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NETWORK ON SOCIAL INCLUSION AND INCOME DISTRIBUTION FINAL REPORT

European Observatory on the Social Situation (SSO)

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EXECUTIVE SUMMARY

The focus of the first report of the network set up to monitor developments in income distribution and social inclusion is on income inequality and the incidence of low incomes across the EU and, in particular, on the relative numbers at risk of poverty, as conventionally defined as those with income below 60% of the median in each country. Its concern is to use all available data, or at least those available at EU level, to examine differences between countries in the rate of relative poverty, as defined, including the new Member States which entered the EU in 2004 and the candidate countries for entry into the Union (ie Bulgaria and Romania, which are at present involved in accession negotiations, together with Croatia and Turkey) and how this is tending to change. A parallel concern is to examine the factors underlying low incomes and the vulnerability of particular sections of the population, most especially children and older people aged 65 and over, to the risk of poverty, in order to provide a guide to policy aimed at tackling relative poverty and exclusion.

Although the focus is on income, and more specifically, on the income of households, a number of other aspects which affect the living standards, or the command over resources, over and above monetary income are also considered. These are housing costs, or imputed rent, and non-monetary benefits, in the form especially of social services of one kind or another, both of which have potentially important effects on the relative position of households in terms of the costs which they need to meet out of income. Since the scale of these effects vary both between countries and between households with differing levels of income, the, accordingly, influence the interpretation of the conclusions reached on the basis of examining relative incomes.

The main issues covered in the report and the conclusion reached, especially those which are relevant for policy, are summarised below.

Differences and trends in poverty rates across the EU

The first part of the report presents an overview of differences in income inequality across the EU and the other countries covered and the changes which have occurred over recent years, insofar as these can be identified from the data available. It also examines differences in the structure of households, which affects the adequacy of income and living standards, and the way that this is tending to change over time.

The data available, which, in addition to the European Community Household Panel (ECHP), come from a variety of non-harmonised national sources, limit the analysis which is possible, especially for the new Member States and candidate countries, and adds a significant element of uncertainty over the results, particularly as regards changes over time. The conclusions reached, therefore, have in many cases to remain tentative until

more comparable and timely data become available from the new EU Survey of Income and Living Conditions (SILC).

The data suggest that the relative poverty, defined as above, is slightly lower, on average, in the new Member States than in the EU-15 so that the proportion at risk of poverty is marginally lower in the enlarged EU than it was beforehand. According to the latest data which are reasonably comparable (which are for 2001), therefore, some 15% of the population in the EU25 have an income lower than the poverty threshold in the country in which they live. At the same time, there are enormous differences between the new Member States and the EU15 countries in the level of the threshold, which, on average, in the former is only 35% of the latter even if account is taken of differences in price levels between the two (ie if income is measured in purchasing power parity terms).

There are equally marked differences in the population below the poverty line across the enlarged EU, the proportion ranging from under 10% in the Czech Republic and Slovenia and only slightly above 10% in Finland and Sweden to over 20% in Greece, Ireland and Slovakia. It is even higher in Turkey at around 25%.

In the EU-15 countries, where it is possible to identify changes over time from the ECHP, there seems to have been some convergence in poverty rates between 1995 and 2000 as a result largely of some increase in the Member States, the Nordic countries especially, where the rate had been lowest at the beginning of the period.

For the majority of those with income below the poverty line, low income appears to be a temporary phenomenon but a long-term one, in the sense that they had poverty level incomes for at least three years out of four over this period. Moreover persistently high poverty rates was an especially marked feature of countries where the poverty rate itself was high.

The proportion of children living in households with income below the poverty line varies even more widely between countries than the overall poverty rate, ranging from 7% in Slovenia and 9% in Denmark to 30% in Slovakia. In Turkey, it is around 32%. Slovenia apart, the poverty rate for children tends to be slightly higher than average relative to the overall rate in the new Member States than in the EU15. The rate seems to be particularly high within countries in lone parent households and in those with three children or more, as well as in households where mothers are not in employment.

Moreover, while, according to the ECHP, there was a modest decline in the proportion of children with income below the poverty line in the EU15 as a whole between 1995 and 2001, the proportion appears to have increased in the few new Member States for which data are available (Poland, Hungary and the Czech Republic). In the EU15 generally, the increased age at which people tend to have children and, therefore, their higher level of income, seems to have moderated the risk of child poverty as well as a generally declining rates of unemployment, though in the UK, increased social transfers to families have been important.

The number of older people of 65 and over with income below the poverty line varies across the EU by more still, from 4% in the Czech Republic and under 10% in France, Hungary and Poland to 30% in Spain, over 40% in Ireland and over 50% in Cyprus. The risk of poverty in old-age seems, in general, to be less in the new Member States than in the EU15, reflecting perhaps more of those in retirement living in households with people in work as well as relative pension levels. Experience varied over the second half of the 1990s, the poverty rate among the elderly rising in Ireland and Finland and declining in Germany and the UK and Germany.

Trends in the structure of households

There are significant differences in the structure of households across the EU which has implications not only for the proportion of population with income below the poverty line but also for social policy. The relative number living alone is much larger in the northern countries of the EU-15 than in the southern countries or in the new Member States and candidate countries. Many of those living alone in all countries are people in retirement aged 65 and over.

The relative number of people living alone has increased over the long-term throughout the EU15 and has been accompanied by an increase in lone parents in most of the northern Member States. This increase was accompanied, in particular, by a decline in couples with children. The same pattern of change, over a shorter period, is evident in the Czech Republic, Slovakia, Hungary and Slovenia though not in Estonia, Cyprus or Malta. There are wide differences across the EU in the household circumstances of those aged 65 and over. In most northern EU-15 countries, the great majority of these live alone or as a couple. Very few live in households with other people and, accordingly, with access to other sources of income, employment income, in particular. This contrasts with the position in the southern countries and new Member States, where a significant number of people in this age group live in households where there is potential income support from other members. In most of the EU, however, the proportion of elderly people living in such households has tended to decline.

The accuracy of indicators of poverty

Any interpretation of the indicators of inequality and relative poverty rates needs to take account of the margins of error applying to the data on which they are based which invariably come from surveys of a small sample of the population. To assess the scale of relative numbers with income below the poverty line and to compare these across countries or to monitor changes in them over time, in order, for example, to decide policy action or to evaluate the policy measures taken, it is essential to take explicit account of the uncertainty surrounding the estimates.

Analysis of these margins of uncertainty indicates, for example, that EU countries cannot be ranked unambiguously in terms of inequality or the risk of poverty when sampling errors are allowed for. The most that is possible is to identify country groups within which levels are similar but which differ significantly from other groups. Denmark, Sweden,

Finland, Austria and Germany, therefore, form a single group in which the degree of inequality is much the same and relatively low, Spain, Greece and Portugal, another group at the other end of the scale where inequality is relatively high. The problem is even more serious for subgroups of the population, such as children or elderly people in retirement, for whom, because of the smaller sample size, the margin or error can be substantially greater.

Similar considerations apply to estimating changes in indicators of poverty or inequality over time, implying that small year to year movements need to be treated with caution and, in many cases are unlikely to signify that poverty rates have risen or fallen much. This applies to poverty rates for children and older people which are a particular focus of policy attention.

Employment as protection against poverty

People in paid employment tend to have the lowest poverty rates in all Member States. By contrast, the relative numbers with income below the poverty line are invariably highest among the unemployed, with Ireland, the UK, Malta and Estonia having the highest rates, reflecting the relatively low levels of unemployment benefit payable to those out of work. In Italy and the Netherlands, the poverty rate among the unemployed has risen markedly since the mid-1990s, reflecting the effect not only of policy but also perhaps of the changing composition of the unemployed.

Accordingly, the risk of poverty for households is very much related to the number of household members who are in work and whether they work part-time or full-time. The differences are especially marked for household with and without children. In nearly all EU15 Member States, half or more jobless households with children fall below the poverty line. By contrast, for households with members fully employed, the poverty rate is lower than the national level and differences due to the presence of children are negligible.

The relative number of those in work with income below the poverty line – ie the working poor – differs across the EU in terms of the age groups most affected. In southern Member States, poverty is more concentrated among older workers, in part reflecting the large numbers employed in agriculture, in the rest of the EU15, among younger workers, a larger proportion of whom tend to live outside the family home and, therefore, have less access to other income apart from their own.

Poverty rates are especially high, as might be expected, among workers with low levels of education (compulsory schooling at most), particularly in the South of Europe, among those working part-time and among workers with temporary contracts of employment.

The relative importance of jobless households

The relative number of jobless households in Member States seems to be as much related to the structure of households as to the rate of unemployment in the country concerned and, indirectly, to the extent of social support for those of work which enables people to

live in households without access to income from employment. Both Belgium and the UK, in particular, have more jobless households than would seem to be implied by their level of unemployment and southern countries less. The proportion of jobless households is, on average, less in the new Member States than in the EU-15 countries despite unemployment being higher, though not in Poland and Slovakia, where unemployment is particularly high.

By the same token, changes in unemployment are not necessarily reflected in counterpart increases or reductions in the number of jobless households. The general fall in unemployment since the mid-1990s in the EU15 has not always, therefore, been accompanied by a corresponding decline in jobless households, the UK being a case in point. This has implications for social policy, the need for which is, accordingly, not necessarily related to the number of people out of work and may not decline as unemployment falls, at least in proportion.

Children in most countries are less likely to live in jobless households than people generally, though the reverse is the case in the UK and Ireland and in a number of the new Member States.

Although very few young people aged 16–24 live in jobless households without access to income from employment in all parts of the EU, the proportion is largest in northern EU-15 countries and smallest in the south of the EU and in the new Member States, partly reflecting the differential availability of social benefits.

The great majority of elderly people of 65 and over live in jobless households in northern EU-15 countries, whereas as in the south of the EU and in the new Member States, the proportion is much lower, implying that many more have access to income from employment and, potentially at least, less reliant on state support. In nearly all Member States right across the EU, however, the relative number of people in this age group living in jobless households has tended to increase over time.

Lone parents, most of whom are women, are less likely to be in employment than others virtually throughout the EU. This is particularly the case in Germany, the Netherlands and above all the UK, reflecting the lack of childcare support. Although still relatively small, the number of lone mothers in work has, however, increased significantly in the last two countries over the past decade.

Factors contributing to the risk of poverty

There is a negative relationship between GDP per head levels and the degree of income inequality across households across the EU and candidate countries. The higher the higher the level of GDP per head, therefore, the lower the degree of inequality. The relationship seems to hold in both the EU15 countries and the new Member States, whether examined together or separately.

High GDP per head, however, is far from being a sufficient condition for achieving a low risk of poverty, though, other things being equal, it tends, on average, to be associated with a relatively small proportion of the population below the poverty line. Four groups of country can be distinguished in this regard: countries (including the Nordic Member States, Austria and France) with high GDP per head and a relatively low poverty rate; countries with high GDP per head and a high poverty rate (including the UK and Ireland as well as Italy); countries with a low GDP per head and a low rate of poverty (including the Czech Republic, and Slovenia); and countries with low GDP per head and a high poverty rate (including Estonia, Latvia and Slovakia). Among the candidate countries, Turkey has both the lowest level of GDP per head and by far the highest rate of poverty of all the countries considered in the report.

The degree of openness of the economy does not seem to affect the poverty rate one way or the other. This finding, however, based on analysing the relationship across countries at one point in time (ie on cross-sectional analysis), does not mean that an increase in openness in a given country would leave the relative number below the poverty line unaffected. It cannot be concluded, therefore, that, for example, a further opening of labour and capital markets in the new Member States would not lead to an increase in income inequality, or that increased globalisation would not affect the risk of poverty across the EU in general. Examination of this issue requires (time series) data for a run of years, which at present are not available.

The relative number of people of working age in employment, however, does seem to affect the poverty rate, in the sense of tending to reduce it, though the relationship is not particularly strong. Again, because this is based on cross-sectional analysis, it does not necessarily signify that an increase in employment in an individual country would reduce the risk of poverty, though *a priori* reasoning suggests that it is plausible that it would. Nevertheless, verification of this across the EU has to await the necessary time series data becoming available.

The data available also indicates that, other things being equal, higher expenditure on social protection relative to GDP is associated with lower rates of poverty, though in the EU15, it does not seem necessarily to lead to a lower degree of inequality.

Extending the analysis to examining poverty rates among children, on the one hand, and older people aged 65 and over, on the other, shows, first, that a large number of children with income below the poverty line tends to be linked to a high overall rate of poverty, but, secondly, this is not the case for older people. Moreover, it also shows that although a high level of social expenditure seems to reduce relative poverty among children, it does not tend to do so in respect of older people, which raises a question over the nature of the pension system in some Member States and the way that it distributes pensions among those in retirement.

A major conclusion from the analysis is the need for data for a run of years to explore the way that changes in GDP per head, employment, economic openness, social expenditure and so on affect the relative numbers with income below the poverty line across the EU so

as to provide a better guide for policy. The availability of longitudinal data – which are provided by the ECHP for the EU15 countries, though with a relatively small sample size and for a period which ended some 5 years ago – would also enable the effect on income of changes in individual circumstances to be examined and the extent to which any reduction in income to below the poverty line is a long-term rather than a transitory phenomenon.

A further conclusion is that a range of factors operating together seem to determine the degree of inequality in a country and its rate of relative poverty, quite apart from its level of prosperity, the level of employment and the amount spent on social expenditure. These factors include political and wider economic features as well as social norms and the institutional framework in place, including the nature of the social welfare system. Since these differ widely across EU countries, despite their similarities in a number of respects, it suggests a need for caution when drawing policy conclusions. In particular, it suggests that the same factors or policies may work in a different way in countries with different norms and different institutional arrangements.

the effect of taxes and benefits on low incomes

Income inequality in society and the risk of poverty is affected not only by the scale of social transfers but also by the way that they are distributed as well as by the operation of the tax system, which can both levy a higher charge on those at the top end of the income scale than those at the bottom and give concessions to the latter which are equivalent to benefits. It is essential, therefore, to take explicit account of the incidence of taxes as well as benefits on those with differing levels of income when assessing the effect of government action on reducing income inequality and the social exclusion which might stem from this. This can be done for the EU15 countries on the basis of the Euromod model of household income but not for the new Member States or candidate countries for which no similar data – or modelling possibilities – are at present available.

While social benefits tend to account for a much larger share of the disposable income of households for those towards the bottom end of the scale than for those further up, the scale of the difference varies significantly between EU15 Member States. This is a reflection of differences in the way benefit systems operate, the relative priority attached to the relief of poverty in their operation and the extent of the use of means-testing to concentrate transfers on those with low incomes. In both Ireland and the UK, therefore, where means-testing is used more extensively than elsewhere, benefits are much more important for low-income households than in other countries, while they are of negligible importance, on average, for those with high incomes. This contrasts sharply with the situation in France and Austria, where benefits account for some 20% of the income of households in the top 20% of the income distribution.

In Austria especially, however, some of these benefits are taxed away, as they are in the three Nordic Member States, where taxes and social contributions paid on benefits are substantial, as well as in Belgium, Italy and the Netherlands. Neglecting these tax charges

when assessing the effect of benefits on household income tends to give a misleading impression of their relative incidence.

The effect on families with children

The relative incidence of benefits net of taxes on families with children as compared with those without is important not only from an equity perspective but also in view of the policy concern evident in many parts of the EU over declining birth rates and the implications of this for future population growth. The extent to which governments, through the operation of the tax and benefit system, cover at least some of the costs of children is, therefore, of some significance in this regard. Analysis of the incidence of benefits and taxes on households with children as compared with those without, however, shows that the former receive, on average, less in benefits net of tax than the latter. This is contrary to what might be expected given the child or family benefits which are payable in most countries along with the widespread tax concessions for children which exist. But it is explicable in terms of the higher pre-tax and benefit income which households with children tend to have, which both increases their liability to tax and reduces their entitlement to – and need for – other social transfers (such as unemployment benefit, housing allowances or social assistance).

Allowing for this and estimating the benefits net of taxes which families receive as a result of having children (which does not mean simply adding up family-related benefits and tax concessions but taking account of the overall effect of the presence of children through a simulation exercise – carried out using the Euromod model of households), shows indeed that tax-benefit systems generally support families with children. The extent of this, however, varies markedly between Member States. It is largest, therefore, in Luxembourg (amounting to 23% of disposable income per head), Austria and Belgium (18% per head) and smallest in Italy, Portugal (7% in each), Greece and Spain (under 5%). These estimates, it should be emphasised, do not include the effect of benefits in kind, or non-monetary benefits, which as indicated below, are of major importance in Denmark and Sweden, in particular (where net cash benefits add around 15% or slightly less to disposable income) where they take the form of free or heavily subsidised childcare and other support on a larger scale than elsewhere.

The estimates indicate, in addition, that tax-benefit systems also serve to reduce the incidence of relative poverty among children to differing extents. The effect of benefits net of taxes is largest in Luxembourg, Austria and the UK, where they reduce the proportion of children with poverty levels of income by 17–18 percentage points, while at the other end of the scale, in Greece and Spain, they reduce this proportion by only around 2 percentage points.

The effect on household income of older children

The age at which children tend to leave the family home varies markedly across Europe. In southern countries and the new Member States, it is significantly older on average than in northern parts of the EU15. This in some degree reflects differences in the support available to them outside the family which affects their ability to live alone or with people

of a similar age. Analysis indicates that in all EU15 countries, except Ireland and Austria, average household income, measured in equivalised terms, would be higher without the presence of older children, implying that they add more to household expenditure than they contribute to income. (This result, it should be noted, assumes that the weight attached to them when calculating equivalised income – 0.5 in each case – is a reasonably accurate measure of the additional household costs which they give rise to). Their depressing effect on household income is particularly large in Italy, France and the Netherlands.

Their effect on the (equivalised) income levels of younger children, however, is relatively small. In particular, their presence contributes to poverty rates among children only to a minor extent. The main exceptions are Ireland and Portugal, where the presence of older children in the household reduces the risk of child poverty, and, most notably, Italy, where their presence increases this risk perceptibly since they bring less income into the household than they add to expenditure.

The effect of non-monetary factors on living standards and the risk of poverty

While the report focuses on examining inequality and the risk of poverty on the basis of household income, conventionally defined, which is the standard way of assessing these aspects, it recognises the importance of taking account of other factors, especially those related to wealth and income in kind, to obtain a full picture. An indication is given of the potential importance of allowing for these other factors by considering two of them in particular – imputed rent, or housing costs which are closely associated with this, and benefits in kind.

The estimates of these show that imputed rent and housing costs vary markedly between households in differing circumstances and with differing levels of income. Housing costs, therefore, which are an inescapable drain on resources, absorb a much larger share of income of those at the bottom end of the scale than of those further up, which in general implies that households below the poverty line are in an even worse position than those further up. The extent of this, however, varies significantly across the EU. The extreme case is Greece where taking explicit account of housing costs, or imputed rent, reduces the relative number of people below the poverty line because most of these either own their own housing or pay no rent. Many of those concerned have small holdings in agriculture and consume their own produce to a substantial extent, which is equally not taken into account in the measurement of their income and which also tends to reduce the effective poverty rate.

Many of them are also aged 65 or over, which accordingly implies that the high rate of poverty among this age group in Greece might be overstated, which is equally the case in Ireland and Portugal, where housing costs for such people tend to be low. By contrast, average housing costs of families with children with income below the poverty line are particularly high in Germany, Denmark and Finland, which implies that the poverty rates for these as conventionally measured might be understated – though in the latter two

countries, in particular, the opposing effect of non-monetary benefits (see below) also needs to be considered. These and other examples not only highlight the importance of allowing explicitly for differences in housing circumstances when assessing inequality and relative deprivation but also emphasise the need to take account of such differences when drawing policy conclusions.

The conclusions are similar as regards non-monetary benefits, which vary equally widely in terms of scale between countries and which affect the relative position of households in differing circumstances, both those with children and older people and those with differing levels of income. The support provided by means-tested benefits in kind to low income families in a number of countries, therefore, implies that income can give a misleading impression of their effective living standards.

Equally, benefits in kind going to families with children and the elderly, in the form in particular of care services, are much larger in some countries than others as well as being worth more to those at the bottom end of the income scale. Such benefits are especially important in Denmark and Sweden, where poverty rates in any case tend to be relatively low but where they are almost certainly overstated as compared with those elsewhere by the exclusion of non-monetary benefits from the definition of income.

Recent policy developments affecting relative income levels

The changes in social benefits and taxes which have occurred in recent years – and, in particular, over the years for which data are not yet available – vary markedly across the EU, reflecting differences in the scale and nature of problems but also differences in the relative priority attached to supporting those on low incomes and reducing the risk of poverty. This reflects, in turn, differences in underlying political and economic circumstances in the design and nature of the tax and benefit system and in social attitudes. It is difficult, therefore, to detect common trends.

The measures which have occurred mainly involve changes to income tax schedules, social contributions and social benefits, though they also include changes in minimum wages and social services. A widespread tendency has been to seek to increase incentives to work and to restrain public expenditure, in particular to ensure the viability of social insurance schemes. At the same time, efforts have been made to try to avoid reducing support for those on very low incomes by extending social assistance in the form of minimum income guarantees. This is especially the case as regards those in retirement, where the focus has been on limiting both pension increases for those already retired and pension entitlement to those not yet of pensionable age.

In an attempt to increase work incentives as well as disposable income towards the bottom end of the scale, social contributions have been reduced or eliminated on low wages in a number of countries, including Belgium, Germany, Greece and the UK, although, of course, these benefit only those in work. To much the same end, minimum wages have also been increased in Spain, Ireland, Portugal and the UK, but have remained unchanged in the Netherlands. Similarly, unemployment benefits have been reduced in

Denmark and Germany partly in order to increase work incentives. In sharp contrast to elsewhere, however, benefits have been increased in real terms in Ireland and Finland, indicating perhaps a differing trade-off between maintaining incentives and raising low income levels.

Efforts to address the problem of relatively high poverty rates among children in Ireland, Portugal and the UK are evident in the increase in transfers to families with children which have occurred in one form or another. Equally, the relatively high risk of poverty among those aged 65 and over in these three countries plus Greece and Spain may have been tempered by recent increases in the pensions or social assistance paid to those in retirement with the lowest income levels.

Overall in the EU15, the policy changes made in the past few years seem to have increased the relative income of those at the bottom end of the scale in Ireland, Portugal and the UK, all countries with relatively high poverty rates, and probably reduced their relative income in Belgium, Germany and Italy.

In the new Member States, the policy changes which have occurred have been particularly diverse and not always consistent, which further increases the difficulty of assessing the effect on those with low incomes. Income tax rates have, therefore, been cut in a number of countries and the number of rates reduced – at the extreme, to just one of 19% in Slovakia. In Poland, on the other hand, an additional top rate of 50% has been introduced and in Slovenia, tax rate bands have been indexed in line with price inflation rather than wage increases, so increasing the effective tax rate. While low income taxpayers have tended to benefit from the changes in most countries, those with higher incomes have typically benefited by more. Moreover, as noted above, many of those at the bottom end of the income scale are not liable to income tax and, therefore, receive no benefit from such changes.

Maternity and other parental benefits have been widely increased and extended, which might have served to reduce the relatively high rates of child poverty in these countries indicated in Part 1 of this report. For example, universal child benefit has been introduced in Cyprus, parental benefit for children under 4 increased in the Czech Republic, supplementary allowances introduced for families with three or more children in Estonia and benefit for the first child doubled, and maternity benefit increased by 50% in Lithuania. On the other hand, in Poland, the period of payment of maternity benefit was reduced in 2002 and birth grants made means-tested.

In the accession and candidate countries, the effects of policy changes on the distribution of income seem to have been particularly mixed. While in Bulgaria, they appear to have increased the relative income of those at the bottom end of the scale by targeting benefits to these through means-testing and increasing the minimum wage in real terms, offset in some degree, by reducing taxes on the highest earners, in Romania, they seem to have widened inequality through the introduction of a single rate of income tax, cutting the link of unemployment benefits to earnings and making uneven reforms to the pension system. In Turkey, they seem to have favoured those with low incomes through the introduction of unemployment benefits, the expansion of social assistance to poor

families and a large reduction in VAT on basic food and health and education services. In Croatia, changes have had opposing effects – an increase in the progressive nature of income tax being offset by the introduction of more concessions and a reduction in entitlement to means-tested benefit – with an uncertain overall impact on those at risk of poverty.

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Table of contents

EXECUTIVE SUMMARY	IV
INTRODUCTION.....	1
PART I OVERVIEW OF POVERTY LEVELS OF INCOME IN THE EU.....	9
CHAPTER 1 POVERTY LEVELS OF INCOME: CROSS-COUNTRY COMPARISONS, TRENDS AND DEMOGRAPHIC FACTORS	10
CHAPTER 2 ESTIMATING THE RELIABILITY OF THE LAEKEN INDICATORS (OVERVIEW FOR 17 COUNTRIES)	61
PART II INCOME AND THE LABOUR MARKET.....	74
CHAPTER 3 POVERTY AND THE LABOUR MARKET: THE RELATIONSHIP BETWEEN LOW INCOMES AND EMPLOYMENT IN THE EU	75
CHAPTER 4 JOBLESS HOUSEHOLDS	97
PART III FACTORS CONTRIBUTING TO POVERTY AND INCOME INEQUALITY.....	107
CHAPTER 5 INCOME INEQUALITY AND POVERTY IN THE EU: A MACRO-LEVEL COMPARATIVE ANALYSIS	108
CHAPTER 6 THE EFFECT OF TAXES AND BENEFITS ON HOUSEHOLD INCOME.....	147
PART IV THE EFFECT OF NON-MONETARY FACTORS ON LIVING STANDARDS	177
CHAPTER 7 IMPUTED RENT AND BENEFITS IN KIND	178
PART V POLICY UPDATE.....	201
CHAPTER 8 RECENT POLICY DEVELOPMENTS AFFECTING INCOME DISTRIBUTION	202
REFERENCES	242