

# Introduction and Executive Summary

## Origins and scope of this book

This book summarizes four years of research on social inclusion and income distribution across the European Union carried out in the framework of the European Observatory on the Social Situation and Demography, which has been established by the Directorate-General for Employment, Social Affairs and Equal Opportunities of the European Commission. It gives an overview of the comparative information that is available for the EU Member States on income distribution, poverty and its causes, access to benefits and social services and material deprivation. It also offers a good insight into the potential of European surveys and notably the EU Statistics on Income and Living Conditions (EU-SILC), the main survey used for the analysis presented in this publication.

Over four years, the consortium — consisting of Applica in Brussels (leader), the European Centre for Social Welfare Policy and Research in Vienna, ISER at the University of Essex in the UK and TÁRKI Social Research Institute in Budapest — analysed various issues relating to income distribution and poverty, including the effect on inequalities of aspects other than income, such as benefits in kind, or social services more generally, or the need to cover essential costs like housing. It also examined non-monetary indicators of exclusion, such as material deprivation. Research was also undertaken into the various causes of inequality and low income and into the changes in these over time (such as the level of economic activity and employment, and the rate of growth in both of these). In addition, using a microsimulation model, detailed analysis was carried out on the effect of various countries' tax and social transfer systems on the distribution of income between households, as well as on the support provided to families with children or to those beyond retirement age. The effect of education levels was likewise examined, together with the influence of a person's family background (such as the education level of their parents and the jobs that they did) on their life chances — or, in other words, the extent to which advantages and disadvantages are transferred between generations. Efforts were also made to identify the social groups most severely affected by low income and economic hardship, such as lone parents, the elderly with inadequate pensions, migrants and ethnic minorities. Regular reports were prepared by a network of national experts on the fiscal and other policies introduced in EU Member States, focusing on their implications for income distribution, and paying particular attention to those people at the bottom end of the scale.

At the beginning of the four-year period, no truly comparative, or comparable, income data existed for all EU Member States. The initial annual reports, therefore, were based on data from the European Community Household Panel (ECHP), the last survey of which was carried out in 2001 (relating to income in 2000), and data from non-harmonised national sources, compiled by Eurostat. In 2006, the consortium was able to use the first release of data from the Statistics on Income and Living Conditions (EU-SILC), a comparable dataset of household income across the EU managed by Eurostat, though this covered only 13 Member States. It was only in 2007 that a full set of harmonised and comparable data became available for all EU Member States — or, more accurately, all except Bulgaria and Romania (where the first survey was conducted two years after the other countries).

The availability of the EU-SILC data has transformed the possibilities of carrying out comparative analysis of income distribution in different Member States and of investigating both the incidence of low income and deprivation and the contributory factors. This, however, does not mean that data problems have disappeared. Because of the sample nature of the EU-SILC and the fact that it is conducted in many different countries, all with somewhat different circumstances and attitudes, checking the data for consistency and robustness and taking account of periodic revisions is a continuous process.

Although the EU-SILC also collects longitudinal data — i.e. data for a subset of the same individuals and households over successive years — the first set of such data has only very recently become available. The analysis undertaken over the four years (2005–08) and reported here was not, therefore, able to cover longitudinal aspects. This is an important limitation, since it is as important to know, for example, how long individuals remain with low levels of income — whether for only a temporary period or more or less permanently — as it is to determine whether they have low income in a particular year.

Even leaving aside the lack of longitudinal data, the fact that the EU-SILC has been operating for only a short period means that it is as yet not possible to examine changes in income distribution or in the incidence of low income over time. While there are data available from the ECHP for the 1990s, as well as data from national sources, methodological differences limit the extent to which it is possible to compare these data with those from the EU-SILC in order to identify long-term trends. Accordingly, most of the analysis undertaken relates to comparisons across countries. Though this limits what can be concluded about the effect of national developments (such as economic growth or an increased rate of job creation) on inequality and social exclusion, it nevertheless provides an insight into the influence of, for example, household circumstances, access to employment and the income it generates, and education levels.

## Structure of the book

Chapter 1 first examines the **distribution of income and the extent of inequality in incomes in EU Member States**, based on summary indices of income inequality, such as the Gini coefficient. The second part is concerned with the risk of poverty across the EU, as measured by the proportion of the population with dispos-

able income below 60% of the national median. The analysis is then extended to consider alternative indicators of the risk of poverty, or low income, defined at the EU level, or, in other words, after taking account not only of relative income levels in different countries but also of absolute differences between incomes in different parts of the EU — in particular, in the countries that entered the EU in 2004 and in the existing Member States. The income concept used throughout the analysis is ‘equivalised’ household disposable income, which explicitly allows for the effect of household size and composition on purchasing power and the fact that two people sharing a household, and pooling their income, can enjoy a higher standard of living than two people living separately.

The concern of Chapter 2 is to examine in more detail **determinants of the risk of poverty and inequalities** in the distribution of income. The first part considers variation in the risk of poverty between people of different ages and living in different types of household, as well as the way in which this is affected by employment — or, more precisely, by the lack of earnings from employment — among household members. The second part examines how far these and other factors — in particular, the age, education level and employment status of the household head — provide an explanation for both the risk of poverty and the degree of inequality in income distribution across the EU.

Chapter 3 looks at **the social situation of the migrant population in the EU Member States**. It first considers alternative ways of obtaining an indication of the size of the migrant population in EU Member States, given the data available, none of which are entirely satisfactory for identifying the people in question. Secondly, it examines the characteristics and circumstances of those identified as coming from outside the EU in terms of their income, their employment status (i.e. whether they are employed, unemployed or not in the work force at all), the jobs that they do, their household circumstances and so on, and compares these against the non-migrant majority population. The aim is to assess whether, and to what extent, migrants are disadvantaged as a group and the proximate reasons for this — whether, for example, it is to do with having a lower level of education or more children, or whether it seems to be for less objective reasons.

Chapter 4 addresses **regional variations on poverty risks and income distribution** in the EU. This is an interesting feature that has, up to now, received comparatively little attention: the extent to which income inequality and the relative number of people with low income varies between regions within countries — whether the incidence of low income is greater in some regions than others. The availability of data from the EU-SILC on incomes at a regional level makes it possible to do this and opens up the opportunity to identify potential regional influences on living standards and the risk of poverty across the EU.

Chapter 5 is concerned with the issue of **material deprivation**, and extends the analysis beyond incomes to other indicators of disadvantage, such as the affordability of certain consumer items or the ability of households to pay their bills on time or to make ends meet. Such an analysis provides an insight into how far differences in income, defined on an annual basis, represent a reliable measure of differences in purchasing power between households, and therefore of living standards. The results reveal much about the deficiencies of annual income as a guide to inequalities and to the risk of poverty and exclusion, and highlight the need for other factors to be taken into account.

Chapter 6 examines **the effect of economic growth on inequalities** during the first half of this decade. Countries with the highest rates of growth over this period were the Baltic states, with Ireland, Slovakia, Hungary and Greece also recording growth rates above the average. The main source of growth in the transition countries was increased productivity, with limited expansion of the numbers in employment. Accordingly, the effect of growth on inequality was rather different in those countries than it was in countries such as Ireland, Spain, Luxembourg and Cyprus, where the numbers in employment increased considerably, thus potentially diffusing the income gains from growth more widely. As is highlighted in the analysis, however, the effect on income distribution depends on the incidence of gains across households and on the extent to which those who took up employment came from households where someone was already in work, as opposed to those where no one was.

Chapter 7 examines **the effects of taxes and benefits on income distribution**. First, it presents some summary measures of the extent of redistribution and of how taxes and benefits themselves are distributed across households with differing levels of income. Then it focuses on the two age groups most at risk of poverty: namely, elderly people who have retired and therefore no longer have access to earnings from employment (except to the extent that they share a household with those in work, such as their sons or daughters in particular) and children, who represent a drain on household income without contributing to it, except through such social benefits or tax concessions as they attract. In both cases, the effect of the tax–benefit system in different countries on preventing the income they have available falling below the poverty line is assessed, using a microsimulation model to compare their incomes with and without social benefits and tax concessions.

Chapter 8 considers **the effect of childcare on household income** in selected countries, in order to illustrate the importance of taking account of the availability of free or subsidised childcare facilities when assessing the distribution of income and the risk of poverty, since the ability of parents with children — and mothers in particular — to work is a major factor underlying relative levels of household income.

Finally, Chapter 9 **reviews the policy changes** that have occurred in the 27 EU Member States and in the two candidate countries, Croatia and Turkey, over the past five years and that have had an effect on the distribution of income and on the relative number of people with income below the poverty threshold. While the focus is on changes in taxes (including social contributions) and benefits (including pensions), it also considers other measures that are likely to have had similar effects, whether or not these have been introduced for redistributive reasons — such as changes in the minimum wage.

## Main findings

The estimation and analysis of measures of income distribution across the EU show that Latvia and Portugal stand out as having the highest levels of income inequality of all Member States, with a Gini index of 38–39%. Countries in the EU with above-average levels of inequality (with a Gini coefficient over 30%) comprise all three of

the Baltic states, two transition countries in Central and Eastern Europe (Poland and Hungary), all the Southern European countries except Cyprus (i.e. Greece, Spain, Italy and Portugal), and Ireland and the UK. At the other extreme, the countries with the lowest levels of inequality are Sweden, Denmark and Slovenia (with Gini indices of below 25%). In between these two groups come the remaining EU Member States (Gini indices above 25% but below 30%), with the Czech Republic, the Netherlands and Austria at the lower end in this regard, and Cyprus, Luxembourg and Slovakia at the upper end.

The relative number at risk of poverty, defined as those with income below 60% of the national median — which is the currently accepted indicator in the EU — varies between 10% and 23% of population across the EU, with the proportion being smallest in the Czech Republic and the Netherlands and highest in Latvia. The proportion is also relatively small in all the Nordic countries, together with Germany, Austria, and a number of the ex-socialist Member States — in particular, Slovakia and Slovenia, as well as the Czech Republic — while it is relatively high in Greece, Spain, Italy and Portugal, as well as in the three Baltic states. While, therefore, there is a close association between inequality and the risk of poverty, it is not perfect.

The poverty thresholds, however, as highlighted in the book, differ greatly across countries in terms of purchasing power, which makes for some difficulty in interpreting the above comparisons without taking this difference explicitly into account. The average poverty threshold in the new Member States is, therefore, over 60% lower than the average for the EU15 when measured in purchasing power terms. Accordingly, while the relative number of people with low incomes defined with respect to the national median is the most widely used indicator of the risk of poverty, it is not particularly meaningful as an indicator of the prevalence of low incomes across the EU. For this, there is a need to take account of purchasing power differences in median income levels and, in consequence, to calculate incomes in different Member States in relation to the EU rather than the national median.

In 2005, it is estimated that some 22% of the EU population (excluding Malta, Bulgaria and Romania), or some 100 million people, had income below 60% of the EU median. In Latvia, Lithuania, Poland and Slovakia, 74–80% of the population in each case had an income below this level, while the proportion was also above 50% in the other transition countries, apart from Slovenia and the Czech Republic. By contrast, in Denmark, the Netherlands and Austria, the figure was 5% or less, and in Luxembourg only 1%.

People considered at risk of poverty are those who may not be able to participate in the normal activities of society, or to enjoy a standard of living that the great majority take for granted, because of a lack of income. The income needed for this tends to be related to the prosperity or affluence of the country concerned, which is the reason why a relative definition of poverty is mainly used in the EU to measure the number of people at risk. The prime responsibility for tackling problems of low income and social exclusion falls on the Member States. Nevertheless, there is also an EU-level interest in these issues, in that one of the main objectives of the EU is to raise the standard of living and quality of life of all its citizens, and to promote economic and social cohesion throughout the Union. This underlines the importance of an indicator of poverty that takes account of income differences between Member States as well as within them.

The incomes of those below the poverty threshold in the EU25, defined in relation to the national median, are, on average, 22% lower than this threshold. This figure, the poverty gap, however, varied in 2005 from 11% (in Finland) to 29% (in Lithuania). These values are (to a moderate extent) positively related to the at-risk-of-poverty rate (the correlation coefficient being 0.56), implying that those below the poverty line tend to have lower relative incomes in countries where the proportion of people falling below the line is larger. In other words, not only are there more people with low income in these countries but the income they have tends to be lower than elsewhere.

Labour market status — whether someone is in employment or not — is a major factor underlying the risk of poverty. Jobless households show the highest risks of poverty in the majority of EU Member States. The proportion of households concerned can be over 50%. In most countries, the risk of poverty falls significantly with entry into the labour market and access to earnings from employment. Age and household circumstances are also important. There are two main risks related to household composition: having a large number of children and living in a lone-parent household, though in a number of countries living alone without a dependent child can also give rise to a high risk if the person concerned is not in work. Both children and the elderly are more likely to have low incomes than are those people of working age. The risk of poverty among children (defined as those under 18) is above the national average in 16 of the 24 Member States for which data are available. The risk of poverty among the elderly is below the national average in many countries, especially in the new Member States, but it is above the national average in most EU15 countries, and the proportion at risk exceeds 50% in Cyprus.

Analysis of the contribution of different factors to explaining inequality indicates that these vary across countries. The UK, Ireland and the three Baltic states seem to have a similar structure of inequality, both education and employment explaining around 15% of the overall level, and age explaining around 5%. The Nordic countries show different structures, with age, education and employment each having broadly similar effects on income inequality, while in the Continental, Central European and Mediterranean countries, education seems to be the most important factor.

Analysis of the situation of migrants in the EU indicates that those who come from outside the Union tend to have a lower level of income and a higher risk of poverty in all age groups than do those people born locally — i.e. the indigenous population. This is the case throughout the EU, or at least in the countries for which the data available are reasonably reliable (mostly the EU15 countries). For those of working age, this does not seem to be a result of them having lower levels of education, since there are no significant differences in this respect between migrants and the local population, especially as regards the relative number with tertiary, or university-level, education. On the other hand, there are marked differences in the extent to which they are in employment and in the kinds of job they do—and, accordingly, their potential earnings. This is most evident in the case of those with tertiary-level qualifications, and most especially for women, who, in most EU15 countries, have a much lower employment rate than their locally born counterparts and tend to be employed disproportionately in low-level jobs.

The relatively unfavourable situation of migrants on the job market — reflected in the disproportionate numbers living in workless households, as well as in couple households where only one person is in work — seems to be a major cause of their low income levels, which feed through into the equally disadvantaged situation of children in migrant families. While children in themselves contribute to the higher risk of poverty faced by migrant families (in the sense that there are proportionately more families with three or more children than among the indigenous population), they do not seem to be the main cause of the high risk. Migrants without children, therefore, also face a higher risk of poverty than do people born locally in a similar situation. The large numbers of children in low-income families among the migrant population, however, is a particular cause for concern, given the potentially damaging effect on their future life chances.

The factors underlying the higher risk of poverty faced by those aged 65 and over with a migrant background are less easy to detect. It may perhaps be because they had lower earnings when they were in work (before they retired) or because they have more limited entitlement to pension, due to less-complete contribution records than people of the same age born in the country in question. At the same time, the difference in their risk of poverty, as compared to the local population, is less than in the case of migrants of working age, which might suggest that they have access to higher levels of income support (such as from minimum pensions) than do their younger counterparts.

The estimates of disposable household income at regional level that can be obtained from the EU-SILC data, although far from complete, reveal interesting differences in the risk of poverty between regions within countries. These differences are not always in line with differences in average income levels — and still less with differences in GDP per head, which is commonly used as a measure of regional incomes, but which can be affected significantly by income transfers and, in some cases more importantly, by both inward and outward commuting.

The data show significant differences in the distribution of income between regions in particular countries, especially in Belgium, but also in Italy. These differences in the degree of income inequality are not closely related to the risk of poverty. In a number of countries, the region with the widest dispersion of income has the smallest proportion of people with income below the poverty line — as in the Czech Republic, France, Poland and Finland; in others, the region with the widest dispersion also has the largest share of the population at risk of poverty (as in Belgium, Spain and Italy).

The analysis of material deprivation and financial hardship across the EU suggests that these are reflected only to a limited extent in the income-based measure of the risk of poverty, which is conventionally used to indicate deprivation. This is particularly so in many of the new Member States, where a significant proportion of the population live in households that report not being able to afford particular consumer durables or a decent meal at least once every other day, or have difficulty in meeting unexpected costs; most of the people concerned have income above the poverty threshold.

This suggests a need to supplement the income-based measure used to identify and monitor the risk of poverty and social exclusion across the EU with indicators

of material deprivation and financial difficulty. The fact that there is a clear (inverse) link between the proportion of people who report being materially deprived and median levels of income per head across countries gives an added reason for this, since such a move would help overcome the limitations of defining the income measure in relative rather than absolute terms when making comparisons between countries.

While income inequality and poverty are relatively strongly, and inversely, related to GDP per head across EU countries, it is difficult to find a consistent relationship between changes in GDP and changes in inequality. The evidence shows cases of increasing income inequality in countries with both relatively high and relatively low growth rates. At the same time, there seems to be a clear link between employment growth and reductions in inequality. In countries where economic growth gives rise to an increase in the employment rate (i.e. in the proportion of people in work, therefore), inequality of earnings among those of working age tends to decline. Increasing employment tends also to reduce the proportion of those living in jobless households, thus contributing to a more equitable distribution of employment and labour income between households.

Economic growth can also affect the degree of inequality if employment or productivity increases to a different extent in different sectors of the economy, or if labour moves from low-productivity sectors to high-productivity ones. Analysis of the various processes involved indicates that shifts of employment between sectors contributed to the changes in the extent of income dispersion observed, as did increasing returns to education in some countries, such as Luxembourg, the UK and Denmark; while in others — Spain and Greece, in particular — a reduction in the earnings gap between those with different levels of education contributed to a narrowing of inequalities.

The Lisbon strategy focuses policy in the EU on economic growth and job creation, on the grounds, in part, that such a strategy will also tend to reduce the risk of poverty and social exclusion. The effect on income distribution, however, is uncertain. While, on the one hand, employment growth is likely to reduce inequality by increasing the number of individuals and households with earnings from work, it can, on the other hand, lead to a disproportionate increase in demand for the most highly educated (so pushing up their earnings relative to others) and/or to an increase in part-time working among women, which has an ambiguous effect on income distribution across households.

An analysis of the effect of taxes and benefits on income distribution in EU countries using the EUROMOD microsimulation model shows that taxes, as well as benefits, contribute to a major extent in the EU to reducing income inequality, though the scale of the effect varies markedly from country to country. While, therefore, those on low incomes tend to pay much less in tax and to gain more from social benefits than those with higher income levels, it is still the case in some countries that the tax burden for those at the bottom end of the income distribution is relatively high, while benefits account for a significant share of the income of those towards the top of the distribution, reflecting in part the earnings-related nature of public pensions in the countries concerned.

Nevertheless, in most countries, a large proportion of the elderly population tend to have incomes towards the lower end of the distribution.

Support for children also varies markedly across the EU, with the benefits received by families with children being particularly low in the Southern Member States and the Netherlands, and relatively high in Hungary, Luxembourg and France, if account is taken not only of child or family benefits, but also of benefits that are paid to households with children, whether or not they are specifically labelled as being for children or families.

In some countries children are also supported through tax concessions, which generally benefit the higher-income households most. In France, Luxembourg and Slovenia, therefore, tax concessions compensate for a fall in the value of benefits as income rises. In the Southern countries, moreover, the absence of generous child benefits is combined with child tax concessions that benefit children in higher-income households in particular, thus giving rise to a regressive effect on the income distribution of families with children. This contrasts with the situation in most other countries, Denmark and the UK especially, where low-income families receive most in the way of support.

Free or subsidised childcare also has an important effect on income distribution and on reducing the risk of poverty in a number of countries across the EU. Analysis of the situation in selected EU Member States indicates that in four of the five countries examined — Belgium, Greece, Finland and Sweden — a larger share of the public expenditure involved in providing subsidised childcare goes more to high- and middle-income families than to low-income ones. Nevertheless, in proportionate terms, the contribution of childcare subsidies to the disposable income of poorer families tends to be larger than for those families with higher income levels.

The inclusion of childcare benefits in the definition of income — on the grounds that it is an essential cost for households to meet if both parents are to work and earn income — tends to reduce the degree of inequality. It also reduces the risk of poverty among children in all the countries examined, though less so in Finland and Greece than in Belgium, Germany and Sweden.

A review of the policy measures introduced by national governments across the EU over the past five years demonstrates that the measures taken vary between Member States — in part reflecting differences in the scale and nature of the social problems they face, but also differences in the underlying political and economic circumstances, in the existing nature of the tax-benefit system, and in social attitudes towards income redistribution and poverty relief.

Nevertheless, it is possible to identify a few widespread tendencies across countries: in terms of tax policy, with very few exceptions, rates have been cut and/or allowances increased over recent years, and there have been attempts to simplify the tax system. Most new Member States now operate a flat-rate tax regime. On the whole, tax changes seem to have benefited higher earners disproportionately, and to have made the distribution of income more unequal.

There has also been a widespread tendency across the EU to seek to improve incentives to work. A policy of making work pay by ensuring that income from employment is always significantly higher than income from social benefits has been pursued using a variety of means, such as refundable earned income tax credits and other in-work benefits, reductions in social contributions, wage subsidies, allowing social assistance recipients who take up a new job to continue,

for a limited period, to claim benefit while earning a wage, and increasing the statutory minimum wage.

Policy changes to make work pay and to restrain public expenditure have, in many cases, been accompanied by compensating measures to protect those on low incomes. These have usually consisted of real increases in guaranteed minimum incomes and/or in rates of social assistance, with the aim, in particular, of improving the incomes of households with children and of supporting mothers so that they can cope better with the competing demands of work and family responsibilities.

Finally, a major aim of policy over recent years has been to improve the long-term financial viability of pension systems in the context of demographic ageing, while at the same time continuing to provide basic income security for those already in retirement. Nonetheless, in a few countries where retirement benefits were particularly low to start with, increases have been implemented across the board, usually through the introduction of wage indexation or other changes in pension formulae.