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## **DELIVERING INCLUSIVE GROWTH**

*Thematic discussions on growth and jobs*

Technical note to the Eurogroup

## **Addressing inequality concerns can lift growth and deliver a better functioning EMU.**

Tackling structural inequality is relevant for every Member State because reducing inequality in the distribution of labour and capital incomes can go hand in hand with stronger potential growth and improved sustainability of public finances. It is less costly to achieve a given level of inequality in household disposable incomes if the distribution of pre-tax incomes is relatively equal. It is particularly relevant for the euro area, where reduction in between-country inequality signals upward real convergence and leads to a better functioning EMU. Tackling cyclical changes in inequality, in particular because of unemployment fluctuations along the business cycle, is also of particular relevance for the euro area. Reforms that enhance the efficiency of automatic stabilisers in each Member State increase the resilience of national economies to shocks while policy coordination among Member States improves the effectiveness of automatic stabilisation in the euro area as a whole. Achieving cyclical convergence, i.e. better synchronised business cycles, contributes to improve the effectiveness of the common monetary policy.

**A holistic approach is needed to deliver inclusive growth, addressing cyclical and structural causes that lead to the observed evolution of income.** After presenting some salient observations on inequality, this note discusses broad policy areas affecting distributional outcomes, which are interrelated with economic growth and public finances. Policies to tackle cyclical inequality developments are discussed first, and then the more structural inequality patterns and policy packaging to effectively promote inclusive growth are presented.

## **The perception of excessive inequality has brought the topic to the forefront of the economic and political debate.**

A special Eurobarometer survey found that 42% of the respondents in the EU “strongly agree” and another 42% “agree” that differences in people’s incomes in their country are excessive.<sup>1</sup> Within the euro area, the percentage of respondents agreeing with this statement varies between 96% in Portugal and 59% in the Netherlands (Figure 1). Although preferences for redistribution differ among the Member States, and also within the Member States among individuals, the widely shared belief is that too much inequality is undesirable.<sup>2</sup> More than eight in ten respondents share the view that national governments should take measures to reduce income inequality. Within the euro area, this share varies between 94% of respondents in Portugal and 65% in the Netherlands. When asked about fairness and opportunities, the majority of respondents in the euro area feel that most things happening in their life are fair and that they are provided with equal opportunities. However, the opinions vary quite a bit, with more than 70% agreeing with these statements in Finland and Ireland but less than 40% agreeing in Cyprus and Greece. Next to income inequality and inequality of opportunity, also

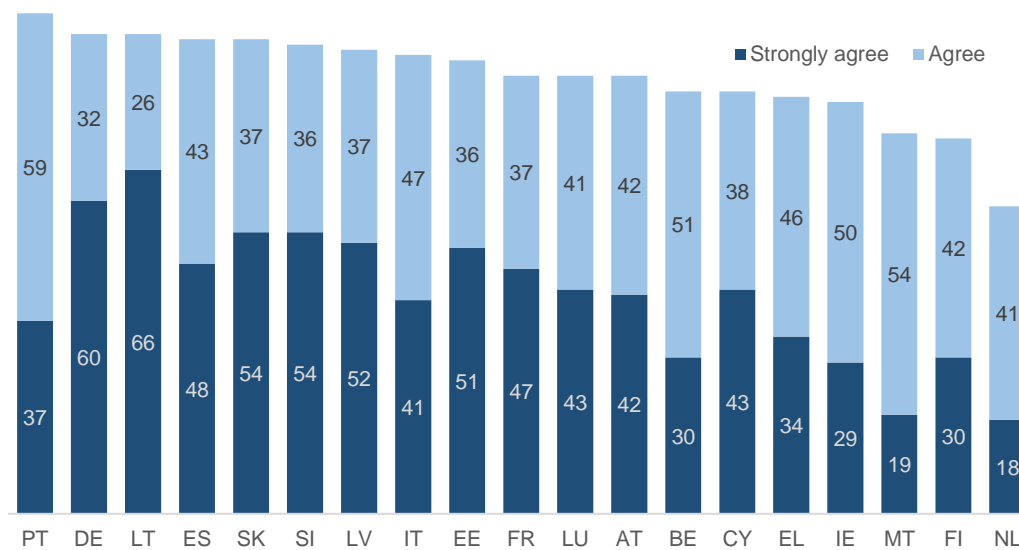
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<sup>1</sup> Special Eurobarometer 471 (2018), *Fairness, inequality, and intergenerational mobility*.

<sup>2</sup> Colagrossi, M., Karagiannis, S. and R. Raab (2019), “The Median Voter Takes it All: Preferences for Redistribution and Income Inequality in the EU-28”, Publications Office of the European Union, Luxembourg; Falk et al. (2018), “Global evidence on economic preferences”, *Quarterly Journal of Economics*, 133(4); Kerr (2014), “Income inequality and social preferences for redistribution and compensation differentials”, *Journal of Monetary Economics*, 66.

wealth inequality can shape perceptions in society, in particular because wealth inequality tends to be more pronounced than income inequality. Differences in exposure to risk (e.g. related to health or unemployment) in combination with a lack of savings (i.e. low or even negative wealth as captured by household indebtedness), can also contribute to a sense of excessive inequality. The perception of excessive inequality may reduce the ability of European societies to build broad consensus around public policies and result in lower potential growth.

Figure 1: Share of respondents (%) that “strongly agree” and “agree” that the differences in people’s incomes in their country are too great, 2017



Source: Special Eurobarometer 471 (2018), *Fairness, inequality, and intergenerational mobility*

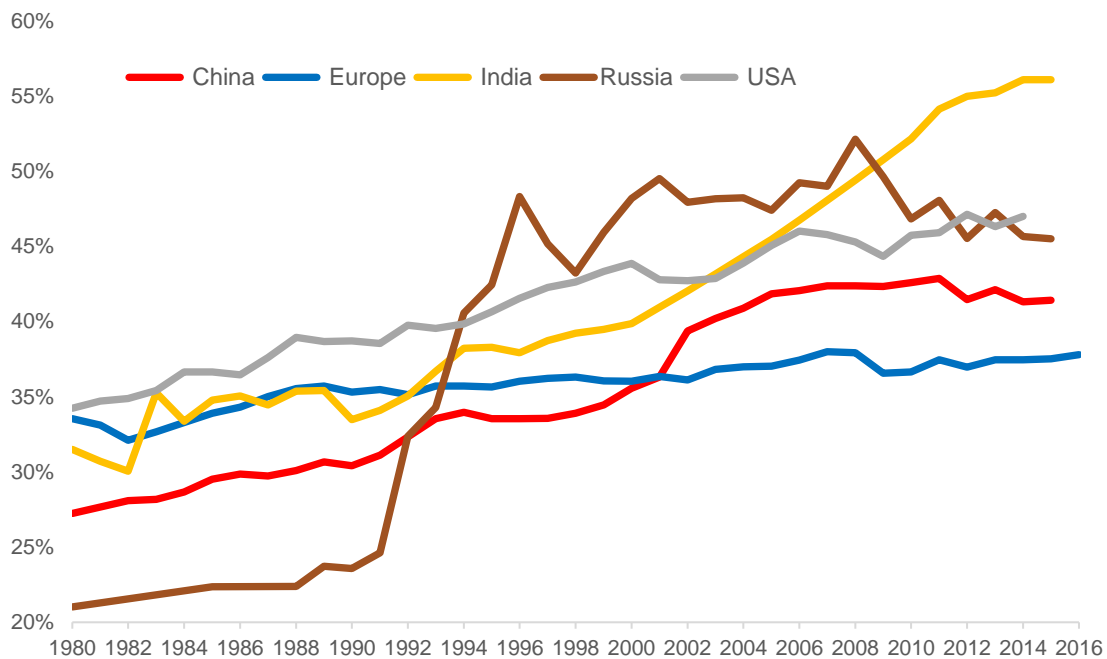
**Seen through a global lens, income inequality is relatively low in the euro area and in the EU. Inequality in *household disposable incomes* remained broadly stable in the majority of the euro area Member States over 2007-2016. Yet, income concentration at the very top has been increasing in Europe as well over 1980-2017.**

Inequality in *household disposable incomes* is lower in the euro area (and in the EU) than in other regions of the world. Further, over 1980-2016, inequality in *pre-tax incomes*, defined as the sum of income from capital and labour received by individuals before the redistribution operated by the tax system but after the operation of insurance-based transfers (i.e. pensions and unemployment benefits), increased less in the euro area (and EU countries) than in many other advanced and emerging economies (Figure 2). In particular, growth has been more inclusive in Europe than in the US. The purchasing power of the bottom 50% income group in the EU grew by 40% over 1980-2017 while in the US it grew by just 3%.<sup>3</sup> Yet, income concentration at the top has been increasing in Europe as well (Figure 3). To sum up, even though growth has been relatively inclusive in Europe, incomes of the bottom 40% grew less

<sup>3</sup> Blanchet T., Chancel L and A. Gethin (2019), “How unequal is Europe? Evidence from Distributional National Accounts 1980-2017”, *World Inequality Lab*. See section 3.5, p.53, fig.27 that plots the evolution of real incomes of the bottom 50%.

than incomes of the top 10%, implying that the benefits of growth accrued in greater proportion to the better off. An important caveat of such an accounting exercise is that it misses situations in which individuals change positions in the income distribution. Upward income mobility compensates for a possibly unequal distribution of the fruits of growth, strengthening its inclusiveness. However, upward mobility may have actually slowed down in several EU Member States, underpinning a sense of unfairness.

Figure 2: Pre-tax national income share held by top 10%

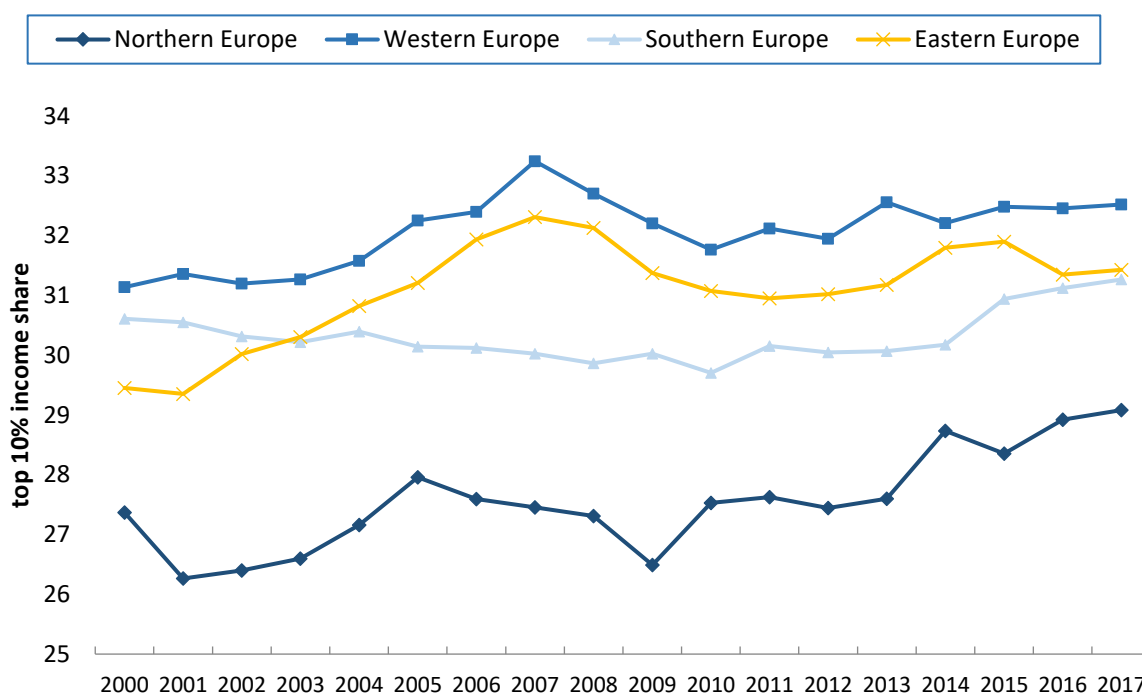


Source: World Inequality Database.

Pre-tax national income is the sum of all pre-tax personal income flows accruing to the owners of labor and capital, after taking into account the operation of pension, unemployment insurance and other social insurance systems.

The combined distribution of France, UK and Germany is used to infer the distribution of national income in the European aggregate.

Figure 3: Pre-tax national income share held by top 10%, by EU region, 2000-2017



Source: Blanchet et al. (2019). *Northern Europe* includes Denmark, Finland, Sweden as well as Iceland and Norway. *Southern Europe* includes Cyprus, Greece, Italy, Malta, Portugal, and Spain. *Western Europe* includes Austria, Belgium, France, Germany, Ireland, Luxembourg, the Netherlands, the United Kingdom as well as Switzerland. *Eastern Europe* includes Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia as well as Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Moldova, Montenegro, Serbia.

**Monitoring the inclusiveness of growth requires a comprehensive approach as inclusiveness is a multi-faceted concept associated with policy action on several fronts. Monitoring of income inequality developments, at national or euro area level, is only one – albeit important – aspect.**

To understand why growth may have been - or been felt as - insufficiently inclusive, one needs to consider several dimensions. *First*, economic growth has not been sufficiently strong, especially during the crisis period where growth was negative in many countries, and therefore living standards did not improve significantly for the average household. *Second*, GDP growth has failed to translate into purchasing power growth, in the sense that the real disposable income of the average household increased less than GDP per capita.<sup>4</sup> *Third*, low- and high-income households did not benefit from growth in the same proportion. Further, there may be a *squeeze of the middle-income households* linked to the phenomenon of *job polarisation*, whereby the share of employment in middle-paying occupations intensive in

<sup>4</sup> A contributing factor may be that in a subset of Member States, productivity developments were not matched by real wage growth. See European Commission (2018), “Wage Dynamics in the EMU”, Note for the Eurogroup. 19 March 2018.

routine tasks decreased. Wage growth in such occupations may have been relatively disappointing.<sup>5</sup>

*Fourth*, public spending may not have been sufficiently effective in ensuring that the worse off households were able to satisfy fundamental needs such as housing, health, and education, on par with the better off. *Fifth*, the tax system not always manages to achieve the twin goals of incentivising productive effort while delivering income redistribution. Enhancing the redistributive capacity of the tax and benefit systems, in particular the ability to reach the worst off and to support the most vulnerable individuals, can reinforce the sense of fairness embedded in the welfare state. *Sixth*, wealth inequality may contribute to a sense of excessive inequality. A recent study documents that the weight of net wealth in national income increased significantly in many advanced economies over the last decades.<sup>6</sup> The distribution of wealth is an important dimension of inequality to monitor, in particular because it helps to pin down the fraction of households whose lack of savings makes them more vulnerable to negative income shocks. *Seventh*, reforms may have distributional effects and require complementary policy actions or compensatory measures to help individuals adjust.

### **Delivering inclusive growth requires addressing both cyclical and structural developments in income inequality.**

Discussions on bringing the income distribution more in line with the socially desirable distribution (as expressed for example by voters) are often concentrating on “curing the patient” by looking into the tax and benefit systems, without addressing the root causes that result in a specific distribution of incomes. This note will argue that a holistic approach is needed to deliver inclusive growth, addressing cyclical and structural causes that lead to the observed evolution of income.

Over the recent period, increases in market income inequality in the euro area were linked to cyclical developments. Income inequality *within individual countries* has increased mainly due to the higher incidence of unemployment during the recent economic crisis. Moreover, as the depth and duration of the recession differed across Member States, there was an increase in income inequality *between countries*. As highlighted in the October 2018 Eurogroup discussion, automatic stabilisers need to be optimally designed, for example through the degree of progressivity of taxes and benefits. Automatic stabilisers need to be complemented with adequate discretionary policies, in particular activation policies and social investments, to avoid situations in which cyclical changes in inequality become entrenched and result in a structural increase in inequality. This underlines the importance for Member States to build fiscal buffers in good times to be able to have fiscal policy play this stabilising role.

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<sup>5</sup> European Commission (2018), *Quarterly Report on the Euro Area*, IV; European Commission (2018), *Employment and Social Developments in Europe*; Goos M. et al (2014), “Explaining job polarisation: routine-biased technical change and offshoring”, *American Economic Review*, 104(8); Autor D. and D. Dorn (2013), “The Growth of Low-Skill Service Jobs and the Polarization of the US Labour Market”, *American Economic Review*, 103(5).

<sup>6</sup> Piketty T. and G. Zucman (2014), “Capital is back: wealth-income ratios in rich countries, 1700-2010”, *Quarterly Journal of Economics*, May: 1255-1310. The authors find that wealth-to-income ratios increased in the USA, the UK, France, and Germany from 200-300% in 1970 to 400-600% in 2010.

**These automatic stabilisers and additional policy responses can contribute to increase the resilience of each economy and of the euro area as a whole to cyclical shocks.**

As such, they have an impact on the cyclical convergence in the euro area, i.e. the synchronisation of GDP growth across countries. This relationship with cyclical convergence makes the topic especially relevant in the euro area context, as it affects the effectiveness of a common monetary policy.

**On top of cyclical factors, longer-run structural developments led to an increase in market income inequality in several Member States.**

Member States may differ in their readiness to embrace the ongoing processes of technological change and of global market integration. Higher costs of adjustment to structural change may be linked to features of the regulatory framework in product, credit, and labour markets that require growth-enhancing reforms. Structural increases in market income inequality may also be linked to insufficient investment in human capital. A suboptimal level of human capital may be a consequence of insufficiently inclusive education and training systems. It may also signal the need to implement a comprehensive lifecycle approach to learning and professional development. The processes of technological change and of market integration can be the twin engines of upward real convergence in the euro area. However, both processes are associated to adjustment costs that must be tackled through an appropriate policy mix.

**The twin goals of *strong and inclusive* growth can be achieved with help of a holistic approach to reform, while failure to deliver inclusive growth may reduce a country's growth potential. A holistic approach to inclusive growth intervenes at the pre-market, in-market, and post-market stages.**

Some policy actions may generate trade-offs between growth and inequality and thus require compensatory measures. However, not all reforms generate an equity-efficiency trade-off. Well-designed policies that may create win-win situations include investing in skills of low-income children, upskilling displaced workers and promoting technology diffusion across firms.<sup>7</sup>

Redistribution systems alone may not suffice to address the challenge of increasing market income inequality. Fostering productivity growth while addressing inequality concerns requires a comprehensive approach to policy design, calling for action at the pre-market, in-market, and post-market stages (Figure 4). The pre-market stage refers to endowing people and firms with the means to carry out economic activity, e.g. by equipping people with skills, or ensuring appropriate infrastructure. The in-market stage refers to functioning of the economy in a way that supports healthy growth without creating excessive income inequality. The post-market stage is about alleviating market income inequality through the redistributive function of tax and benefit systems.

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<sup>7</sup> OECD (2018), "Opportunities for All: A Framework for Policy Action on Inclusive Growth".

Entrenched inequality may harm the growth potential because it may result in inequality of opportunity and lead to suboptimal investment in human capital and higher costs of adjustment to structural change. Education and regional development policies need to intervene at the *pre-market stage* to achieve equality of opportunity by delinking access to and success rates in education from the spatial and social background of individuals.

Policies intervening at the pre-market stage to achieve the right level of endowments for the population are to be combined with policies intervening at the *in-market stage* to achieve an efficient allocation of resources and keep market competition strong.<sup>8</sup> Inclusive and adaptive labour markets, open and contestable product markets, and efficient credit markets contribute to provide individuals with strong incentives to engage in innovative activity and to seize new professional opportunities. An important way in which the market incentivises effort is through providing rewards. It is therefore desirable that individuals increase their lifetime earnings when they invest in human capital. Similarly, it is desirable that entrepreneurs are rewarded for investment in risky activity. As shown by Aghion et al. (2019), more patenting is indeed linked to more income concentration at the very top but at the same time the process of Schumpeterian creative destruction may contribute to delivering higher social mobility.<sup>9</sup>

Intervention at the pre- and in-market stages needs to be completed at the *post-market stage* with tax and benefit systems that achieve a more desirable outcome in terms of equity by mutualising the cost of risk and dampening market income inequality. Inequality in terms of household disposable incomes is indeed lower than market income inequality in all EU Member States. Further reforms may be needed though to reinforce the effectiveness of the redistribution system. In particular, the tax systems may need to be adjusted in view of increasing their growth friendliness and fairness, also in light of the emerging digital economy and to fight aggressive tax planning. In addition, the benefit systems may need to be modernised to reinforce their redistributive capacity, to enable individuals to invest in human capital throughout the lifecycle while also ensuring their fiscal sustainability.

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<sup>8</sup> Chapter 2 on “The rise of corporate market power and its macroeconomic effects” in World Economic Outlook (April 2019) by the International Monetary Fund reports a generally moderate but broad-based rise in corporate market power, related with the winner-takes-most nature of the digital economy. The macroeconomic implications so far have been rather modest, but the IMF is also warning against further increases of market power in the future.

<sup>9</sup> Aghion et al. (2019), “Innovation and Top Income Inequality”, *The Review of Economic Studies*, 86(1).

Figure 4: Inclusive growth requires policy packages that intervene at the pre-market, in-market and post-market stages



**The European Semester has a clear focus on inclusive growth and the 2019 recommendation for the euro area spells out the objective of achieving inclusive growth through a holistic approach to growth-enhancing reforms over the longer horizon. Furthermore, the next Multiannual Financial Framework provides a number of instruments to support national reform efforts and investments.**

Monitoring of progress in delivering strong and inclusive growth is achieved through a multi-dimensional assessment of inequality developments and of institutional reforms in the European Semester. The coverage of inequality developments in the Country Reports is being broadened and deepened. Member States are encouraged to improve their ability to reduce poverty and tackle income inequality by improving the effectiveness and adequacy of the social safety net while also increasing the growth friendliness of their tax system by, for example, reducing the tax burden on low-wage earners. Effective equality of opportunity can be achieved by increasing the inclusiveness of the education and vocational training systems, by adopting a lifecycle approach to learning and professional development, and by increasing the effectiveness of public spending on lifelong learning in particular through an improved use of private - worker and employer - incentives to invest in on-the-job training. Member States can also improve the effectiveness of public investment schemes and make better use of public-private financing schemes to foster innovative investment and to facilitate technology diffusion. Addressing regional disparities in the access to essential public goods and services would help to achieve equality of opportunity and reduce the rural-urban divide. Finally, Member States are encouraged to improve the quality of institutions and the effectiveness of the public sector (e.g. through spending reviews) as well as to reinforce

business dynamism by delivering effective market contestability and by improving the efficiency of the banking sector in allocating funds to the real economy. The next Multiannual Financial Framework provides a number of instruments to support national reform efforts and investments, in particular the cohesion policy funds and European social fund. The budgetary instrument for convergence and competitiveness can speed up the implementation of structural reforms and investments. Furthermore, the InvestEU programme provides for financial support to investment. Finally, the European Pillar of Social Rights is about delivering new and more effective rights for citizens, including equal opportunities and adequate social protection.

### **Issues for discussion**

*Which factors behind inequality developments would you consider the most important in your country?*

*Which policy action to foster inclusive growth would you consider as most promising or most urgent?*

*What is your experience with policy packaging? How can one address the trade-offs, when they arise? For example, how can inclusive growth be strengthened without hampering innovation and entrepreneurship?*