Globalization and the Equity Issues in Postsocialist Transition Economies

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Abstrakt

Equity issues in policymaking are difficult to resolve because they are linked not only to economic matters but also to social constraints and political conflicts. The more this is the case of the postsocialist economies in transition to a market system at the era of globalization. The historical and irreversible process of first liberalization and then integration of thus far performing, to the extent, separately capital, goods and labor markets into one world market, on the one hand, and gradual institutional building and privatization, on the other hand, are causing a significant shift in the income pattern of the postsocialist emerging markets. Inequality is growing, contrary to the expectations of many, with many implications for the standard of living and the long term growth tendencies.

While globalization is contributing to long-term acceleration of economic growth and open a chance for many countries and regions to catch up with more advanced economies, at the same time it is causing growing inequality, both between the countries and within them. On the average, standard of living is growing, but so is growing the distance between the rich and the poor. Hence, equity issued should always be a concern of policymaker, especially in postsocialist transition economies' early years of systemic change.

I. Introduction

Equity issues in policymaking are difficult to resolve because they are linked not only to economic matters but also to social constraints and political conflicts. The more this is the case at the era of globalization – the historical and irreversible process of first liberalization and then integration of thus far performing, to the extent, separately capital, goods and – to a limited degree and with a certain delay – labor markets into one world market. While globalization is contributing to long-term acceleration of economic growth and open a chance for many countries and regions to catch up with more advanced economies, at the same time it is causing growing inequality, both between the countries and within them (Tanzi, Chu, and Gupta, 1999). On the average, standard of living is growing, but so is growing the distance between the rich and the poor (World Bank, 2002). Equity should always be a concern of policymaker, especially in postsocialist transition economies' early years of systemic change.

This chapter discusses first the concept of "emerging markets", especially the position of postsocialist economies in the global economy. Then the characteristics of income distribution under the former centrally planned system and the changes taking place during transition to a market system are examined. Later, the expectations for income patterns' change and the assets distribution are discussed as is the issue of increasing inequality. The next chapter reviews the policy options and evaluates the transition's impact on inequality. The general conclusion is that although inequality inevitably rises during transition, policymaking can link the income distribution with growth in such a way that it may contribute to its pace and durability.

II. The postsocialist emerging markets

The notion of "emerging markets" is blurred. It gets a different reading in the countries in which it was coined, that is highly developed market economies (Mobius, 1996; Garten, 1998; Gilpin, 2001), and in the countries to which it directly applies, including – of course – the postsocialist countries in transition to a market economy, civic society and political democracy (Kolodko, 2002). The latter is a large, if heterogeneous, group with a well-defined center and hazy periphery. It is easier to say with certainty what is not an emerging market than what it *is*. One could say that emerging markets do not include, by definition, either those highly developed market economies which have long evolved mature institutional systems, or those countries which have yet to set out on the path of market development. Thus outside this group are all rich, institutionally mature countries. These comprise all the "old" members of the OECD (except Turkey), and several countries which have attained a high development level in recent decades, acceding wholeheartedly to the world economic exchange and liberalizing their economic regulations.

At the opposite end of the list of countries that certainly cannot be included among the "emerging markets" are four types of economies. The first one, rendered totally obsolete by the postsocialist transformation, comprises the orthodox socialist (or communist) states, like North Korea and Cuba. The second is made up of countries which either by way of their own political preference, or through international sanctions imposed upon them, is largely isolated from broader contacts with the world economy. The third group consists of failed states with dysfunctional institutions, which are not only unable on their own feet to take part in global

economic exchange, but even internally appear ungovernable. Finally, the fourth group – which is the most important source of candidates for an "emerging market" status – comprises countries which are gradually approaching a stage in structural reforms, opening and liberalization where a qualitative change is about to take place that may soon enable them to take advantage of free global capital flows and international free trade. One can classify with this group some postsocialist countries which have belatedly embarked on the transformation, like Turkmenistan or Uzbekistan.

Methodologically, it is also possible to treat as "emerging markets" all economic systems which cannot be considered fully mature. Then one would also have to include in this category Iraq beside China, Belarus beside Poland, Libya beside South Africa, Cuba beside Mexico. Indeed, the classification here is a matter of convention, rather than sharp distinctions based on substantive criteria. This is not really the main point and there is no need to argue whether Singapore and Slovenia still count as "emerging markets", as global investors would have it,[2] or whether Pakistan and Kazakhstan have already attained this status, although not as fast as some global corporations and the governments of the most highly developed economies would wish.

Of greater importance is the interpretation of the "postsocialist emerging market" category, as well as its theoretical and especially pragmatic implications. Does the fact that a country counts as an "emerging market" has a bearing on its socio-economic development, and in particular, on its chances for accelerated and *equitable* growth, which are of special interest for us here? This is one of the issues that the two interpretations of the "emerging" and "postsocialist" markets – from their own perspective and that of the advanced economies – are concerned with.

From the point of view of (institutionally) developed and (materially) rich countries, the "emerging markets" are treated instrumentally. This applies also to the postsocialist economies in transition to a free market system. For developed countries, they form yet another segment of the expanding field of economic activity. Thanks to its "emergence", a new region of the world – until dozen or so years ago somehow closed for an economic penetration – opens up by creating an opportunity to invest profitably surplus capitals, sell products and acquire resources, including relatively cheap labor, or, quite often, drain a highly-qualified personnel. Hence, an additional demand "emerges" – and becomes globalized – which now can be satisfied, as the political, cultural, economic and financial barriers that used to block access to these regions of the world are being torn down.

Such an approach emphasizes not so much a commitment to the socio-economic development (including concern about "equitable growth") of an "emerging" market, as the opportunity to increase one's own capacity for expansion and to multiply the wealth of the already rich countries. Sometime it happens at the costs of emerging postsocialist economies, sometimes on their behalf. It depends on several factors, including the geopolitical position, but especially relies on the countries' own strategy for development and true political concern about equity issues and fair income distribution. However, while the market is getting "global" and the postsocialist markets are integrating into it, so is becoming the issue of inequality in the last decades. Thus growing inequality within the postsocialist economies is taking place as a result of both – the transition to a market system (with its inherited relatively larger income dispersion

[2] In some international analyses, certain countries are occasionally included in two groups simultaneously. For instance, Hong Kong, South Korea, Singapore and Taiwan have been treated by the IMF and the World Bank since a couple of years now as advanced economies, whereas global investment banks still classify them as emerging markets.

than in a driven by the egalitarian mood former socialist countries) and ongoing globalization (of which the transition process is an indispensable part).

As for the "emerging markets" themselves (which, incidentally, did not insist on being thus named), they have a totally different outlook on this subject. What matters from their point of view is not the additional outlet created in their territory for the capital and goods from other, more advanced countries, but the rapid maturation of their own economic systems, leading to the emergence of full-fledged market economies. On this interpretation, the principal goal is not to create a new *sales market* for others, but to build a new, *market system* which is institutionally liberalized and progressively opens, much to its own benefit, to an expanding range of outside contacts.

Such a system should ensure a higher level of efficiency and faster output growth, hence also improving the living standards and concerning about equity issues of the societies in countries described as "postsocialist emerging markets". The object of the game is to have market *economies* and civic *societies* emerge, rather than just *markets*. This distinction is significant, for it emphasizes the main objective, which is rapid and equitable growth, to be achieved by the creation of an inclusive, open, globally involved market economy with strong institutions (Kolodko, 2002; World Bank, 2002; North, 2002).

III. The long shadow of centrally planned economy

Income distribution under the centrally planned system was more equal than during the transition period as well as compared with the market economies at that time. However, among these economies of Central and Eastern Europe and the former Soviet Union (in)equality varied. It is possible to distinguish some patterns by examining these countries' Gini coefficients (reflecting here distribution of net disposable income). In the late 1980s, the Gini coefficient varied from a low of 20 (for the Slovak Republic, at that time a part of former Czechoslovakia), to 28 (for Uzbekistan, at the time a part of former Soviet Union), mostly being between 23 and 24 points. Compared with the advanced market economies, the countries of Eastern Europe – excluding the former Yugoslavia – had Gini coefficients of, on average, 6 percentage points less than Western European countries (see Table 1).

Table 1. Income Inequality Indexes in Eastern and Western Europe, 1986–87

	Gross Earnings		Net Disposable Income	
	Gini Coefficient	Decile Ratio	Gini Coefficient	Decile Ratio
Czechoslovakia	19.7	2.5	19.9	2.4
Hungary	22.1	2.6	20.9	2.6
Poland	24.2	2.8	25.3	3.0
Soviet Union	27.6	3.3	25.6	3.3
Great Britain	26.7	3.2	29.7	3.9
United States 1/			31.7	
West Germany 2/			25.2	
Australia			28.7	

Source: Atkinson and Micklewright, 1992; Milanovic, 1998.

1/ 1987.
2/ 1981.

If one would use the classification proposed for the OECD (Atkinson, Rainwater, and Smeeding, 1995), none of the former centrally planned economies would qualify as high income inequality (Gini coefficient of 33–35), or even average income inequality (29–31). All of these economies would be either low income inequality (24–26) or very low income inequality (20–22). Hence, before transition, the dominant pattern of income distribution should be considered as relatively equal, but definitely not as egalitarian. If measured by the Gini coefficients in terms of distribution of disposable income, the situation was similar in Finland, Sweden, West Germany, the Netherlands, and Norway.

Let us examine income distribution and inequality in the former centrally planned economies compared to that of the market economies at that time. It is important to stress that the income distribution in this part of the world was not affected much by what was going in the other parts of the world economy, especially due to the relative closeness of these economies and inconvertibility of their currencies. Of course, the centrally planned system – reformed to a great extent in Hungary and Poland and very little in most of the remaining former socialist countries – had played a major role here too. This comparison will help explain the qualitative changes that occurred later, during first 15 years of postsocialist transition to a market economy. However, one should note two groups of systemic differences between centrally planned and free market economies and their policy implications during the transition. The first difference is the primary nominal income distribution. The second difference is the income redistribution mechanism.

Regarding primary income distribution first, in the socialist economies the dominant state and collective ownership of the means of production minimized the role of capital gains, profits, rents, dividends. This type of individual income did play a marginal role and only in countries with relatively significant private sector (Hungary, Poland, and Yugoslavia) did it

influence households' income distribution.[3] However, the interest was not significant due to weak banking sectors and lack of other financial intermediaries. Thus the wages and pensions accounted for most household's disposable income.

Second, concerning the income redistribution mechanism, the wage systems and policies were very centralized, and in only a few countries (again, especially in Hungary, Poland and former Yugoslavia) did the market-oriented reforms allow for relatively greater wage diversification. In Poland in the 1970s, the highest-to-lowest-wage ratio – at least, according to the official party guideline – should not exceed 6:1, although for about 90 percent of the labor force, the actual wages ratio was close to 3:1. Social and political pressure for semi-egalitarian redistribution of income was indeed very strong. This pressure, together with the socialist egalitarian ideology was the driving force behind more equal income distribution than elsewhere (yet much less egalitarian than at the early stages of socialist system, in the 1950s and 1960s), and impacted heavily on labor allocation and productivity.

Third, the state pension system was directly linked to the wage system. Therefore, the proportions of pensions for the retired and social benefits for the disabled were similar to the proportions of salaries. Of course, on average, pensions were lower than wages, but their proportions were a consequence of a more or less egalitarian wage policy.

As for the redistribution of the primary nominal income under the socialist system the extensive range of subsidies on basic goods and services was of great importance. In Poland in 1980 – the year of the largest working class protest ever held in a socialist country[4] – the subsidies accounted for as much as 10 percent of the national income. However, their distribution, although mainly to the poor, did not make real income allocation, or in-kind consumption, much fairer. Subsidies were granted for goods and services with low income elasticity, mainly apartment rent and mass transportation. These subsidies targeted the lower-income groups (Cornia, 1996), but also helped middle-income households because, for instance, the larger the apartment one had and the more often one traveled, the greater the subsidy. Hence, it could – and did – happen that what intentionally was aiming at the decrease of inequity in reality was causing it increasing still further.

Second, unlike in the market economies, taxation did not play an important role. Direct taxes were of marginal significance in income dispersion – they accounted for no more than 2 percent of gross salaries and in the majority of cases there was no difference between gross and net income. For most of the population, gross remuneration was the same as net compensation, with all consequences and policy implications for transition to a new system.

Third, shortages were common to all these economies. Although shortages differed among countries – in goods, intensity, and timing – they influenced the final distribution of real disposable income in a major way (Kornai, 1980; Kolodko, 1986; Nuti, 1989). The "shortageflation" phenomenon – that is, vast shortages accompanied by an open, price inflation

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[3]For instance, in Poland in 1989, about 20 percent of GDP was from the private sector, of which about one-third was nonagricultural. Undoubtedly, such legacy from the reformed centrally planned regime was quite helpful for the implementation of the structural changes this time leading to the full-fledged market system. This legacy explains also – to a certain extent – relatively better performance of the Polish economy during the initial years of transition, despite the failure of ill-advised "shock without therapy" in 1989-92 (Kolodko, 2002a).

[4] It is said in a "socialist economy", because by all means it had not deserved to be referred to as a "centrally planned economy", since it was not lead at that time any more by a discipline of a central plan.

(Kolodko and McMahon, 1987) – had a major effect on actual consumption. Income was often insufficient to acquire needed goods and services, so nominal demand could not be satisfied. Queuing, rationing schemes, parallel markets, forced substitution, involuntary savings, and corruption were common in the distribution system. True access to scarce goods and services sometimes had even greater significance than the nominal income. Hence, it is impossible to evaluate the income distribution based only on the data on money income dispersion.

This legacy and such point of departure towards the new system have impacted heavily upon the expectations and changes in income distribution patterns in the postsocialist countries. Despite it is already 15 years since the transition has taken off, the shadow of the socialist income distribution patterns and policy lays on the mentality of the people and, to a certain degree, on the policy of governments in postsocialist countries.

III. **Expectations versus reality**

There is no doubt that one of the main causes of the postsocialist revolution in the Central and Eastern Europe stemmed from the peoples' conviction that income distribution was unfair and unequal, contrary to political claims and the system's ideological foundations. It is difficult to say whether the people were more concerned about the absolute level of their income or the relative income, that is the way it was distributed, however, it is likely that the latter played a significant role in sparking the collapse of the old system and then the transition to a new one. The desire for fair and equal income distribution was very strong and social dissatisfaction and political tensions were rising due to the growing disparity in real income (Kolodko, 1989). Not only at the onset of the transition but still today, some do not want to move from relatively egalitarian socialism to widely non-egalitarian capitalism. There is still considerable naïveté that the market regime will bring higher and more equitably distributed income. It won't. Just the opposite.

Hence, at the beginning of the transition, there was the widespread conviction that this process would quickly bring both higher income and more fair distribution of the fruits of a better-performing economy. As naïve as this attitude is, it is still present, even among some professionals and leading politicians familiar with the economic and social realities. Optimism increased still further when eight of the transition countries, i.e. Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia concluded the accession negotiations with the European Union in December of 2002 and have joined the EU in May 2004. This was leading some to believe that the development gap between the transition countries and those in the old EU-15 member states would be closed with 10 years or so. Unfortunately, it will take longer, if it will happen at all (Kolodko, 2002). It is so, because the development gap is too large to close in a time span of just one generation.[5] The example of long lasting – and still continuing – processes of catching up with the income of the richer countries by the Southern European members of the EU, that is Greece, Spain and Portugal, is very instructive here. Being the members of the EU for 19 to 23 years already, there are still lagging behind with their output level and thus standard of living of their population. Therefore, the gradual diminishing of the existing development gap can be accomplished only when the rate of growth in Central and Eastern Europe is much faster than in Western and Southern Europe. Unfortunately, due to the

[5]According to the European Union Commission and Eurostat estimates, the GDP per capita on a PPP basis in accession countries hovers below 50 percent of the EU-15 average. This is indeed a very large gap.

severe collapse in output during the first years of the transition, the gap between these two parts of the continent has widened quite significantly. One should not expect more than is feasible.

Political leaders and trade unions activists assumed that the liberalization of prices and the elimination of shortages would lead to more equal income distribution. In some countries, such as the Czech Republic and Russia, these leaders thought that privatization through free asset distribution would improve income distribution. Vast circles of professionals and politicians believed that the reforms of the transfer system – especially of pensions – should not raise income inequality but rather the opposite. Nevertheless, for a number of reasons, this has not been the case. Short-term results did contribute to more equal income distribution. For instance, price liberalization improved access to goods that earlier had been in short supply. Soon thereafter, however, other transition events, such as the severe contraction of real salaries and the rapid increase in unemployment, increased the number of poor, while in some cases at the same time the number of reach had increased too, due to the rent-seeking and grabbing the de-nationalized assets. In effect the pattern of income distribution worsened and inequality increased.

After dozen or so years of postsocialist transition the poorest part of the society has been participated in the national income for much smaller scale than it was the case at the final stage of the socialist system at the turn of the 1980s. If their participation in the national income is measured by the share of the poorest quintile (that is the poorest 20 percent of the population) in total national income, than it fluctuates between less than 5 percent in case of Russia and about 10 percent in case of the Czech Republic and Hungary (Table 2).

Table 2: Share (in %) of the poorest quintile in in national income in period 1997-2001

Country	Share
Russian Federation	4,9
Georgia	6,0
Turkmenistan	6,1
Armenia	6,7
Bulgaria	6,7
Estonia	7,0
Moldova	7,1
Azerbaijan	7,4
Latvia	7,6
Poland	7,8
Lithuania	7,9
Tajikistan	8,0
Kazakhstan	8,2
Romania	8,2
Croatia	8,3
Belarus	8,4
Macedonia, FYR	8,4
Slovak Republic	8,8
Ukraine	8,8
Kyrgyz Republic	9,1
Slovenia	9,1
Uzbekistan	9,2
Hungary	10,0
Czech Republic	10,3

Source: World Bank, 2003.

The policy *vis-à-vis* income distribution implemented during the 1990s and continuing at the 2000s has been, in a sense, to walk from one point-of-no-return to the next. Hence, the societies have been indeed forced to agree with the unexpected for most of them and hardly welcome results of such changes. The clearest example of this has been seen in Russia, where the gap between expectations and achievements has grown since the transition began. In Poland, the greatest gap between the expectations and the real changes existed in the early stage of transition, because the accompanying costs were too high. Thereafter, policy design was more realistic (Poznanski, 1996; Kolodko and Nuti, 1997). However, because of unfair budgetary redistribution the inequality may increase still further since 2004, due to the corporate tax cut and because of decreasing certain social transfers as an immediate consequence of tax cuts.

So far, the greatest disappointment among populists in political parties, both of the left and of the right, has been in privatization. The higher the expectation for an egalitarian mass privatization, the greater the disappointment. As in many other transition countries, the populist

anticipation that postsocialism would evolve into a "people's capitalism" – due to the wide, free distribution of denationalized assets – led to frustration. Although many people did receive free shares, they got rid of them quickly. Due to ongoing redistribution, the shares are now accumulated by fewer individuals which are oriented more toward entrepreneurship and accumulation of capital than consumption. There is nothing wrong with this type of redistribution as long as the people are not misled by their leaders, the emerging market rules are transparent, public interest is taken into account, and redistribution patterns contribute to sound development (Shorrocks and van der Hoeven, 2004). Unfortunately, this has not been the case in most of the transition countries.

In the former centrally planned economies income levels and living standards differed significantly by region. The largest differences were seen in the former Soviet Union and former Yugoslavia. The dismantling of those countries did ease the regional tensions between the richest and the poorest former republics after they became independent, for example, between Estonia and Tajikistan in the former Soviet Union, and between Slovenia and Macedonia in the former Yugoslavia. Other countries experienced contradictory expectations, which have had significant policy implications. People living in the more backward regions expected a quick improvement in their standard of living. Those living in the richer regions assumed they would be forced to transfer part of their income to the poorer regions, and they have been quite reluctant to do so.

Hence, it was expected that the transition would bring a lessening of regional differences and tensions. It has not. In certain areas they are even much larger than 15 years ago. For example, in Poland – if the country is divided into 44 regions according to so-called NUTS III methodology taking into account precisely the average regional income – the income per person in the richest region is equal to about 270 percent of country's average, while in the poorest region to a meager 57 percent. Therefore, the ratio between the metropolitan Warsaw, with income per capita in 2004 hovering at about 120 per cent of the European Union average, and the poorest region of the country, that is of the Chelm-Zamosc district in Eastern (and rural) Poland, with the income per capita at about 25 per cent of the EU average, is roughly like 5:1.

It is quite likely that it will be growing still further in the foreseeable future, due – *inter alia* – to the inflow of foreign direct investments and other funds to more developed regions, both from the view point of hard infrastructure and the quality of human capital, than to the ones which are lagging behind. Paradoxically, the regional development policy exercised within the European Union, instead of decreasing the existing differences, may contribute to their further growth. However, if it will happen, it will take place on the path of higher than otherwise – due to the integration and economic convergence – growth of production and consumption. Therefore both, the average standard of living *and* the inequality, will be higher.

Although income distribution varies among countries, all transition economies have some common features. Income inequality is rising in all these countries. The fluctuations in people's income – first it fell, and then it grew – and in its distribution has led to higher than ever in their lifetime income inequality. The greatest changes occurred during the early stages of transition, when real income contracted significantly, but at a different pace by income group. Hence, in a matter of relatively very short period of time, the income proportions have changed significantly. From such perspective the transition economies can be divided into three groups (Milanovic, 1998).

In the first group, consisting of Hungary, the Slovak Republic, and Slovenia (with a combined population of 18 million), income distribution, measured by the quintile relations, has not changed. No quintile group gained or lost more than 1 percentage point, so the income shift

did not occur between those groups but within them. The changes were rather minor. In Hungary, the Gini coefficient went up by 2 percentage points (from 21 to 23), in Slovenia, by 3 points (from 22 to 25). In the Slovak Republic, even more equal distribution was observed in 1993–95 than in 1987–88, since the Gini coefficient fell from 20 to 19 points (see Table 3).

In the second group, which includes Belarus, the Czech Republic, Latvia, Poland, and Romania (with a combined population of 84 million), moderate regressive transfers were noticed. Maximum losses were within the range of 1 to 2 percentage points and occurred only toward the three lower quintiles. At the same time, the gains of the top quintile varied from about 6 points (for the Czech Republic and Latvia) to below 2 points (for Poland). Thus, only the highest quintile benefited, and only in terms of the share of income. Due to the severe contraction, the absolute level of real income declined in all quintiles although the higher the quintile, the lower the decrease. In this second group of countries, the Gini coefficient rose by only 2 points in Poland (from 26 to 28), but by a significant 8 points in the Czech Republic (from 19 to 27).

In the third group, which consists of Bulgaria, Estonia, Lithuania, Moldova, Russia, and Ukraine (with a combined population of more than 220 million), the changes were much greater. Income decline of the bottom quintile was 4 to 5 percentage points, and the second and third quintiles lost similar margins of their earlier share. In Russia, Ukraine, and Lithuania, the fifth quintile gained as much as 20, 14, and 11 points, respectively. The greatest shift occurred in Russia, where the bottom quintile share of income was halved – from 10 percent to 5 percent – while the top quintile jumped from the relative high of 34 percent to as much as 54 percent. The Gini coefficient increased by 11 points in Bulgaria, and doubled in Russia and Ukraine, jumping from 24 and 23 to 48 and 47 points, respectively.

At the end of the first five-six years of transition, income distribution in the first and second groups of countries was, on average, still more equal than in the developed market economies. In the third group, however, especially in the former Soviet Union, income distribution continued to be less equal than in the old 24 OECD member countries. Lately, the process has taken another route. Although in most of these economies income inequality has continued to grow, albeit at a much slower pace than before, in a few it has stabilized. More recently, in the last five-six years of transition, this inequality has hovered around the dispersion structure that resulted from the changes that followed the earlier shocks. Only in Russia and some other post-Soviet republics as well as in Slovenia it was still growing in a meaningful way. Of course, the income of some households and professional groups still fluctuates, but the changes are not as remarkable as they were in the first half of the previous decade, that is, they fluctuate between quintiles and deciles at much less scale than before.

Table 3. Changes in Income Inequality During Transition, 1987-2001

	Gini Coefficient (Income per capita)		
	1987–88	1993–95	1998-2001
Kyrgyz Republic	26	55 3/	47.0 7/
Russia	24	48 3/	45.6 7/
Ukraine	23	47 2/	46.2 7/
Lithuania	23	37	36.3 5/
Moldova	24	36	39.2 7/
Turkmenistan	26	36	26.5 6/
Estonia	23	35 3/	40.1 6/
Bulgaria	23 1/	34	31.9 8/
Kazakhstan	26	33	31.2 7/
Uzbekistan	28 1/	33	26.8 7/
Latvia	23	31	32.4 5/
Romania	23 1/	29 2/	30.3 7/
Poland	26	28 4/	30.5 6/
Belarus	23	28 3/	33.7 7/
Czech Republic	19	27 2/	27.0 7/
Slovenia	22	25	28.4 5/
Hungary	21	23	24.4 5/
Slovak Republic	20	19	25.8 5/

Sources: UNDP, 1996; Milanovic, 1998; UNDP, 2002; World Bank, 2003.

Note: For most countries, the income concept for 1993–95 is disposable income. In 1987–88, it is gross income, since, at that time, personal income taxes were small, as was the difference between net and gross income. For the data for periods 1987-89 and 1993-95 income includes consumption in-kind, except for Hungary and Lithuania in 1993–95.
1/ 1989.
2/ Monthly.
3/ Quarterly.
4/ Semiannual.
5/ 1998.
6/ 1999.
7/ 2000.
8/ 2001.

However, it must be stressed, that in the postsocialist emerging markets the income distribution is still in flux and does change much more – and rather towards still larger inequality – than it changes in other emerging markets, e.g., in Asia or Latin America. It is due to vast and comprehensive ongoing structural and institutional changes that are taking place in these countries all the time, despite the progress accomplished so far with the systemic change to the market economy (Kolodko, 2003). Hence, taking into consideration the significant delay with the availability of relevant data, the true situation existing in the countries of East Central Europe and former Soviet Union currently differs from the one described here on the basis of available data more than it may be the case of other emerging markets. That is so, because in the latter there is not such a dramatic change in the income and assets distribution (and

redistribution) pattern as it occurs in postsocialist countries. In another words, the income inequality in 2004-05 in transition economies is definitely higher than it can be read from the not up-dated statistical data, which is emerging much slower than these markets do.

Not only for this cause all these observations must be taken with proper caution. Although the transition economies are going through a vast, intensive process of liberalization, they still lack as sophisticated market institutional arrangements as those typical for the advanced market economies. Thus, their common feature is an extensive shadow economy, consisting of unregistered economic activities, the income from which is significant but very difficult to evaluate. The shadow economy, estimated to contribute from 15 percent to 30 percent of GDP in these countries, does affect inequality in a remarkable way.[6]

Because there are many types of unregistered activities, the real challenge is to find the most appropriate way to institutionalize the shadow economy, that is rather to incorporate it into the official one rather than through it away as the baby together with a bath. Whereas some activities should be blocked and eliminated, some others should be made official. The parallel economy encompasses organized crime, which has to be toughly fought, but primarily it is composed of a lot of small-scale businesses in many sectors that produce the goods and provide the services, the jobs, the income but – for the time being – no fiscal revenue.

This type of emerging entrepreneurship, which creates a reasonable source of income for many households, should be tolerated and gradually incorporated into the official economy by various means of the “stick and carrot”, especially establishment of friendly business climate through cutting the red tape and diminishing the fiscal burden imposed on the firms, if it is in line with the proper adjustment on the expenditure side of the budget. Yet before this task is accomplished a significant amount of income will be made in the shadow economy and, simultaneously, a significant part of the total income will be redistributed through the parallel sector. The size of the former and the range of the latter is again anyone’s guess. These corrections in the dispersion pattern definitely complicate the picture drawn from the analysis of official income distribution alone.

At one end of the spectrum, many households engaged in the shadow economy – particularly in the trade, housing construction, maintenance, and some traditional service sectors – have higher income than is recorded formally in the household budget surveys. Although most – if not all – of the unemployed are officially counted in the bottom quintile, some should instead be counted in the second, at least. Given the substance of the shadow economy and the methodological problems in accurately measuring unemployment, it is obvious that an important fraction of this group makes money outside the registered economy. Therefore, their true earnings are higher than the official statistics – or even the more comprehensive household budget surveys – show.

At that other end of the spectrum, the official picture may be biased even more than for the poor, because many activities of the new entrepreneurial class are not recorded at all. Using various means, they are often able to conceal from the tax officials a significant part of their actual income. Both tax evasion and tax avoidance are still – despite the accomplished progress, especially in countries integrating with the European Union – widespread in transition economies, primarily due to relatively poor tax administration and low moral standards of emerging capitalists and a part of medium class. Whereas the creation of effective fiscal order and an efficient tax collection system is a long-lasting process, taxation is often treated as a sort

[6]For the advanced market economies, the scope of the shadow economy is estimated at about 15 percent of GDP for the European Union countries and below 10 percent for the United States.

of punishment. It is often believed that taxation limits the business sector's ability to expand and is rarely seen as a fair and rational instrument of income redistribution.

The range of the informal sector, with all its merits and drawbacks for income dispersion, depends on maturity of institutional arrangements, on the one hand, and developments in the real economy, on the other. In economies with relatively more advanced market institutions and a higher market culture – for example, in the countries which have joined in 2004 the European Union – the scope of tax evasion is much smaller than in the other countries of the region, with weaker market institutional arrangements. Although it is difficult to measure and impossible to quantify, it seems to be feasible to claim that the shadow economy is larger in Ukraine than in Poland, in Armenia than in Latvia, in Romania than in Hungary, and in Macedonia than in Slovenia. And for various reasons it is larger in Russia than in China.

As for real developments, the tendencies are mixed. In the fast-growing countries, at least part of the expansion is due to vigorous activities in the parallel economy, thus its impact on income levels and its structure is greater. As output rises, more people considered jobless make ends meet by working in the shadow economy than by collecting the dole from the safety net. The business communities are also able to take greater advantage of soaring shadow markets. At the same time, weak regulations allow them to hide at least part of their actual revenue. In the countries with continuing recession, an increasing number of people are looking for an opportunity to earn money wherever they can, including in the shadow economy, but they have fewer opportunities than in a growing economy.

The outcome of what has happened thus far is a puzzle and can only be roughly estimated. It is recognized that the shadow economy contributes to the higher income of all social strata, but it is impossible to estimate precisely how it influences the final distribution of net disposable real income. Although the informal sector contributes to higher production and welfare as a whole, it also transfers part of the income from some households to others. Because one cannot exactly and precisely map these income flows, one can only draw general conclusions.

It is not a zero-sum game. Income redistribution conducted within the borders of the parallel economy – as well as between the parallel and the official economy – can enhance overall growth. Thus, in the long run, it can contribute to a higher standard of living for the whole society. It seems, therefore, that the parallel economy – through its contribution to actual national income and its impact on its redistribution – does raise inequality. Moreover, it may be claimed that in the transition economies, as well as in other emerging markets, the difference between the official and the true picture of income distribution – if one takes into account the shadow economy – is much greater than in the high developed market economies.

IV. The change of income distribution's pattern

The income distribution has changed qualitatively during transition. Particularly important is that a majority of the subsidies and allowances – previously provided by the government to certain social and income groups to support their consumption in kind – have been radically reduced or eliminated completely. Since the beginning of the transition, the removal of the subsidies has been seen as absolutely necessary by various international organizations, especially by the International Monetary Fund. The Fund was willing to back only structural adjustment polices that led to the liquidation of all subsidies. This external pressure

was mixed with domestic tugs-of-war between the countries' political extremes, that is between the old left and the new right populists on one side, and the free-market zealots on the other.

Depending on the social and political situation as well as on the chosen path of price liberalization and adjustment, the way the subsidies were removed influenced income dispersion. The more radical the subsidy cuts, the deeper the shift in income inequality. Whereas some shortages did indeed disappear rather quickly (*the shops were full of goods…*), the real income and money balances of households shrank even faster *(...because the consumers' pockets became almost empty*). Consequently, the ultimate effect of slashing subsidies and price liberalization did contribute to an improvement of the fiscal stance and the introduction of a market-clearing mechanism, but it was achieved at the cost of growing inequality.

In the meantime, however, the unavoidable part of transition – price liberalization together with far-reaching subsidy reductions – has been causing high inflation. Often, what rises first and the most is the basic cost of living – the prices of food, housing, utilities, and public transport. Inflationary income redistribution – executed through the downward adjustment of real income by different rates per household group – significantly increased income inequality in the early 1990s. With extremely high inflation, real income distribution had depended on the indexation procedures used at the time of the stabilization policy. Because of this unequal indexation, inequality continues to fuel social tensions. Since that problem is far from solved in any transition economy, the leading countries notwithstanding, the ongoing change in relative wages will continue to cause political friction.

As a result, the shifts of income between certain groups will also continue, regardless of the change of these groups' contributions to the national welfare. In terms of inequity, these changes will cause certain changes in the existing pattern of income distribution, mainly in the relative position of some professional groups *vis-à-vis* others. While some segments of the given country are becoming a part of the global labor market – with all its implications for the income distribution – most of the labor market is not directly and/or deeply involved in such exchange. The trade between the former centrally planned economies is still relatively high, despite their ongoing opening up. These countries which are transforming faster are also absorbing a large part of the foreign direct investment.

Economic reforms liberalized the wage setting in the state sectors. Regardless of the initial pace of denationalization, by the beginning of 2000s, in most of transition economies more than three quarters of labor force earned their salaries in the private sector. Thus, income has become more tightly linked to qualifications, experience, occupation, and performance. The transition has meant a closer relation between an individual's past investment in his own human capital and its current remuneration. That, in turn, has led to still greater wage dispersion. Because the quality of human capital varied more than did salaries under central planning, the later realignment of wages with levels of human capital has increased income inequality.

Even more significant for rising income inequality is the shift of labor from the state to the private sector. Not only is the dispersion of wages in the latter larger than in the former, but the average income earned is higher. This is due mainly to the higher labor productivity in the private sector as the state is in control of a number of obsolete, noncompetitive industries, and poorly managed, relatively low paid services, such as education, health care, and central and local administrations. Because of the meager budgetary situation, these sectors have not been able to compete with remuneration provided by other industries, performing profitably on a commercial basis. Therefore, the rising share of labor engaged in the rapidly growing private sector has raised income inequality. This is merely a reflection of the accommodation of the market to the higher quality of labor engaged in these activities. Nevertheless, in transition

economies, to the extent that the labor market is still quite rigid and far from perfect, the salary ratio remains somewhat distorted.

When an economy moves from the centrally planned to the free-market system, the most revolutionary and fundamental changes take place in asset ownership. The basic features of the beginning of capitalism after socialism are denationalization, privatization, property restitution, participation of foreign direct and portfolio investment and the development of financial intermediaries to accompany private sector's expansion. These events have a major impact on changes in income distribution and, of course, growing inequality. As a result the share of wages and social transfers in total households' income decreases, while that of capital gains – for example, profits, dividends, interest, and rents – increases. This process itself contributes significantly to growing inequality. Market reforms inevitably result in some unfair redistribution, as it is an unavoidable byproduct of the transition process. Whereas limiting the range of the postsocialist redistribution is a matter of sound policies, containing it entirely is simply impossible.

The fundamental shift of assets from state to private hands has been followed by a shift in the income earned on these assets in the same direction. Obviously, these changes have also increased the inequality. Therefore, one must decide how the transformation of property rights suppose to be designed and by what means it should be managed? The two options would be, at one extreme, to sell state property to any investor, especially a strategic one, at the market-clearing price, and, at the other extreme, the utopian option of freely distributing all assets among eligible citizens.[7] In the real world some combination of the two extremes is needed. Hungary chose a path closer to the first option, the Czech Republic closer to the latter, and Poland between the two. The implications for corporate governance and microeconomic efficiency differ by option, but so do the consequences for income inequality in the long run. And the choice between the two options is not simple. More unequal privatization, by selling to strategic investors, favors competitiveness and hence the income level, whereas more egalitarian distribution of assets favors income equity but does not necessarily improve efficiency.

The populist mainstream in both economics and politics has suggested that mass privatization through the free distribution of shares can offset the hardship caused by structural adjustment, especially growing unemployment and falling real earnings and pensions. This may be true, but only to some extent and only as temporary compensation for lost income. In fact, in several countries, workers have gone on strike – not against privatization but in favor of it. These strikers were not zealots of capitalism and a free market; they just wanted quasi-money – the shares, or the vouchers, certificates, and coupons, entitling them to shares'– which they felt was rightly theirs. However, it is bizarre that a poor person would have no access to an adequate social safety net, yet owns one or two shares of a privatized enterprise. This poverty and lack of social protection did not accord with the vision of market economy under "people's capitalism". Furthermore, it barely reduced the inequality and resulting tension.

The problem of equality versus inequality is even more serious. The basic issue is not the change in the income distribution pattern in, say, 1990–2004 – although for some 20 percent of the population these have been their last years – but the irreversible foundation that has been laid for income distribution in the future. This change is the result of the stormy and indeed badly regulated and controlled process of asset distribution linked to the privatization process. In other words, when some were fighting for more fair indexation of their modest income (i.e., the

[7]The point is that assets distributed on the primary market ─ for free or for a nominal, symbolic fee ─ are sooner or later redistributed on the secondary market. Again, people are free to do so, but in the end it leads to the accumulation of these assets by only a few, with all the consequences for growing inequality.

current flow), the more cautious were trying to acquire as much property as possible (i.e., stock, or future income).

In conclusion, taking only the flow of income into account, one cannot accurately answer the question about the scope, direction, or pace of change of inequality. Those that are, in fact, rich (owning many assets) may report very little income, whereas somebody else – a relatively poorer person – can pay the highest possible taxes. To properly measure inequality in emerging postsocialist market economy, one must analyze not how the flow of income is dispersed, but how it is distributed and how the stocks of denationalized assets are divided. Otherwise, one will get a distorted picture, if not false, like from watching only part of the movie screen. Unfortunately, there is not even a rough statistical basis for such considerations. Most income flows are registered, but asset transfers are not. And that is so rather deliberately, since the actual policy and policymakers – being under tremendous pressure from the interest groups, including the biased and manipulated so-called free media – are not that much keen to know the truth.

The introduction of comprehensive taxation systems has changed the income distribution mechanism and its final outcome. Fiscal order in transition countries is not yet the same as in the mature market economies. The personal income tax – for some countries, entirely new phenomenon – is in most cases progressive, although the brackets and scales vary by country and can change in either direction. Because higher income is taxed at a higher margin, such taxation – unlike in a couple of cases with a flat tax[8] – decreases the gap between the net disposable income of better- and worse-remunerated people and, subsequently, narrows the scope of inequality.

In transition economies, the fiscal regimes and policies are not stable and hence neither is the equalizing effect of fiscal policy. There are continuous debates and political battles between the parties on raising and lowering the taxes and, of course, doing these both changes at the same time. Most recently, however the fashionable approach seems to be the desire to cut taxation, even if it causing still larger fiscal deficit. Again, the true system is never a masterpiece of public finance theory and reasonable, long term-oriented policy, but always a political compromise. Sometimes, quite rotten and hence with all negative consequences in the longer run for both, sustainability of growth and its equitable character. Of, more often, a lack of such.

V. Conclusions

The core of transition process is to change a former centrally planned regime to a market economy that suppose to be able to expand and compete internationally. In the era of contemporary globalization it is more difficult – and more important – than ever. Other issues, including income and wealth distribution, are often seen as secondary goals of economic and social policies, or simply as byproducts of the systemic changes. In fact, in transition economies one can observe the frantic process of wealth buildup, which can be seen as a sort of postsocialist primary capital accumulation. If not immediately then soon thereafter, people get the message that capitalism cannot be restored or created without capital and capitalists – and the inherent consequences for inequality. The conclusions are obvious. *During transition*

[8] In a few countries, i.e., in Russia and since recently in Slovakia, a flat personal income tax has been introduced. For obvious reason, it will contribute to growing inequality. Not only for this reason such fiscal policy will fail and in due time will be replaced by the progressive taxation system. It is only a matter of time. And – as it happens strangely also in economic policy – a matter of fashion.

inequality must rise, and policymakers should try to shape such inequality in a way that facilitates the transition's goals.

From social and political points of view, it is a challenge to allow for any meaningful shift of income from the bottom to the top quintile, even at the time of robust growth. Certainly, it is much more difficult to do so during a period of collapse in output, or when the growth is sluggish. For the transition economies, the latter has been the case for a number of years. Therefore, in considering the issue of inequality, one has to distinguish between the stages of contraction and growth. Contraction has lasted from a relatively short period of 3 years in Poland to a staggering 10 years in Ukraine. The problem became still more serious, while the average income was on the decline and policy favored the promotion to a new middle class. Under such condition poverty must also be increasing. Hence, during the long lasting period of transitional contraction, the redistribution mechanisms have transferred additional portions of already falling income from the poorer parts of society to the richer.

This is the picture as seen from a macroeconomic perspective. On the micro level, however, the changing pattern of income flow reflects mostly the shift in certain population groups' contributions to GDP. This product unfortunately, has been shrinking for several initial years of postsocialist transition. The poor were getting poorer because their contribution to declining national income was falling faster that the contributions of other groups. The shorter had been this extremely difficult period and the smaller was the fall in output, the better. It may be argued that both the scope and the length of the transitional recession, which was to some extent avoidable, could be reduced (Kolodko, 1992 and 2000b).

Fortunately, sooner or later all transition economies have started to grow. In 2003 the average rate of GDP growth has been hovering around 4,5 percent (EBRD 2003) and such a pace of expansion can be sustained for many years to come. When an economy is on the rise, the issues of inequity and inequality can be addressed in a different way. During a recession, the question is how can the loss of income be shared? Or how can particular social groups participate in its decline? Under an expansion, the question can be modified: how should growing income be distributed? Or, in other words, how should the increment in national income be divided between population groups? Even in the most advanced market economies, policy affects how income is shared, as it cannot be left exclusively to spontaneous market forces (Stiglitz, 2002 and 2003). And more so in transition countries, where the market forces are, by definition, in the making. The best policy guideline for the government is to intervene only to the extent that guarantees a compromise between the interests of particular income groups and provides sufficient incentives for capital formation to facilitate development and hence the growth in the standard of living for all.

Thus far, transition has brought mixed results. That is true also *vis-à-vis* the issues related to income inequality. The biggest challenge for policymakers is how to deal with growing inequality and at the same time widening of poverty. This challenge is made more difficult by the interrelationship between the two as well as by the aftermath of a severe, long-lasting recession, which has brought the GDP per person in majority of the postsocialist countries to the level that even in 2004 is not yet matching that of the pre-transition period, i.e., attained before 1989. Hence, growing inequality is not only a political issue that will provoke tensions and conflicts, but one that creates an economic obstacle to durable growth (Tanzi and Chu, 1998).

When a policymaker trying to catch-up with a more advanced world faces a trade-off between faster growth with higher inequality (but less poverty) and slower growth with lower inequality (but widening poverty), he can be happy because his choice is clear. Policy should

facilitate fast growth and sustained development, and income policy should support these obvious goals (Kanbur, 1998). Then, in the longer run, everyone's standard of living may improve. After the initial surge of inequality, and when the economy is on the rise, it may be even possible to reduce disparity without harming the ability to expand. This seems to be even truer for inequity. Therefore, the more the transition advances and the stronger the foundations for fast and durable growth, the weaker is the trade-off between equity and efficiency.

Globalization is not an obstacle to such ambitious target as the equitable growth. It can make it more difficult to accomplish, yet under certain conditions it can help. The latter however, can happen only if the government policy is properly involved in the process of growth and income distribution. Neither too much of liberalism, nor too much of interventionism makes a good guidance. Hence, the quest for the optimum proportions between the two must continue. For sure, this is the case of the postsocialist emerging markets during the era of globalization, because the existing pattern of income distribution is not yet final. It will be changing and fluctuating for a long time into the future.

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