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## Europe's Hidden Inequality

by Michael Dauderstädt

The European Union (EU), in its founding treaties, set itself the aim of economic, social and territorial cohesion. This aim is generally interpreted to mean that the EU will strive to reduce income inequality within its area of integration. Reducing inequality is, as recent studies continue to show, an important and just goal since inequality blights the lives and prospects of those affected.

### Unequal Income Distribution in Europe

As a result of a number of enlargement rounds since 1972 the EU consists of member states at widely varying stages of development and divergent income levels: besides small, rich countries, such as Luxembourg (annual per capita income: around 60,000 euros), there are also large, poor countries, such as Romania (annual per capita income: around 2,900 euros). A comparison of Europe's regions reveals even more egregious differences between the richest region (Luxembourg) and the poorest: annual per capita income in the poorest regions of Bulgaria and Romania is even lower than the national average. With a few exceptions, functional income distribution between wages and profits has long been deteriorating in the EU. The wage share has fallen, for example, in the countries of the Eurozone, from 68% in the 1970s to 57% in 2006. This deterioration in functional distribution, as well as more marked wage dispersion, also partly explains the deterioration in personal income distribution in most member states. Official Eurostat data confirm this trend showing increasing intra-country inequality, which is estimated through the S80/S20 ratio, i.e. the total income of the richest 20% divided by that of the poorest 20% of the respective population (a value of 4 meaning that the former earn four times more than the latter). By calculating the inequality within the EU as a whole as a weighted average of these intra-country values they give it a value of about 4.9, which has been rising over the past decade.

As far as the EU27 (the present EU with 27 member states) and the EU25 (minus Bulgaria and Romania) are concerned, the Eurostat figures – ranging between 4.5 and 5 – underestimate real inequality considerably. This is mainly because they present the (weighted) averages of the member states. These averages, however, abstract from the enormous differences in per capita income between the countries. Eurostat has not compared the incomes of what is really the richest quintile in the EU with those of the poorest, but erroneously assumes that the richest (or poorest) quintile is the sum of the richest (or poorest) quintiles of all member states.

In fact, the richest quintile consists predominantly of households in the richer member states, and includes even the second and third richest quintiles in those states, whose average income is still higher than that of the richest quintile in the poorer member states. The poorest EU quintile consists of the richer quintiles of the poorer member states (in Bulgaria and Romania, for example, from all quintiles). To ensure precision the 100 million (that is, about the size of one EU27 quintile) richest (or poorest) individuals in the EU would have to be identified and aggregated.

### Realistic Estimate of Income Distribution: The EU Is More Unequal than India

If one makes the effort to construct realistic EU quintiles on the basis of the available EU data, an entirely different picture of the relationship between the richest and the poorest EU quintiles emerges (cf. Table 1). The first such estimate for 2004, based on World Bank data, yielded relatively low values[1]; however, a methodologically more precise estimate[2] using EU data yields somewhat higher values. It makes a big difference whether incomes in the various member states are compared in terms of purchasing power or exchange rates. Since purchasing power in the poorer countries is higher (primarily because of lower rents and services), the differences are correspondingly lower.

**Table 1: Income Distribution in the EU25 and EU27 by international comparison (total income of the richest 20% divided by that of the poorest 20% of the respective population)**

| | EU25 | | EU27 | | India | China | Russia | USA |
|---|---|---|---|---|---|---|---|---|
| | Euro | PPS * | Euro | PPS * | | | | 8.42 (2000) |
| **2004** | | | (9.8) | (5.5) | 5.61 | 8.34 | | |
| **2005** | 8.85 | 6.21 | | | 5.61 | 8.34 | | |
| **2006** | 8.07 | 5.75 | | | | | | |
| **2007** | 8.05 | 5.93 | 11.20 | 7.23 | | | 8.96 | |
| **2008** | 7.58 | 5.67 | 10.13 | 6.79 | | | | |

* PPS: Purchasing Power Standard

Source: For the EU 2004: World Bank, Eurostat and author's own calculations (Dauderstädt 2008); for the EU 2005–2008 Eurostat and author's own calculations (Dauderstädt and Keltek); non-EU: World Bank.

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Table 1 presents comparative figures based on World Bank data for China, India, Russia and the USA. World Bank data may be based on other measurement methods, but a comparison seems justified to the extent that the Bank's data on inequality in individual EU member states comes very close to those of the EU. If one measures EU inequality in euros it comes out significantly higher for the EU27 than for all four large countries of comparison. The picture is rosier for the EU25, coming out at around the same level. Measured in purchasing power terms things look rosier still. However, as inequality within countries is measured in the respective national currency without taking into account regional purchasing power, a comparison with euro figures seems obvious.

The new estimates also make possible a more realistic view of the dynamics of inequality. While the official EU statistics report rising inequality, actual inequality between 2005 and 2008 was on a downward trend. This was due to the fall in inequality between countries which more than compensated for the increased inequality within EU states. It remains to be seen whether this trend will survive the recent crisis, which has severely reined in or even put into reverse the catch-up processes of some poorer member states. The final outcome will depend on how much growth has fallen in the richer countries in comparison.

**From Inequality to Social Cohesion**

The high inequality between states is increasing – mediated by the integration of the markets for goods, services, capital and labour in the EU – inequality within states. This effect was to be expected in the richer member states since wages there have come under pressure due to cheap imports, immigration and relocation of production. The same mechanisms should have improved distribution in the poorer countries. However, to the extent that it was visible at all, this effect could be observed only very late in the wake of strong – and apparently not sustainable, unfortunately – periods of growth from 2004.

The reduction of inequality, therefore, requires a dual approach in the form of measures to reduce inequality between and within member states. Domestically, wages should rise with productivity (plus the target inflation rate) in order to give workers a decent share in economic growth, which would also ensure more stable domestic demand and impede harmful competitive devaluations in real terms. Besides primary distribution, however, state redistribution also affects the extent of inequality. Transfers which substitute market incomes where they are lacking (for example pensions, social security, unemployment benefit, sick benefit) should increase in step with average per capita income.

The EU should monitor wage policy and issue clear warnings with regard to divergence in either direction (unrealistic wage increases or severe wage restraint). There should be a minimum wage policy to underpin this goal and to prevent a race to the bottom by paying immigrants and service providers at the wage level of the relevant host country. These problems will be assuaged to the extent that income and wage levels rise in the countries of origin. The reduction of inequality between states, therefore, makes a twofold contribution to social cohesion in Europe. As already mentioned, this has also been responsible for the progress made in recent years. However, if these catch-up and convergence processes were to slow down or even go into reverse, these successes would be put in jeopardy. Against the background of the crisis, therefore, the following policies are appropriate:

- Investment in poorer member states should be less dependent on the herd instinct of the capital markets and be funded to a greater extent through public financing channels, such as the European structural funds or the European Investment Bank. To that end, the EU's own resources should be increased, with the raising of European taxes. Stricter regulation of the financial markets should avert the emergence of debt-driven bubbles.
- Admission to the Monetary Union or the adoption of the euro should no longer depend on attaining narrow inflationary and exchange rate goals since this forces countries to restrain appreciation of the national currency in real terms, which is a key element in catch-up processes.
- Enlargement policy should demand of candidate countries, besides the fulfilment of the Copenhagen criteria, a minimum level with regard to income and income distribution, since the accession of poor and unequal countries hinders and even jeopardises social cohesion in the EU.

Finally, the EU should make available better and clearer statistical information on inequality in Europe. Eurostat should regularly publish data not only on relations between quintiles, but also on average per capita incomes for all quintiles in all member states, if possible going back to 1995 in order to make possible a realistic assessment of the evolution of income distribution.

[1] M. Dauderstädt (2007), Ungleichheit und sozialer Ausgleich in der erweiterten Europäischen Union, Wirtschaftsdienst, Vol. 88, 4, April, 261–269.
[2] Dauderstädt and Keltek (2011) 'Immeasurable Inequality in the European Union' Intereconomics Vol. 46/1 pp.44-51.

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**Further reading:**

Michael Dauderstädt and Cem Keltek (2011) Immeasurable Inequality in the European Union, *Intereconomics* Vol. 46/1 pp.44-51. Available online at: http://www.intereconomics.eu/