# 4. Income and inequality

## Introduction

The recent financial crisis was caused by the global economy being massively out of equilibrium. As the word equilibrium derives from the Latin *aequi* (equal) and *libra* (balance or scales, an ancient symbol of justice), it is perhaps unsurprising, though not widely recognised, that inequality has been a root cause of the financial crisis and current recession. Inequality is linked to economic performance in several ways. In unequal countries with weak financial regulation (such as the UK) those on low incomes borrowed money in an effort to emulate the lifestyles of those on higher incomes. In countries that did not experience a credit boom (such as Italy), inequality was associated with low growth and low domestic demand, as those on low incomes tend to spend a higher proportion of their incomes than those on high incomes. As will be demonstrated, across Europe as a whole, countries with more equal societies have tended to fare better during the crisis than unequal societies.

The current recession has reduced national income and thereby the size of the pie from which workers can cut their share. Workers' incomes can be reduced through wage cuts and also through unemployment (see Chapter 3). To date most of the effect of the recession on workers has been through increases in unemployment. However, as the labour market deteriorates further, there will also be downward pressure on wages. Some countries that have led the recession (Lithuania and Estonia) have already experienced nominal wage cuts (wage cuts in simple money terms), and in the UK, in spite of small nominal increases, the value of wages when converted into euros has fallen steeply.

It is unclear how the financial crisis will impact on inequality and, due to the nature of data collection, it will be some time before post-crisis data are available. During recessions the wage share of gross domestic product (GDP) typically increases, as profits fall faster than wages and unemployment. However, as unemployment increases this change in the wage share will tend to be reversed. Insofar as those in precarious employment (often the temporary workers, part-time workers, and migrant workers) are usually the first to lose their jobs, their loss of income will be likely to generate greater inequality and more poverty. However, as the minimum wage acts as a wage floor in most EU countries, a general fall in incomes may actually lead to greater equality during the recession, though, once again, this can be expected to be no more than temporary.

In this chapter the economies of Europe are benchmarked against each other in terms of incomes and inequality, and a link between inequality and the current recession is shown. It is important to remember that, for some countries, the recession started before the financial crisis. Ireland, for instance, saw falls in income beginning in 2007. While these 'recession-leader' countries may indeed provide some indication of what can be expected to happen in other countries in the near future, it must be remembered that the specific circumstances faced by each country are unique.

### Themes

4.1 Income and the crisis

4.2 Inequality and the crisis

4.3 The working poor

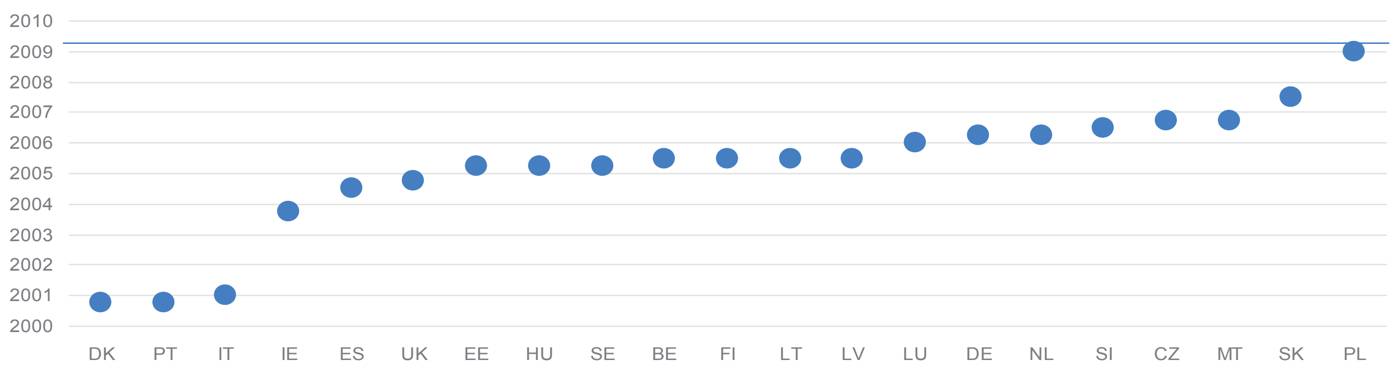
4.4 Conclusions

# 4.1 Income and the crisis

## A lost decade?

Figure 2.3 of Chapter 2 has compared GDP levels across Europe. However, changes in GDP during the crisis may also be usefully observed from a different angle. Due to the current recession, real GDP has fallen back to levels first seen earlier this decade. Although, largely due to advances in science and technology, GDP can be expected to grow in real terms over time, the current recession has led to major reversals in this trend. Figure 4.1 shows when the current level of real GDP was first achieved with the date of the onset of the financial crisis (Q3 2008) serving as a benchmark. In this way it can be seen that the recession has, in some cases, wiped out almost an entire decade of progress. For example, the GDP of Denmark has regressed to levels first seen at the turn of the millennium, and the Estonian economy has fallen back three years since the financial crisis hit. This reversal to GDP levels of an earlier date can be due either to a large decrease in GDP during the crisis or to very slow growth during the past decade combined with a moderate decrease in GDP during the crisis. This alternative way of looking at the impact of the crisis helps to show the long-term economic performance of countries (such as Italy) which, although they have not seen large percentage falls in GDP, have been experiencing slow growth and progress since the beginning of the decade.

**Figure 4.1 A lost decade? when was current GDP first achieved**




Source: Eurostat (2009) *Quarterly National Accounts*. Notes: This Graph shows when the current level of seasonally adjusted real GDP per capita was first achieved. Current Period taken as Q2 2009, except Poland (Q1 2009) and Italy (Q3 2008) Data unavailable for AT, CY, FR, RO, GR and BG

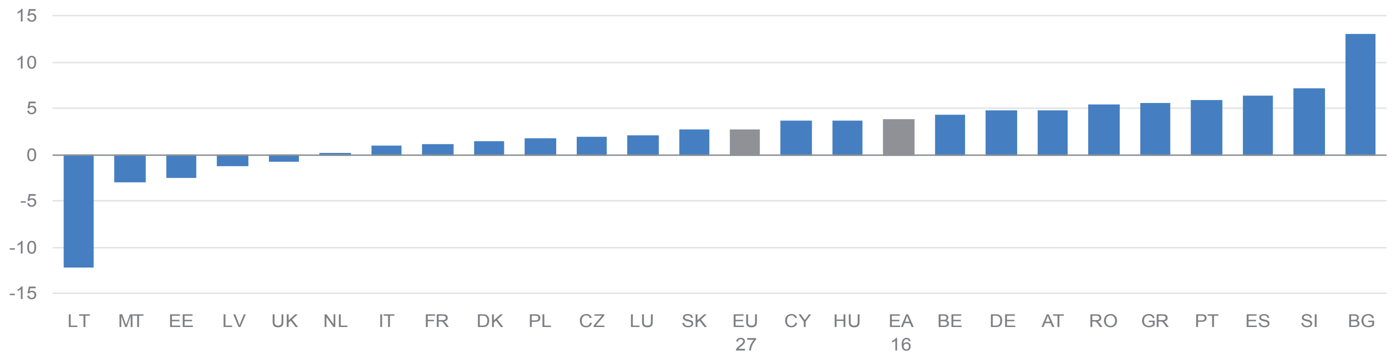
# 4.1 Income and the crisis

## Change in wages

Despite the crisis, workers in most countries have obtained nominal (and real) wage increases, as shown in Figure 4.2 on year-on-year increases in real wages and salaries. Part of the reason that salaries have increased is the delayed impact of wage increases negotiated following the spike in inflation during the summer of 2009, which coincided with the end of a period of wage moderation that had lasted for much of this decade. Actual wage decreases have been seen in some countries, including Lithuania where they fell by 12 per cent, and it remains to be seen whether employers in other countries will seek to use the recession as grounds for imposing wage decreases. Omitted from the graph, however, are those workers for whom unemployment meant a total loss of wages. What is more, if, proportionately, more lower-paid workers (such as low-skilled workers or migrants) lose their jobs, the result can be an increase in the average wage even though no wage increase has actually been granted.

Whether wages increase or decrease depends on many factors, such as the industrial relations set-up in the various countries. However, the countries that were hit by large decreases in GDP, such as the Baltic countries and the UK, have suffered real wage decreases. Countries whose labour markets are under pressure (see Chapter 3) are those experiencing the lowest growth in wages and wage decreases. Spain, though badly hit by the recession, has shown real wage increases, a development that is perhaps unsurprising, as it has been, for the most part, badly paid temporary workers who lost their jobs in Spain, where the temporary employment rate decreased by about 5 percentage points within a single year.

**Figure 4.2 Year-on-year percentage real change in wages and salaries (Q2 2008 to Q2 2009)**



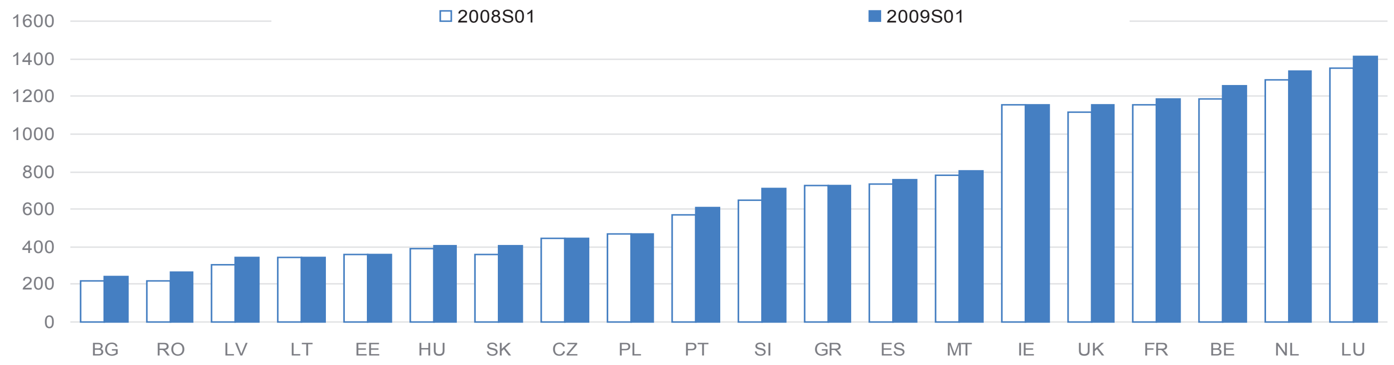

Source: Eurostat (2009) *Labour Cost Index and Harmonized Index of Consumer Prices*. Note: Seasonally adjusted change in real wages and salaries,2008Q2 to 2009Q2, except Netherlands, Luxembourg and Italy 2008Q1 to 2009Q1. (NACE rev2 sectors B-N). Data unavailable for IE, SE and FI

# 4.1 Income and the crisis

## Rising minimum wages

Almost all countries have seen an increase in the nominal (and real) minimum wage during the crisis, though data is only available on a bi-annual basis. Figure 4.3 shows the pre-crisis and post-crisis statutory minimum wages for European countries in terms of Purchasing Power Parity (PPP). PPP adjusts the minimum wage for the differences in purchasing power across countries (e.g. things tend to be cheaper in poorer than in richer countries). Minimum wages tend to reduce income inequality within a country by placing lower limits on the amount people are paid. Interestingly, however, the Nordic countries tend to have the most equal wage structure but have no statutory minimum wage, although union agreements have led to de facto minimum wages. Countries having no national statutory minimum wage are Austria, Denmark, Finland, Germany, Italy and Sweden (European Foundation for the Improvement of Living and Working Conditions 2005). The current low inflation has helped minimum wages keep their value across Europe. For more information on minimum wages during the crisis see Schulten 2009.

**Figure 4.3 Minimum wages for 1st half of 2008 and 1st half of 2009 (PPP)**



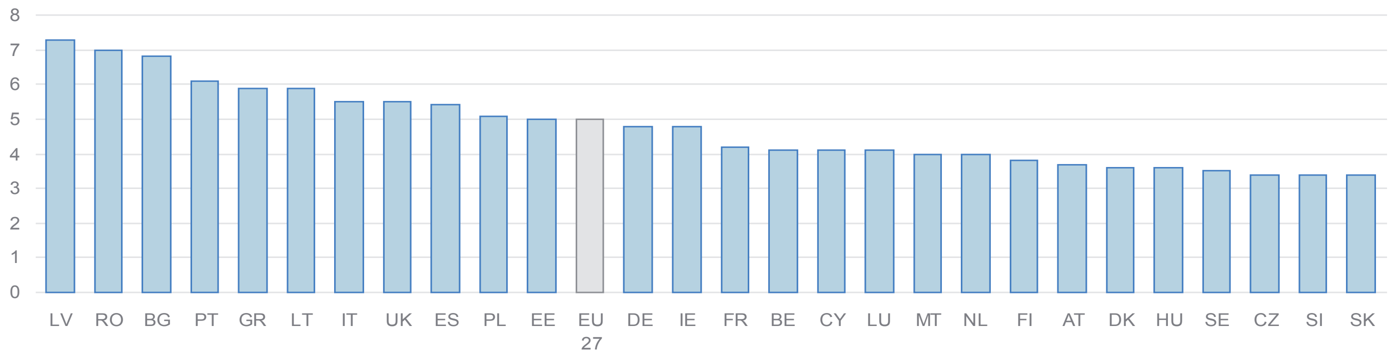

Data source: Eurostat (2009) *Minimum Wages*. Note: Minimum wages for first half of 2008 and 1st half of 2009 (except GR first and second half of 2008). Purchasing Power Standard. PPS estimated for 2009 Data unavailable for CY.

# 4.2 Inequality and the crisis

## Unequal incomes

As stated earlier, measures of GDP give no indication of how income is distributed within a country. The 80/20 income share ratio compares the incomes of the bottom 20% with those of the top 20% (Figure 4.4). In 2008, in Romania those at the top 20% level of income earned seven times more than those at the bottom, while in Slovakia the highest 20% earned about 3.4 times more than the lowest. There is no East/West divide of inequality across Europe. The countries with the lowest inequality are the more economically advanced of the former Communist countries and the Nordic countries. Data is not so far available on how the economic crisis has affected inequality, although, interestingly, between 2007 and 2008 Latvia (one of countries hardest hit by the crisis) saw the 80/20 income share ratio increase from 6.3 to 7.3. From the end of 2007 to the end of 2008 Latvian unemployment doubled, suggesting that the increase in household inequality is due to an increase in unemployment. By contrast, in Lithuania, another country particularly hard hit by the crisis, the ratio has remained constant at 5.9, despite a doubling of unemployment.

**Figure 4.4 Inequality of income distribution 2008 (80/20 income quintile share ratio)**



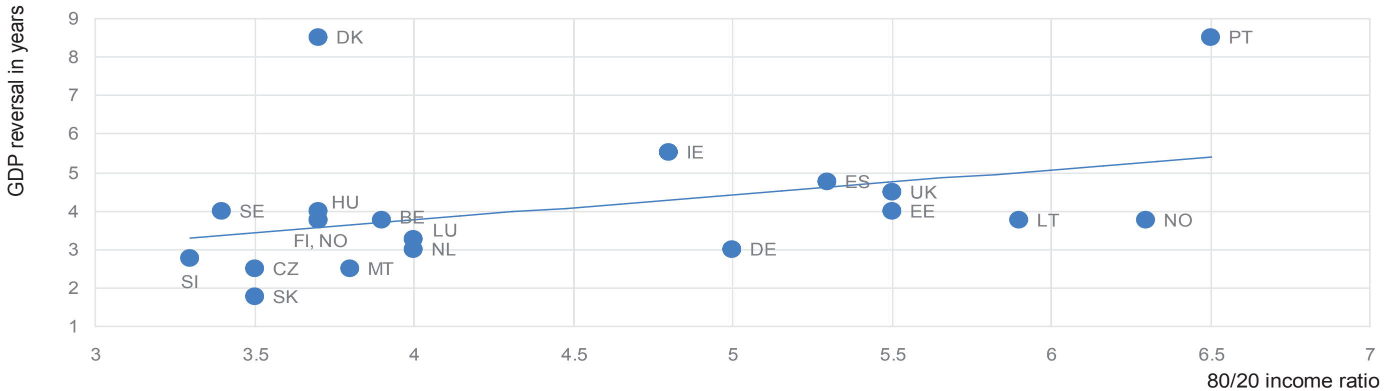

Data source: Eurostat (2009) *Survey of Income and Living Conditions*. Note: 2008 values except for IE, IT, UK and EU27.

# 4.2 Inequality and the crisis

## Did inequality cause the crisis?

Comparing Figure 4.1 with Figure 4.4 shows how inequality is associated with poor economic performance during the current recession. Figure 4.5 shows the relationship between the 80/20 income ratio and the number of years by which GDP has regressed during the current crisis. There is a clear association between inequality and reversals in GDP during the recession (though Denmark, in the top left of the graph, is a notable exception). It is plausible that inequality led to, and exacerbated, the current crisis. European economies can be divided into three categories: relatively equal countries (those countries with an 80/20 income share ratio of less than four); relatively unequal countries with easy access to credit; and unequal countries with limited access to credit. People with lower incomes tend to spend more of their income, rather than save. In equal societies aggregate demand tends to be higher, as those on lower incomes in equal countries have relatively more money than those on lower incomes in unequal countries. This allows for stable growth. In unequal societies (such as the UK and Spain) aggregate demand was temporarily boosted by creating an unsustainable credit boom, allowing people on low incomes to borrow money to match the lifestyles of the richer groups. However, the incomes of these low earners proved too low to allow them to repay their debts, contributing to the financial meltdown. In unequal societies where access to credit was limited (such as Italy), there was no dramatic financial crash. In these countries the lack of aggregate demand resulted in economic stagnation. This suggests that more equal societies, with a more balanced distribution of income, tend to have a more balanced growth path.

**Figure 4.5 Relationship between inequality (80/20 income quintile share ratio) and reversal in GDP**



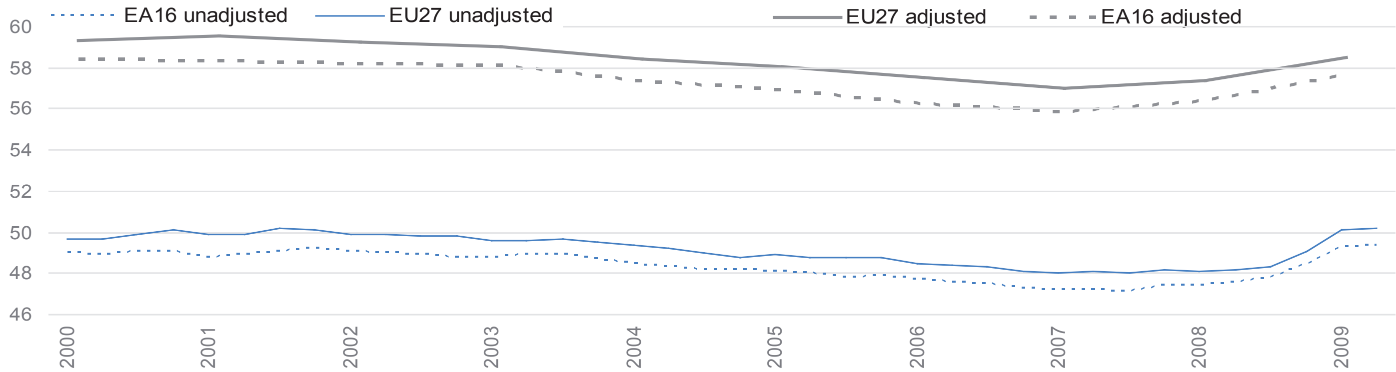

Data source: Eurostat (2009) *Survey of Income and Living Conditions* and *Quarterly National Accounts*. Note: 80/20 income ratio uses 2007 figures GDP reversal as per Figure 2.

# 4.2 Inequality and the crisis

## Wage share increases slightly

The wage share gives the share of GDP that goes to workers in the form of compensation (the sum of wages and other contributions from employers). The unadjusted wage share is simply the compensation of all employees in an economy as a share of GDP, and so excludes the self-employed. As there may be some bias caused by workers switching from being employees to being self employed, the adjusted wage share adds the earnings of the self-employed (by implicitly assuming that they earn the same as employees). During recessions the wage share typically increases, which has been the case during the current crisis (Figure 4.6), as the profits of firms fall faster than wages and employment adjusts in the face of downturns in the economy. However, this increase in the wage share is most likely to be temporary, as more workers are laid off during the recession (see Arpaia and Pichelmann 2008 for more information). As can be seen from Figure 4.6, the adjusted and unadjusted wage share move broadly parallel to each other.

**Figure 4.6 Wages as a share of GDP: adjusted and unadjusted EU wage share**



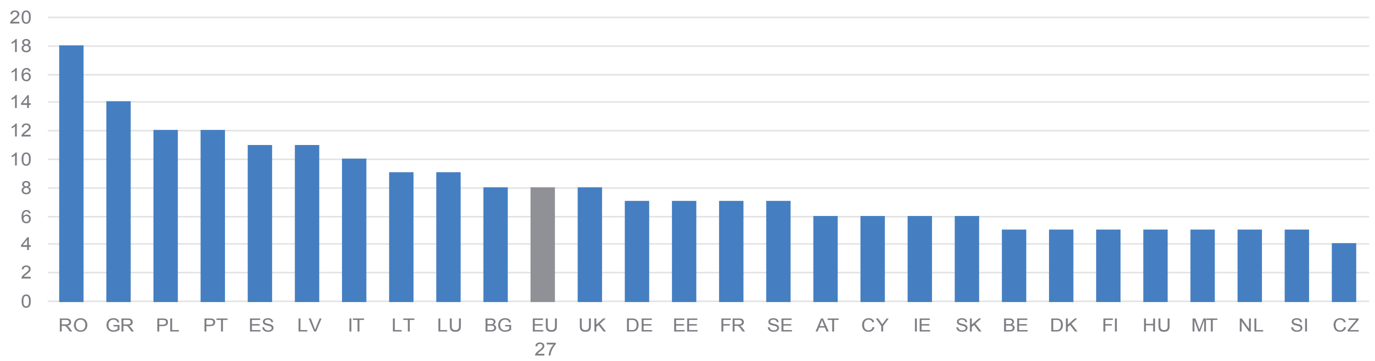

Data source:Eurostat (2009) *Quarterly National Accounts* (unadjusted share) and AMECO (adjusted share). Notes: Adjusted wage share at current market prices uses annual data (2009 figure is estimated); Unadjusted wage share uses seasonally adjusted quarterly data.

# 4.3 The working poor

## When working is not enough

Although the unemployed and inactive are perhaps the group most likely to face poverty, being in work is, despite the existence of minimum wages, no guarantee of escaping poverty. The ranking of countries with the highest at-work risk of poverty (where disposable household income is 60% or less of median disposable income) are broadly in line with measures of inequality (Figure 4.7). In Romania a staggering 18% of those working are at risk of poverty, whereas the EU average is 8%; in the Czech Republic, meanwhile, the figure is as low as 4%.

**Figure 4.7 In work at risk of poverty**



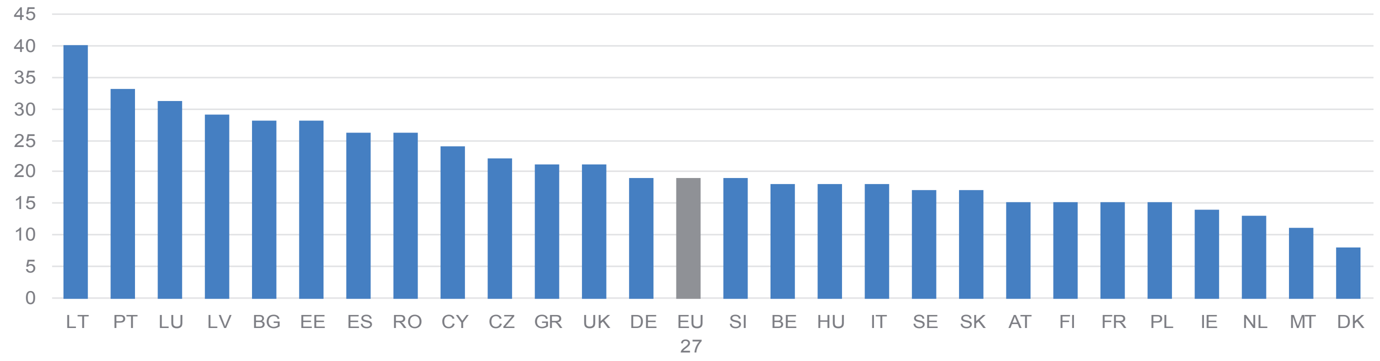

Data source: Eurostat (2009) *Survey of Income and Living Conditions*. Note: 2008 Figures except IE, IT, UK, and EU27.

# 4.3 The working poor

## Some groups are more at risk

Eurostat data shows that the risk of poverty is even higher for groups such as younger workers, and particularly for single parents, as illustrated in Figure 4.8. Though it is too early to see how the crisis, overall, has affected the risk of poverty for working single parents, Lithuania saw an increase in this risk from 24% to 40% between 2007 and 2008, Latvia an increase from 23% to 29% and Portugal from 19% to 33%. The ranking of countries in relation to this risk is somewhat different to that relating to 'at risk of poverty' for all workers and rankings of inequality. For example, Ireland and Luxembourg have average levels of inequality as measured by the 80/20 income ratio, but Ireland has one of the lowest measures of in-work risk of poverty for single parents, while Luxembourg has one of the highest levels. Although Nordic countries are normally associated with greater equality, Norway and Sweden come mid-table for this particular group of marginal workers. Possible explanations for the difference between the at-work risk of poverty among single parents and for all workers include government measures such as child welfare payments, social welfare payments, and programmes to promote work amongst women, as well as cultural differences such as the fact that young Irish single mothers tend to live with their parents (Combat Poverty Agency 2006). What is more, the propensity for single parents to work may differ from one country to another.

**Figure 4.8 In work at risk of poverty – single parents**




Data source: Eurostat (2009) *Survey of Income and Living Conditions*. Notes: 2008 Figures except IE, IT, UK, and EU27.

## 4.4 Conclusions

A noticeable trend across the EU, applying equally to both east and west, is that the more unequal countries have been the hardest hit by the current recession. In terms of real GDP, countries such as Slovenia, the Czech Republic and Slovakia in the east, and the Nordic Countries in the west, have not suffered the same reversals as the less equal Baltic countries in the east or Mediterranean countries and the UK in the west. Indeed, the current crisis shows how the notions of east and west are increasingly irrelevant in relation to considerations of equality and inequality, Denmark being an interesting exception in this respect for, in spite of a noticeable increase in inequality over the past decade of slow economic growth, Denmark still has incomes among the highest in Europe, and inequality that is among the lowest. In terms of GDP, the first decade of the new millennium is, for many countries, a lost decade with Denmark, Portugal and Italy having fallen back to levels of GDP first seen at the beginning of the decade. Though there has been a definite drop in GDP, the impact on wages has so far been unclear. In Lithuania and Estonia wages have already fallen in nominal and real terms.

Given the record low inflation combined with both real and nominal wage increases due to lags in collective agreements, wages have so far been stable across the EU, but it remains to be seen how they will develop if unemployment remains high over the long term. As a result of the crisis, many more people are having to survive on unemployment benefits, while there have been effective wage cuts due to the fact that many employees are working reduced hours. To date minimum wages have remained largely stable throughout the crisis. Due to the lack of up-to-date data, it is unclear what impact the crisis will have on inequality. Countries that have led the recession can give some indication as to what we may expect in the future. Between 2007 and 2008 Latvia saw an increase in the 80/20 income ratio, a pattern that may be replicated in other countries. While labour's share of national income has so far recorded an increase during the crisis, it remains to be seen whether this share will remain higher in the long term since it is a stylised fact that during recessions the wage share first increases and then decreases. The Baltic countries, Malta and the UK, meanwhile, have seen real wage decreases.

As stated at the beginning of this chapter, the word equilibrium has its roots in the Latin words for 'equal' and for 'balance'. In seeking strategies to exit the recession and prevent a future recession, policymakers should remember that it is equality and justice that are at the root of a stable economic equilibrium.