The redistributive impact of economic policy reforms: The case of Spain in the EU context

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Various EU countries´ economic policy responses to the crisis may have exacerbated their already increasing levels of inequality. Preliminary evidence for the case of Spain shows that the country´s adoption of more ambitious fiscal consolidation and structural reform measures appears to have been in detriment to equity.

The relationship between income inequality and economic performance has long been studied. It seems clear that inequality has increased in most Western countries since the 1970s. However, in response to the crisis, some EU countries, and Spain in particular, have since 2010 adopted economic policy reforms (fiscal consolidation plans and structural reforms) that are likely to have further aggravated the increase in income inequality. This article assesses the redistributive consequences of the aforementioned economic policy reforms by reviewing available evidence to present two basic findings: (a) Public expenditure on education and health is found to be both growth and equity friendly in the short and in the long-term. In 2009, the countries facing the strongest fiscal consolidation pressures, Spain included, halted their long-term trends of steady increases in education and health spending. As a result, by 2012, some EU governments' public per capita expenditure on education and health is half that of others'. This supports some of the empirical evidence regarding low spending countries´, such as Spain´s, poorer recent performance on various equality indicators; and, (b) In terms of the impact of structural reforms on inequality, it is still too soon for a comprehensive assessment. However, there is preliminary evidence that the 2012 labour market reform in Spain is likely to have had a regressive impact on lower-wage earners that switched jobs, "movers", experiencing the largest wage reductions. All in all, it seems that Spain and other EU countries that were hardest hit by the crisis have suffered three waves of inequality: (i) the global trend of increasing inequality since the 1970s; (ii) the 2008 crisis, which was particularly hard on these countries as regards labour shedding; and, (iii) the economic policy responses that followed, which might have avoided the worst, but have exacerbated inequality.

Introduction

Income inequality is becoming more relevant on global leaders´ economic, political and social agendas, as evidenced by President Obama recently referring to it as "the defining challenge of our times."

There exists a long standing debate on the causal link between inequality and growth in the broader

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context of examining the possible effects of capitalism. The recent work of Piketty (2014) has brought about a revival of this historical debate by claiming that in economies where the rate of return on capital exceeds the rate of output growth, inherited wealth will always grow faster than earned income.

The latest crisis has also refocused attention on this longstanding issue, as some EU countries, and Spain in particular, have since 2010 adopted economic policy reforms and fiscal consolidation plans which have had an impact on existing income inequality. For instance, governments have passed a series of reforms (labour market, social security, housing regulation, etc.) or have adopted more stringent fiscal policy stances with clear impact on citizens' living conditions.

The purpose of this article is to provide a basic framework for analyzing the redistributive consequences of policy reforms in general as well as to review available evidence on this topic as regards the case of Spain. Two types of policy reforms are considered: fiscal consolidation and structural reforms. With respect to the latter, the analysis for the case of Spain focuses on the impact of the labour market reform, as most of the other structural reforms have been adopted only recently and it is not possible to measure their impact. The paper also overviews existing literature on the impact of economic policy on inequality.

Inequality facts and conceptual framework

Inequality facts, causes and consequences

The relationship between income inequality and economic performance has been long studied. Some of the most recent academic contributions to this debate include Piketty (2014) and Atkinson (2015) and, from policy circles, the OECD [(Cingano, 2014) and OECD (2015)], the IMF (Dabla-Norris *et al.,* 2015) and the European Commission (Pichelmann, 2015).

Certain basic facts stem from this literature. First, inequality appears to have increased in most Western countries since 1970s, irrespectively of the indicators examined (Piketty, 2014; Cingano, 2014; Atkinson, 2015; OECD 2015). Second, inequality trends have been less clear in emerging and developing countries with some large countries, most notably China, experiencing declining inequality (Dabla-Norris *et al.,* 2015).

The main explanations behind these trends in inequality are also somewhat generally accepted. To begin with, technological progress and the resulting skill premium, coupled with the erosion of certain labour market conditions, are likely to be the major drivers in advanced economies, while financial deepening is associated more with the rising inequality in emerging and developing countries. In fact, as Rognlie (2015) notes, wealth dispersion is likely to have many other determinants apart from the difference between output growth and capital returns, as mentioned in Piketty (2014). Just to name a few, these include, according to Pichelmann (2015), educational institutions, globalization, changes in the structure of capital markets, and the functioning of housing markets.

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Concerning the much-debated issue of the economic relevance of inequality, available evidence suggests that income distribution matters for growth. In particular, Dabla-Norris *et al.* (2015)

find that for a set of 159 advanced, emerging and developing countries, the impact of increasing income shares on growth qualitatively depends on the income quintile. When the income share of the top 20 percent of the wealthiest people increases, GDP declines over the medium-term. However, increases in the income share of the bottom 20 percent are associated with higher GDP growth. This finding is consistent with the empirical results for OECD countries, in which the rise of income inequality between 1985 and 2005 is estimated to have subtracted almost 5 percentage points of cumulative growth between 1990 and 2010 (OECD, 2015).

The mechanisms that channel the impact between income inequality and poor growth are different across different groups of countries. In the developing world, income inequality is a symptom of material (food, health, education, housing) deprivation which, in turn, jeopardizes people's fundamental development. In advanced economies, the connections are likely to be more indirect: it is likely that high wealth concentration limits the investment opportunities for the broader society (OECD, 2015), it may engender the preconditions for financial crisis by intensifying leverage and overextending credit (Rajan, 2010), and it might even allow lobbyists to push for financial deregulation (Acemoglu, 2011). Finally, in extreme cases, income inequality may contribute (coupled with other social evils, such as corruption) to damaging trust, social cohesion and lead to costly conflict.

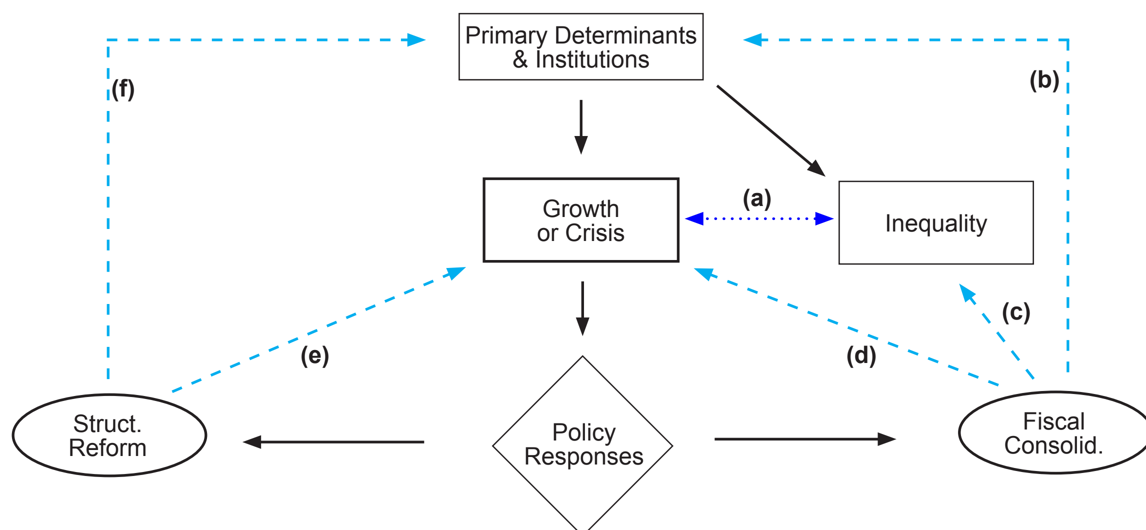
Conceptual framework

Based on a review of existing literature, Exhibit 1 depicts the likely relationships between economic policy reforms and income inequality.

The beginning of the cycle are the primary or fundamental determinants of economic growth: the amount and quality of several types of capital (human, physical, technological), the fundamental institutions and regulations that create the conditions for sustainable growth (ease of doing business, health and education systems, etc.) and even more intangible, but very important inputs such as the rule of law, trust and social cohesion. This fundamental block has two

Exhibit 1

Conceptual framework for the relationships between economic policy responses and inequality



Source: Author´s own elaboration.

types of impacts on inequality: one direct, closely related to the human capital of the country; and the other indirect, mainly through economic growth which, if properly distributed, may reduce income inequality.

For the cases in which growth needs to be re-stimulated, such as in the wake of a crisis, there are two broad types of policy interventions to undertake: fiscal consolidation (spending cuts and/or revenue increases) and structural (*i.e.* regulatory) reforms.

This simple framework generates six types of relationships, labeled from **(a)** to **(f)** in Exhibit 1, briefly discussed below.

The relationship between growth and income distribution is a much-debated issue (see above) and it is represented in Exhibit 1 by Relationship **(a).**

Fiscal consolidation policies may have three different effects. Certain spending cuts (or revenue increases) have a structural impact on the proper functioning of the health, education or judiciary systems (just to name a few). These policies may increase inequality in the medium or long-run by jeopardizing growth - Relationship **(b)**. Even if fiscal consolidation instruments do not have structural effects on the fundamental determinants of growth, they end up having an impact either on inequality –Relationship **(c)**– or on growth -Relationship **(d)**.

Table 1

Summary assessment of growth and equity effects of fiscal consolidation instruments in OECD countries

	Growth		Equity	
	Short-term	Long-term	Short-term	Long-term
Spending cuts				
Education	- -	- -	-	- -
Health	- -	-	-	-
Other government consumption	- -	+	-	
Pensions		++		
Sickness and disability payments	-	+	- -	-
Unemployment benefits	-	+	-	
Familiy-related expenditure	-	-	- -	- -
Subsidies	-	++	+	+
Public investment	- -	- -		
Revenue increases				
Personal income taxes	-	- -	+	+
Social security contributions	-	- -	-	-
Corporate income taxes	-	- -	+	+
Enviromental taxes	-	+	-	
Consumption taxes	-	-	-	
Recurrent taxes on immovable property	-			
Other property taxes	-		++	+
Sales of goods and services	-	+	-	-

Source: Cournède et al. *(2013).*

The impact of structural reforms on income inequality tends to be more indirect through their impact on the growth model. Some reforms, like those of the labour and product markets (including the housing market), the business environment and certain areas of the public administration, have a direct impact on growth - Relationship **(e)**. Some other policy reforms aim at addressing more structural determinants of economic activity, like the schooling and education system, as well as certain welfare, health and family-support plans - Relationship **(f)**.

For examples of these relationships, Barkbu et al. (2012) and Varga and Veld (2014) provide estimations of the impact of structural reforms on growth in the EU. On the fiscal consolidation front, Cournède et al. (2013) present a taxonomy of the fiscal consolidation instruments and assess their likely impact on growth and equity, both in the short and the long-term, for the OECD countries (Table 1).

Table 1 offers several key takeaways. In the short-run, most fiscal consolidation plans are harmful to growth and in some instances, this adverse effect

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extends over the medium and long-run. This is the case, most notably, as regards cuts in education and public investment as well as increases in income taxes (personal and corporate) and increases in social security contributions. In the long-run, there are a series of fiscal adjustments that may enhance growth, but each fiscal instrument requires a separate analysis. For instance, for the pro-growth effects of reducing unemployment benefits to materialize, there can be no structural lack of demand and the reform should not prompt inefficient employee-job matches. Similarly, cuts in disability expenditure are conducive to growth only to the extent that there is scope for improvement in the corresponding national disability protection system (e.g. reducing the scope for relatively able workers receiving disability assistance). The case for the reduction in public subsidies is clearer as this removes distortions. In general, however, it is important to emphasize that there is no theoretical or empirical basis as to what is the optimal size of the public sector in the economy.

With respect to the implications of fiscal consolidation policies on equity, the most adverse effects correspond to expenditure cuts in basic services, like health, education and family-related expenditure. Therefore, on the basis of OECD work, pursuing these types of polices does not generate a growth-fairness tradeoff, but rather a worsening on both fronts. In contrast, the tradeoff is faced when considering increasing personal and income taxes: they have a positive and strong impact on equity but harm growth. This is in line with the findings of Darvas and Tschekassin (2015), who reach the conclusion that income inequality tends to increase after fiscal consolidation episodes.

The situation in Spain in the EU context

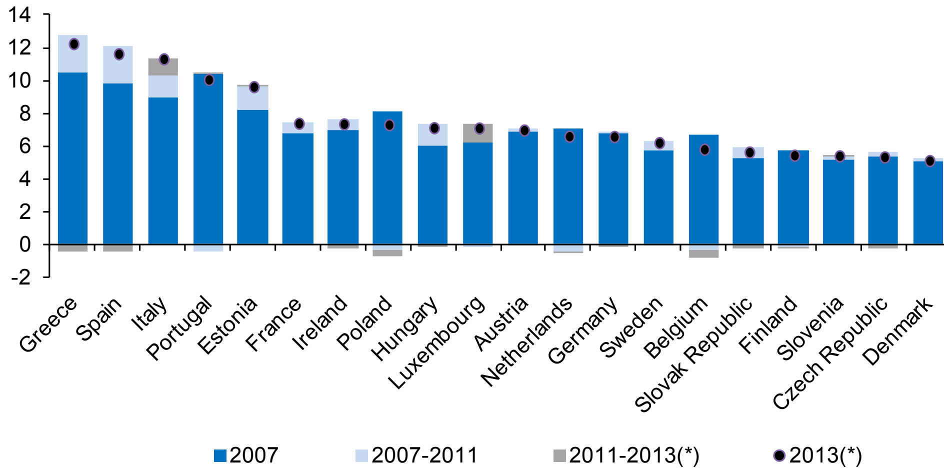
The situation before the crisis and reforms

Exhibit 2 represents the 90/10 share ratio, that is, the ratio of the average income in the top 10% of the income distribution to the average income in the bottom 10% for the set of EU countries for which the OECD reports data. The 90/10 share ratio is considered one of the basic indicators of income inequality and polarization.

Following this metric, Exhibit 2 shows that Spain was the second most unequal country by 2007,

Exhibit 2

Income share ratio (90/10): The ratio of average income of the top 10% income distribution to the average income of the bottom 10% of the income distribution

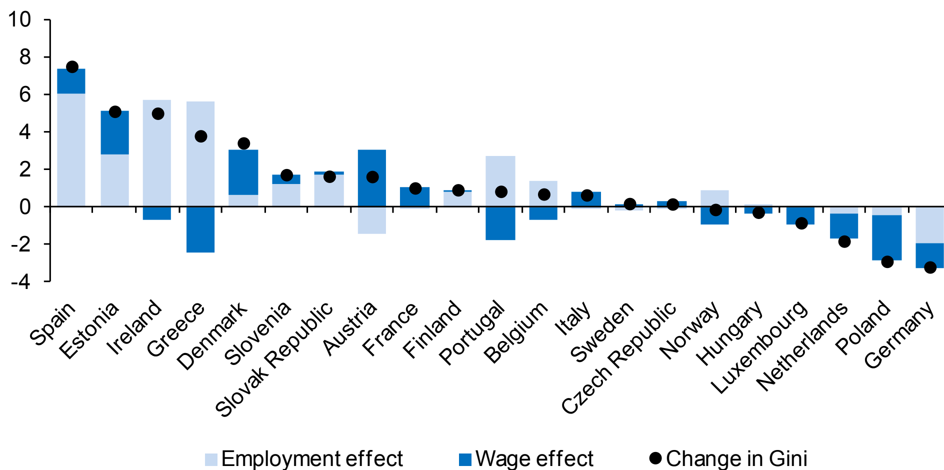


Note: (*) Represents the latest available year. The latest available data refer to 2014 for Hungary; 2013 for Finland and Netherlands and 2012 for the other countries. Data shown for 2011 refer to 2012 for Hungary. Data shown for 2007 refer to 2008 for France, Germany, Spain and Sweden.

Source: OECD (2015).

Exhibit 3

Decomposition of changes in the Gini coefficient of labour income: Percentage point change in Gini coefficient, 2007-2011, working-age individuals (*)



Note: (*) Gini coefficient of labour income among the entire working-age population estimated by assigning zero earnings to non-workers. Residuals excluded.

Source: OECD (2015).

only after Greece and that it is the country where income polarization expanded more in the period 2007 – 2011. Since 2011, in Spain and in most countries, there has been a slight correction of income polarization.

In Spain, the functioning of the labour market, which is a primary determinant of households' income, has significantly contributed to this increase in inequality. Exhibit 3 decomposes the increase in the Gini coefficient of labour income between 2007 and 2011 into two categories: the inequality increase due to job losses (employment effect) and the one due to reduction in wages (wage effect).

In line with the previous result, Spain is the country where labour income inequality grew most between 2007 and 2011 and the majority of this increase is the result of the surge in unemployment after the 2008 crisis.

The situation after the crisis and reforms

Fiscal consolidation

As mentioned above, the reduction in government spending in education and health is generally believed to hurt both economic growth and equity, in the short, medium and long-term alike. It is therefore important to monitor what happened to this type of expenditure as a result of the fiscal consolidation that several EU countries have undertaken since 2010.

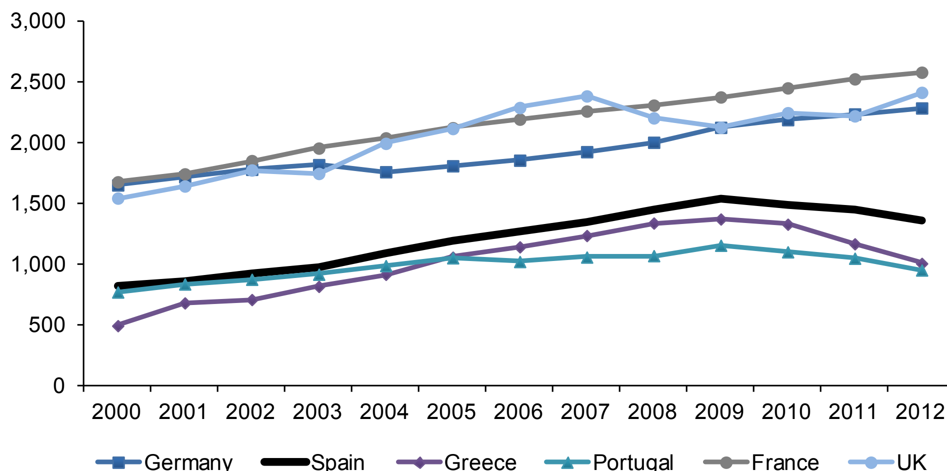
Exhibit 4 and Exhibit 5 represent total general government per capita expenditure in current prices, for health and education, respectively, from 2000 to 2012 in the three largest EU economies (Germany, the United Kingdom and France) and in the three EU countries that have adopted the most ambitious fiscal consolidation plans (Greece, Portugal and Spain).

Although countries in the second group have been systematically spending less than those in the first group, particularly on health, in all six countries (except in the UK), public expenditure steadily increased from 2000 to 2009 in both areas. However, since 2009 the two groups of countries followed different trajectories.

The three largest EU countries have continued expanding expenditure in these areas, while

Exhibit 4

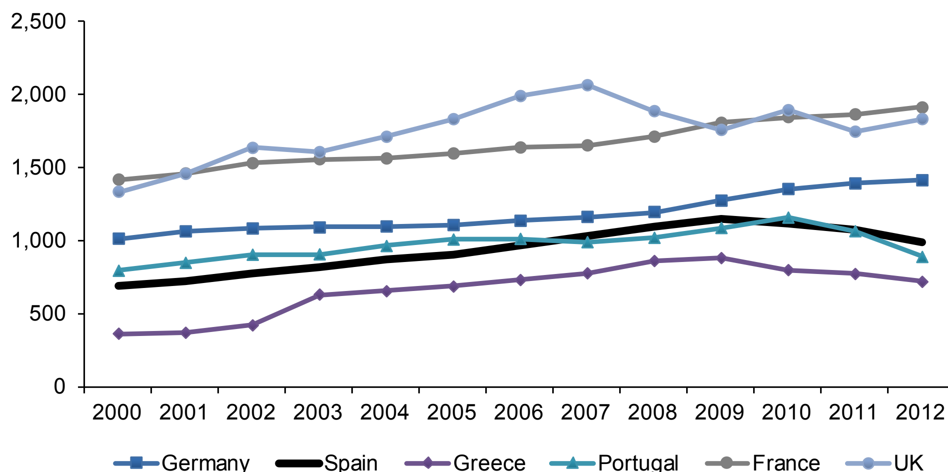
General government total expenditure per capita on health in current prices for selected EU countries



Source: Eurostat.

Exhibit 5

General government total per capita expenditure on education in current prices for selected EU countries



Source: Eurostat.

the three countries facing fiscal consolidation pressures have reduced it. This has resulted in the governments of Greece and Portugal spending nearly half the amount per capita on health and education than the governments of France and the UK in 2012, with Spain in the middle, but converging towards to lower spending group.

Focusing on the post-crisis period, and in a similar vein to Darvas and Tschekassin (2015), Table 2 shows the variation in public expenditure in health and education, from 2009 to 2012, in all EU-27 countries and for the EU-27 and EU-15 as a whole. Expenditure variations are reported in current prices and adjusted for population. Table 2 also includes the cumulative inflation rate in the 2009-2012 period.

Public expenditure on education and health has decreased in only 5 of the EU-15 countries between 2009 and 2012: Greece, Portugal, Ireland, Spain and Italy. In Spain, the reductions have been larger in education (-14.1% in population adjusted spending and -13% in current prices) than in health (-12.3% and -11.2%, respectively). To place these variations in context, it is useful to benchmark them with changes in two indicators. Firstly, in the EU-15 block, there has been an increase of 5.5% in health and 3% in education (in population-adjusted terms). So there is a marked divergence between Spain and the EU-15 and EU-27. Secondly, the cumulative inflation rate in Spain between 2009 and 2012 was 7.7%, so the reduction in public expenditure in real terms in health and education is underestimated by the variation in current prices.

As regards to cuts in health and education expenditure, there is a marked divergence between Spain and the EU-15 and EU-27.

Table 2

Variation in general government expenditure on health and education, 2009-2012, in current prices and adjusted for population. Pro-memoria: Variation in prices (HICP) 2009-2012

Percentage

	Health		Education		Memo. Price variation
	Current prices	Population adjusted	Current prices	Population adjusted	
EU-27*	6.6	5.6	4.2	3.5	8.0
EU-15	6.7	5.5	4.1	3.0	7.0
Belgium	14.1	10.6	11.9	8.4	8.5
Bulgaria	24.5	26.9	-7.3	-5.5	9.1
Czech Republic	9.2	8.3	8.0	7.2	7.0
Denmark	8.0	6.6	8.4	7.1	7.5
Germany	7.3	7.5	10.8	11.0	5.9
Estonia	15.1	16.0	12.2	13.1	12.5
Ireland	-13.4	-14.5	-2.5	-3.8	1.5
Greece	-27.3	-26.6	-19.3	-18.5	9.1
Spain	-11.2	-12.3	-13.0	-14.1	7.7
France	10.1	8.6	7.3	5.8	6.4
Italy	-0.1	-0.7	-7.8	-8.4	8.0
Cyprus	4.6	-3.3	-2.9	-10.3	9.4
Latvia	-1.5	4.2	-2.9	2.7	5.3
Lithuania	9.2	15.8	1.4	7.4	8.7
Luxembourg	13.7	6.9	23.4	16.1	9.7
Hungary	10.0	11.1	-4.4	-3.5	15.0
Malta	26.1	24.1	26.0	24.0	8.0
Netherlands	12.7	11.0	3.0	1.5	6.4
Austria	7.2	6.2	7.8	6.8	8.0
Poland	10.6	10.8	20.1	20.3	10.6
Portugal	-17.8	-17.6	-18.4	-18.3	7.9
Romania	-9.7	-8.2	-18.0	-16.5	16.0
Slovenia	-1.7	-2.8	-2.1	-3.2	7.2
Slovakia	-10.4	-10.8	0.3	-0.1	8.7
Finland	14.9	13.4	7.7	6.2	8.4
Sweden	34.2	31.0	31.5	28.4	4.3
United Kingdom	16.2	13.5	6.6	4.2	11.0

Note: (*) EU-27 excludes Croatia from EU-28 due to lack of data for this county. EU-15 includes Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, United Kingdom, Austria, Finland and Sweden.

Source: Eurostat.

Structural reforms

It is well known that it takes time for structural reforms to deliver expected results. One of the most relevant structural reforms undertaken in Spain has been the labour market reform adopted in 2012 (see García Perez and Jansen (2015) for a general assessment of the reform and Fernández Kranz (2015) for an specific evaluation of the impact of the reform on wages).

The initial assessment by Fernandez Kranz (2015) suggests that the group of workers known as "movers," *i.e.* those workers who have changed employer and might be unemployed for some time, have suffered most of the adjustment. In particular, on average, between 2008 and 2013, wages have decreased 17% for movers and 1.6% for "stayers" (*i.e.* workers that have remained in the same company throughout the period). These are the average changes across the entire wage distribution, but the variation between quintiles shows that the wages for the lowest quintile of "movers," *i.e.* the 20% of "movers" that earn the lowest wages, have decreased by more than 20% between 2008 and 2013. Although this evidence is preliminary and limited, it suggests that the labour market reform is likely to have had an adverse redistributive effect.

Preliminary evidence suggests the labour market reform is likely to have had an adverse redistributive effect.

Conclusions

The severe economic crisis that hit Spain and a number of other EU countries in 2008 required a bold policy response, both in terms of fiscal discipline and pro-growth structural reforms. It seems the worst-case scenarios have been avoided, but now it is time to begin assessing the redistributive "side-effects" of the actions taken since 2010, when the reformist agenda gained momentum. It is a well-established fact that Western societies are becoming more unequal since the 1970s, and therefore, it is relevant to know whether the crisis and the policy reaction it prompted have smoothed or exacerbated this long-run trend.

In terms of fiscal consolidation plans, it is clear that the policy reaction in Spain and in some other EU countries has been regressive. There is robust evidence that public spending on health and education achieves both growth and fairness goals. However, the long-term trend that many "peripheral" EU governments have followed of steadily increasing funds in these two areas was abruptly stopped after 2009. In 2012, the latest year for which data are available, the expenditure per capita on health and education in Greece and Portugal is half that of France and the UK, with Spain somewhere in the middle but converging to the lowest values. This supports some of the empirical evidence regarding Spain´s poor recent performance on various equality indicators.

Regarding the redistributive impact of structural reforms, the evidence is much more limited because not enough time has passed since the reforms´ adoption. For this reason, in Spain, we focus on measuring the impact of the labour market reform. And even for this particular instance, the available information is scarce. As recent work by Fernández Kranz (2015) suggests, the reform has placed most of the burden of the adjustment on the lower-wage "movers" (*i.e.* workers that change employer). Although this is only an initial and partial exploration of the phenomenon, and more research in this field is clearly justified, the results are not encouraging in terms of the redistributive impact of the labour market reform in Spain.

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