

RISING INEQUALITIES: THE RISK OF FRAGMENTATION OF THE EU

The trend towards increasing inequality since the late 1970s is nowadays uncontroversial (Piketty, Saez, and Atkinson 2011; Piketty and Saez 2013; Piketty 2013; IMF 2007; OECD 2008). Yet, the relationship between income distribution and economic performance did not play an important role in the economic debate of the past 50 years. The traditional textbook dichotomy between efficiency and fairness, that underlies the concept of Pareto optimality, has long fed the idea that the economist's job is to study the conditions for optimal allocation of resources among participants to the economic process (in order to maximize social welfare); once overall welfare is maximized, economists left the task of choosing the distribution of income to sociologists, political scientists, anthropologists, provided this distribution did not distort the incentives of agents. As a consequence of this dichotomy, the debate on the effects of inequality, through its impact on incentives (to work, to innovate), has long focused on the links between income distribution and long-run growth, while little has been said on the possible effects of inequality on business cycles. After a number of studies in the 1990s (Alesina and Rodrick 1994; Deininger and Squire 1996) broadly concluding in cross section studies that high inequality tends to be associated to lower growth, the issue virtually disappeared from the academic and policy debate alike. The idea that the "tide lifts all boats" would serve as a justification of the impetuous growth of high and very high incomes (the "superstar economy", see Dew-Becker & Gordon, 2005) that accompanied the two prosperous decades 1990s and 2000s.

The financial crisis challenged this view. First, because in spite of the heavy hit taken by the financial sector, it disproportionately hit middle and low incomes (OECD 2011; Stiglitz 2013), although this is not true in every country: in the UK for example, top incomes have been hit as hard as middle and low incomes. Second, because it called for a deeper understanding of the impact of income distribution on economic performance, beyond its effects on incentives. The crisis marked in effect the arrival point of a process during which inequality either depressed growth, or triggered increasing debt by households at the bottom of the distribution (Fitoussi and Saraceno 2010; Cynamon and Fazzari 2008; Fitoussi and Saraceno 2011). A sharp contrast emerged in particular between the pre-crisis sustained growth of Anglo-Saxon countries (where consumption out of debt substituted consumption out of income) and the relatively poor performance of the main European economies, where institutional and cultural factors led to a much lower expansion of household debt. The search for high returns on investment from those who benefited from distributive changes led to the emergence of bubbles and to the overvaluation of agents' collaterals, thus easing borrowing. Increasing inequality therefore did not "cause the crisis". Rather, it contributed, together with institutions and increasing financial deregulation, to the increasing imbalances between savers and borrowers. Within countries this meant increasing debt of a substantial part of the population; and between countries this led to increasing capital flows from savers (Germany and China first and foremost; but also oil producing countries) to borrowers (the U.S., the European peripheral

countries). These growing imbalances in turn made the world economy more fragile, and amplified the effects of the financial crisis.

While the majority of economists trace the increase of inequality to the effects of skill-biased technological progress (e.g. Rajan, 2010), some point to the increasing weight of finance in the economy, that triggered rents and predation (Galbraith 2012). Our aim here is not to enter into this debate, but rather to highlight the channels through which inequality contributed to the imbalances described above.

A number of economists established a link between increasing inequality and the appearance of bubbles, but they attribute it to the hyperactivism of monetary policy, that attempting to shield low-skilled workers, was excessively expansionary. Rajan (2010) in particular claims that the right policy would have been to favour, through structural reforms, the access of low-skill workers to training and education. While there may be some truth in the argument that policy in the United States (but only there) was excessively loose in the period 2003-2005, Rajan's argument is not convincing if one takes a longer perspective. Imbalances started building in the 1990s, and a first bubble, the dot com, burst in 2000; policy prior to that episode was much less expansionary than in the early years 2000.

It is likely in fact that while loose monetary policy may have played a role, the impact of inequality on macroeconomic performance is more structural. Fitoussi and Saraceno (2011) argue that from a macroeconomic point of view, the increase in inequality triggers redistribution from households with high propensity to consume to households with a lower propensity to consume. The reasons for this difference in the propensities may be traced back to the work of Kalecki (1942) and Kaldor (1955) on income distribution, and it may be related to a minimum (subsistence) consumption level, to liquidity or credit constraints, to a lexicographic utility function, or to satiation phenomena.

If propensities to consume differ, then the overall propensity to consume is affected by income distribution, and an increase in inequality causes it to decrease. The reduction of consumption then, tends to depress aggregate demand and income¹.

As the increase of inequality has been widespread, one should have observed, in the past three decades (and especially in the years prior to the crisis), a chronic deficiency of aggregate demand, and a tendency of growth to stagnate. But why then did the growth performances in the past two decades in the United States and Europe diverge? The economies of United States and the European Union have many similarities in what concerns the level of development, technological progress and the like. Even what used to be a major difference, market flexibility, (in particular labour markets), most European countries significantly increased it; so that the differences in market flexibility with the US are not as large as they used to be in the early 1980s. Fitoussi and Saraceno (2011) argue that the apparent contradiction between a common trend of increasing inequality and differing macroeconomic performances can be explained by the interaction of the chronic aggregate demand deficiency, common to all the countries, with the institutional frames and the credit policy responses, which were instead extremely

1. The counterpart is increased savings but it will not raise growth if we are in a global saving glut.

different. In the US, and in some European countries (UK, Spain), the reduction in the share of the lowest quintiles has been compensated by increasing private indebtedness, in turn made easier by an increasingly deregulated financial system, able to lend to poorer and poorer households. Both in terms of levels and in growth rates, short term debt (mostly consumption credit) in the years 2000 has been substantially larger in the US and in the UK than in continental Europe. In these countries as a consequence, the level of consumption remained high, but financed out of debt rather than of income (Cynamon and Fazzari, 2008). In continental Europe, more restrictive rules for financial markets made credit more costly and difficult to obtain which prevented a similar expansion of debt. Spain is an intermediate case, in the sense that it experienced a significant increase of both short and long (mortgages) debt. The level of the former, nevertheless, remained low, and in fact, the Spanish exceptional growth of the early years 2000 has been largely determined by the boom of the housing sector. The increase in inequality which has negative effects on aggregate demand has not had an apparent effect on the economy because it was compensated by high levels of indebtedness – enabled by credit deregulation and then expansion – and low savings rates among the poorest. The puzzle of a common trend of increasing inequality and differing macroeconomic performance could therefore be explained by the support given to the rise of credit.

To summarize, consumption was sustained, at the price of increasing debt in some countries, while it stagnated and originated from excess savings in others. The excess savings of the latter in turn financed the excess consumption of the former, creating a fragile equilibrium based on increasing current account balances. This equilibrium was broken when the crisis hit, and the fragility of the world economy magnified the shock to financial markets.

Below the crisis impact on inequality in Europe is analysed. The focus is on both inequalities and the labour market, with a special focus on long-term unemployment, as well as an analysis of the development in income inequalities and poverty. Finally it is discussed how inequality can be fought.

1. Long-term unemployment increases risk of rising inequality

Before turning to the question of rising inequalities and the risk of poverty from a macroeconomic perspective it is worth taking a look at recent labour market developments that might give rise to rising inequalities and risk of poverty within the EU. The Great Recession has indeed left its marks. In most Eurozone countries, per capita GDP is still below its pre-crisis level. The convergence process that had taken place in the euro area since the 1990's has been dramatically interrupted and reversed. Divergence will be mainly striking regarding the situation on the labour markets. Then even if growth is picking up in the years to come, the social consequences of the crisis will be long lasting.

The dramatic increase in long-term unemployment and in unemployment among low skilled workers is of particular concern. Past experience shows that the longer one is unemployed the more difficult it is to get a job. Firms do not find long-term unemployed workers as attractive as workers who have avoided unemployment or at least long-term unemployment. A number of studies including Elmeskov and MacFarlan (1993) and Llaudes (2005) thus indicate that long-term

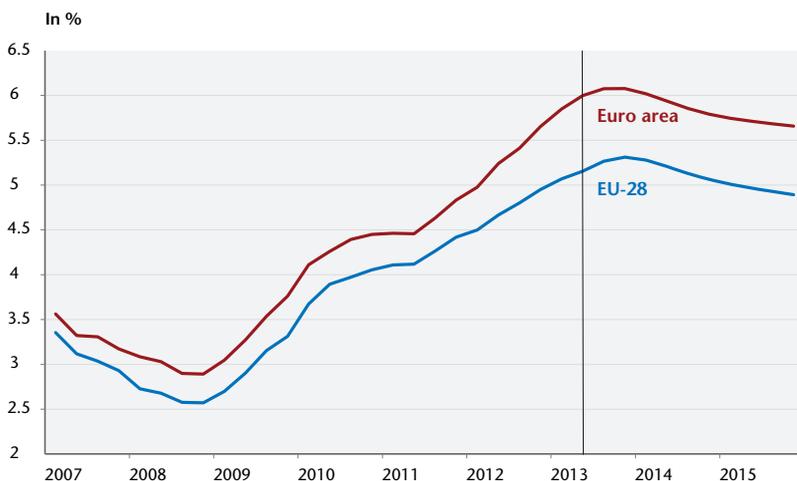
unemployed are not a real part of the competition for jobs. This may of course also lead to some kind of discouragement among the long-term unemployed so that the job search intensity at some stage may become lower. As a result long-term unemployment diminishes the effective size of the workforce which as pointed out in last year's iAGS, in the end can lead to a higher structural level in unemployment through hysteresis effects. The increase in long-term unemployment may therefore stoking up severe problems for Europe in the future.

Sooner or later the large group of long-term unemployed will run out of unemployment benefits increasing the risk of poverty if they do not get a job. The large share of long-term unemployment is therefore very concerning and may become a deep social issue for the European society and give rise to increasing inequality and poverty.

Last year the iAGS predicted unemployment in 2013 would reach 12.1 percent in the euro area and more than 11 percent in the EU. The iAGS also predicted that in 2013 long-term unemployment, i.e. the number of people who have been unemployed for 12 months or more, would reach 9 million people in the euro area and 12 million people in the EU-27. Unfortunately all of these predictions have turned out to be correct and long-term unemployment now stands at the highest level measured in since the late/mid 90'ties.

Even though overall unemployment is expected to decrease slightly towards 2015, long-term unemployment is still likely to remain high in the coming years. Estimations performed in this chapter (see Box 4) imply that 64 percent of the increase in unemployment within the EU eventually turns into long-term unemployment. The calculations actually imply a long-term unemployment rate above 5.5 percent in the euro area and 5 percent in the EU-28 in 2015. Depending on the size of the labor force this amounts to just below 9 million long-term unemployed in the euro area and some 11 ½ million in the EU-28 in 2015.

Figure 14. Long-term unemployment



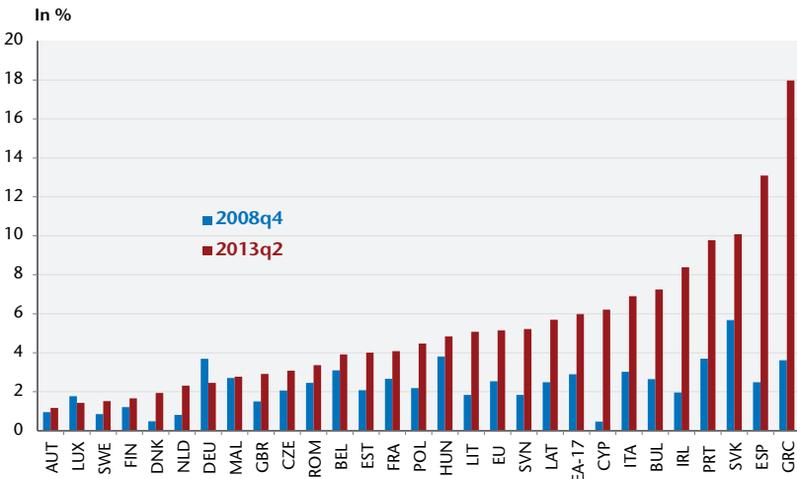
Note: The vertical line indicates the last observation, i.e. the second quarter of 2013.

Source: Eurostat, OFCE-IMK-ECLM forecasts.

Long-term unemployment actually began to stabilize in the spring 2010 but since spring 2011 long-term unemployment has increased by approximately 2 million people in both the EU and within the euro area. In the second quarter of 2013 long-term unemployment thus reached 12 million people in the EU who have been unemployed for a year or longer. Of these 12 million, 9.3 million were long-term unemployed in the euro area. Long-term unemployment accounts for almost 47 percent of all unemployment within the EU and for almost 50 percent of total unemployment in the euro area.

Looking at the impact on long-term unemployment in the individual countries one can observe large differences across countries. The troubled countries in southern Europe and Ireland have suffered the largest increase in long-term unemployment. In Spain for instance long-term unemployment prior to the crisis stood at 2.5 percent of the labor force which was below the average in the euro area. Today more than 13 percent of the labor force are long-term unemployed corresponding to almost half of the unemployed in Spain.

Figure 15. Long-term unemployment in the individual countries prior to the crisis and today



Source: Eurostat.

Figure 15 reflects the effect of the crisis, but the effect of an increase in unemployment on long-term unemployment is likely to be different across countries. For instance, in the Nordic countries like Denmark and Sweden the impact of the increase in unemployment on long-term unemployment has been around 47 percent while it has been around 70 percent in many Southern European countries and in the euro area as a whole.

OECD (2009) estimated the effect of an increase in the unemployment rate on the long-term unemployment rate using the approach described in Box 4. The same calculations are made here for Germany, France, Spain, Italy, the UK, Denmark and the EU. The results are summarized in Table 1 below. The calculations show that in say France an increase in the unemployment rate of one

percentage point will cause the long-term unemployment rate to increase by 0.57 percentage points, so approximately 57 percent of the increase in unemployment in France will turn into long-term unemployment. In Spain the impact of an increase in the unemployment rate of one percentage point will cause long-term unemployment to increase by 0.7 percentage points and in Italy the effect is even larger 0.83 percentage points. But even Germany which has undertaken large labor market reforms would in the case of an increase in the unemployment rate of one percentage point suffer an increase in the long-term unemployment rate of 0.73 percentage points. In Denmark, on the other hand, the impact is much smaller – only 0.38 while for the EU as a whole, the impact is about 0.64.

The results in Table 9 are rather similar to the results obtained in OECD (2009) though it should be mentioned that the effect for Germany in OECD (2009) is estimated to be somewhat larger – namely 0.85. OECD (2009) however do not include a trend to capture recent labor market reforms which is highly significant.

Table 9. Effects of an increase in unemployment on long-term unemployment

	Effect on long-term unemployment	Std	T-value	R ²
DEU	0.73	0.03	22.8	0.99
FRA	0.57	0.17	3.37	0.97
ESP	0.70	0.03	22.9	0.99
ITA	0.83	0.04	14.5	0.99
GBR	0.66	0.03	20.9	0.98
DNK	0.38	0.02	19.7	0.96
EU	0.64	0.02	32.5	0.99

Note: To capture recent labor market reforms a trend is also introduced in the estimations. Also dummy variables are introduced to capture unobserved features that might cause structural breaks. For Germany a reunification dummy is introduced. The stability of the estimated parameters is satisfactory and there are no signs of structural breaks in any of the estimated relations. Also the hypothesis of a unit root in the error terms is rejected at both a 5 percent and 1 percent significance level in each of the estimated relations. Estimations for EU are based on EU-15 because longer time series are available for EU-15 than for EU-28.

Source: OFCE, ECLM, IMK calculations based on data from OECD and Eurostat.

Box 4. Estimating the impact from unemployment on long-term unemployment

The impact of a higher aggregate unemployment rate on long-term unemployment is calculated by estimating the following dynamic relationship:

$$LTU = a + b_1 LTU-1 + b_2 LTU-2 + c_0 UNR + c_1 UNR-1 + c_2 UNR-2$$

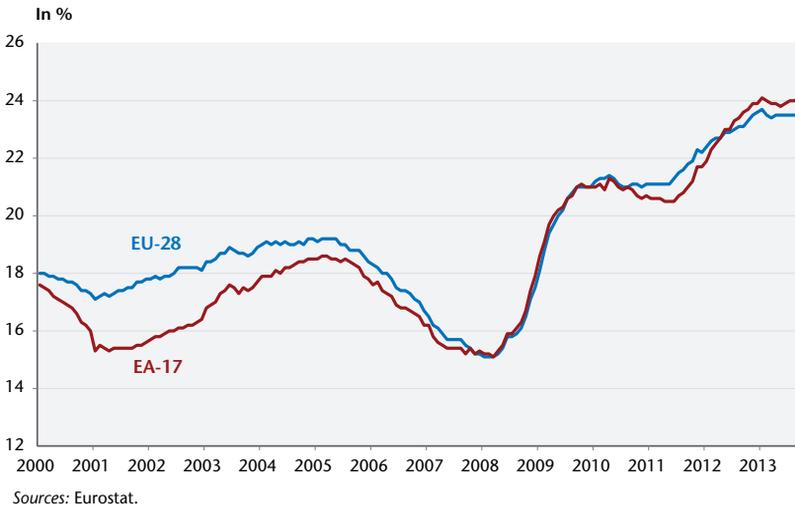
where LTU is the long-term unemployment rate and UNR is the unemployment rate – both expressed in terms of the labor force. LTU-1 is the long-term unemployment in the previous year (likewise for UNR-1 etc.).

The relationship between the long-term unemployment rate and the unemployment rate is estimated by using annual data from the OECD labor force statistics.

Long-term unemployed are defined as people having been unemployed for a year or longer

More and more youths are also long-term unemployed. Thus some 2 million of the 5.5 million young unemployed under 25 are long-term unemployed. Long-term unemployment among youths is also likely to remain high in the coming years. Youth unemployment is still rising and looking back in history the current level is the highest that has been measured in EU-15 and in EA-13 since the mid/late 90'ties. In September 2013, 5.5 million young people under 25 were unemployed in the EU-28 corresponding to an unemployment rate of 23.5 percent. In the euro area 3.5 million young people under 25 are unemployed corresponding to 24.1 percent of the young people under 25 in the labour force (Figure 16).

Figure 16. Youth unemployment

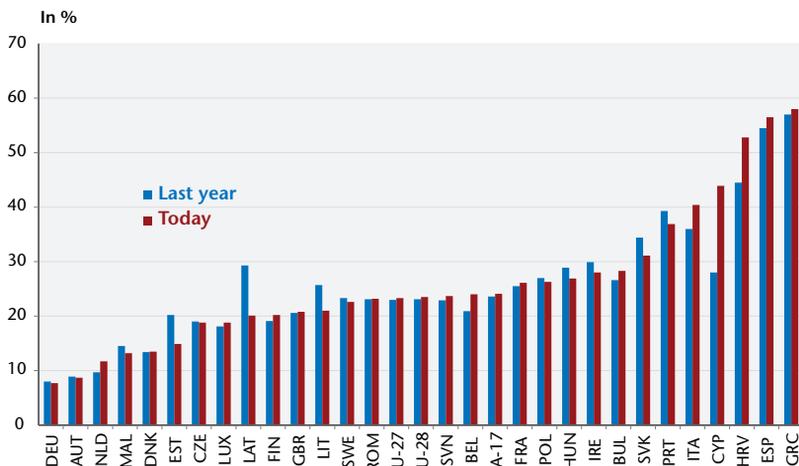


Within the last year, youth unemployment has increased further in already troubled countries like Greece, Spain, Italy, Croatia and Cyprus (Figure 17). Countries including France, the Netherlands and Belgium however have also experienced an increase in youth unemployment within the last year.

Another group that is at risk of poverty and marginalization are the unemployed low-skilled workers and unemployment has continued to rise among low skilled. In the second quarter of 2013, 20 percent of the low skilled workers (education levels 0-2) in the EU were unemployed corresponding to almost 10 million persons. For workers with upper secondary and post-secondary non-tertiary education (tertiary levels 3-4), unemployment is about 10 percent while it is only 6½ percent for workers with higher education corresponding to tertiary levels 5-6.

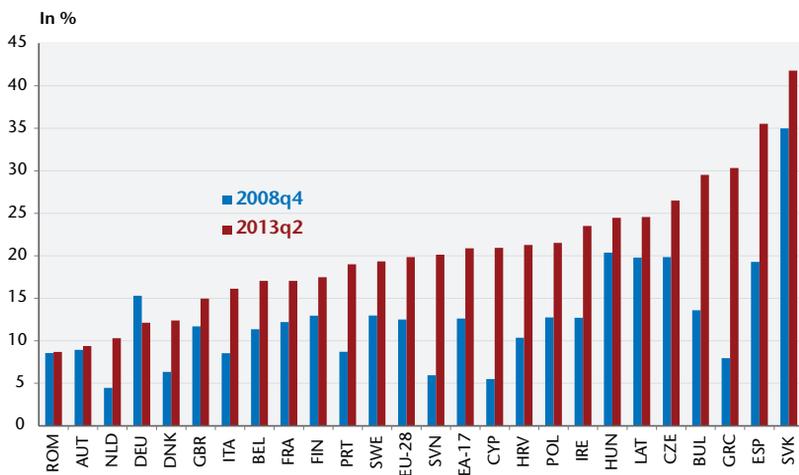
Low skilled workers have by far suffered the largest increase in unemployment compared with other educational groups on the labour market. Looking at the individual countries it is clear that unemployment among low skilled workers is very high in many already troubled countries like Greece, Spain, Ireland and Cyprus. In many Eastern European countries like Slovakia, Bulgaria, the Czech Republic, Latvia, Hungary, Poland and Croatia unemployment among low skilled workers is above the EU average. One finds the lowest rates in Romania, Austria, the Netherlands, Germany and Denmark.

Figure 17. Youth unemployment in Europe



Source: Eurostat.

Figure 18. Unemployment among low-skilled workers in Europe



Source: Eurostat.

2. Income inequality and poverty during the crisis

The economic crisis has brought significant changes in the standard of living for many Europeans. Measuring the changes in income distribution, including inequality across countries, may be associated with uncertainties, especially in recent years. Nevertheless, we will attempt to do it below, being well aware of some of the pitfalls. Box 5 gives a more detailed evaluation of the data.

Box 5. Measuring inequality and poverty

Eurostat's SILC database is the data source to the figure in this chapter.

SILC is an instrument aiming at collecting timely and comparable cross-sectional and longitudinal multidimensional microdata on income, poverty, social exclusion and living conditions. EU-SILC data are collected by National Statistical Institutes and could come from different sources. In some participant countries a new survey was launched with cross-sectional and longitudinal elements. In other countries a combination of registers and surveys is used, that is the data for the same respondents are collected partly by interview and partly from register. The sample size is between 4.000 and 20.000 depending on the size of the country. Most survey data is associated with uncertainties. There could be uncertainties associated with the sample size, the sample stratification, the response rate, the countries' different weighting methods etc. The uncertainty increases when you look at data over time and across countries.

In the SILC database the uncertainties are especially related to extreme observations (outliers), being both extremely high and extremely low (including negative) incomes, as these observations outliers can have large impact on the results of the various inequality measures. It is especially measures as the Gini coefficient and the s20/80 ratio that are affected by these outliers. Poverty targets are not affected by these outliers to the same extent, as they are not based on the entire aggregate income, but are instead based on the median income. Nevertheless we have chosen to present survey-based inequality measures in this chapter. The indicators are presented on a rather aggregated level in order to make the conclusions as robust as possible. Despite these reservations, the SILC database is still one of the best data sources to describe inequality across European countries.

For further reading about the SILC database see - EU-SILC (2012), DIW (2010), Hauser (2008), JESP (2011), IMPROVE (2013) and ISER (2012).

Our first focus will be on analyzing the evolutions of income inequality during the crisis. The Gini coefficient and the share of national income per decile are good indicators to estimate evolution of inequality. Second, we study the evolution in poverty. To do that, we study the development in the anchored at-risk-of-poverty rate and the un-anchored at-risk-of-poverty rate for different groups in society (children, elderly, unemployed) and then we look at the importance of social transfers and education.

It is important to distinguish the two analyses. Indeed, inequalities can be stable while poverty increases and *vice versa*. Box 6 discusses the difference between the anchored at-risk-of poverty rate and the unanchored at-risk-of-poverty rate and the importance of choosing the right indicators when measuring inequality and poverty in an deep recession.

Box 6. Anchored at-risk-of-poverty rate vs. unanchored at-risk-of poverty rate

Definitions

The unanchored “standard” at-risk-of-poverty rate is defined as the proportion of the population whose equalized disposable income is below 60 percent of the median income. The indicator is relative to the disposable income in both time and country, making it an indicator of social inclusion specific to the year and to the country.

The change in the at-risk-of poverty rate anchored in a particular year is defined as the proportion of the population whose equalized disposable income is below 60 percent of the median income in a particular year (here 2008) - adjusted for inflation. In short the anchored indicator defines the share of the population who would have been at-risk-of-poverty in their country in 2008. In some European countries this share has grown fast, because of overall income decline, and in others this share has shrunk, because of income growth.

Anchored or unanchored?

Whether one or the other measure is appropriate depends on what you are interested in measuring.

As median disposable income varies between countries, comparison of at-risk-of-poverty rates becomes difficult. Median income has developed very differently in the European countries over time, and even more so since the beginning of the crisis in 2008. This has made country comparisons less meaningful, because median income has grown in some countries and declined in others.

When using an at-risk-of-poverty indicator anchored in a specific year, the indicator becomes absolute over time but still relative between countries. This makes it an indicator of the share of the population with not enough disposable income to buy a fixed basket of goods and services specific to each country.

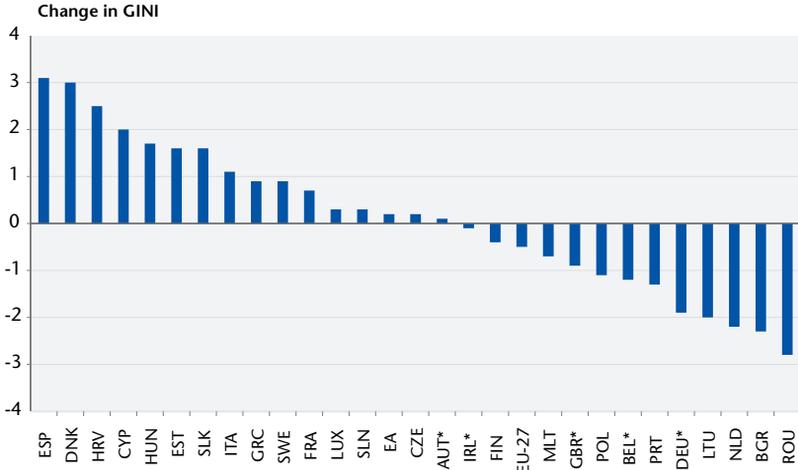
However, since the basket of goods and services considered to be the minimum acceptable to avoid the risk of poverty tends to expand over time as real incomes grow, it can also be argued that the standard indicator of the at-risk-of-poverty rate, which takes account of such an expansion, is the more relevant one for measuring changes in those at risk of poverty, because the people at-risk-of-poverty should also take part of the general increase in the prosperity in society.

Growth of median incomes plays a key role in the development of the anchored measure. If all people become poorer, poverty by definition increases. If all people become richer, poverty by definition decreases, which is not the case with the standard unanchored measure. Although it may be problematic for long-term comparisons, anchoring the at-risk-of-poverty rate provides a good measure of the changes in living standards experienced by people in the short run. This makes it possible to compare countries with a different overall income development. The indicator is still a relative indicator of social inclusion in the sense, that the threshold is specific to each country. A family with a specific disposable income can be at risk of poverty in some countries and at the same time not in others.

Source: European Commission (2011), EU-SILC (2012) and KU LEUVEN (2013).

The Gini coefficient measures the degree of equality in a society. In a country where all people have the same equalized disposable income the Gini coefficient is 0, in a country where a person has all the income the Gini coefficient is 100². Figure 19 shows the change in the Gini coefficient in the EU. As seen in the figure Southern European countries like Spain, Croatia, Cyprus, Italy and Greece have seen quite a remarkable increase in income inequality during the crisis, whereas a group of central European countries, such as Belgium, Netherland and Germany have experienced decreasing inequality.

Figure 19. Change in GINI coefficient 2008-2012



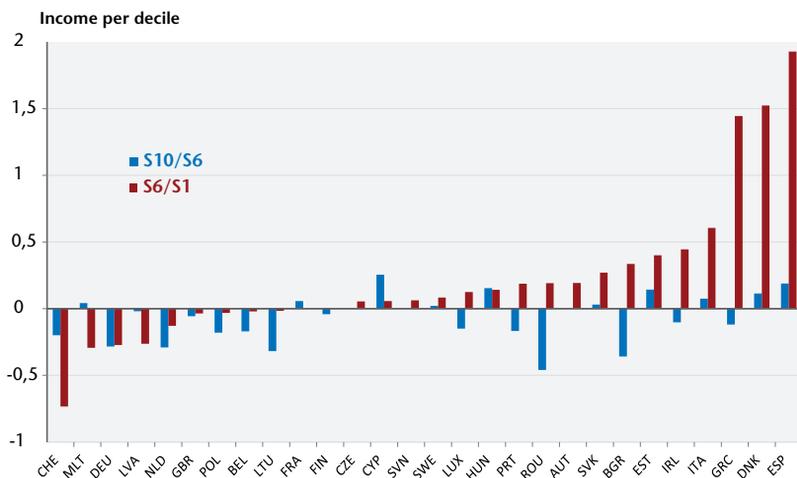
Note: For countries marked with * 2011 are the latest data available. 2012 data for EU-27 and the euro area are estimated. 2012 Data for Italy are provisional.
 Source: Eurostat SILC database.

Figure 20 decomposes the evolution of inequalities at the top (S10/S6) and at the bottom (S6/S1) of the income distribution, using ratios of decile's share of income (S6 represents here the share of income received by households of the 6th decile of equalized disposable income). In Spain, Greece and Italy, the increase of inequality is driven by an increase at the bottom of the income ladder: the relative share of national equalized income received by the 10% poorest people (S1) greatly decreased between 2008 and 2010 compared to S6. On the other hand, in Germany, inequalities decreased both at the top and at the bottom of the income. This is also true, to a lesser extent, in the United Kingdom, where top incomes were hit by the financial crisis.

One of the consequences of increasing income inequality and increasing unemployment is that more Europeans are at risk of poverty. Figure 21 shows the change in the anchored at-risk-of-poverty rate from 2008-2012. The anchored at-risk-of-poverty rate is the share of people with a national median equalized disposable income after social transfers, here anchored in 2008 and adjusted for inflation.

2. Here, we multiply the standard Gini coefficient by 100.

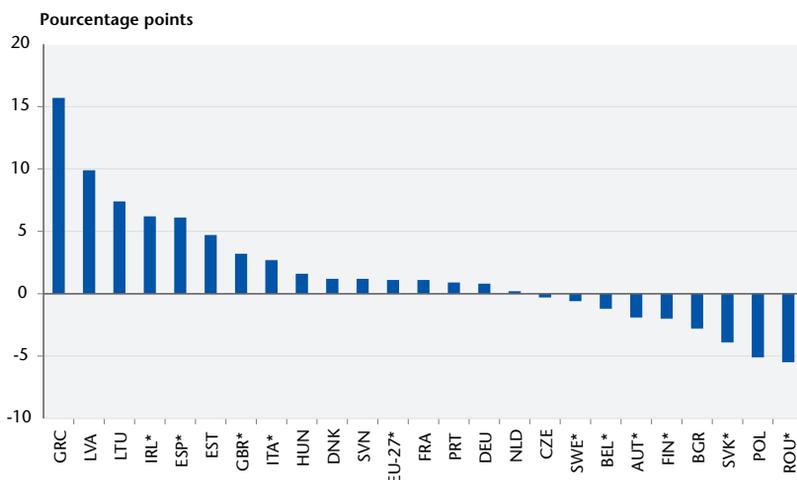
Figure 20. Evolution between 2008 and 2012 of share of national equalised



Note: S10 is the share of national equalised income detained by the 10% richest people. S6 is the share of national income detained by people with incomes between the 5th and the 6th decile income.

Source: Eurostat SILC database.

Figure 21. Change in the risk of anchored poverty 2008-2012



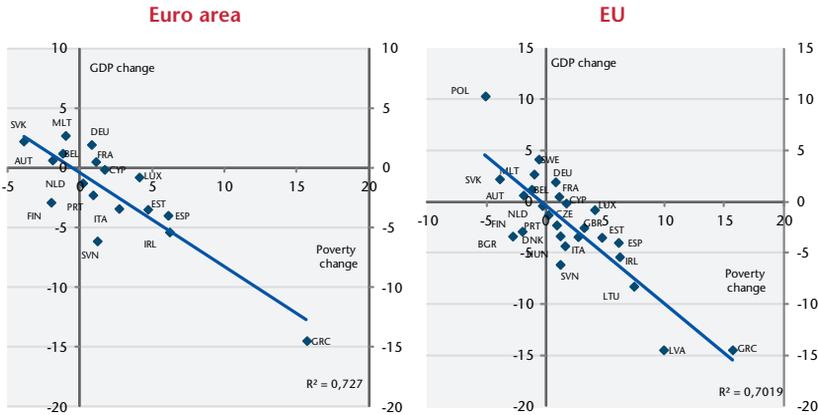
Note: For countries marked with * 2011 are the latest data available. At-risk-of-poverty rate anchored in 2008. Change in the percentage of total population.

Source: Eurostat SILC database.

A decrease/increase in the anchored poverty risk over time indicates that the living standards for low-income groups are improving/worsening compared to the base year (2008). It is especially Southern European and Baltic countries that have experienced deterioration in the living standards for low income groups during the crisis, see Figure 21. Contrary to the standard poverty rate measure, the study of anchored poverty rate does not take into account the evolution of median income.

Figure 22 shows the correlation between the change in GDP from 2008-2011 and the change in anchored poverty from 2008-2012 for the euro area and the EU. There seems to be a strong negative correlation, meaning that the harder a country has been hit by the crisis, the larger is the increase in the anchored poverty rate. This is due to the fact that as income decreased for a large part of the households, many crossed the anchored poverty line. However, when using a unanchored threshold, this correlation disappears, because GDP declines also turns into declines in the median income.

Figure 22. Correlation between change in GDP and change in anchored poverty:



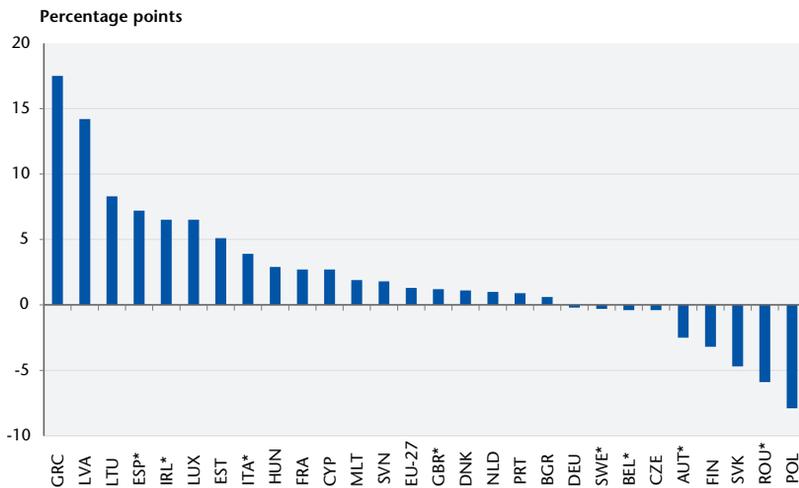
Note: For countries marked with * 2011 are the latest data available. At-risk-of-poverty rate anchored in 2008. Change in anchored RoP from 2008-2012. Change in GDP from 2008-2012.
 Source: Eurostat and SILC database.

Poverty does not affect all age groups in the same proportion. Figure 23 shows the change in the anchored poverty rate for children and Figure 24 shows the change in the poverty for people at the age of 65 years or more.

In general it is the same group of countries that experience high increases in the overall poverty rate, that are also experiencing increases in the child poverty rate. Child poverty is very concerning since children are an extremely vulnerable group. This is due to their dependent status (they can only partly influence their own well-being) but also due to the decrease or the stagnation of family benefit in many countries during the crisis. On top of that they are the future of Europe and lack of opportunities during childhood is likely to have long-term consequences for the concerned individuals as well as for society as a whole.

A slightly different picture is seen amongst the elderly (Figure 24). In the majority of countries, the poverty rate has decreased amongst the elderly, and in the few countries where the poverty rate has increased, the increase is significantly lower than for other age groups. The reason why the elderly have been relatively immune to rises in the poverty rate during the crisis properly reflects that elderly's incomes are relatively stable and unaffected by business cycles. This pattern confirms the trends described in previous OECD studies, e.g. OECD (2013), with youth and children replacing the elderly as the group at greater risk of income poverty.

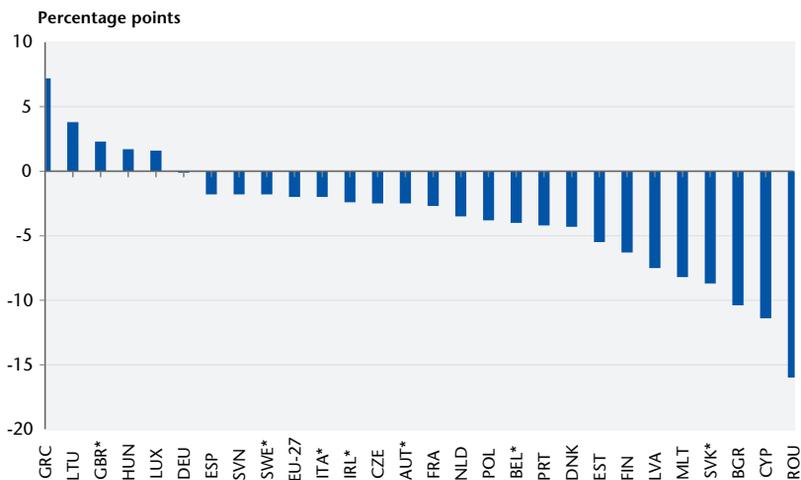
Figure 23. Change in the anchored risk of poverty for children (under 18 years) 2008-2012



Note: At risk of poverty rate for the population under 18 years. For countries marked with * 2011 are the latest data available. At-risk-of-poverty rate anchored in 2008.

Source: Eurostat SILC database.

Figure 24. Change in anchored the risk of poverty for pensioners (65 years or more) 2008-2012

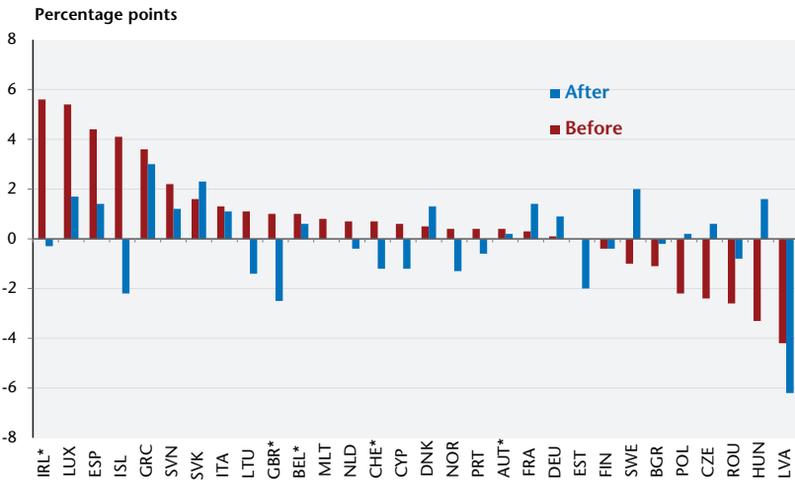


Note: At risk of poverty rate for the population 65 years and more. For countries marked with * 2011 are the latest data available. At-risk-of-poverty rate anchored in 2008.

Source: Eurostat SILC database.

Despite the lower living standards for low income groups in some countries, social transfers have eased the pain and have reduced the amount of people living in the risk of poverty. Figure 25 shows that the transfers played an important role in unanchored poverty reduction in the countries hardest hit by the crisis between 2008 and 2012 (Spain, Portugal, Italy). In these countries, the poverty rate after social transfers increased slower than the rate of poverty before social transfers, which means that transfers effectively compensated for part of the overall increase in the poverty rate. However, the impact of transfers varies across countries. In “Northern countries” (Germany, Sweden), the impact of transfers fell between 2008 and 2012. In this respect, France behaves like Northern countries.

Figure 25. Evolution of the difference in poverty rates before and after social transfers, 2008-2012

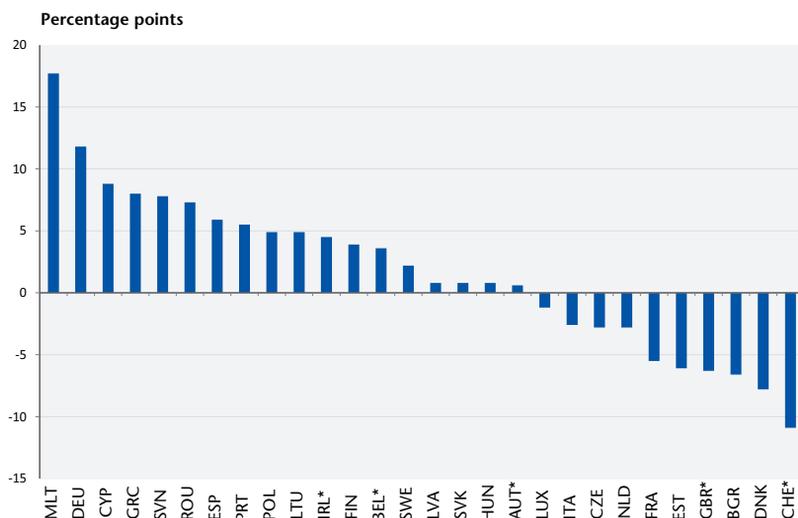


Note: For countries marked with * 2011 are the latest data available. Percentage of total population. Pensions excluded from social transfers. Reading: In Spain, the poverty rate before transfers increased by more than 4 points between 2008 and 2012. After transfers poverty rate increased by only 1,4 point : transfers are therefore more effective at reducing poverty in 2012 and 2008.
Source: Eurostat SILC database.

However, the impact of transfers should be relativized. Indeed, these are not sufficient to compensate for the massive rise in unemployment in some countries. In Spain, the gap of poverty rates between employed and unemployed has increased to 5.9 points (Figure 26). These changes can be explained again by the massive increase in unemployment in the countries concerned.

As stated above unemployment growth leads to an increase in long-term unemployment, which means, in a lot of countries, an increase of uncompensated unemployment. This mechanism leads to a decrease in income for the unemployed and to an increase of inequalities between the employed and the unemployed (Figure 26). Furthermore, in the long term, the increase in long-term unemployment could also lead to a loss of human capital (Decreuse and Di Paola, 2002; Jackman and Layard, 1991).

Figure 26. Evolution of the difference in poverty rates between Employed and Unemployed, 2008-2012



Source: Eurostat SILC database.

Finally, the risk of poverty is not only unevenly distributed among age groups, but also amongst education levels, Table 10. There is a significant higher risk of poverty amongst the European with the lowest education level. This picture is

Table 10. Risk of poverty divided by education level, 2012 (selected countries)

Percent	Level 0-2	Level 3+4	Level 5+6
BEL*	33.7	17.8	10.4
BGR	72.7	45.3	24.2
DEU	36.3	21.7	11.5
GRC	41.8	37.8	18.1
ESP	33.7	25.7	14.0
FRA	24.6	17.7	10.2
ITA	37.0	24.1	15.8
HUN	50.6	28.0	12.2
NLD	16.6	15.5	10.9
PRT	27.3	18.3	8.3
FIN	26.8	20.5	6.4
GBR*	34.2	22.3	12.9
EA	32.4	21.4	12.0
EU	35.3	23.3	11.9

Note: Pre-primary, primary and lower secondary education (levels 0-2). Upper secondary and post-secondary non-tertiary education (levels 3 and 4). First and second stage of tertiary education (levels 5 and 6). population aged 18 and over. For countries marked with * 2011 are the latest data available. 2012 data for EU-27 and the Euro area are estimated. 2012 Data for Italy are provisional.

Source: Eurostat, SILC database.

seen in all European countries. It is especially in Eastern European countries where the risk of poverty exceeds 50 percent for the lowest educated in a number of countries. On the overall European level, the risk of being poor is three times as high if you have a low education compared to if you are highly educated. This is partly explained by the fact that low skilled workers are more exposed to unemployment, which could be due to a queuing phenomenon.

3. Inequality and poverty have a deep structural and socio-economic impact

Austerity is dominating fiscal policy in Europe, pushing more Europeans into unemployment and poverty. Oxfam has calculated that, if left unchecked, austerity policies could put between 15 and 25 million more Europeans at risk of poverty by 2025 and it could take up to 25 years to regain living standards prior to the economic crisis OXFAM (2013). The figures above show an overall picture of a Europe that is not converging but diverging, with some countries lagging more and more behind. One of the main ideas behind the European Union was to allow the member countries to converge. The more divided the countries are the harder it is to create a common direction for fiscal policy and, in the end, a fiscal union. But as Leschke, Theodoropoulou and Watt (2012) show, those countries in Europe where social spending was already least generous and inequality highest tended also to be those that planned to make the largest cutbacks in social spending, as part of their EU-mandated Stability and Convergence programs, in the face of the crisis.

When social security budgets, and public sector services are cut and labour markets are deregulated, it all serves to weaken the mechanisms that combat inequality. Austerity both pushes more and more Europeans into unemployment, but it also erodes the safety net that was supposed to help them. The result is not surprisingly increases in poverty and inequality.

Poverty and inequality is not only a problem in humanitarian terms. Inequality and poverty are also shown to have deep structural and socio-economic impact on the economy. Easterly (2007) has shown a highly significant negative correlation between inequality and long-run economic development. Higher inequality generates a lower level of economic development, and the causality (cause-and-effect) is clearly that way. This means that low inequality gives a higher level of prosperity in the long run. The mechanism goes through poorer institutions and lower education level. Altogether Easterly (2007) finds that higher inequality leads to: 1) Poor institutions in the form of more corruption, more political instability and lower levels of democracy. 2) Lower level of education. And therefore 3) A lower level of economic prosperity.

These conclusions are supported by other studies. Wilkinson *et al.* (2010) also finds that high inequality is associated with lower education outcomes. Increases in inequality and poverty can put the political legitimacy at stake KU LEUVEN (2013). One example is that increases in inequality have been found to be correlated with lower trust between people Wilkinson *et al.* (2010).

There is an alternative. Below we outline an alternative approach, which will reduce poverty, inequality and unemployment by creating jobs and wealth. The alternative is based on four pillars:

- 1) A European investment plan
- 2) Active labour market programs
- 3) Increasing the education level
- 4) A fair tax system

These four pillars are described below.

3.1. A European investment plan

We need to rethink our strategy concerning Europe's way out of the crisis, stimulating the economy in order to create wealth and jobs. The IMF (2013a) has recently concluded that *"fiscal consolidation has typically led to a significant and persistent increase in inequality, declines in wage income and the wage share of income, and increases in long-term unemployment ... fiscal consolidation that are unduly hasty pose risk to recovery. So countries with the scope to do so should opt for a slower pace of consolidation, combined with policies to support growth"*.

Chapter 4 outlines a European plan for investment, showing how a common investment plan can create growth and employment in Europe, thereby reducing poverty and inequality.

3.2. Active labour market programs

Increasing expenditures and effort on active labour market programs will also reduce inequality and poverty. Passive labour market programs are traditionally unemployment insurance schemes, whereas active labour market programs are training activities and other reintegration policies targeted at the unemployed, (as opposed to a general training or education subsidy). Active programs may include education aiming at upgrading the skills of unemployed workers or employment programs intended to prevent skill losses during the period of unemployment Filges *et al.* (2011). In other words, active labour market programs are aiming at securing the employability of the unemployed. It is a well-known fact that low employability is a side effect of being long-term unemployed (see section 1).

As seen in the Figure 27 below there seems to be a clear negative correlation between the average Gini coefficient and the expenditures on active labour market programs from 1995-2010, indicating that countries that are high-spending on active labour market programs also tend to have better records on income redistribution than low-spending countries. Investing in employability and a stronger social protection system will not only protect the weakest in society here and now, it will also help fighting inequality in the longer run.

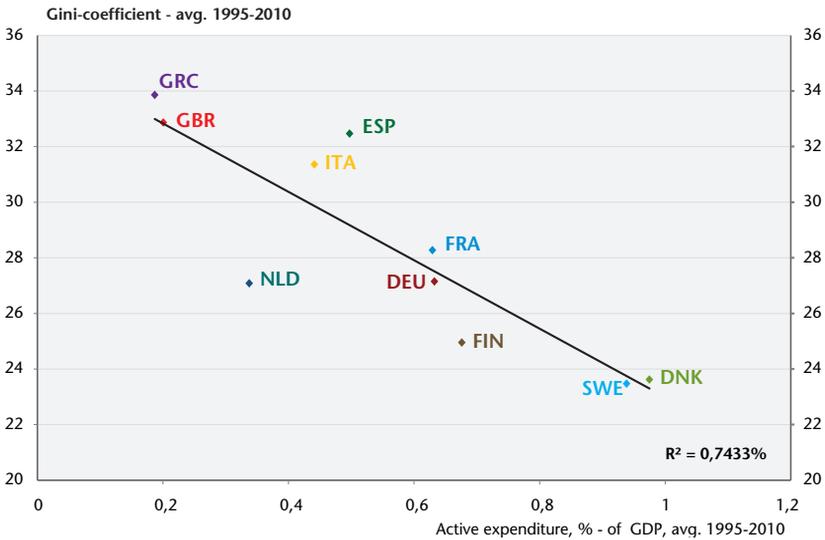
As already stated above child poverty is especially concerning. TARKI (2010) finds that unemployment is the leading cause of child poverty in the EU. Ensuring that parents are employed is therefore a crucial mechanism to reduce the risk of child poverty. Policies that improve the conditions for low income families with children will reduce child poverty. This could be seen in the form of higher labour participation among parents, including improved parental leave arrangements, which makes it easier to return to work after maternity leave.

Increasing the female participation rate is also likely to reduce the risk of poverty for children. By increasing the female participation we can increase employment and create more equal opportunities for men and women. One way

to make it more likely for women to participate in the labour force is to develop and subsidize the public childcare system.

Finally there is the introduction of a minimum wage. A coordinated European wage policy with focus on minimum wages would raise the incomes at the bottom and reduce the poverty rate for employed, the so-called working-poor. Chapter 3 outlines the case for a European minimum wage norm, and shows an alternative strategy based on convergence and coordination of wage policies.

Figure 27. Correlation between Gini coefficient and active expenditures



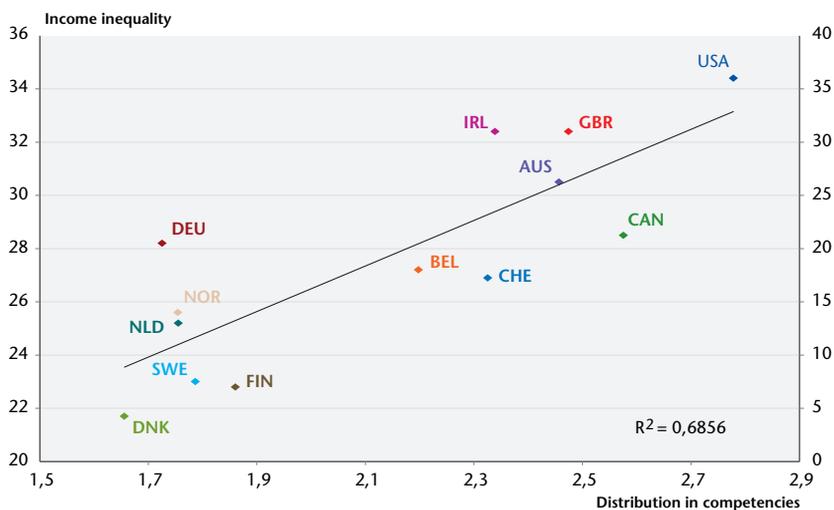
Sources: The Rockwool Foundation on the basis of OECD and Eurostat ROCKWOOL(2013).

3.3. Increasing the educational level

As shown earlier the risk of poverty is three times as big if you have no or a lower education compared to a higher education. Easterly (2007) and Wilkinson (2010) also find that inequality and education levels/outcome is negatively correlated. The Figure 28 below shows income inequality spread and variation in competencies in a number of countries. It is seen that there is a clear positive correlation between the variation in skills and the variation in incomes.

By increasing the educational level for the weakest we can lift the incomes in the bottom and in this way reduce income spread and hereby inequality. The supply of unskilled labour is reduced relative to that of skilled labour. In this way it is possible to fight social inequality by getting weaker groups employed. Increasing the education level will also benefit the large group of unskilled or low skilled young people in Europe. More young people should have at least an upper secondary education and more adults, especially those without training, should have better opportunities to upgrade their skills through adult and continuing education.

Figure 28. Income variation and distribution of competencies



Note: Distribution of competencies measured as the best 95 percent relative to the worst 5 percent. Income variation in disposable income.

Source: Calculations on the basis of data from OECD.

3.4. A fair tax system

Reforming the tax system in Europe is an obvious field to reform when it comes to poverty reduction and creating a more equal Europe. By reforming tax systems in Europe in order to make it fairer and more progressive, it will not only create a more equal society. It can also be part of the financing of tax decreases for low-income earners as well as investments in physical assets, education and active labour market policy.

Not only income taxation, but also corporate taxation should be reformed. Tax competition in the EU is already a 'race to the bottom', where corporate tax cuts and reductions in the top rate of income tax in one country makes other countries follow. It is an unhealthy tax competition because there is a risk that it will not end, before the corporate tax rate is zero, and the income tax schedule is markedly less progressive, threatening the financing of the welfare state. The result is a negative spiral with no winners, as countries follow each other down, in an attempt to hijack investments and businesses from each other. It is therefore important to build a political consensus on a coordinated policy for corporate taxation.

The consensus to combat tax evasion and tax havens is broad. The European Commission has estimated that European countries annually lose in the area of 1 trillion Euros because of tax evasion EU-COM (2012). Therefore, it is gratifying that the large EU countries have intensified action against tax evasion and against the European countries that attract money by hiding information from other countries. The current challenges with the ongoing economic crisis, the unhealthy corporate tax competition and tax evasion are best solved by international coop-

eration, and the EU can play a central role in doing so. However, this requires that the EU cooperation changes track and turns in a more progressive direction.

Another option is to tax high incomes and wealth for a period of time to both reduce the debt burden and the increase in inequality experienced during the last decade. There is no simple solution on how such a tax should be put together. The IMF has proposed a one-off tax on private wealth also called "capital levy". The idea is that such a tax, if it is implemented before avoidance measures are taken, and as long as there is a belief that it will never be repeated, will not distort behavior (IMF, 2013b). If the IMF position is a step in the right direction, conceding that if the States in Europe are poor, households are rich, the idea of a one-off capital levy should be taken with caution. First, the premise is that capital taxation creates distortion, which should be relativized if we believe we are in a regime of excess savings. Second liquidity issues make the 'capital levy' difficult, especially on real estate. Third, it is difficult to assess the macroeconomic consequences of such a shock treatment. For all these reasons, a stable annual taxation of capital at lower rates than the capital levy seems preferable.

Finally the EU should implement a common Financial Transaction Tax. Eleven European countries have already agreed on implementing the tax from 2014, but other European countries should join the initiative. The revenue from the tax could be used to invest in jobs, to implement active labour market policies, to invest in education etc.