

Income and inequality

Introduction

In the context of its aim to promote ‘inclusive growth’, the Europe 2020 strategy has a new headline target to address issues of income and inequality. This strategy – in what is an improvement on the earlier Lisbon Strategy – now has a headline target to ‘lift 20 million people out of poverty’ by 2020 (European Commission 2010j). With regard to income, the strategy contains guidelines on wage competitiveness and also the fight against low pay.

The introduction of a target to reduce poverty is a positive improvement over the previous Lisbon Strategy (where there was no such headline target). However, there has been a change in how poverty and social exclusion are measured which is at odds with the various commonly accepted definitions. ‘What gets measured gets done’ is a common management adage. Changing how poverty is measured can change the policies that are used to reduce poverty.

The creation of a new indicator to measure poverty and social exclusion, combined with the fact that member states can now define ‘joblessness’ as equating with poverty, serves to weaken the fight against poverty. By targeting ‘joblessness’ and claiming to target poverty, member states may now push people into low paid jobs, increasing the numbers of working poor whilst achieving nothing in the fight against poverty.

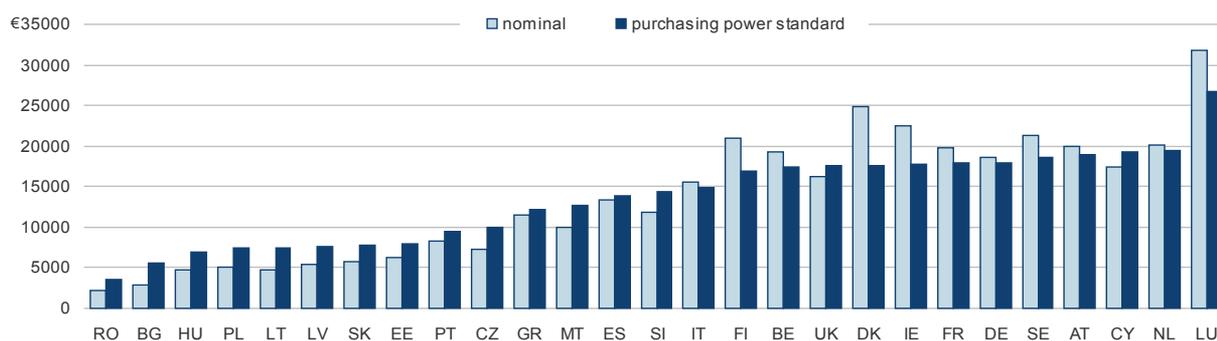
In this chapter the developments in incomes and inequality are outlined. Also how the new Lisbon 2020 strategy will impact on incomes and inequality is discussed. A particular focus is given to how the changed definition of poverty and social exclusion will affect the fight against poverty.

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Incomes

Figure 3.1 Median equivalised annual net income by country 2009



Data source: Eurostat (2010b) *European Labour Force Survey (ELFS)*.

Notes: Equivalised net household income gives the income after taxes and transfers per equivalised person in a household. Equivalised means that children are given a lower weighting than adults.

What to include in 'inclusive growth'

Though the EU 2020 strategy includes no specific policy on income, it does aim for 'inclusive growth', which should have some positive bearing on income and equality. Figure 3.1 shows the annual median net income of individuals/households, after taxes and transfers, in each EU nation. The median income is the midpoint in the distribution of income, the point above which half of households are richer and below which half are poorer. The chart is based on households' nominal disposable income expressed in euros and, as can be seen, these incomes are very unequally distributed across the EU. In the past, growth that was 'inclusive' of all EU members has been achieved through the use of structural and cohesion funds which helped to fund infrastructure projects in the EU. Such projects have helped poorer EU countries to converge with richer countries. However, in the new EU 2020 strategy there are no explicit targets to increase spending on such programmes, in spite of their record of success. Meanwhile, tax increases and cuts in transfer payments due to austerity programmes (see Chapter 1) will reduce households' net incomes.

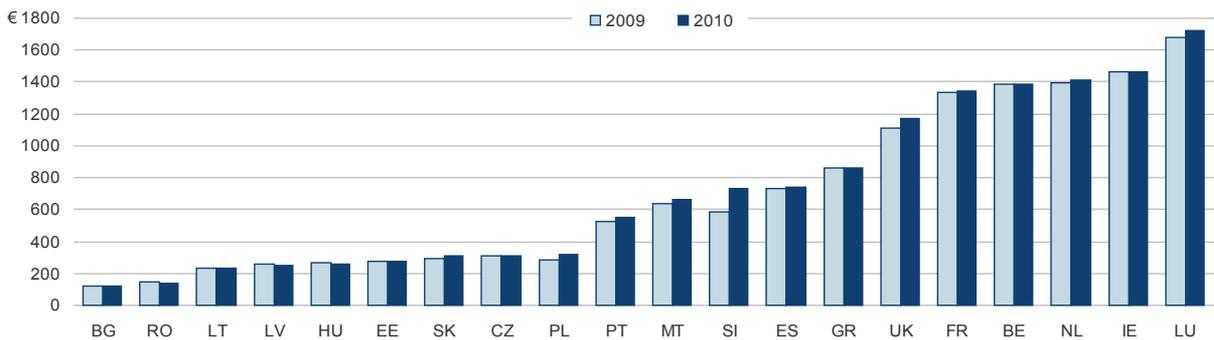
In euro terms, the average household income in the richest country (Luxembourg) is 14.7 times higher than the average for the poorest country (Romania). To take account of the fact that prices are also usually lower in poorer countries, an adjustment is made by recourse to 'Purchasing Power Standards' (PPS). While this adjustment to take account of price differences does serve to halve the gap between the richest and poorest countries, this gap nonetheless remains huge and the average household in Luxembourg is in a position to buy a staggering 7.5 times more than the average household in Romania. Adjusting for prices also affects the ranking of countries. Denmark, for instance, from being the country with the second highest average household income, moves down into tenth place when measured in terms of PPS.

The 'median' figure tells only about the income of middle-range households, providing no information about the income of the very poor or the very rich. Yet it is necessary to achieve growth that is inclusive not only of all countries but also of the whole population within each country. Over the past thirty years, the top earners have increased their share of income more than those in the middle or at the bottom (Atkinson and Piketty 2010). During the same period, the source of income has also changed. Income from wages, which is

more important to those in the middle, has increased less than income from the various forms of capital revenue, which mostly benefits those at the top. Social transfers are a further important source of income, especially for those close to the bottom of the income distribution. In the rest of this chapter, wages and the distribution of income will be examined in greater detail.

Incomes

Figure 3.2 Monthly minimum wages 2009 and 2010



Data source: Eurostat (2010b).

Note: Minimum wages for second half of 2009 and second half of 2010. Data unavailable for CY. AT, DE, DK, FI, IT and SE have no national minimum wage.

Including low-paid workers

While the integrated guidelines of the EU 2020 strategy (European Commission 2010) do state that the ‘quality of jobs and employment conditions should be addressed by fighting low wages’, no direction is actually given as to how this fight might be conducted. Nor is this particular prerequisite for the achievement of ‘inclusive growth’ a prominent feature of the EU 2020 strategy. On the contrary, it is hidden away in the annex Guideline 7 (which deals with increasing labour market participation and reducing structural unemployment).

Regular increases in minimum wages are an effective way of ensuring that low-paid workers are included in ‘inclusive growth’, since their existence ensures that the lowest wages keep pace with average wages. Statutory minimum wages are found in 21 EU countries, while most of the seven remaining countries that do not have minimum wage legislation have de facto minimum wages based on collective agreements. Figure 3.2 shows the monthly minimum wage in countries that have national minimum wages. This is a nominal figure, and it should be borne in mind that the length of

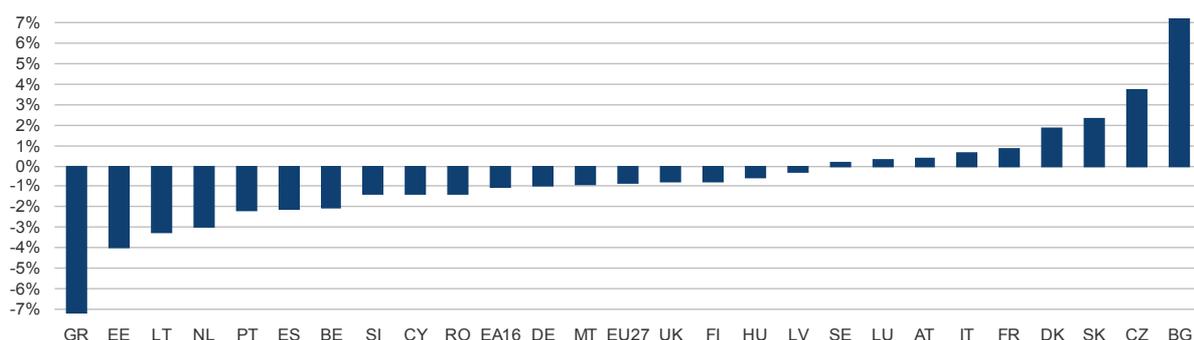
the working week differs from one country to another. Consequently, Ireland, for instance, has a higher monthly minimum wage than France, despite France having a higher hourly rate, because in Ireland the standard working week is 39 hours, as against a 35-hour week in France.

In Luxembourg the monthly minimum wage, measured in euros, is 14 times higher than in Bulgaria. In most countries the nominal minimum wage has increased or remained stable, though in Romania and Hungary it has decreased. However, as almost all EU countries experienced inflation during the period in question, the real value of the minimum wage has decreased in many countries, including France. As growth returns to the European economy, the fight against low wages will be essential to prevent long-term unemployment. This is necessary to prevent poverty traps, for otherwise ‘work will not pay’. What is more, as the European economy has been hit by a dramatic fall in aggregate demand, increasing low wages can help to boost demand, and so increase growth and employment. Though growth will not automatically increase inclusion, inclusion of the low-paid can increase growth.

Minimum wages affect, however, only the lowest paid workers. Wage changes for the average worker will be examined in the next section.

Incomes

Figure 3.3 Real change in business sector wages Q2 2009 to Q2 2010



Data source: Eurostat (2010b) *Labour Cost Survey (LCS)* and *Harmonized Indices of Consumer Prices (HICP)*.
Note: Data unavailable for DK, FR, GR, IE and SE. Q1 2009 to Q1 20010 for BE, IT, and PL.

Including wages

In its second guideline (European Commission 2010l) on 'addressing macroeconomic imbalances', the Commission calls for wage developments to be 'consistent with price stability, productivity trends and the need to reduce external imbalances'. The Commission also states that wages should 'take into account differences in skills and local labour market conditions and respond to large divergences in economic performance across regions within a country'.

Over the past year wages have in fact not been consistent with price stability. They have been too low, rising more slowly than inflation (and productivity). Low wage growth and wage cuts put downward pressure on aggregate demand, leading to more firm closures and unemployment, which can lead to deflation. Figure 3.3 shows changes in wages in real terms (i.e. taking account of inflation) in the business sector, with declines occurring in most countries. Falls in public sector wages have, in some countries, been even larger. As these tables are based on hourly wages, they fail to reflect any reduction in earnings due to a drop in the number of hours worked. In Lithuania, a country particularly badly hit by the recession, real wages have fallen due to a combination

of a drop in nominal wages and price inflation. Nominal year-on-year falls in hourly wages have also occurred in Estonia, Greece, Netherlands, Portugal and Spain while in Latvia rates have remained stagnant. Such developments represent a threat to the European Central Bank's goal of price stability. The existence of such downward wage flexibility indicates, furthermore, that Europe's problems can certainly not be attributed to a general lack of labour market flexibility.

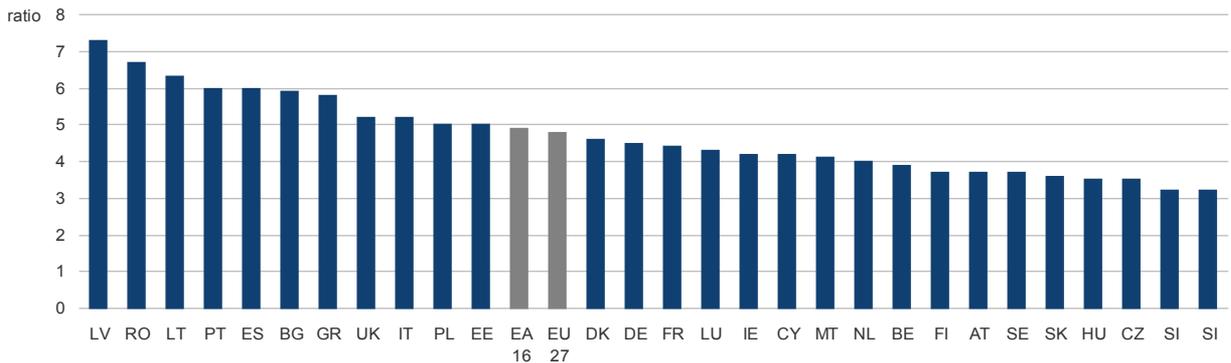
Guideline 2 (European Commission 2010l), which relates to differences in skills and 'large divergences in economic performance across regions within a country' may conflict with the aim to fight low wages. Regional differences can be reduced either through economic migration, thus denuding poorer regions of their population, or by investing in poorer regions. Priority to the latter option would not place further downward pressure on wages, and would allow for 'inclusive growth'. Similarly, the use of supply-side policies (as seen in Guideline 2) that 'take into account differences in skills and local labour market conditions' will do nothing to solve the fundamental problem in the labour market, namely, a lack of demand. Low wage growth, it is argued, can improve competitiveness and thus employment. However, low wage growth reduces income that workers spend on imported goods and this has a spillover effect of reducing

neighbouring countries' ability to export and boost employment. It is, in other words, a 'beggar-thy-neighbour' policy.

In Guideline 3 (European Commission 2010l), EU 2020 also recommends that countries with current account deficits reduce 'real unit labour costs'. These are more commonly, and intuitively, known as the labour share of income. Yet there is no corresponding call on countries with surpluses to proportionately increase the labour share of income, but only to 'reduce structural impediments to private domestic demand' (Guideline 3). There has been a general downward trend in the labour share of income. However, a point that is ignored is that deficit countries such as Greece and Spain actually have a lower labour share of income (and so lower real unit labour costs) than Germany, the most prominent surplus country. This shows that wage restraint in countries such as Spain and Greece will have a limited impact on improving their trade balance, and that policies that target non-labour costs to businesses are necessary.

Inequality

Figure 3.4 Inequality of income distribution 2009 (80/20 income quintile share ratio)



Data source: Eurostat (2010b) *European Labour Force Survey (ELFS)*.

Including exclusion – tackling the causes of the crisis?

Inequality has been put forward as a fundamental driver of the current crisis (Strauss-Kahn 2010). However, the EU 2020 strategy includes no explicit plan to reduce inequality, but only poverty. While poverty affects only the bottom section of the income distribution, overall inequality should not be ignored, as it has been shown to have negative effects on society as a whole (Wilkinson and Pickett 2010). The 80/20 ratio compares the incomes of the top 20% of the population with those of the bottom 20%. In countries with weak financial regulation, high levels of inequality led poor people to borrow money that they cannot now repay, leading to the financial crisis and also trade deficits. In countries like Germany, wage restraint designed to boost exports led to a lack of domestic demand. This situation cannot be sustained. It is essential to rebalance economies so that workers can afford to buy the fruits of their labour without the need to borrow money. The current crisis shows that the

world economy simply became too unequal to sustain demand for the goods and services produced.

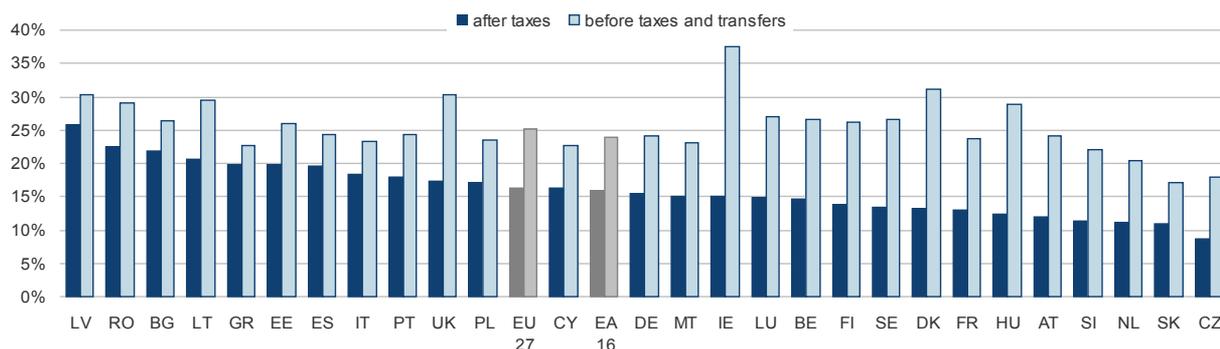
There are many ways to measure inequality, and there is no consensus as to which method is the best. The choice of measure used depends on data availability and also on which forms of inequality are considered important by the person or agency presenting the information. Figure 3.4 shows the 80/20 ratio, which compares the share of income (after taxes and transfers) that go to the top 20% of the population compared with the share taken by the bottom 20%. Such measures of the overall distribution can fail to provide some important information, however (such as whether changes are due to income growth for top earners, or wage compression for bottom earners). For most countries, incomes for those at the bottom have been stable relative to middle earners, while top earners' incomes have increased. Such changes are partially concealed by the use of forms of measurement that relate to overall distribution.

As can be seen from Figure 3.4, the countries with relatively greater inequalities are among those that have suffered most during the current recession (Ireland being a notable exception). This is attributable to the fact that in many of the less equal societies poorer people were attracted by low interest rates to borrow money.

In Latvia the top 20% receive 7.3 times more income than the bottom 20%, but in Slovenia this ratio between the two extremes is no more than 3.2. Differences among countries are due to a combination of differences in taxes and transfers, and also differences in gross incomes. Though the EU 2020 strategy does target poverty, it is also necessary to target inequality throughout the income distribution in order to ensure economic recovery, so that demand is not reliant on credit.

Inequality

Figure 3.5 At-risk-of-poverty rate, 2009



Data source: Eurostat (2010b) *European Labour Force Survey (ELFS)*.
Note: Pensions are excluded from social transfers.

The meaning of poverty

The EU 2020 strategy aims to lift 20 million people out of poverty. However, who are those who suffer poverty?

There is, of course, no perfect measure of poverty. The standard measure of poverty which was used by the EU until recently was a measure of 'relative poverty'. However, the EU has created a new composite measure of poverty. The new EU measure defines as being in poverty, or social exclusion, individuals who 1) are in relative poverty; or 2) suffer from absolute poverty; or 3) have low work intensity. Regarding the second criterion, households must now be too poor to afford four basic items (see Eurostat Glossary) in order to be regarded as being in severe absolute poverty and included in the index (previously being deprived of three items was the standard cut-off point). Meanwhile, as a result of the introduction of the third criterion, households with a low work intensity are automatically classified as being in poverty, regardless of income.

An individual is considered to be in relative poverty if s/he lives in a household in which the equivalised income is below the poverty line defined at the level

of 60% of an average income (as shown in Figure 3.1). This has the advantage that it adjusts for what are perceived as decent living standards in societies with different levels of income. Using this measure, 80 million people in the EU are in relative poverty, according to the EU 2020 document.

However, under the terms of this definition, a person with the median national income cannot be in relative poverty, no matter how low that person's income may be. This is because someone on the median income always has 100% of the median income. If the median income is very low, then the cut-off point for being considered as in relative poverty is even lower.

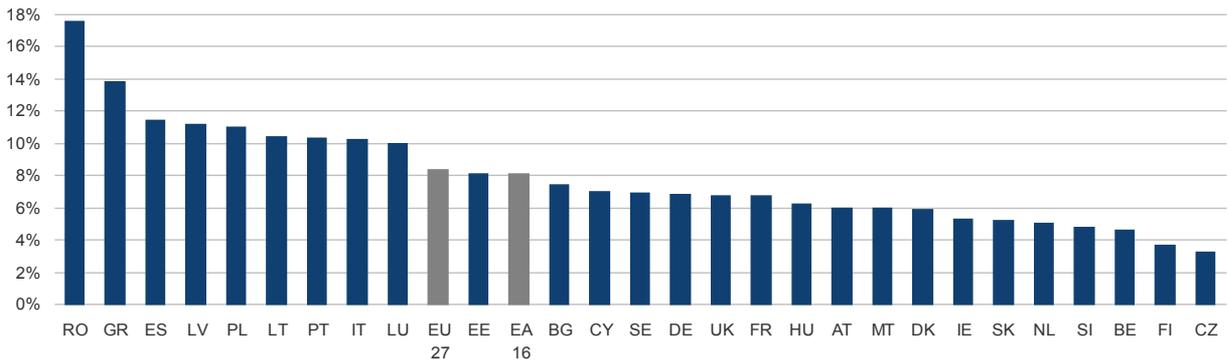
There is a wide variance between poverty before and after taxes and transfers (such as social insurance). In Guideline 10 the EU states that 'benefit systems should focus on ensuring income security during transitions and reducing poverty'. Figure 3.5 shows the proportion of the population in relative poverty. As can be seen, the social systems of Ireland, Denmark and Hungary are particularly successful at reducing poverty, whereas Latvia and Greece are among the less successful. Thus, while the Danish social system manages to reduce relative poverty by more than half, the Greek system reduces it by only 14%. While the Czech system is also successful at reducing relative poverty, the Czech Republic also has

a comparatively low level of relative poverty even before taxes and transfers are included.

Using this measure of poverty is not without its problems, particularly in a recession. In normal times, when average incomes are gradually increasing, the poverty line also rises. The risk-of-poverty rate is indeed also used as one way of measuring social exclusion. The median income in Romania might allow one to have an inclusive social life in Romania, but the same income in Luxembourg would not allow someone to be fully included in what is considered a normal social life in that society. Given the huge income disparities across the EU, such gaps can cause some problems in ascertaining the relevant point of reference. Also, what if median incomes are declining in a recession, as is happening in some countries such as Ireland? If median incomes fall, but lower incomes remain stable, the incomes of the poor will rise relative to those in the middle. In other words, the poverty rate will fall despite no actual improvement in living standards.

Inequality

Figure 3.6 In-work poverty, 2009



Data source: Eurostat (2010b) *European Labour Force Survey (ELFS)*.

The working poor

The EU's new definition of poverty includes jobless households (households that use only 20% or less of their work potential). Though joblessness is linked to poverty, having a job is no guarantee of escaping poverty, as indicated by the fact that 8.4% of workers in the EU are currently living in relative poverty. Fighting low pay (as suggested by Guideline 7) is an effective way to reduce in-work poverty.

Figure 3.6 shows differences across Europe in in-work poverty. Romania displays the highest rate, with 17.6% of workers at risk of poverty. Just like the at-risk-of-poverty measurement, this is a measure of relative poverty. Insofar as Romania has especially low median incomes (Figure 3.1), the high number of workers with only 60% of this median income is particularly alarming. In the Czech Republic and Finland, by contrast, only 3.2% and 3.7% of workers suffer from relative poverty.

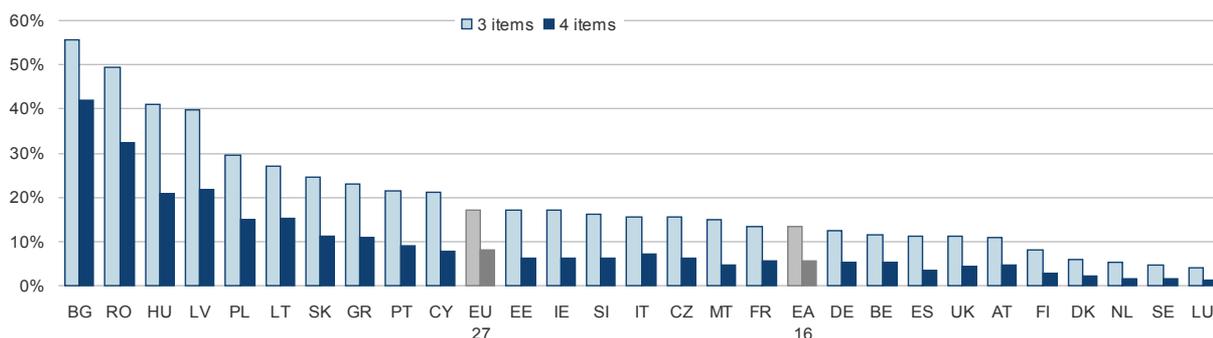
Apart from wages, household composition is a major determinant of in-work poverty. Single-parent families are particularly at risk of poverty, given that there is usually only one breadwinner and that single parents are less likely to be able to work full-time. However,

various social measures, such as child-care facilities and transfer payments (including children's allowance), can help overcome these handicaps.

Among the Eurozone countries, Greece and Spain show the highest proportion of people suffering in-work poverty. These countries were also amongst those hardest hit by the global recession, and are suffering from trade deficits. For these countries the EU guidelines of reducing the wage share and fighting low pay may be mutually contradictory. These two countries in particular show how only inequality-reducing policies of wage-led growth across the EU will meet the EU guidelines of addressing poverty (by ensuring higher wages) and reducing trade deficits (by reducing dependence on exporting).

Inequality

Figure 3.7 Material deprivation 2009



Data Source: Eurostat (2010b) *European Labour Force Survey (ELFS)*. Note: 2008 data for UK.

Material deprivation

An alternative measurement of poverty that is also commonly – albeit less frequently – used is absolute poverty. This is also referred to as material deprivation. Statistical agencies have a list of basic items that are considered necessary for the enjoyment of a decent standard of living. It is important to remember that such lists refer to things of which people are deprived due to lack of income rather than choice of lifestyle. These survival items include such basic things as an ability to heat the home, to eat meat or fish (or appropriate protein supplement) every second day, alongside items that are necessary to avoid social exclusion, such as a telephone. What is considered a basic necessity may vary from country to country due to cultural or climatic differences. The Irish Central Statistics Office, for example, considers a warm waterproof coat to be necessary, but this is something a resident of Malta could probably do without. By contrast, the Maltese National Statistics Office includes a computer as a basic item. Something that was once considered a luxury is now, in this advanced economy, considered necessary in order for people to be able to interact and be socially included.

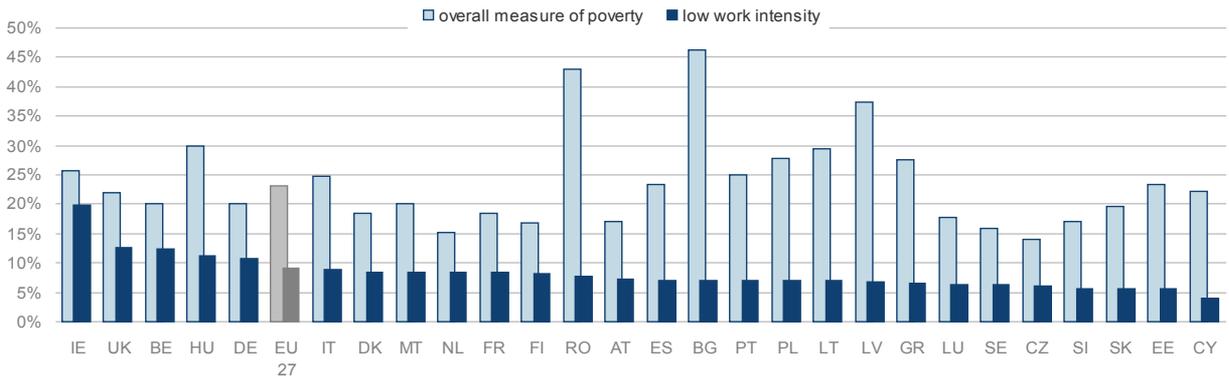
For the purposes of cross-country comparison, the EU has a list of nine basic items. This has the advantage of being directly comparable in all EU countries. The previously accepted definition of material deprivation was that someone was unable to afford three or more items (such as heating a home) from a list of nine basic items. However, the definition used in relation to the EU 2020 targets is that material deprivation must be severe, that is the inability to afford four or more items. One result of this change in definition is that households that are too poor to heat their homes, to feed themselves properly, and are unable to pay their normal household bills, may no longer be regarded as being in poverty.

Figure 3.7 shows the proportion of the population suffering material deprivation. Material deprivation (as previously defined) is not a sufficient qualification for inclusion in the EU's composite poverty indicator, it must be severe (Eurostat 2010c). In most countries use of the new definition serves to cut the absolute rate of poverty roughly in half. In Bulgaria, under the old measure, over half the population were considered to be materially deprived, in stark contrast to the measure of relative poverty where, by construction, it is mathematically impossible for more than half the population to be in poverty. A country that chooses material deprivation as its criterion for achievement of the poverty

reduction target must in future use the new criteria, that is, the new definition of severe material deprivation. This will result in people being reported to have been lifted out of poverty despite being still too poor to afford some of the items necessary to live life with dignity.

Inequality

Figure 3.8 Low work intensity 2009 and overall measure of poverty



Data Source: Eurostat (2010b).

The royal poor

In an effort to make the target of lifting 20 million people out of poverty more attainable, an additional indicator of poverty has been devised (see previous sections in this chapter). Unfortunately, this new indicator, according to which households that use less than 20% of their working capacity are regarded as being in poverty or socially excluded, is largely useless for the measurement of poverty.

It is true that there is most frequently a link between joblessness and poverty. However, we know this only because we already have suitable means of measuring poverty. Governments are free to choose their preferred poverty indicator (while the Commission itself is making use of the composite measure). By changing the definition of poverty, governments can 'tackle' what is a cause of poverty and claim victory in reducing poverty. Why is this important? Gaining a well paid job is indeed a good way to escape poverty. In Europe today, however, as was shown in Figure 3.6, having a job is per se no guarantee of escaping poverty. Supply-side policies (as proposed in some countries' austerity packages) such as slashing welfare benefits and the minimum wage may force people

into ultra-low-paid jobs. However, such policies will in no way reduce genuine poverty, as it is commonly measured and understood.

As can be seen from Figure 3.8, the country with the highest level of joblessness is Ireland. Traditionally, unemployment in Ireland was solved by mass emigration. Thus, if the Irish government were to choose joblessness as its target, waves of mass emigration would probably reduce a large part the Irish jobless population. The reported rate of poverty would decline in consequence, despite the destruction of family ties, and the draining of youth from local communities.

Just how bad the use of 'joblessness' as an indicator of poverty is most blatantly exposed if joblessness is envisaged – as is possible under the EU2020 Strategy – as the sole criterion for consideration as being as in a state of poverty or social exclusion. Approximately 40 percent of the 'jobless' are not suffering from relative poverty or severe material deprivation. Just how ludicrous this is becomes apparent when it is considered that, by this measure, even some of the aristocrats and 'rentiers' of Europe may be classified as living in poverty!

Figure 3.8 also shows the composite measure, which adds together all those who are in relative poverty, absolute poverty and low work intensity, to show the proportion of the population considered to be in a state of poverty or

social exclusion. The inclusion of 'joblessness' and removal of those suffering material deprivation (but not severe deprivation) weakens the usefulness of this composite indicator. The poor choice of definition is compounded by the use of 2009 as the benchmark year, for 2009 was (hopefully!) the low point of the global recession. One would expect employment to have increased over the past year without there being a structural change in the level of joblessness. This is simply because employment moves up and down with the business cycle. Hence, including joblessness as a measure of poverty can allow the EU to claim nominal poverty reductions, even if no permanent real reductions are achieved.

Conclusions

Impoverished indicators

Though the inclusion of a poverty reduction target in EU2020 is a welcome development, the indicators selected for measurement of progress towards this target appear somewhat ill-chosen.

The Commission's composite indicator is weakened by the inclusion of 'joblessness'. Whether an absolute or a relative measurement of poverty is the more appropriate can be argued either way, so that a composite of the two is a reasonable compromise. The inclusion of only the severely deprived may be justified by the argument that anti-poverty policies should be designed to target only those suffering the direst of circumstances. Alternatively, it can sensibly be objected that the targetting of severe deprivation alone means that the much larger numbers of citizens who suffer the effects of 'ordinary' material deprivation are ignored in anti-poverty policy terms.

No remotely sensible argument can be made, however, that 'joblessness' is a good measure of poverty. Some 'jobless' households are not in poverty. Some wealthy individuals choose not to work. What is more, the choice of 2009 as the baseline year will cause further distortion, as there are households whose members, during that year, were on short-time working schemes but which are not in poverty. As (hopefully!) 2009 was the low point of the crisis, many people will, by this criterion, be lifted out of poverty simply by a return to a full working week – despite never having been in real poverty anyway. Such a change is merely the result of a cyclical upturn and signifies no structural change in poverty. Accordingly, using the new composite indicator, one person returning to full-time employment may be 'lifted out of poverty' while another suffering material deprivation will have never been considered to be in poverty.

The strongest criticism of all must be reserved, however, for governments that choose joblessness as the sole

measure of poverty. Such a target allows for the expansion of the working poor, with no genuine decrease in poverty.