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Maurizio Bussolo, World Bank.

Leveling the Playing field: distributional tensions and consequences for the social contract in Europe

Introduction

This paper is an overview of a well-advanced report with the same title. The report is analyzing new distributional tensions that have emerged in Europe and Central Asia (ECA). Globalization, technological change, and aging have affected groups unevenly, and perceptions of reduced social mobility and equality of opportunity are spreading. There is a growing sense that the existing social contracts that regulate markets, define responsibilities and benefits, and redistribute incomes, are no longer working well for everybody. Increasingly large groups in societies – younger cohorts, those working in disappearing occupations or in geographic locations with stagnating industries, those without the right connections, and others – have not experienced upward mobility and feel that they are in an inequality trap. Others, the well-off and upper classes, are retreating from the use of public goods and prefer to purchase education, health and other services from private providers. In other words, cracks in the existing social contract are becoming visible. The report explores policy options to support adjustments in the social contract for the next generation, with a focus on addressing the growing inequality of opportunity. The challenge to agree on an inclusive social contract is an urgent one, as polarization in recent voting behavior could be interpreted as a sign of a growing divide between those who benefit from new economic realities and those who have limited opportunities. This report has two broad goals: a) provide a systematic analysis of distributional tensions in ECA, and b) inform the debate over policies that would support a sustainable and inclusive social contract in the region.

Positive analysis: what are the distributional tensions?

Describing the cross-regional evidence on the cracks of the social contracts in ECA is the goal of the first part of the report (and of the overview paper). Compared to the Arab Springs in the Middle East and North Africa region, ECA has not experienced social unrest and revolts of that scale. Perhaps, lower support for centrist parties and political tensions in the East part of the region are the most overt, and easily measurable, symptoms of an erosion of the social contract.

Inequality does not seem to be a serious problem for countries in the ECA region; in fact, in terms of both levels and trends, other regions in the world are more negatively affected by it. It is indeed the case that in ECA inequality as measured by aggregate indexes, such as the Gini, is not very high and has been, mostly, stable in the recent decade. So why focus an entire report on distributional tensions? For, at least, three important reasons.

First, vertical inequality—i.e. inequality across the whole population—may not be changing, but other features of distribution are. For example, the ‘disappearing middle class’ and the polarization of labor markers may *not* be registered by the Gini but could still generate rifts. It is possible that incomes are clustering at the extremes of the distribution and while (vertical) inequality may go down, polarization may go up (Zhang & Kanbur, 2001). Similarly, inequality between groups (sometimes called ‘horizontal’ inequality) may be increasing. This means that disparities between rural and urban communities, age groups, or people with different occupations, or education backgrounds may be rising. Social cohesion can be under pressure when superior economic positions and better opportunities are available to some groups but not others. Assessing these tensions requires looking beyond the usual aggregate measures of inequality.

Second, when asked, in opinion surveys, people express concerns about inequality. Across all countries in the region, a large majority believes that inequality is worsening. And this does not seem a short term reaction to the recent economic crisis. Compared to the beginning of the 90s, more people, especially in Western and Southern Europe, think that they live in a highly unequal society. Recent low growth, since the 2008 global financial crisis, may have exacerbated this view. Rather than dismissing these perceptions as misperceptions, it is important, once again, to investigate which are the potential causes of the anxieties of large majorities of ECA populations (see Davalos et al 2016).

It is likely that individuals are distressed about unfairness rather than inequality.¹ In more technical terms, inequality is often measured on outcomes, such as consumption levels, incomes, or wealth, while fairness refers to the quality of the process generating those outcomes. Even with a stable inequality levels, inequality of opportunity—or the proportion of the overall inequality due to circumstances beyond the control of individuals—may be rising. A recent study (Davalos et al 2016) shows that getting a ‘good’ job—a crucial step in accessing stable middle-class living standards—is becoming increasingly difficult and more due to ‘having connections’ rather than skills and effort. Assessing changes in fairness, or equality of opportunity, has not been done before² and may be crucial to understand the links between distributional tensions and fissures in the social contract. This is the third reason for a report focused on distributional change.

The analysis of inequality of opportunity can also have an instrumental value. Inequality of opportunity, rather than income inequality, can be related to aggregate economic growth. It has been suggested (Bourguignon et al. 2007 and World Bank, 2006) that the existence of strong and persistent inequalities in the initial opportunities open to individuals can generate true inequality traps that represent severe constraints to future growth of an economy, by preventing entire groups from participation into economic and social life.³ Given these motivations, the first part of the report focusses on three major areas of distributional tensions:

- a) Polarization of the labor markets and related pressure on the middle class;

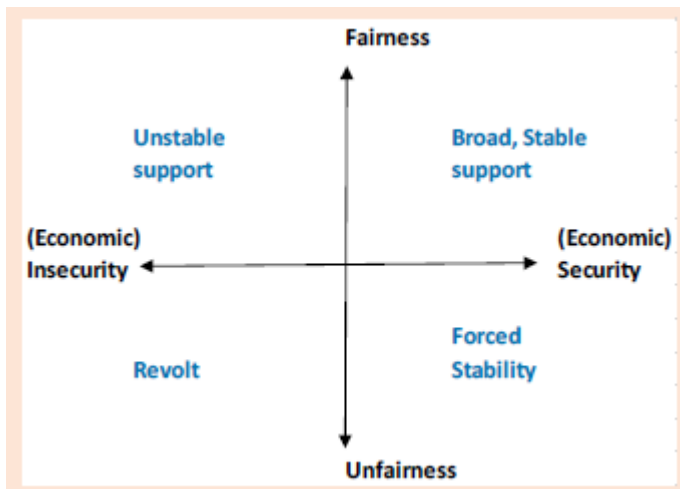
- b) Disparities between groups (horizontal inequality): age and location are initially identified as relevant criteria forming the groups; as shown below, in the region, there are signs of increasing gaps between generations and geographic areas;
- c) Inequality of opportunity and inter-generational mobility.

In addition to these distributional tensions social preferences for redistribution will also be studied closely. A welfare regime can be stable and successful only if it achieves an equilibrium between the distribution generated by market forces and social preferences for equality and fairness. Normally, a certain level of public redistribution and social protection are used to reach such an equilibrium. However, if distributions generated by the markets are shifting and/or societies perceive these changes as unfair, welfare regimes may need to adapt to guarantee the stability of the social contract.

The link between these distributional tensions (and their perception) and the stability of the social contract is provided by the fairness/unfairness and (economic) security/insecurity conceptual framework, which is illustrated by Figure 1.

When the process generating economic outcomes is fair (or at least perceived as fair), and individuals have a certain degree of security then the social contract is stable. The other quadrants in the figure shows different cases where the social contract is under threat.

Figure 1: Fairness, economic security and the social contract, a preliminary conceptual framework



Source: authors

Finally, a special effort of the report consists of identifying and measuring long term trends. Rather than attempting to explain differences across countries at a specific time, the attention and value added of the report is to evaluate changes across time. These are more likely to be linked to the long term structural forces—such as globalization, technological change and demographic aging—and likely to continue in the future.

Normative analysis: how can the social contract be patched to absorb these tensions?

The second part of the report (and of the overview paper) outlines a structure to “rethink” the social contract in ECA. The report explores the potential for moving to a fairer system including policy options that provide greater access to essential income-generating assets, no matter the circumstance at birth. It will also examine tax and transfer systems and their ability to insure and protect given the rapidly changing structure of the labor market. Do insurance systems tied to employment make sense in a world where employment tenures get shorter and shorter? Are more universal approaches to protection such as the Universal Basic Income more appropriate given the greater probability of being out of work for extended periods of time? What are the costs and benefits of such universal approaches, how can they be financed, and are they sustainable? While they might provide income support, can they even begin to compensate an individual for the personal cost of involuntary job loss? Improvements in non-economic factors such as autonomy and status may also be important in restoring workers’ sense of well-being. The report will examine how labor market policies and institutions may need to reform and whether they can help improve both economic (increasing incomes) and non-economic (autonomy and status) rewards to effort, and facilitate job matching.

End Notes

¹ As recently reported in an article of Nature, “when fairness and equality clash, people prefer fair inequality over unfair equality” (Starmans, Sheskin, Bloom, Christakis, & Brown, 2017).

² At least not done for the countries in the ECA region. There are some recent studies for the US, see Chetty et al. (2016), who show that intergenerational mobility, a ‘special’ case of equality of opportunity, has dramatically fallen in the last few decades.

³ For an empirical analysis of the relationship between inequality of opportunity and growth in a sample of US states see Marrero and Rodríguez (2013); they decompose total inequality into inequality of opportunity and inequality of effort, showing that GDP per capita growth rate is negatively correlated with the former and positively with the latter. A similar line of research has been followed by Ferreira et al. (2014), with a cross-country analysis involving a sample of 84 countries.