ESRI RESEARCH BULLETIN
JANUARY 2021

WHAT DROVE INCOME INEQUALITY DURING THE GREAT RECESSION

KARINA DOORLEY

EVIDENCE FOR POLICY

ESRI ECONOMIC & SOCIAL RESEARCH INSTITUTE

What drove income inequality during the Great Recession[1]

*Karina Doorley (ESRI)

ESRI Research Bulletins provide short summaries of work published by ESRI researchers and overviews of thematic areas covered by ESRI programmes of research. Bulletins are designed to be easily accessible to a wide readership.

INTRODUCTION

Concern about income inequality increased during the Great Recession amidst fears that job losses and wage cuts, together with austerity measures, were widening the gap between rich and poor. In Europe, Portugal; Ireland; Italy; Greece and Spain were most severely affected by the Great Recession between 2007 and 2013. Inequality in market income (i.e. income before taxes and transfers are taken into account) increased in each of these 'crisis' countries due to rising unemployment and wage cuts. However, inequality in disposable income (i.e. after taxes and transfers) fell or was broadly stable in every country but Spain. Thus, tax-benefit systems did much to cushion income inequality in these countries during the Great Recession. This paper shows how tax and benefit policy contributed to these stable headline measures of inequality in disposable income. It distinguishes between the effect of: (i) pre-existing taxes and social welfare benefits – the so-called 'automatic stabilisers'; and (ii) new or modified taxes and benefits that were introduced during the Great Recession – 'discretionary' policies.

DRIVERS OF HEADLINE INEQUALITY INDICES

Figure 1 shows how inequality in disposable income, measured by the Gini Index, changed between 2007 and 2013 (black diamonds). A rise (fall) in the Gini index corresponds to an increase (decrease) in inequality. The bars indicate the relative contribution of market income changes, discretionary policy and automatic

[1]This Bulletin summarises the findings from: Doorley, K., Callan, T. and Savage, M. (2021), What drove income inequality in crisis countries during the Great Recession?1. Fiscal Studies.

DOI: https://doi.org/10.1111/1475-5890.12250

*Karina.doorley@esri.ie

stabilisation. Within these last two categories, the effect of taxes and benefits is shown separately.

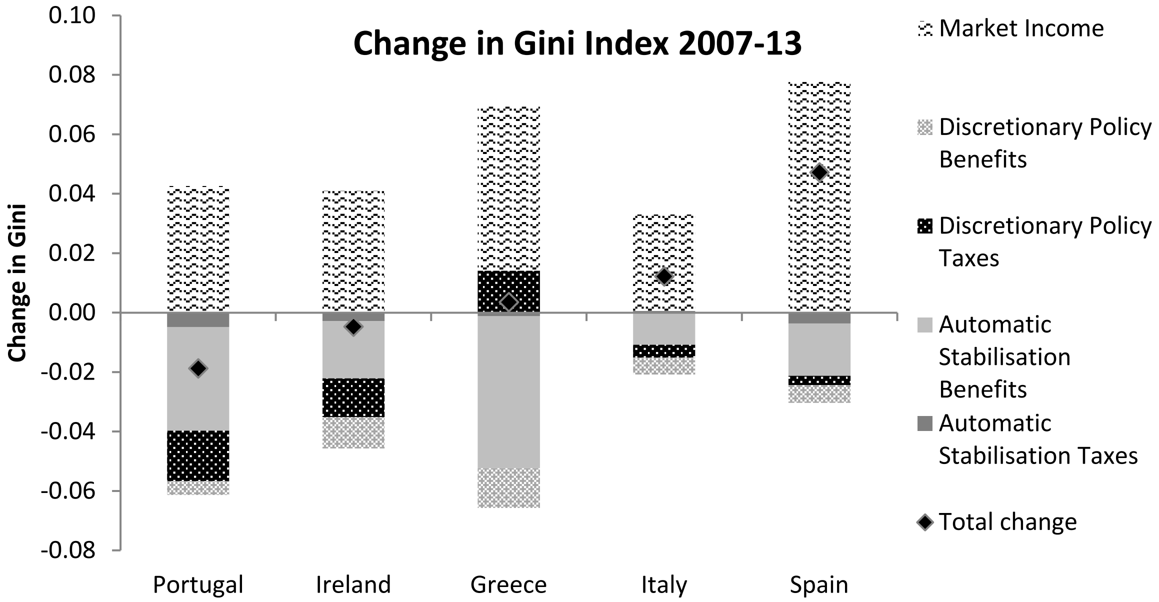

Figure 1 Structural Decomposition of the change in the Gini Index into the contribution of market income, discretionary policy and automatic stabilisation over the crisis period

Changes in market income, caused mainly by job losses and wage cuts, worked to increase income inequality. These increases were partly offset by the effect of discretionary changes to tax policy, which reduced inequality in all countries but Greece. This is because all of the countries studied made their tax-benefit systems more progressive during the crisis. Increased progressivity means a relative increase in the tax burden for high earners which can reduce income inequality. Discretionary changes to benefits during the crisis reduced inequality slightly in all countries, with larger effects in Ireland and Greece.

Automatic stabilisation made a bigger contribution to decreasing income inequality. In each country, the effect of automatic stabilisation was larger than that of discretionary policy and, in some countries (Portugal and Greece), its magnitude was comparable to that of market income changes. Benefits proved to be more effective automatic stabilisers than taxes. In Portugal, Ireland and Greece, existing benefits cushioned the shock to market income to the extent that inequality decreased or was relatively stable between the beginning and the end of the crisis. In Spain, the existing benefits system also cushioned inequality but not to the same extent, with the result that the Gini index increased by 4 points.

These findings tell us that the success with which four of the five 'crisis' countries maintained stable levels of income inequality during the Great Recession was mainly thanks to their pre-existing benefits systems. Countries which devoted more resources to unemployment supports, such as Ireland and Spain, were also those in which unemployment protection played an important role in cushioning inequality. Old-age benefits played a more important role in Greece, Italy and

Portugal where a higher proportion of the population is of retirement age and where multi-generational households are more common.

Discussion

Overall, automatic stabilisation, particularly through the benefits system, played a larger role than discretionary policy in reducing inequality in crisis countries during the Great Recession. Automatic benefit stabilisation cushioned income inequality increases by between thirty and one hundred percent in the countries studied. This highlights the importance of a well-designed tax-benefit system in dealing with unexpected market shocks.

The design and effectiveness of the pre-existing tax-benefit system, or automatic stabilisers, will be important when governments begin to consider withdrawing new, targeted supports provided during the current pandemic. These include the Irish Pandemic Unemployment Payment (PUP) and the Employment Wage Subsidy Scheme (EWSS). These supports have been very effective at stabilising income inequality in 2020. Recent work using SWITCH, the ESRI's tax-benefit model, estimates that, unlike during the Great Recession, these discretionary policies have been as important as automatic stabilisers in cushioning income inequality in Ireland in 2020. The withdrawal of the PUP and the EWSS may therefore lead to increases in income inequality in 2021, in the absence of a labour market recovery.[1]

[1] Doorley, Karina & Keane, Claire & McTague, Alyvia & O'Malley, Seamus & Regan, Mark & Roantree, Barra & Tuda, Dora, 2020. "Distributional Impact of Tax and Welfare Policies: COVID-related policies and Budget 2021," Quarterly Economic Commentary: Special Articles, Economic and Social Research Institute (ESRI).

Whitaker Square,
Sir John Rogerson's Quay,
Dublin 2
Telephone **+353 1 863 2000**
Email **admin@esri.ie**
Web **www.esri.ie**
Twitter **@ESRIDublin**

ESRI ECONOMIC & SOCIAL RESEARCH INSTITUTE