The story of our inequality

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(This note is a transcript of the lectures that I gave in February 2015 at the Autonomous zones of the University "Ss Cyril and Methodius" in Skopje, Macedonia. The Autonomous zones were created by the students, as part of their efforts to stop the proposed Higher Education Law. The movement also included massive protests, marches, and other "guerrilla" actions, and eventually lead to change in the government, in May 2015.)

I'm here to tell you a story. Not because the Minister of Education said you are kids, but because this is a story that all clever people should know.

Once upon a time there was a country… And it fell apart. Several countries emerged from it. The first of those, in the first two years of its independence, had a decline in the economic well-being, measured through the real Gross Domestic Product (GDP), of approximately 15%. Afterwards, during the next 15 years, its economy started growing steadily, as a result of what it doubled. It reached its pre-break-up level of development in 1996. Currently, it has a per capita GDP of nearly 25,000 US dollars (in international prices)[1], which makes it a high-income country (see Figure 1).

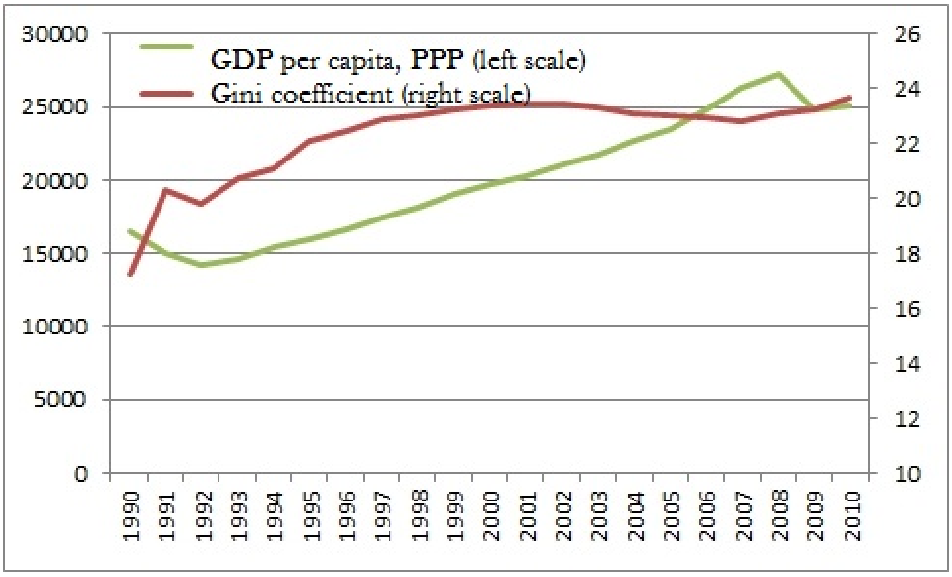
The second country that emerged also experienced a decline in its economic welfare after the break-up, with a difference that it was more prolonged (5 years) and more severe (20%). After the decline, its economy started growing, too, but much more slowly. It reached the level of development it had before the crisis only in 2007. Currently, its per capita GDP is only 9,000 US dollars (in international prices), as can be seen on Figure 2.

Turning back to the first country, we can see on Figure 1 that the inequality in the income its people make, measured through the Gini coefficient, increased sharply in the early transition. The pace of growth of the inequality slowed down afterwards, and somewhere in 2000, it started to fall. Today, its Gini coefficient is around 24, which is one of the lowest in Europe[2].

[1] Data on GDP are from the World Development Indicators of the World Bank (link).

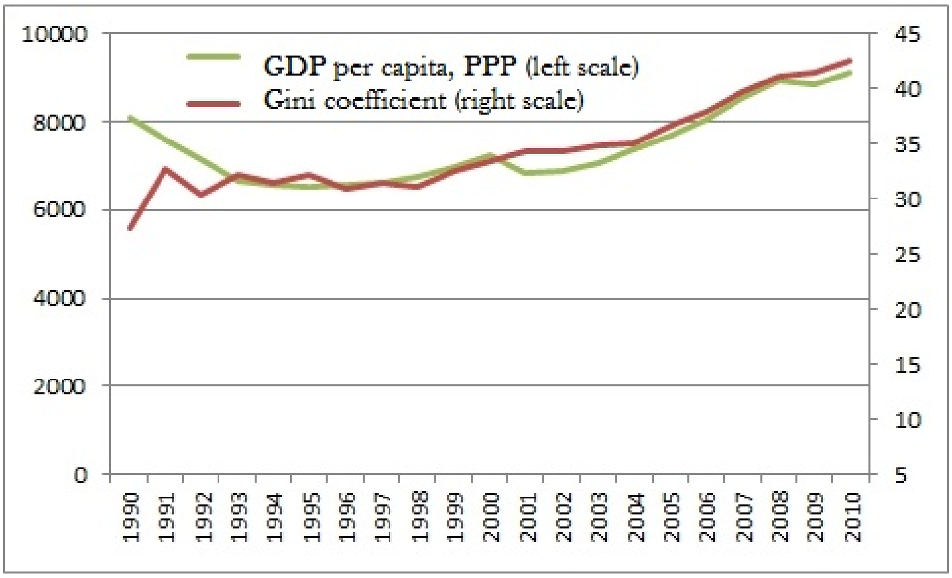
[2] Data on income inequality are from the Standardized World Income Inequality Database, version 4, compiled by Frederick Solt (link).

Figure 1 – GDP per capita (in 2005 international dollars) and Gini in country 1



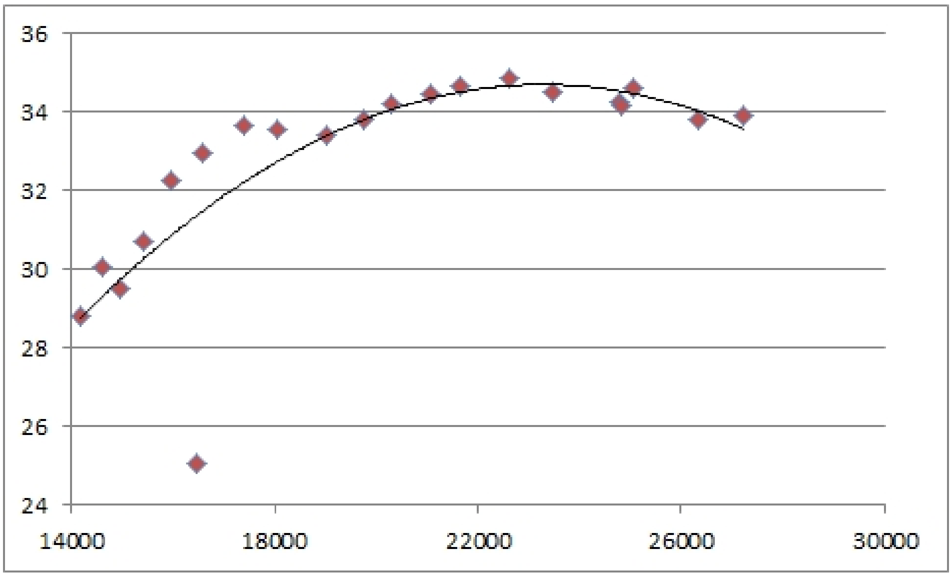
In the second country, income inequality also rose sharply in the early transition. Afterwards, however, it continued to grow steadily throughout all the time. Currently, its Gini is approximately 43, which is the highest in Europe.

Figure 2 – GDP per capita (in 2005 international dollars) and Gini in country 2



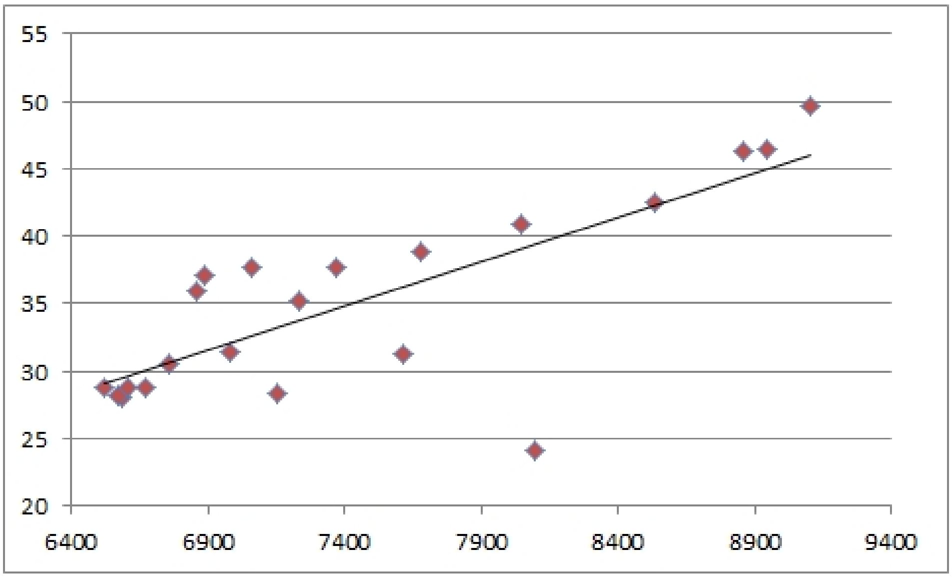
If we plot the GDP and the Gini one against the other for the first country (Figure 3), we can see that the relationship between the two is parabolic – in the beginning, as GDP grows, so does inequality. After the GDP reaches a certain level, inequality starts to decline with economic growth. This is the so-called Kuznets curve, which Simon Kuznets, the Nobel laureate, proposed in 1956.

Figure 3 – GDP per capita (horizontal axis) vs. Gini (vertical axis) in country 1



In the second country, the relationship between the GDP and the Gini is not parabolic, but linear – as income grows, so does its inequality (Figure 4). There is no Kuznets curve here. Economic growth is never associated with a decline in inequality.

Figure 4 – GDP per capita (horizontal axis) vs. Gini (vertical axis) in country 2



The first country has a rather high degree of labour market regulation[3], similar to the one in Germany. It has a minimum wage since 1999, which is set at approximately 70-75% of the average

[3] Data on labour market regulation are from the Economic Freedom of the World report (link).

wage. It has very progressive income tax rates, which range from 16% for those with lowest incomes, to 50%, for those with incomes exceeding 5,500 euros monthly.

The second country has a rather low degree of labour market regulations, something like the UK. It introduced minimum wages only in 2012, set at just 40% of the average wage. It has a “flat” tax rate, of 10% for all income levels.

The first country is – Slovenia.

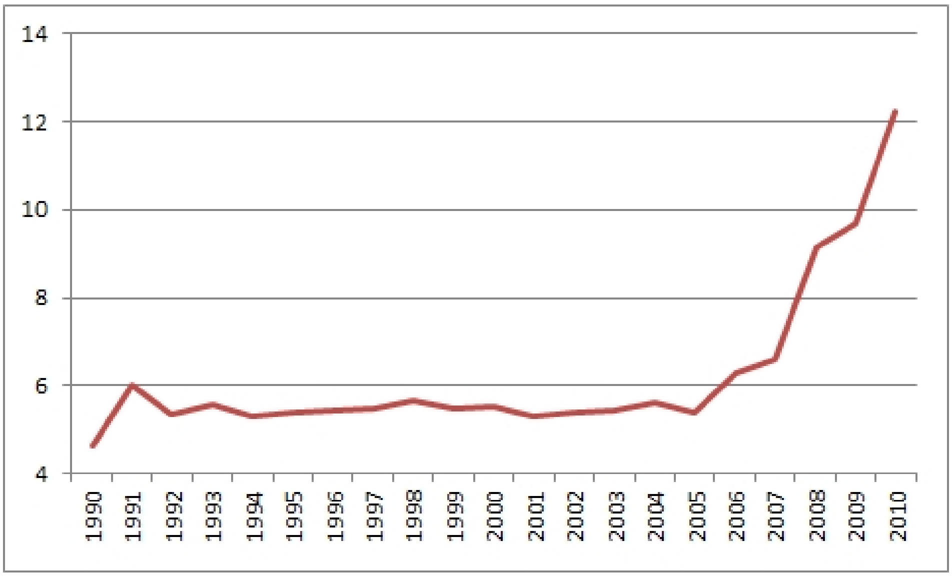
The second one is – Macedonia.

The moral of the story – for a country to have economic growth, which will be equally distributed, there must not be a dominance of owners of capital over the workers. Additionally, the government has to be efficient in the redistribution of the income.

But, since you are not kids, and you don’t believe in pulp fiction, i.e. you are well aware of the difference between correlation and causation, I’ll have to try a bit harder in order to convince you that it’s really like this.

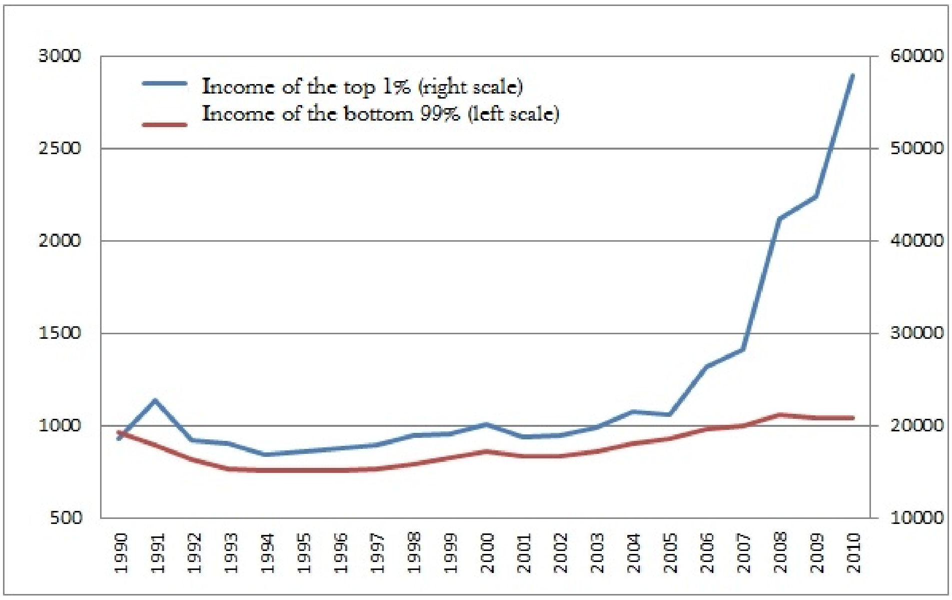
Back to our dark reality. Let’s take a look at the income inequality in Macedonia through a different lens – the lens of the income that ends up in the hands of the richest 1% of the people (Figure 5). The top 1% income share in 1990 was around 4.5%. In the early transition years it jumped to 6%. Afterwards, it remained stable until 2005, and then, it started growing rapidly, reaching 12% in 2010 (the last available data). This is the third highest level in Europe, after UK and Germany, which have a top 1% income share of 13%. For comparison, Serbia, Croatia and Slovenia have a share of around 6%.

Figure 5 – The top 1% income share in Macedonia



If we decompose the income in Macedonia on a part that ends up in the hands of the plebs (the 99% of the people) and a part that ends up in the hands of the patricians (the top 1%), it can be noted that the income of the plebs for the whole period grows on average by 0.5% per annum, while the income of the patricians grows on average by 7% per annum. The differences become especially pronounced after 2005, when the income of the top 1% tripled in 5 years, while the income of the bottom 99% increased by 20% (Figure 6).

Figure 6 – income of the top 1% and the bottom 99%



In order to understand this dramatic rise in inequality after 2005, one has to take a more careful look at the economic growth during this period. Several explanations can be proposed for the rise. It may happen that the increase in inequality is because the economic growth is concentrated in sectors which have above-average wages. It may also happen that there is an increase in the dispersion of wages in the sectors where most of the economic growth occurs. These two explanations would be consistent with the "skill-premium" hypothesis. Finally, it may happen that the economic growth ends up in the hands of the capital owners, not the workers, which have in general higher average income. Let's investigate these three hypotheses in greater detail.

Is the growth in sectors which have above-average wages? The growth between 2005 and 2010 is almost entirely concentrated in three sectors – construction, trade and telecommunications. Construction and trade have below-average wages. Only telecommunications have above-average wages. So, it seems little plausible that the increase in inequality is because the economic growth happens in sectors with high wages.

Is the growth in sectors which have an increase in the dispersion of wages? It doesn't seem so. The share of firms with a range of wages between 1 and 1.9 (firms with low dispersion) in 2005, in trade, construction and telecommunications, was 69%, 56% and 80%, respectively. In 2010, the share of these low-dispersion firms it rose to 78%, 66% and 85%. Consequently, the second possible explanation, that economic growth is concentrated in sectors with an increase in the dispersion of wages, is not supported by the data, either.

Finally, let's see the increase in the income of the capital owners and the workers. The total wage bill in trade and communications grew by 42% between 2005 and 2010. In construction, total wages grew by 32%. The growth of the profits of the capitalists during the same period was even higher – 51% in trade and communications and 82% in construction. Given that profits end up in the hands of fewer people and are higher on average, it can be indeed said that this has resulted in an increase in inequality.

Thus, it seems that economic growth has been "captured" by the capitalists. Why is this happening? Because during this same period we can observe a decline in the labour market regulations, i.e. in the labour rights. The index of labour market regulations in 2005, according to the Economic Freedom of the World report, was about 6, which is a rather high degree of regulation, similar to those in France and Germany. In 2010, this index reached 8, which is a low level of regulation, similar to the one in UK.

What is the role of the government in this story? The government has the duty to act as Robin Hood. It has to redistribute income, from those who earn more, to those who earn less, because inequality is harmful for the society. But the government in Macedonia does not look a lot like Robin Hood. The redistribution in Macedonia, measured through the difference between the market and the final inequality, is very low. In 2010, it was approximately 10% (market Gini was 49, final Gini was 43). At the same time, the redistribution in Slovenia was around 30%. If Macedonia had redistribution like Slovenia, its Gini would be around 35, which is the average in Europe.

Why does the government redistribute so little in Macedonia? The first reason lies in the regressive tax system. Macedonia has a "flat" income tax, because of what those who earn a little and those who earn a lot pay the same 10% of taxes. But, Macedonia, at the same time, has a floor and a ceiling for calculation of the social contributions, which make those with below-average wages pay higher contributions (as a share of their income) than those with above-average wages. This practically means that the person who gets the minimum net wage of 150 euros, pays approximately 35% to the state, while the person who had the highest wage in 2012, of 76.000 euros, paid only 11% to the state.

The second reason for the low redistribution lies in the social protection system. In Macedonia, the social assistance for a four-member family is around 5.200 denars per month (70 euros), or 40 denars per day per person. Because of this, the extreme poverty (2 dollars a day) in Macedonia, according to World Bank data, was 9% in 2010, which is by far the highest in Europe. But, social transfers in Macedonia are not just low; they are poorly-targeted too. The poorest 10% of the households in Macedonia received only 50% more social assistance than the richest 10% of the households (9.200 vs. 6.300 denars).

I can hear you say – this all refers to 2010, immediately after the global economic crisis. Things must have changed since then… Let's see if they have. Let's take a look at the economic growth since 2010. The growth in 2010-2013 is driven primarily by the construction (the epic "Skopje 2014" project) and industry (the foreign direct investment). In the construction, total earnings of employees grew by 15% during this period. In industry, just by 3%. At the same time, profits of the owners of the capital in the construction grew by 54%, while in industry – by 83%. This means that the workers benefit very little from the publicly-financed construction boom and from the heavily-subsidized foreign direct investment. The cream goes to the hands of the few who own the companies. In parallel with this, there have been no changes in the tax system between 2010 and 2013, but there has been a worsening in the targeting of the social assistance. The assistance that goes to the poorest 10% of the households has increased by 1000 denars on average, while the assistance that goes to the richest 10%, has increased by 3000 denars. Because of all this, inequality has likely increased between 2010 and 2013.

This brings us to the end of our story. If I convinced you that inequality in Macedonia is on the rise because of the low labour rights, the regressive tax system and the low and poorly-targeted social security system, what remains to do is – to put a name to this story. To be honest with you, I didn't invent this story. This story was written 10-15 years ago, by two excellent economists, Daron Acemoglu and James Robinson. The paper in which the story is published was named "The political economy of the Kuznets curve". The main message of the story is that economic growth does not reduce inequality by itself, as Kuznets argued, but that, in order to reduce inequality, the society needs redistributive institutions. Elites establish such institutions only under pressure, and the pressure comes from the social mobilization of the citizens. If mobilization is low, the outcome is usually "autocratic disaster", i.e. low growth and high inequality, as in Macedonia so far. If the mobilization is high, the outcome is usually high growth and low inequality, like in Slovenia. Looking at the things that are going on in Macedonia right on - the marches, the protests, and the autonomous zone - I would conclude by saying – WE CAN DO IT!