

Pro-economic freedom policies and income inequality in the EU countries

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Abstract

Over the past decades there have been considerable changes in policies and institutions in favor of economic freedom in the EU countries. This trend coincides with widespread increases in income inequality in numerous EU member states. To what extent does economic freedom encourage inequality? This paper examines the relationship between economic freedom and income inequality in the EU countries using panel data for the 2000s.

Data on inequality of income distribution refer to the Gini coefficient of income and the income quintile share ratio (the S80/S20 ratio) from Eurostat. Concerning economic freedom, we consider the Economic Freedom of the World index (EFI) reported annually by the Fraser Institute and the Index of Economic Freedom provided by the Heritage Foundation (HFI). In addition, we include some control variables in our regression specifications to correct for the influence that factors other than economic freedom may have on income inequality.

We consider the three main approaches to regression analysis with panel data: pooled regression, fixed effects model, and random effects model. In this direction, the null hypothesis of no country effects is rejected in all estimations, implying that a pooled regression model is inappropriate. Thus, panel data models must be used, as they permit controlling for individual effects not controlled by the explanatory variables introduced in the models. The random-effect model is rejected in favor of the fixed-effects model.

The empirical evidence suggests that economic freedom seems to entail greater income inequality, taking into account both overall economic freedom indices of the Fraser Institute and the Heritage Foundation. However, not all areas of economic freedom affect income distribution similarly. In accordance with the dimensions of economic freedom provided by the Fraser Institute, government size and regulation are robustly associated with a reduction in inequality, whereas legal system, access to sound money, and freedom to trade internationally seem not to be significantly related with income distribution in the European context.

From a policy perspective, among other implications, what emerges from the results is essentially the challenge of making progress in improving economic freedom, as a central aspect of human liberty that favors economic growth, compatible with a more equitable economic performance.

Keywords: Economic freedom; Income inequality; European Union

JEL Classification: C82, D31, E02, O52

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