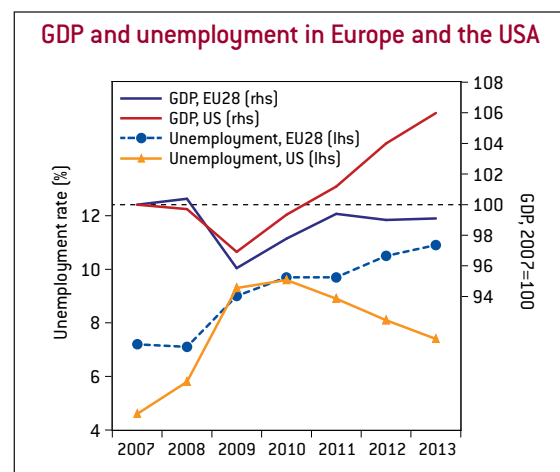
Director of Bruegel  
guntram.wolff@bruegel.org

**THE ISSUE** The European Union faces major social problems. More than six million jobs were lost from 2008-13 and poverty has increased. Fiscal consolidation has generally attempted to spare social protection from spending cuts, but the distribution of adjustment costs between the young and old has been uneven; a growing generational divide is evident, disadvantaging the young. The efficiency of the social security systems of EU countries varies widely. Countries with greater inequality tended to have higher household borrowing prior to the crisis resulting in more subdued consumption growth during the crisis. The resulting high private debt, high unemployment, poverty and more limited access to education undermine long-term growth and social and political stability.

### POLICY CHALLENGE

Policymakers face three main challenges. First, addressing unemployment and poverty should remain a high priority not only for its own sake, but because these problems undermine public debt sustainability and growth. Second, bold policies in various areas are required. Most labour, social and

fiscal policies are the responsibility of member states, requiring national reforms. But better coordination of demand management at European level is also necessary in order to create jobs. Third, tax/benefit systems should be reviewed for improved efficiency, inter-generational equity and fair burden sharing between the wealthy and poor.



Source: Bruegel. Note: rhs = right-hand scale; lhs = left-hand scale.

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EUROPE FACES major social problems. More than six million jobs were lost between 2008 and 2013 in the European Union, increasing the number of unemployed people to more than 26 million and an unemployment rate of almost 11 percent in 2013, the highest in more than two decades. Poverty, as measured by the share of severely materially deprived people, increased to 9.9 percent by 2012<sup>1</sup>. Income inequality, as measured by the Gini-coefficient, remained at the same level in 2012 as in 2007, but it is now higher than three decades ago.

However, Europe's social problems are diverse and there has been increasing divergence, especially within the euro area. Prior to the crisis, income inequality in different EU countries reflected the diversity of social models. Income inequality levels in Greece, Italy, Latvia, Lithuania, Portugal, Spain and the United Kingdom were well above the levels in the core EU countries. During the crisis, southern Europe countries in particular went through worrying social developments<sup>2</sup>. But it is not only the north

and south that are diverging. Latvia is the most unequal country in Europe and Slovenia is the most equitable. While 44 percent of people are severely materially deprived in Bulgaria, the rate in Luxembourg is only 1 percent.

Before the crisis, Europe's social model was generally thought to be not especially growth friendly, but to be able to provide adequate social protection. With the crisis, its ability to protect the most vulnerable has been seriously questioned. According to Eurobarometer (2012), 80 percent of respondents think that poverty has increased in their own country over the past 12 months. The social fall-out from the crisis has put issues of social fairness, the impact of income inequality and unemployment, and their impact on economic growth at the centre of the economic policy debate.

This Policy Brief assesses the developments in unemployment, poverty and inequality and their impact on economic growth and the sustainability of public finance. We argue that current levels of unemployment and poverty are not only undesirable,

but also undermine the short and long-term growth potential of Europe's economies, with negative implications for the sustainability of public debt. The last section discusses possible policy choices, which mostly but not exclusively will fall to national policy makers.

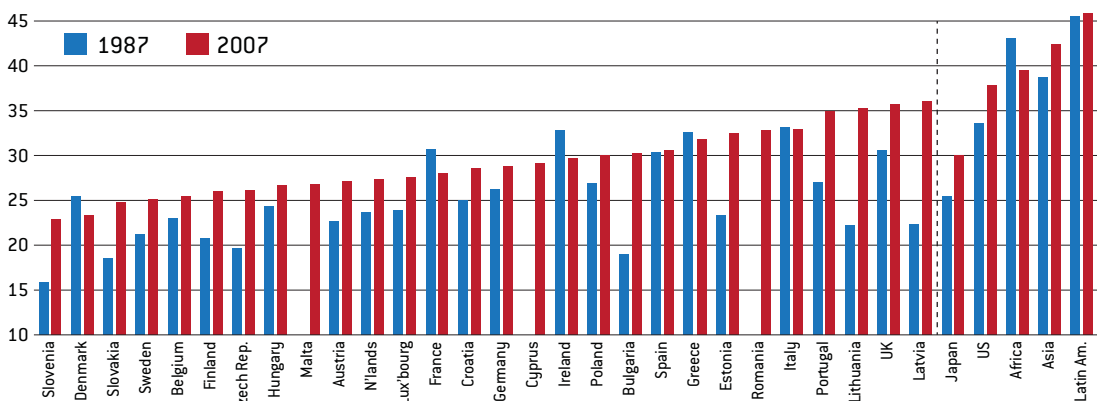
MAIN SOCIAL TRENDS IN THE EU

Inequality also reflects choices related to the social models of different countries. Inequality has been on the rise since about 1980 in several advanced economies, while it was high in developing and emerging countries even before that. A commonly used indicator for income inequality is the so-called Gini coefficient, which shows that income inequality increased in almost every EU country from 1987-2007 (Figure 1). The level of income inequality in Europe varies: while it is below the average measured in emerging and developing countries, it is similar to the US level in, for example, Latvia, the United Kingdom, Lithuania and Portugal, but it is much lower in Slovenia, Denmark and Slovakia.

1. The severe material deprivation rate indicates the proportion of people who cannot afford at least four of the nine following items: 1) utility bills and loan payments; 2) one week's annual holiday away from home; 3) a meal with meat, chicken, fish (or vegetarian equivalent) every second day; 4) unexpected financial expenses; 5) a telephone (including mobile phone); 6) a colour TV; 7) a washing machine; 8) a car and 9) heating to keep the home adequately warm.

2. European Commission (2014).

Figure 1: Gini index of income inequality, post taxes and transfers, 1987 and 2007



Source: Bruegel based on Standardised World Income Inequality Database.



The increase in income inequality was particularly pronounced for the top income share in a number of countries. Recent research<sup>3</sup> shows that the share of pre-tax income accruing to the top 1 percent of earners has increased significantly in the United States, the UK and Ireland, while in continental European countries this increase was far less pronounced.

The efficiency of social security systems varies widely in different EU countries. Sapir (2006) argued that the efficiency of the Mediterranean social model is low and at the same time inequality levels are high. More recent data corroborates this finding. Figure 2 shows that most Mediterranean countries, but also some northern European countries, achieve comparatively lower reductions of income inequality for any given amount of social expenditure and for a given level of average personal income taxes<sup>4</sup>. For example, the share of social expenditure is similar in Greece and Denmark, but while the Danish system is able to reduce income-inequality by 45 percent, the Greek can

reduce it only by 20 percent. For countries with less efficient redistribution systems, a reform of the social model would therefore appear to be a promising avenue, with the potential to reduce substantially government spending without increasing income inequality. Given the pressure on public finances and the doubts about the sustainability of public finances in some countries, such reforms appear indispensable. However, it is also clear that these are not one-dimensional choices. Some social measures might not be targeted at reducing income inequality, but rather at pursuing other socially desirable goals.

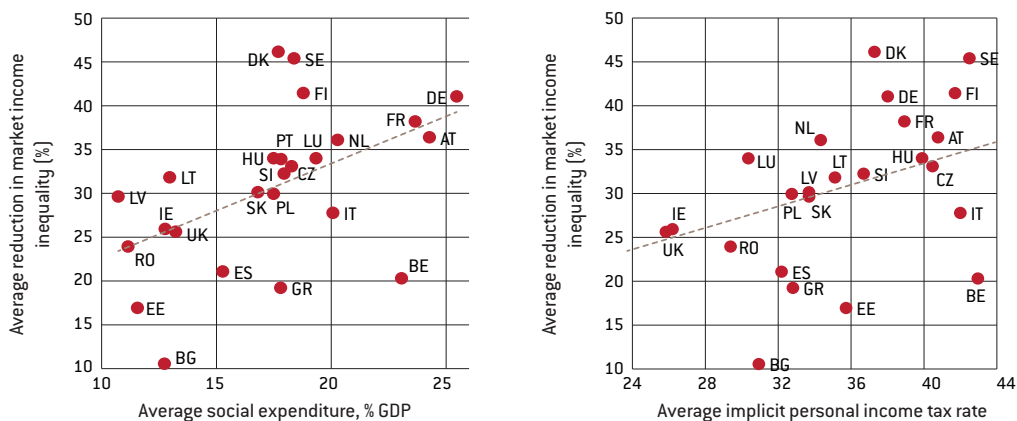
The economic crisis has led to a significant deterioration of the social situation in a number of EU countries. In particular, (long-term) unemployment, youth unemployment and poverty have increased substantially in most EU members<sup>5</sup>. Generally, the increase in poverty and unemployment has been more pronounced in countries that already had higher levels of inequality pre-crisis, in particular

the countries of southern Europe and the Baltics. However, in terms of income inequality, the effects of the crisis have been less clearly distributed. In some cases, income inequality actually fell in EU countries in severe recessions because of falls in the top incomes. In other countries, however, income inequality has increased significantly.

**DID FISCAL ADJUSTMENT DURING THE CRISIS TAKE INTO ACCOUNT THE NEEDS OF THE POOR?**

Most EU countries underwent significant fiscal consolidation in the last few years. An important question is whether this adjustment tried to preserve spending categories that are of central importance for unemployment and social stability. In the EU as a whole, spending cuts were concentrated in broad public services, economic affairs and environment protection, while in general spending on social protection was preserved at least in relative terms, even in the countries that implemented the largest fiscal adjustments (Table 1)<sup>6</sup>.

Figure 2: Correlation between the reduction of market income inequality and fiscal indicators, 2000-11



Source: Bruegel using data from Eurostat's Government expenditure statistics, Eurostat's implicit tax rates by economic function and the Standardised World Income Inequality Database. Note: the reduction in market income inequality is the percent difference between the Gini coefficient after taxes and transfers and the Gini coefficient before taxes and transfers.

3. For example Alvarado *et al* (2013).

4. Three quarters of the reduction in inequality is due to transfers, while the remaining quarter is the consequence of direct household taxation, according to OECD (2012a).

5. For a comprehensive overview of the developments of social indicators in Europe, see Darvas *et al* (2014).

6. In Table 1 we grouped countries into a few broad groups for readability.



The distribution of the costs of adjustment between young and old has been uneven. Spending on families and children, unemployment, education, health, sickness and other social protection increased below inflation – a cut in real terms. By contrast, spending on housing and old age increased more than inflation<sup>7</sup>.

The picture is different for different sub-groups of countries. In the three euro-area countries with full Troika programmes and in the three Baltic countries, cuts were much more substantial across the board, reflecting the significant fiscal consolidation needs. However, in relative terms, one can observe that certain spending items seem to have been spared from cuts. In particular, spending on the elderly was preserved or increased substantially. While spending on the unemployed also increased significantly, unemployment benefits per unemployed person declined (Figure 3). This indicates reduced benefits per person, but also reduced eligibility<sup>8</sup>. Such declines suggest that automatic stabilisers are not allowed to take their full effect in countries facing the sharpest fiscal adjustment needs. Spending on families and children was cut quite substantially in the programme countries, the Baltics, Italy and Spain. Even in the core EU countries, such spending was cut in real terms. We found that child poverty increased more in countries that cut family and child benefits more and therefore these cuts were not purely efficiency-inducing. Spending on education has declined even in nominal terms in the countries facing the most severe fiscal adjustment

needs, but also in real terms in other country groups.

The crisis has brought to the fore an increasing generational divide. Probably related to the composi-

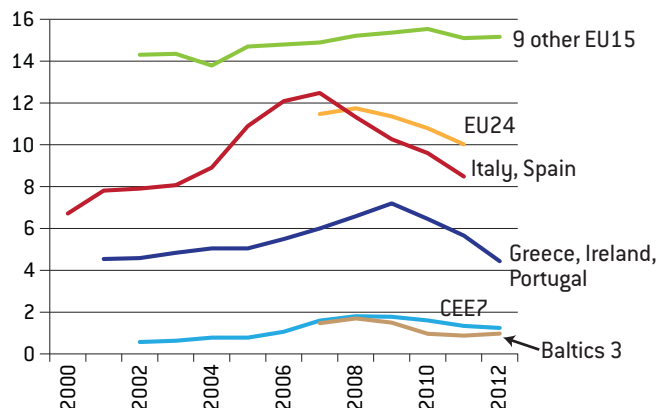
tion of social spending described above, social indicators for the elderly showed little deterioration and in fact the severe material deprivation rate for elderly people has declined during the past five

**Table 1: General government expenditure by function, % change 2009-12 (in current prices and constant exchange rates)**

	EU24 (share)	EU24	Greece, Ireland, Portugal	Italy, Spain	9 other EU15	Baltics	7 other CEE
Total general govt. expenditure	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). EU15 refers to EU members before 2004. CEE refers to central and eastern European countries that joined the EU in 2004-07. 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.

**Figure 3: Unemployment benefit payments per number of unemployed, € thousands per year**



Source: Bruegel using data from Eurostat. Note: see the definition of country groups and the method of aggregation in the notes to Table 1.

7. From 2009 to 2012, the number of people over 65 years increased by 5 percent [there is no comprehensive dataset on the number of pensioners] and the number of children decreased by 1 percent in the EU, but social spending on families and children was preserved much less than spending on the elderly.

8. In Greece, only 15 percent of unemployed people receive unemployment benefits from the government.



years, which is certainly a benign development (Figure 4)<sup>9</sup>. But social indicators suggest that the younger generation has suffered seriously: children who live now in households in which their parents no longer work and young people who are not in work or education. There is now a serious danger that a lost generation might develop in several member states, which would undermine medium- and long-term growth prospects for the whole continent, adding to social and human costs.

**UNEMPLOYMENT, POVERTY AND INEQUALITY AND ECONOMIC GROWTH**

Unemployment, poverty and inequality are linked with long- and short-term economic growth. The relationship and causality between the different factors is complex. A central argument in many earlier discussions focused on the beneficial long-term effects of inequality: that re-distributive measures would reduce incentives for workers to perform well, hamper entrepreneurship and undermine productivity growth. Yet, more recently, the drawbacks of inequality have moved back to the centre of the debate. A recent International Monetary Fund study, for example, found that lower net inequality is correlated with faster and more durable growth and there is surprisingly little evidence for the growth-destroying effects of fiscal redistribution at the macroeconomic level<sup>10</sup>.

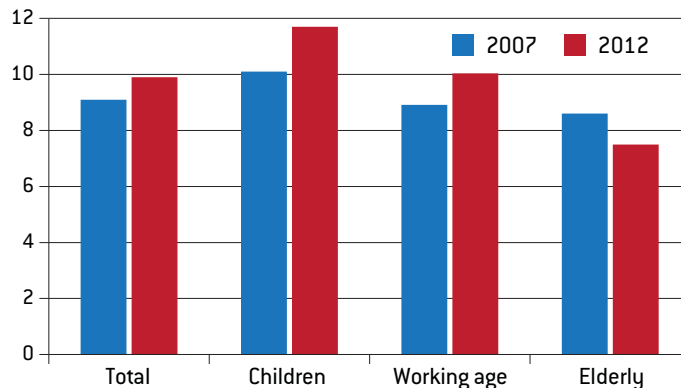
Long-term unemployment, which can deepen poverty and inequality, undermines productivity also

in the long term. In the short-term, there are different dynamics. Deep recession can lead to significant increases in unemployment and thereby affect long-term growth. A number of different channels can be identified.

A first and important line of argument is that rising income inequality has led to excessive borrowing by low-income households, which eventually became unsustainable. In the US, there is strong evidence<sup>11</sup> that with the decreasing amount of income going to the bottom 95 percent of the income distribution, those

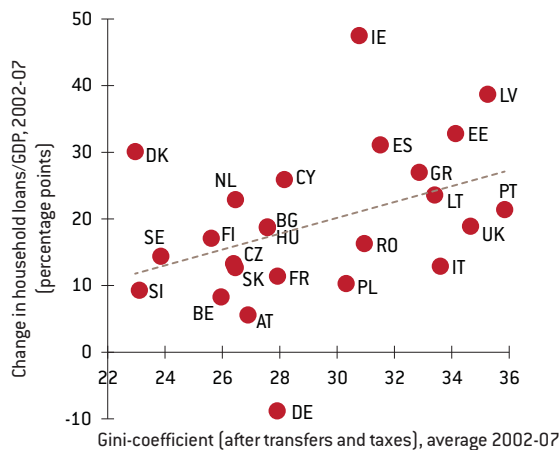
households borrowed on a substantial scale and they did so to buy houses and consume more. Consequently, consumption inequality has been less pronounced than income inequality. With the bursting of the housing bubble, the heavily indebted families in the bottom 95 percent income distribution could not borrow more to smooth consumption. This resulted in weaker consumption trends and attempts to repair balance sheets slowed down the recovery. Balance sheet problems in the household sector are also important in a number of European

Figure 4: Severe material deprivation rate in the EU27, 2007 vs 2012



Source: Bruegel based on Eurostat. Note: Children: below 18 years; working age: 18 to 64 years; Elderly: over 65 years.

Figure 5: Gini coefficient vs the change in household debt pre-crisis



Source: Bruegel using data from Eurostat (household debt) and Standardised World Income Inequality Database (Gini coefficient).

9. Poverty among the elderly declined up to 2010, but increased slightly in 2011-12, though there was a decline overall between 2007 and 2012, as Figure 4 shows.

10. Ostry *et al* (2014).

11. Rajan (2010), and Cynamon and Fazzari (2014).



countries. Interestingly, countries with increasing household debt tend to be those that have higher levels of inequality (Figure 5). Therefore, one cannot exclude the hypothesis that large increases in borrowing in a number of EU countries was related to the higher levels of inequality, and that this inequality contributed to the build-up of the problems of today.

High household debt levels are a significant drag on consumption growth (Figure 6) and undermine the correction of social imbalances. History shows that the deleveraging process exerted a protracted negative impact on economic growth<sup>12</sup>. Low economic growth, in turn, undermines the ability of economies to create new jobs and to find ways to reduce income inequality. The substantial debt problems of many euro-area countries therefore not only undermine growth, but in themselves are also an obstacle to the reduction of social problems in the monetary union.

High and persistently high levels of unemployment undermine

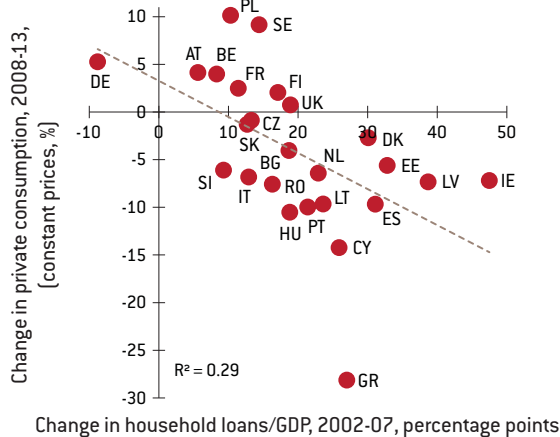
both short-term and long-term growth potential, and increase inequality. Three factors are central. First, unemployed people do not contribute to the current productive process, thereby increasing the pressure on those working to provide all the resources needed. Second, the unemployed consume less and thereby domestic demand is weaker in countries with higher unemployment rates<sup>13</sup>. Third, the longer unemployment persists, the more work-related skills are lost and the more difficult re-integration into the active labour market becomes. Unemployment among young people, which is at record high in a number of EU countries, is especially alarming because a long period of unemployment after graduation, when a worker should acquire the first skills in the workplace, can undermine whole careers – creating a lost generation and also having trickle-down effects on fertility rates and child support. When children grow up in families in which parents do not work for long periods or work irregularly, their opportunities are curtailed com-

pared to children whose parents work. Unemployment therefore increases income inequality for those directly affected and it might also have lasting effects on income inequality for the next generation. Long-term unemployment is also a major determinant of poverty. While short-term unemployment can usually be bridged by households thanks to savings and unemployment benefits, the longer a period of unemployment lasts, the greater the risk of falling into poverty<sup>14</sup>.

Poverty and persistent unemployment also undermine the ability of households to provide for adequate healthcare for the family and education of children. The resulting inequality of opportunity, ie the ability to access education on equal terms with families in which the parents are in jobs, is an important problem. The OECD (2012b) finds that in all OECD countries, higher levels of economic, social and cultural status of parents is associated with higher educational attainments for their children. Rising unemployment, reductions in wealth and relative social decline therefore undermine the educational opportunities for children.

Unemployment can also undermine growth and financial stability by affecting social stability and undermining support for positive change. Eurobarometer surveys show that the change in citizens' trust in the EU and in national governments has evolved in a broadly similar way and in general there was a greater decline in trust in countries facing high unemployment. When trust in EU and domestic political insti-

Figure 6: Change in household debt before the crisis vs consumption growth during the crisis



Source: Bruegel using data from Eurostat.

12. See McKinsey Global Institute (2012) and Ruscher and Wolff (2012).

13. See, for example, Hurd and Rohwedder (2011) and Christelis et al (2011).

14. In a panel regression framework, Duiella and Turrini (2014) found that long-term unemployment appears the most significant and robust explanatory factor for severe material deprivation, stronger than income-per-capita variables.



tutions is low, the acceptability of painful structural reforms and fiscal consolidation measures is lower, which could diminish the reform momentum and may even lead to political instability.

Overall, a number of EU countries face a serious unemployment and poverty challenge, undermining the opportunities for personal fulfilment, reducing economic growth and threatening public finances. With households under pressure and social support budgets affected, support for national and EU authorities has tumbled to record lows.

### IMPLICATIONS FOR POLICY

A number of conclusions can be drawn from the analysis.

First, addressing unemployment and poverty should remain a high priority not only for its own sake, but also in view of the sustainability of public debt and the growth rates of our economies.

- High levels of unemployment undermine long-term growth;
- Youth unemployment in particular can have lasting negative effects, as skills are undermined over the whole lifetime, with trickle-down effects on fertility rates and child support;
- Poverty undermines the ability to access educational and health services, with a knock-on negative effect on long-term productivity;
- Excessive income inequality might raise the risk of excessive household borrowing leading to later periods of subdued consumption growth;
- Poverty and unemployment

undermine trust in government and might hamper reform;

- The resulting reform fatigue and weaker short-term recovery and medium-term potential growth adversely affect the sustainability of public finances. In turn, weaker public finances necessitate larger fiscal adjustments, thereby adversely effecting social developments.

Second, addressing social problems requires actions in various policy fields both at national and European levels.

- Most of the labour, social and fiscal policies sit with member states. Inefficient labour markets should be reformed, training schemes should be improved, tax/benefit systems should be better targeted and aligned with the needs of the poor and unemployed;
- European initiatives include an agreement between EU employment ministers and the European Commission that youth unemployment requires urgent action<sup>15</sup>, the mobilisation of a €6 billion youth guarantee fund, and a Commission communication on the “*social dimension of economic and monetary union*”<sup>16</sup>. While such initiatives are welcome, they are unlikely to trigger a break-through and may even raise expectations that cannot be met, further undermining the trust of citizens in the EU;
- Another European level initiative should be a greater focus on demand management. In our view, weak demand has been a major reason for job losses and social problems,

even though fiscal consolidation was necessary in a number of member states. If demand remains low, more flexible labour markets will not create employment to the extent needed. However, the EU countries facing the most severe social problems are unable to support demand with fiscal tools, because of their weak public finance positions. Therefore, European initiatives are wanted, such as:

- Better use of the European Semester to achieve an optimal aggregate fiscal stance for at least the euro area, but preferably for the EU<sup>17</sup>;
- Fostering public investment when there is a need and the fiscal space allows;
- More EU investment projects using project bonds and more forceful EIB lending; and
- The discussion on a euro-area budget should be revived to help adapting the aggregate fiscal stance of the euro area to the aggregate economic situation and to limit that in the future fiscal consolidations have to be particularly severe in those countries that would most need fiscal policy to stabilise the situation;
- More demand would help to reverse the chronically low inflation in the euro area, which would foster private sector deleveraging, sustainability of public finance and the intra-euro price adjustment.

Third, tax/benefit systems should be reviewed for improved efficiency, intergenerational equity and fair burden sharing between the wealthy and poor.

15. ‘Actions to foster youth employment in the Member States’, Declaration of the EU Ministers of Labour and the Commissioner for Employment, Social Affairs and Inclusion agreed at the Conference on Youth Employment, Berlin, 3 July 2013.

16. European Commission (2013).

17. See Darvas and Vihriälä (2013).



- We showed that the same levels of social expenditure and household taxation are translating into very different reductions in market income inequality in different EU countries. This suggests that there is scope for reducing government spending without undermining the achievement of goals in countries with inefficient welfare systems;
- We also showed that the fiscal adjustment was greater for families with children and education than for pensioners. While pensioners should be protected, the deteriorating social condition of the young has long-term consequences for public finances and growth. Therefore, when efficiency-inducing spending cuts are not available, inter-generational equity should play a greater role in the design of fiscal policies;
- The recent debate on the progressiveness of the tax system suggests that a greater contribution from the highest earners might not hamper economic growth<sup>18</sup>. Wealth taxes and inheritance taxes have recently been considered as further revenue sources that would reduce the tax burden on the disadvantaged. Since taxing high incomes and wealth might induce migration of the wealthy to less-taxed countries, such tax measures require European and international tax cooperation and should again be discussed at European level.

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18. Piketty and Saez (2012).

