

EUROPE AND CENTRAL ASIA STUDIES

TOWARD A NEW SOCIAL CONTRACT

Taking On Distributional Tensions
in Europe and Central Asia

OVERVIEW

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Overview

Toward a New Social Contract

Taking On Distributional Tensions in Europe and Central Asia

**Maurizio Bussolo, María E. Dávalos,
Vito Peragine, and Ramya Sundaram**

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Contents

Foreword v
About the Authors and Contributors. vii
Acknowledgments. ix
Regional Classifications Used in This Report. xi

Toward a New Social Contract: Taking On Distributional Tensions in Europe and Central Asia 1

- Distributional Tensions and the Need to Rethink the Social Contract 2
- Equity: A Key Aspiration in the Region. 3
- Balancing Markets, Policies, and Preferences. 3
- The Market-Generated Distribution of Incomes. 5
- Public Policy Responses 10
- Preferences for Equity. 12
- Fissures in the Social Contract 14
- Looking Ahead: Public Policies for a Stable Social Contract 15
- Conclusion 18
- Notes 18
- References 19

Foreword

Rising inequality is among the most serious problems of our times. Economic progress has been remarkable in the last few decades, but not everyone has enjoyed the same gains, or even the same opportunities. The aggregate indicators, such as GDP growth or employment rate, paint a positive picture. Indeed, the setback of the global financial crisis of 2008 has been overcome, and most countries around the world have seen their income and employment not only return to the levels before the crisis but, in most cases, go beyond those and reach new heights.

However, a different picture comes into focus when one goes beyond the aggregates.

Technological change, globalization, and policy reforms have influenced industries, regions, and ultimately people in very different ways. Entire sectors have lost importance and many occupations are under threat of disappearing. In many countries, the labor share of total income has been declining, and given the accumulation of capital wealth in the hands of a minority, incomes are concentrating at the top of the distribution.

These changes have created opportunities, but the challenges cannot be overlooked. Services such as education and health care—key inputs to the accumulation of productive human capital—are becoming more expensive, and equal access to good-quality services is becoming an issue. Risk-sharing arrangements via targeted assistance or more general insurance have limitations. This uneven playing field generates inequality traps: without mobility and flexibility, technology- and globalization-driven opportunities become elusive, some groups are left behind, and distributional tensions arise.

In contrast to what populist proposals are promising, there is no quick fix. Curbing the trends—stopping trade or rejecting technologies—as well as passively compensating the losers have not worked in the past, and they will not work in the future. But inaction is not an option. The way societies adjust to distributional tensions and maintain social cohesion can make a big difference, not just in terms of equity but also in terms of future prosperity.

Given the long and varied experience with social welfare institutions, one would perhaps think that countries in Europe and Central Asia are well equipped to deal with distributional tensions. But, in fact, these institutions were designed for a very different economic environment. A key difference, even if not the only difference, is a rapidly transforming labor market where long-term wage employment is no longer the norm, especially not for the younger generations.

Instead of a quick fix, a long-term productive and stable solution requires (1) understanding better how inequality is evolving, and whether the growth process is or is not inclusive, and (2) rethinking the social contract—the shared principles used to regulate markets, define responsibilities and benefits, and redistribute incomes.

This report aims to offer contributions to these two requirements.

Inequality among individuals (or households), usually captured by inequality indexes such as the Gini, has shown a mixed pattern for the Europe and Central Asia region. Compared with the levels at the time of the fall of the Berlin Wall, this *vertical* inequality is, by the late 2010s, at higher levels. Also, it has been shown that using tax data, the concentration of incomes at the top has increased. However, this report demonstrates that it is persistent unfairness and growing inequality between groups—rather than individuals—that are insidiously corroding social cohesion. Tensions between workers, between generations, and between regions have been increasing.

Insecurity, unfairness, and growing tensions among groups have also led to perceptions of increases in overall inequality and influence demands for corrective actions. Fissures in the social contract are becoming more evident. Losers from the distributional tensions—young cohorts, routine task-intensive and low-wage workers, inhabitants of lagging regions—choose to voice their discontent by supporting extreme political movements and parties or choose to exit the social and political dialogue altogether.

In terms of rethinking the social contract, rather than prescribing or even identifying a specific set of policies, the report proposes a set of three policy principles that, considered jointly, could help level the playing field and redesign a stable social contract. The principles consist of (1) moving toward *equal protection* of all workers, no matter their type of employment, while promoting labor markets' flexibility; (2) seeking *universality* in the provision of social assistance, social insurance, and basic quality services; and (3) supporting *progressivity* in a broad tax base that complements labor income taxation with the taxation of capital.

With its concerns for distribution and fairness and their implications for political stability and sustainable economic growth, this report continues the World Bank work in support of *paving the way toward shared prosperity* in Europe and Central Asia.¹

Cyril Muller
Vice President, Europe and Central Asia Region
The World Bank

Note

1. This paraphrases the title of an earlier study in the same series: Bussolo, Maurizio, and Luis F. López-Calva. 2014. *Shared Prosperity: Paving the Way in Europe and Central Asia*. Washington, DC: World Bank.

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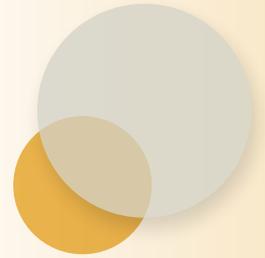
		European Union				Western Balkans
		Western Europe	Southern Europe	Central Europe	Northern Europe	
Europe and Central Asia	European Union and Western Balkans	Austria	Greece	Bulgaria	Denmark	Albania
		Belgium	Italy	Croatia	Finland	Bosnia and Herzegovina
		France	Portugal	Czech Republic	Sweden	Kosovo
		Germany	Spain	Hungary	Estonia	Macedonia, FYR
		Ireland	Cyprus	Poland	Latvia	Montenegro
		Luxembourg	Malta	Romania	Lithuania	Serbia
		Netherlands		Slovak Republic		
		United Kingdom		Slovenia		
Eastern Europe and Central Asia		South Caucasus	Central Asia	Russian Federation	Turkey	Other Eastern Europe
		Armenia	Kazakhstan			Belarus
		Azerbaijan	Kyrgyz Republic			Moldova
		Georgia	Tajikistan			Ukraine
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Toward a New Social Contract

Taking on Distributional Tensions in Europe and Central Asia

The Europe and Central Asia region stands out as the most equal region in the world. Of the 30 countries around the globe with the lowest Gini coefficient—a measure of income inequality whereby a lower coefficient corresponds to a more equal distribution—23 are in the region.¹ Compared with other regions, the countries in Europe and Central Asia redistribute income on a larger scale and have more extensive welfare systems, more progressive taxation, and more generous social protection. This reflects the strong preference of Europeans for egalitarian societies.

Yet, people in Europe and Central Asia are dissatisfied with the status quo and, as in regions that exhibit greater inequality, demand changes.² More people are either voting for populist parties that promise to get rid of current policies and establish a new social order, or they are not voting at all. Separatist movements are on the rise, while trust in political institutions is on the decline.

The primary goal of this report is to analyze changes in the distribution of incomes and resources that, even if not fully reflected in changes of inequality *among individuals and households*, are affecting people's security, aspirations, and sense of well-being and identity. When asked in opinion surveys, a large majority of people across all countries in the region expresses concerns about rising inequality. It is important to investigate the potential sources of these beliefs and views.

The report emphasizes the relevance of distributional tensions *among groups* and of unfairness. These reflect the economic drivers of the rising discontent with the political and social order in the region. The clash between these distributional tensions and the preferences for equity is posing a serious challenge to the social contract in Europe and Central Asia.

Distributional Tensions and the Need to Rethink the Social Contract

The weakening of the social contract is occurring in the context of a rapidly changing economic landscape. The entry of China, India, and the transition countries of Eastern Europe and Central Asia in the global market in the 1990s expanded the size of globally integrated labor markets from 1.5 billion workers to 2.9 billion workers, the “great doubling” as Freeman (2007, 55) calls it.³ Recent technological progress is increasing the demand for advanced problem-solving and interpersonal skills, while the demand for less-advanced skills decreases as routine jobs become automated. Digital transformation allows new technologies and start-up firms to scale up quickly and is rapidly altering production patterns. These global forces continue to roil labor markets and cause uneven economic impacts throughout societies in Europe and Central Asia.

These pervasive changes are affecting specific groups differentially. Although some are benefiting from the transforming economic landscape, others are not. The report describes in detail the key distributional tensions among groups that are identified according to four criteria: birth cohort, occupation, place of residence, and, following the literature on inequality of opportunity, circumstances beyond the control of the individual, such as parental background and gender.

Horizontal inequality among groups—which affects young workers, people in vanishing occupations, individuals lacking good social networks, and people living in lagging regions—is not captured by the vertical inequality in income among individuals and households that is measured by the Gini coefficient. The changes in the Gini coefficient may even be at odds with the deepening distributional tensions. Widening horizontal inequality makes people feel they lack opportunity in an unfair system.

A shift to part-time, temporary, or gig jobs, such as driving for Uber, provides income, but not the benefits offered through full-time employment in this region. The value placed on noneconomic factors, such as autonomy and status, is also threatened by the rise of nonstandard forms of employment. This leaves workers more vulnerable to economic shocks and, regardless of income, perceptions that they are less well off.

Individuals who expected to join the middle class through educational attainment or through work experience find themselves instead struggling for financial stability and security. The steady size of the region’s middle class masks the presence of considerable disappointment among working-age individuals who may still enjoy middle-class incomes but do not have middle-class economic security.

The report shows that government policies and institutions, which were designed in the twentieth century and had been working satisfactorily for quite

some time, are not equipped to handle the emerging distributional tensions. This inadequate response clashes with the value that people place on equity and stability in the region and creates an imbalance. This imbalance—across markets, policies, and preferences in the distribution of resources—is a major reason for the appeal of populism and is exerting pressure on the social contract.

Based on an analysis of the rising distributional tensions in the region, this report calls for a fundamental rethinking of the principles behind the policies and institutions that regulate markets, define responsibilities and benefits, and redistribute incomes—a rethinking of the social contract where equity, progressivity, and universality are reevaluated.

Equity: A Key Aspiration in the Region

The desire for social equity is a characteristic of European civilizations dating back more than 2,000 years.

“There should exist . . . neither extreme poverty nor . . . excessive wealth, for both are productive of great evil,” wrote Plato (Tanzi 2018, 302).

“An imbalance between rich and poor is the oldest and most fatal ailment of all republics,” Plutarch later affirmed (Tanzi 2018, 302).

Following the Great Depression and the devastation of World War II, societies in Europe greatly expanded the welfare state. In Western Europe, free markets were combined with broad participation in education, social safety nets, and income redistribution, as well as universal access to health care. During the same period, countries in the eastern part of Europe and Central Asia featured state-controlled economic activity, alongside universal, state-provided access to services and to guaranteed work. While political, ideological, and economic perspectives differed significantly across countries, a common theme was the aspiration for equity and social cohesion.

Such a commitment to equity is not evident across all regions of the world. For example, in North America, the United States does not have a European-style welfare system because of different social preferences and degrees of aversion to inequality (Alesina, Glaeser, and Sacerdote 2001). About 70 percent of people in the United States believe the poor can help themselves to improve their situation. In Western Europe, only 40 percent of individuals believe that poor people have a chance to escape poverty on their own; in Eastern European transition countries, the share drops to 24 percent. As a result, a majority in Europe supports government policies to ensure well-being and redistribute income.

Balancing Markets, Policies, and Preferences

The term “social contract” originated in political philosophy in reference to the agreement of individuals to give up part of their freedom in return for protection provided by the state (for example, see Hobbes 2012; Locke 1988; Rousseau 1968). This report puts an economic interpretation on the concept. Individuals accept the broad outline of economic policies if the outcomes of these policies coincide with their preferences. This dynamic is similar, although not identical, to

the approach of Binmore (1998), who sees the social contract as an equilibrium of a game between social entities and individuals, as well as the analytical approach proposed by Kanbur (1999) in the context of optimal taxation. It also resembles the recent effort to evaluate social progress, including distributional issues, by the International Panel on Social Progress (IPSP 2018). According to Rodrik (1999), well-functioning social contracts allow countries to manage shocks effectively and adapt to new, efficient equilibria. Countries that have unresolved distributional conflicts may experience inefficient outcomes because the losers do not trust the system, opt out, and resist the needed adjustments. Distributional tensions, if not balanced by corrective policies, institutional arrangements, or a shift of preferences on equity and fairness, can generate cracks in the social contract and stop or severely hinder economic growth.

Thus, a stable social contract finds a balance among the following (figure 1):

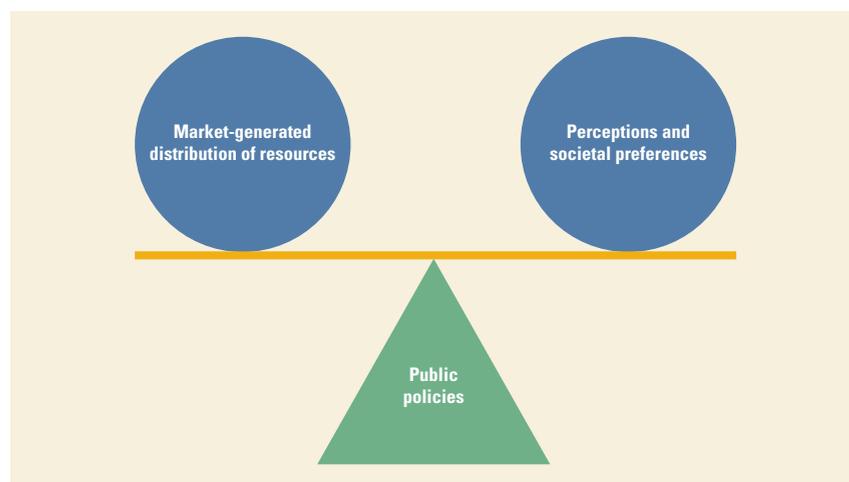
- The market-generated distribution of resources and incomes
- Public policies, including taxes and transfers, regulation, and the provision of goods and services, that alter this distribution
- Individual and societal preferences for equity, perceptions of inequality, and the demand for the redistribution of opportunities and outcomes

Temporary deviations from an equilibrium among these three elements are normal and can be tolerated. However, a long-term imbalance risks generating ruptures in the social contract.

This conceptual framework is an organizing principle of the report. The report first describes the rise in horizontal inequality in the market-generated distribution of income and examines how policies (regulations, redistribution through taxes and transfers, and public expenditures) fail to fully address this. It also shows people's preferences for equity and the increasingly negative perceptions of the situation in income distribution and fairness. A main contribution of the report is the organization of a wealth of data and empirical research around the three elements shown in figure 1.

This structure also highlights a growing imbalance between the distribution of income generated by the market and the policy regime in responding to the

FIGURE 1
The social contract as a dynamic equilibrium



desires of individuals about equity. A failure to resolve this imbalance can undermine social cohesion and have serious implications for the stability of the social contract. The polarization in recent voting behavior in several countries of the region is a symptom of the discontent.

The final section of the report thus considers changes in the policy framework that could support a return to a long-term equilibrium and a renewed and stable social contract.

The Market-Generated Distribution of Incomes

The first part of the report considers four distributional tensions generated by the market:

- The intergenerational divide, or disparities between young and old generations
- Inequalities among workers engaged in different occupations, such as office clerks and machine operators versus nurse's aides, private security guards, or the more highly skilled engineers and scientists
- Inequality in access to economic opportunities based on geographical location
- Inequalities of opportunity based on gender, ethnicity, background, or other characteristics rather than individual effort (figure 2)



FIGURE 2
Distributional tensions along four dimensions are explored

Some groups are on the losing side of more than one of these distributional tensions. Because it supports economic and political stability, the middle class is an important group. The first part of the report analyzes the extent to which the four distributional tensions are linked to the malaise of the middle class.

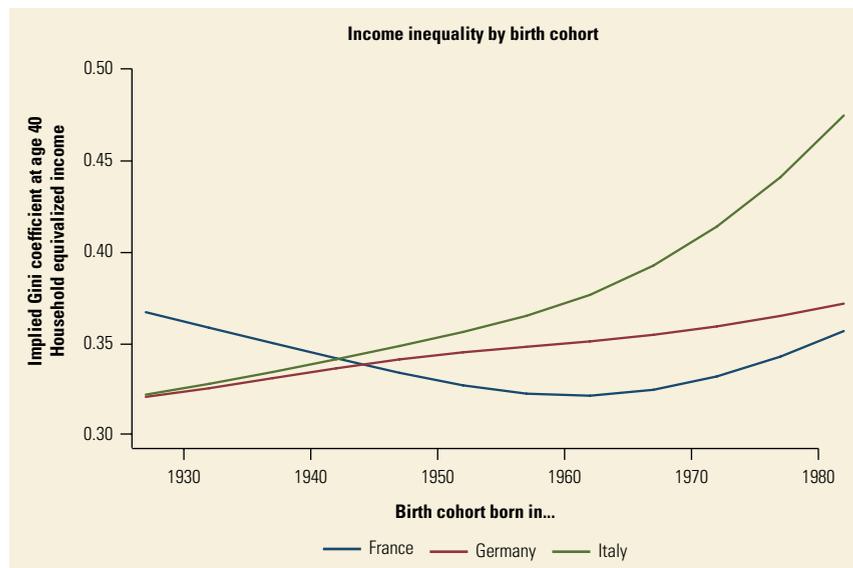
The four distributional tensions have emerged amid concerns and resentment over the falling share of labor relative to capital in total income and over the increasing concentration of top incomes and wealth. In the United Kingdom, the share of income held by the top 1 percent has risen by 7 percentage points in the past 25 years, reaching 14 percent in 2014. The number of billionaires in Western Europe rose from 90 in 1996 to 379 in 2017, and the number of Russian Federation billionaires rose from 8 in 2001 to 96 in 2017.

A Growing Intergenerational Divide

In Western Europe, relative to older cohorts, younger cohorts include a larger share of workers who are unemployed or in low-quality jobs. In 2015, temporary contracts represented close to 50 percent of employment among workers ages 15–24 in France and the Netherlands, compared with around 20 percent among the overall population in both countries. The young will likely have to work more years and will likely have less savings to finance retirement despite longer work histories compared with preceding generations. For these younger workers, lower earnings and fewer old-age income prospects imply a widening intergenerational divide, which is an important source of distributional tension even if it is masked by positive income trends more generally.

In addition, younger workers in Southern and Western Europe are facing higher income inequality at every point of the life cycle compared with older generations (figure 3). For example, income inequality among Italians born in the

FIGURE 3
Income inequality is much higher among cohorts born in the 1980s



Source: Bussolo et al. 2018.

1930s was similar to that in (fairly equal) Japan (Gini coefficient of about 0.31). In contrast, income inequality among the cohorts born in the 1980s was at the level of (highly unequal) Chile (Gini coefficient of about 0.48). This greater income dispersion can be interpreted as a sign of greater insecurity and vulnerability.

Because inequality tends to rise as cohorts age, starting the life cycle with high inequality increases the likelihood of even greater inequality in the future. Together with slower growth, this creates more insecurity, along with the serious risk that populations in Europe and Central Asia will age ever more unequally (OECD 2017).

Polarization in Occupations

Occupational polarization has increased because economic transformation favors some sectors and occupations. More broadly, occupations intensive in routine tasks, typically in the middle of the wage spectrum, have shrunk across Europe: their share of employment has fallen by more than 10 percentage points in Southern and Western Europe and by close to 5 percentage points in Central and Eastern Europe (figure 4). This has forced many middle-skilled workers into lower-skilled occupations, thereby reducing the incomes of low-skilled workers. At the same time, occupations at the top of the wage distribution—typically intensive in nonroutine cognitive tasks—have increased. This has been associated with an upward pull in incomes among highly skilled workers. Overall, the polarization of occupations in Europe has translated into greater labor income inequality: the Gini index of labor earnings rose by 8 points in Germany and Spain from the mid-1990s to 2013 and by about 5 points in Poland during the same period. More seriously affected by the occupational changes were workers already at the bottom of the income distribution, but workers in the middle also faced reductions in earnings growth and greater job insecurity because mid-income occupations are disappearing.

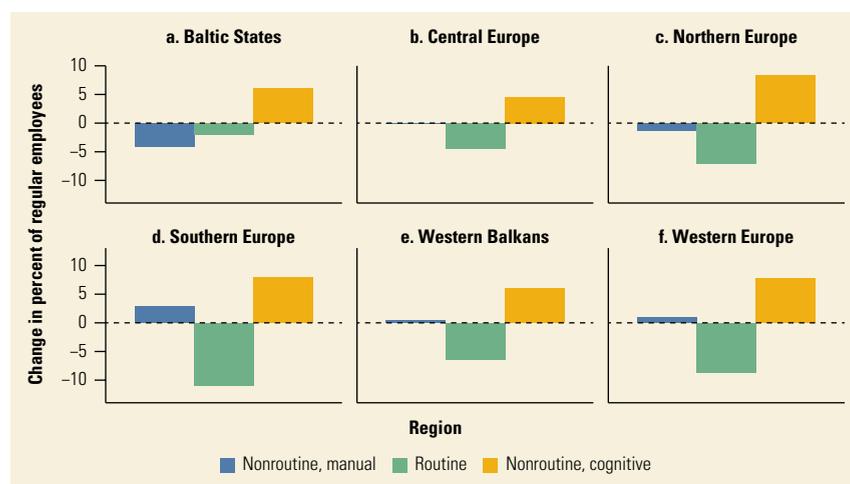


FIGURE 4

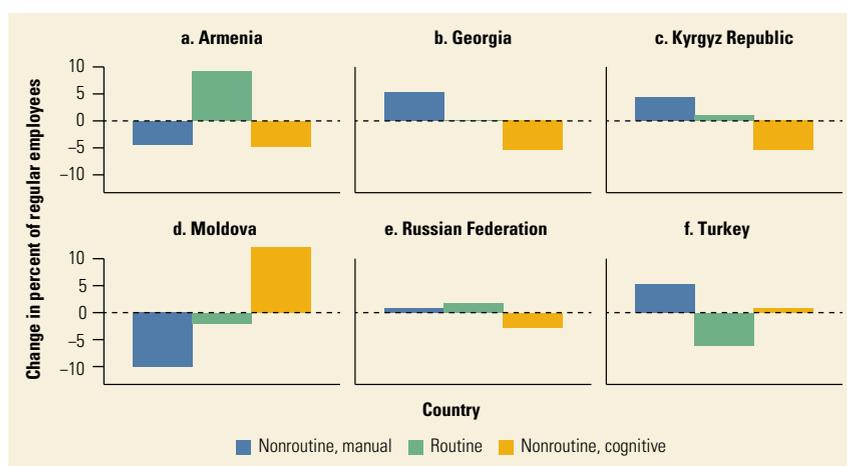
The employment share of routine task-intensive occupations has fallen in Europe
Change in the share of employment, by occupation category, late 1990s to early 2010s

Source: World Bank calculations based on household surveys and labor force surveys.

Note: **Northern Europe:** Denmark, Finland, Norway, Sweden. **The Baltic States:** Estonia, Latvia, Lithuania.

FIGURE 5

The share of employment, by occupational category, early 2000s to mid-2010s



Source: World Bank calculations based on household and labor force surveys.

In the eastern part of Europe and Central Asia, particularly in the former Soviet Union economies, the picture is more nuanced. Occupational change has been less significant, and, with the exception of Moldova, this has meant a reduction in nonroutine cognitive task-intensive occupations. Highly skilled workers, usually prevalent in this occupation type, experienced an average decline of about 5 percentage points in their share of employment in Armenia, Georgia, the Kyrgyz Republic, and the Russian Federation (figure 5). This occupational transformation in the former Soviet Union economies risks frustrating the aspirations of the well-educated younger cohorts that are entering the job market.

A Spatial Divide

Differences in income levels and poverty rates persist among regions in many countries of Europe and Central Asia, and, despite increases in average consumption among households over the past decade, inequalities between geographical areas have widened in several countries. In Armenia, for example, the difference in poverty rates between the less well-off and the more well-off regions rose from 25 percentage points to 38 percentage points between 2005 and 2014. In Romania, the poverty rate in the least well-off region was 2.5 times higher than the rate in the most well-off region. The poorest region in France had an at-risk-of poverty rate three times higher than the rate in the richest region. In the European Union (EU), despite a reduction in country-level inequalities, differences in output across regions have been widening (figure 6).

Differences in educational attainment are a key determinant of spatial gaps in welfare and undermine equality of opportunity. Across the region, in both the east and the west, there are gaps in the quality of education both between socioeconomic groups and between rural and urban areas. The spatial divide in learning between youth in urban areas and youth in rural areas in Bulgaria and Moldova is equivalent to around two years of schooling.

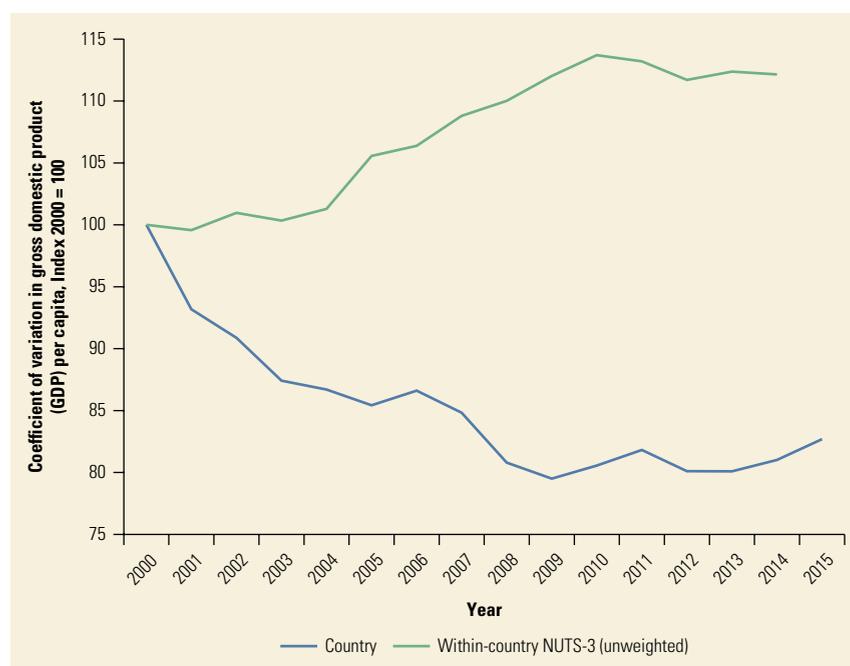


FIGURE 6
Between-region spatial inequalities within countries have increased in the European Union

Source: Farole, Goga, and Ionescu-Heroiu 2018.

Note: Country refers to the coefficient of variation across European Union countries, signaling convergence in gross domestic product (GDP). The within-country coefficient of variation measure is at the Nomenclature of Territorial Units for Statistics–3 level (NUTS-3). GDP per capita is measured in Purchasing Power Standard (PPS).

Inequality of Opportunity

Inequality is often measured in outcomes, such as consumption, income, wealth, or even education, while fairness refers to the process generating these outcomes. Even in a context of stable income inequality, opportunity inequality—the proportion of the overall inequality deriving from circumstances beyond the control of individuals—may rise. Finding a good job—according to many, a crucial step in accessing a stable, middle-class standard of living—is becoming more difficult. It involves possessing favorable connections more than possessing ability or effort (Dávalos et al. 2016). Inequality of opportunity or changes in fairness may be emerging as key distributional tensions in the region.⁴

In Western Europe, the transmission of education privileges from parents to offspring has decreased (a result of the mass education effort), and the education premium in wages has also been trending downward. Together, these phenomena should have reduced overall inequality of opportunity. Instead, inequality of opportunity in incomes has been generally stable at high levels. Parental background still counts in explaining inequality in the earnings of offspring through a networking mechanism, analogous to the social separatism of the upper classes, as reflected in the growing importance of private education, private health plans, and private pensions (Milanović 2017). This means that networking among well-off parents buys better positions for the offspring in the income distribution, thereby achieving the same objectives promised by private education.

In Eastern Europe, by contrast, inequality of opportunity in education is increasing, which translates into greater inequality of opportunity in the labor market. Birth circumstances, especially parental background among individuals, are more important determinants of access to tertiary education among the generation that came of age in the early 2000s than among the generation that entered educational institutions before the subregion's transition to the market economy. Indeed, a large portion of inequality of opportunity in education among the youngest cohorts in Eastern Europe is explained solely by parental background: access to education has become more unfair over time because it is increasingly linked to parental educational achievement.

Increased Vulnerability in the Middle Class

Policies are often justified by reference to the needs of the middle class partly because a large, thriving middle class has been associated with political stability and sustained economic growth (for example, see Birdsall 2010; Birdsall, Graham, and Pettinato 2000; Easterly 2001).

Overall, the rise of distributional tensions and persistent unfair economic processes have altered the complexion of the region's middle class, reducing economic security and disappointing the expectations of many workers who had anticipated that they would be able to enjoy a middle-class lifestyle.

While the changes in the size of the middle class have been quite slow, there has been a pronounced deterioration in the sense of security and an expansion in the risk of dropping out of the middle class and into poverty. For example, the income necessary to guarantee a small probability of falling into poverty has risen from an average of US\$34-a-day purchasing power parity (PPP) to an average of US\$40-a-day PPP in the last decade (Bussolo, Karver, and López-Calva 2018) (figure 7).⁵ This additional US\$6 can be interpreted as an increase in the insurance premium to mitigate the growing risk of falling into poverty. In some countries, the cost of the premium climbed by 100 percent or more. Thus, it rose from US\$14 to US\$32 in Bulgaria and from US\$22 to US\$44 in Latvia. This surge in vulnerability, linked to the changing profile of the middle class, is in line with the perception that the middle class is losing out. It has provoked heated policy debates and proposals for a full overhaul of taxation and social protection. It also has implications for the political platforms that can gain support from the middle class.

Public Policy Responses

Public policies are struggling to cope with rising inequality between groups in the region.

The significant progress in economic and social equality during the second half of the 20th century, mainly in Western Europe, was supported by mass education, labor unions, and substantial redistribution through taxation and public transfers (Atkinson 2016; Milanović 2017). Government policy and the welfare state were crucial in the effort to achieve equity and still deliver a considerable reduction in vertical inequality. For the 28 countries in the EU, the difference between the Gini

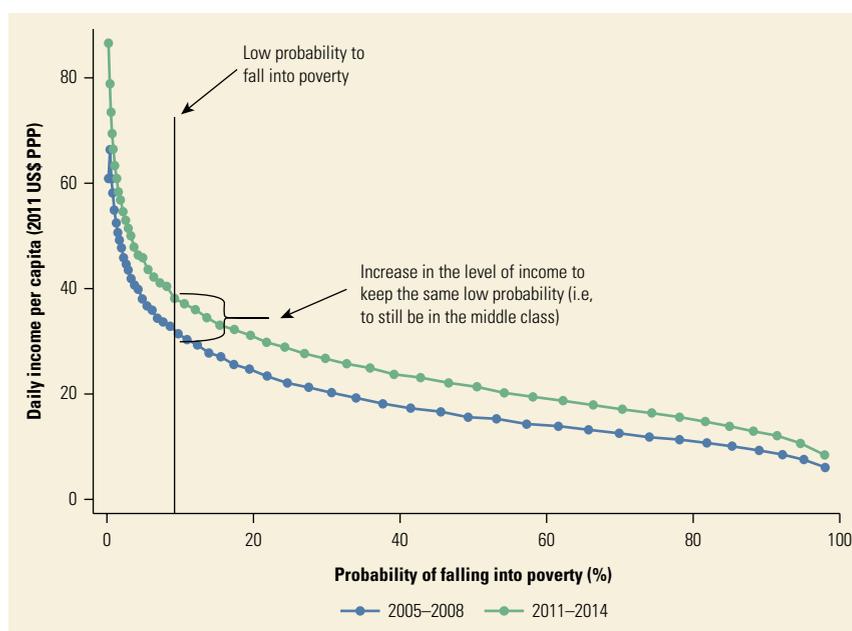


FIGURE 7
The middle class in the European Union has become more vulnerable

Source: Calculations based on data of the Longitudinal–User Database of EU-SILC (European Union Statistics on Income and Living Conditions) (database), Eurostat, European Commission, Luxembourg, <http://ec.europa.eu/eurostat/web/microdata/european-union-statistics-on-income-and-living-conditions>. Note: The two curves in the figure have been obtained using pooled data for Austria, Belgium, Bulgaria, Cyprus, Denmark, Estonia, France, Greece, Hungary, Iceland, Latvia, Lithuania, the Netherlands, Norway, Poland, the Slovak Republic, Slovenia, and Spain during the two periods indicated.

of market incomes and the Gini of disposable incomes averages the equivalent of 20 Gini points—an amazing feat.

However, the institutions and the policies face significant challenges in adapting to the profound global changes of the past few decades. The reaction of the welfare systems in most European countries to the emerging distributional tensions was partial and sometimes inconsistent. Losers were compensated by increases in transfers, but not by a significant decline in taxes. Several countries in Central and Eastern Europe introduced a flat tax on personal income, starting with Estonia in 1994 and followed by Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Romania, and the Slovak Republic.⁶

These policies were largely regressive in terms of the vertical inequality of the income distribution. In Hungary, which was the last of the group of countries to institute the flat tax, in 2011, the average tax rate paid by the top three deciles of the income distribution fell by 2 percentage points between 2007 and 2014, while the rate paid by the bottom three deciles remained practically unchanged.

However, these and other policy changes had an even greater impact on horizontal inequality or inequality between groups. For instance, average tax rates in Bulgaria, Hungary, and Poland were reduced significantly for the winners of the shifts in occupations, while average tax rates were reduced by a smaller amount or remained unchanged for workers in occupations for which demand was falling. These changes accentuated the widening divide between the winners and losers of the changes in occupations. In Hungary, the

distribution of income across age-groups was adversely affected. The average tax rate among tax-paying individuals ages 18–24 rose by more than 8 percentage points; among individuals ages 35–44, however, it dropped by 2 percentage points, and, among the 45–54 age-group, it did not change. In an already polarized society, these tax policy changes, on top of the initial disparities in market incomes and the reduced job security affecting younger workers, widened the intergenerational divide.⁷

Although most politicians pay lip service to the needs of the middle class, little has been done to protect vulnerable workers through changes in tax and transfer policies. Support has shrunk for households that rely on a single source of market income, and such households are facing a growing risk of falling into poverty. This contrasts with the support for households with several earners or pensioners, groups with greater economic security that rely on multiple sources of income or on steady public transfers. Dual earner households in Poland obtained a tax cut of close to 5 percentage points, a pattern similar to that in other Central and Eastern European countries. Similarly, in Belgium, Finland, and Sweden, households that were dependent on transfers and that enjoyed relatively high levels of income security also benefited from tax changes. In contrast, the economically insecure have not benefited from tax changes in any of these countries.

Preferences for Equity

Rising income inequality among groups runs counter to the strong preferences for equity and fairness in the region. If inequality in a country is not in line with the preferences of the population, there will be a demand for corrective action. The government may respond with changes in redistributive policies. However, if the policies do not address the dimensions of inequality that people care about and perceive as unfair, the policies are likely to fail.

The gap between perceptions of inequality and the inequality measures economists use is substantial and persistent. This may be because perceptions do not reflect reality, but it may also mean that individuals are concerned with types of inequality that are not readily or accurately measured by traditional objective indicators. In any case, perceptions matter.

“We suggest that most theories about political effects of inequality [demand for redistribution, the political participation of citizens, democratization] need to be reframed as theories about effects of perceived inequality,” note Gimpelson and Treisman (2018, 27). Indeed, the demand for redistribution is much more closely correlated with the perceptions of individuals on inequality than with traditional measures of inequality (figures 8 and 9).

What Drives Perceptions?

People form their perceptions of inequality by considering the actual dispersion of incomes (or resources), as well as the process that generates this dispersion.

How much do people value the security afforded by stable employment, and how does this influence their views on inequality? When individuals are

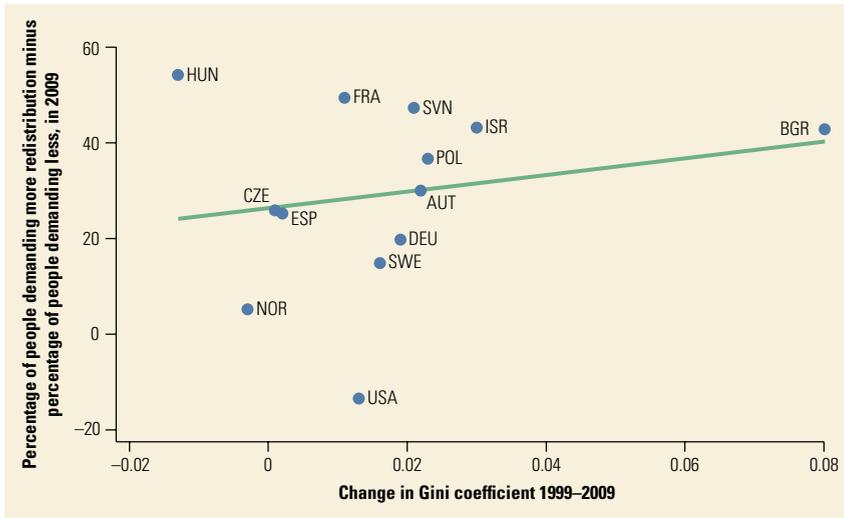


FIGURE 8
Measured changes in inequality explain little of the demand for redistribution

Source: Bussolo, Ferrer-i-Carbonell, Giolbas, and Torre (2018).

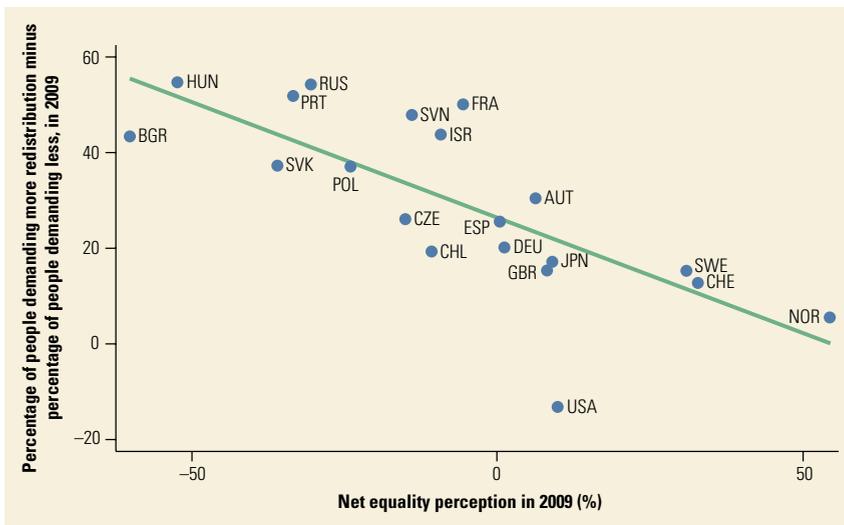


FIGURE 9
Perceived inequality correlates strongly with the demand for redistribution

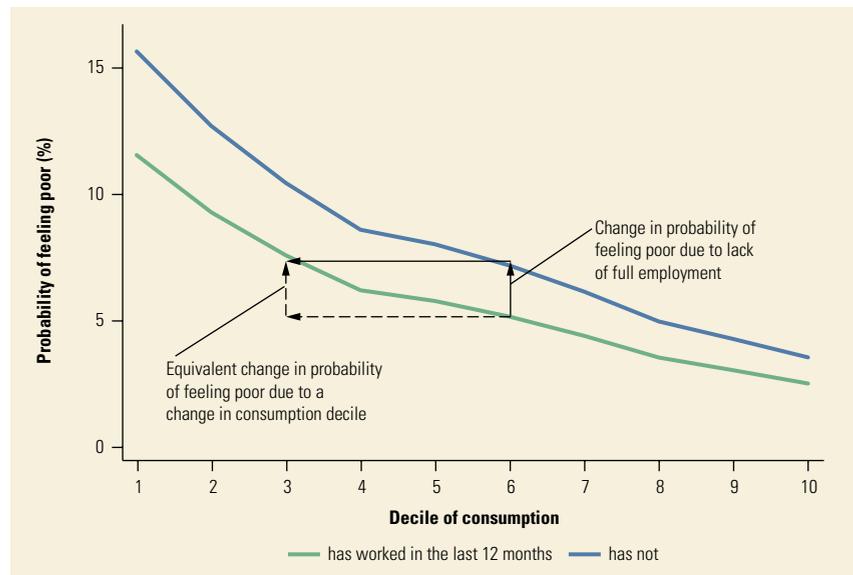
Source: Bussolo, Ferrer-i-Carbonell, Giolbas, and Torre (2018).

Note: Net equality perception is defined as the difference between the share of people believing their country is equal and the share of people believing their country is unequal.

asked to place themselves on a 10-step income ladder on which the bottom step represents the poorest 10 percent of the population and the top step the richest 10 percent, individuals who are not in stable, full-time employment are more likely to report that they feel poor (that is, that they belong to the lowest deciles or steps of the ladder) compared with those who have such employment (figure 10). Declining job security is clearly an important source of dissatisfaction among middle-class workers. Similarly, for a given income, people reporting that they are in good health place themselves higher in the income distribution than do people who report they are in bad health.

FIGURE 10

At any decile of consumption, individuals more likely feel poor when they are not in full-time employment



Source: Bussolo and Lebrand 2017.

Fissures in the Social Contract

Labor market regulations and redistribution systems in Europe and Central Asia have not been effective in protecting important segments of the population from the rise in social tensions driven by market forces. This means that societies are becoming less equitable, while people continue to value equity, which is evident from their preferences for fairness and their assessments of the impact on their welfare of the changes.

This imbalance may be reaching a critical level. Voting is becoming more polarized, and populist parties have achieved success in recent elections. Separatist movements have spread in Catalonia and Scotland. The 2018 appointment of a government led by the League and the Five Star Movement in Italy; the 30 percent of votes achieved by Marine Le Pen, an extreme right-wing candidate, in the runoff of the 2017 French presidential election; and the emergence of the euroskeptical Alternative for Germany in the 2017 German election are examples. Meanwhile, the already low level of trust in institutions has continued to trend downward. In 2015, only 11 percent of the respondents to the Life in Transition Survey expressed complete trust in their national government, and only 10 percent in their national parliament. This calls for a reexamination of the social contract with a focus on remedying the emerging distributional tensions and reestablishing social cohesion.

Analysis of recent data show that there is a direct correlation between these manifestations of the imbalance, or of the cracks in the social contract, and the emerging distributional tensions described above. For example, the group of workers penalized by recent shifts in the demand for skills appear to be voting more regularly for extremist parties. There is also evidence that polarization of the voting is related to regional welfare disparities. And younger generations are opting out of the system by not voting, as shown by their declining turnout at elections across Europe.

Looking Ahead: Public Policies for a Stable Social Contract

Market-driven inequalities, absent or delayed adjustments in public policy and institutions, and strong preferences for equity are contributing to instability in the social contract in the region.

The countries of Europe and Central Asia differ in many respects, and policy prescriptions ought to be context specific. Even so, three principles are relevant to any consideration of policy instruments to achieve people's aspirations for an equitable and cohesive society and to build a stable social contract:

- Promote labor market flexibility, while maintaining protection for all types of labor contracts
- Seek universality in the provision of social assistance, social insurance, and good-quality basic services
- Expand the tax base by complementing progressive taxation on labor incomes with taxation on capital

These principles can contribute to tackling the emerging distributional tensions affecting the stability of the social contract. Any approach should incorporate all three. Acting on one or two alone might exacerbate tensions.

Labor Market Flexibility and Protection

The dynamic labor markets of today call for greater efficiency in job matching that helps workers embrace better opportunities and assists firms in finding appropriate skills. This helps everyone in adapting and benefiting from the new world of work. The traditional employer-employee relationship has eroded in Europe over the last two decades. The erosion has been more dramatic in some countries, such as Poland. It has been accompanied by a proliferation in alternate types of contracts. Labor regulations should keep pace and avoid creating divisions among groups that may fuel distributional tensions and undermine the equality of opportunity.

Efforts to achieve flexibility cannot be undertaken only at the margin, which would result in protecting some workers, but not others. Partial reforms would mean that a majority of the people entering the labor market or starting new jobs will be active in nonstandard employment. In several countries, graduating from temporary to permanent employment is difficult. Some workers therefore experience greater economic insecurity, while others are in permanent employment with strong protections.

In the western part of the region, efforts to foster more flexibility should be aimed at closing the divide in protection across types of employment, thereby reducing labor market segmentation. The Jobs Act in Italy sought to reach this goal by simplifying the types of labor contracts and offering protection for all workers. In the eastern part of the region, informality is widespread in several countries, and a large share of the workforce does not benefit from the protections offered by labor regulations or by social insurance. If informality remains substantial, the key is to reform labor market institutions and other business regulations to promote greater formalization.

Social Assistance, Social Insurance, and Key Services

Social assistance is still an important policy arm in efforts to reduce poverty in many countries in the region. More nonpoor households are becoming vulnerable. This is incompatible with the aspiration to end poverty and vulnerability and promote a middle-class society. Extending the reach of social assistance programs ought to be a key feature of any new social contract among countries in the region.

The nature of the initiatives implemented to realize the objective of providing guaranteed minimum protection among the population will vary by country. Fiscal and political considerations are crucial. There are advantages and disadvantages to means testing and to universal approaches. Income-based targeted schemes, well established in many countries in the region, can be used to supply generous transfers by assisting the people most in need. However, that may leave many people unprotected, including the many nonpoor who are vulnerable. Complex eligibility rules, stigma effects, a lack of knowledge among potential beneficiaries, and the administrative burden of delivering and receiving the benefits are some of the obstacles. Universal approaches to social assistance may address some of these challenges.

The universal basic income (UBI) being discussed in many forums could provide broader protection and security to the population through greater coverage and take-up, and it would reduce disincentives to work. Yet, a UBI may be associated with other challenges. Depending on the design, it might entail a substantial fiscal burden, and the feasibility and equity impacts of implementing a UBI relative to other approaches must be weighed. A pure UBI—a minimum income transfer to all individuals—does not exist in the region, but categorical unconditional cash transfers are being provided as a benefit among population groups such as children and the elderly.

The emergence of distributional tensions represents a clear message: the growing economic insecurity affecting nonpoor households is a call for a review of the design and coverage of social assistance.

The changing nature of work is likewise a call for a reexamination of social insurance. In Europe and Central Asia, pension systems are the main channel for social insurance. However, the systems in many countries do not supply adequate protection in old age to individuals who have been active in nonstandard forms of employment or in informal work or who have been out of work. Aging populations threaten the sufficiency of the coverage and financial sustainability of the systems.

The poverty-preventing objective of social insurance among the elderly, chronically ill, unemployed, or disabled should be separate from the consumption-smoothing objective. Insurance against the catastrophic risk of illness, injury, job loss, and other shocks that could drive households into poverty could be provided directly by government in conjunction with income support for all people in need as part of a guaranteed minimum poverty prevention package. This minimum package could cover everyone and would be financed through general tax revenue, thereby avoiding reliance on employment relationships and mandatory payroll contributions. The decoupling of social insurance from employment could facilitate the expansion of coverage to all, reduce the adverse impact on work

incentives and the labor demand of firms that is associated with the financing of social insurance through payroll taxes, and enhance the sustainability of social insurance systems. In a dynamic labor market, such an insurance scheme could encourage people to seek out and take on better jobs without fear of losing coverage. Meanwhile, a mandated insurance plan could address consumption-smoothing if the provider of the financing for program benefits is identified and the benefits are reasonable in relation to the contributions.

Public policies in Europe and Central Asia also need to aim at recognizing a universal right to quality services to ensure that everyone can build their human capital and access economic opportunities. Key services—water, sanitation, transportation, education, health care, childcare, and eldercare—are provided in most countries. Yet, these services are not available to all. Under a stable social contract, they should not be out of reach of segments of the population. Universal provision of these services as a premarket intervention could represent great progress in ensuring equal opportunity for all.

Education, in particular, has been a great equalizer. Education systems can help level the playing field by addressing the concern over the widening inequality of opportunity and the persistent spatial inequalities in many countries. However, simply expanding access to education no longer guarantees equal impacts. The focus should be not only universal access to schooling, but also universal access to learning as a key feature of a new social contract. Throughout education systems, learning should include the development of cognitive skills (numeracy and literacy) and socioemotional skills so that younger generations, regardless of their socioeconomic background or the location of their residence, leave school prepared to lead productive lives and able to adapt to the changing nature of work. Developing these skills starts early in life. So, the gaps in the access to early childhood education that affect the most disadvantaged need to be closed.

Education and training services accessible to all adults that allow for learning new skills or for upskilling require strong partnerships between public and private providers. Employers should be encouraged to participate, which may require incentives, especially if more flexible labor markets and shorter job tenure reduce the returns to investments by firms in employees. Firms could contribute to building training systems that are more flexible in responding to labor market demands and provide more work-based learning.

Progressive Tax Systems

Public policies need to expand the tax base, raise tax rates on top earners, and implement more progressive taxation that does not target only income. Higher taxes on capital income and higher taxes on wealth (for example, on inheritance or bequests) could underpin a more equitable fiscal system in the region. Because capital and the returns to capital are concentrated among a smaller share of the population, taxes on capital could enhance the progressivity of tax systems and reduce the inequalities between economic groups. They could also promote equality of opportunity among people whose lack of endowments mean that they do not start life on an equal footing. They can also supply a source of financing to expand and strengthen the social contract.

Increasing progressivity in the inheritance tax and in capital income taxation represent ways to promote equity and boost financing sources. In a globalized world where capital is highly mobile, capital taxation would be difficult to establish without coordination across countries. Recent proposals include global or regional taxes on capital (Atkinson 2016; Piketty 2014).

Conclusion

The widening economic fissures in the societies of Europe and Central Asia are affecting young workers, people in vanishing occupations, individuals lacking good networks, and residents of lagging regions, and they are threatening the sustainability of the social contract. Institutions that have achieved a remarkable degree of equity and prosperity over the course of several decades now face considerable difficulty in coping with the associated challenges. Surveys reveal growing concerns about the inequality of opportunity, while electoral results show a marked shift in favor of populist parties that offer radical solutions to voters dissatisfied with the status quo.

There is no single solution to all the ills in every country, and the response to these problems varies considerably across the region. However, this report proposes three broad policy principles:

- Promote labor market flexibility, while maintaining protection for all types of labor contracts.
- Seek universality in the provision of social assistance, social insurance, and basic quality services.
- Expand the tax base by complementing progressive labor income taxation with the taxation of capital.

These principles could guide the rethinking of the social contract and fulfill the aspirations for growth and equity among the peoples of Europe and Central Asia.

Notes

1. Calculations based on data in Milanović 2016; PovcalNet (online analysis tool), World Bank, Washington, DC, <http://iresearch.worldbank.org/PovcalNet/>.
2. Other World Bank reports have analyzed the need to adjust the social contract in other regions and have also provided evidence on the changing nature of intergenerational mobility (Ferreira et al. 2013; Narayan et al. 2018; World Bank 2015). The challenges of new distributional tensions seem even bigger in Europe and Central Asia given the limited tolerance for inequality in this region. Riddo-Cano and Bodewig (2018) analyze the impact of emerging inequalities on economic growth in the European Union (EU). The current report focuses on additional distributional tensions and challenges facing taxation and social protection systems.
3. Freeman (2007, 55), writing about the effect of this doubling on the United States, asserts that it “presents the U.S. economy with its greatest challenge since the Great Depression.” He adds that, “if the country does not adjust well, the next several decades will exacerbate economic divisions . . . and risk turning much of the country against globalization.”

4. Recent studies document this phenomenon in the United States. For example, Chetty et al. (2016) show that intergenerational mobility, a special case of equality of opportunity, has fallen dramatically in the last few decades. For a recent global perspective, see Narayan et al. (2018). Also see EqualChances.org (database), World Bank, Washington, DC, <http://www.equalchances.org/>. The database is the first online repository of internationally comparable information on inequality of opportunity and socioeconomic mobility.
5. For more on the definition of the middle-class income thresholds in terms of vulnerability, see López-Calva and Ortiz-Juárez (2014).
6. The Czech Republic and the Slovak Republic abandoned the scheme in 2013 after having introduced it in 2008 and 2004, respectively.
7. The estimates refer to 2007–14. This period is not long, but the trend observed is in line with the trajectory observed in the longer period, for example, in taxation. The data are based on EUROMOD (Tax-Benefit Microsimulation Model for the European Union) (database), Institute for Social and Economic Research, University of Essex, Colchester, UK, <https://www.euromod.ac.uk/using-euromod/access>; EU-SILC (European Union Statistics on Income and Living Conditions) (database), Eurostat, European Commission, Luxembourg, <http://ec.europa.eu/eurostat/web/microdata/european-union-statisticson-income-and-living-conditions>.

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Contents of Toward a New Social Contract: Taking On Distributional Tensions in Europe and Central Asia

About the Authors and Contributors vii
Foreword ix
Acknowledgments xi
Abbreviations xiii
Regional Classifications Used in This Report xv

Overview 1
 Distributional Tensions and the Need to Rethink the Social Contract 2
 Equity: A Key Aspiration in the Region 3
 Balancing Markets, Policies, and Preferences 3
 The Market-Generated Distribution of Incomes 5
 Public Policy Responses 10
 Preferences for Equity 12
 Fissures in the Social Contract 14
 Looking Ahead: Public Policies for a Stable Social Contract 15
 Conclusion 18
 Notes 18
 References 19

1 Introduction 21
 Emerging Distributional Tensions in Europe and Central Asia 21
 The Potential Implications for the Social Contract 22
 Is a Rethinking of the Social Contract in the Region Warranted? 24
 Notes 26
 References 26

2 Are Distributional Tensions Brewing in Europe and Central Asia? 29
 Inequality Across Individuals in Europe and Central Asia 30
 Labor Market Polarization and the Shifting Demand for Skills 38
 An Increasing Generational Divide, and the Young Are Losing Ground . . . 50
 Persistent Spatial Disparities across the Region 65

Rising Inequality of Opportunity, Particularly in the East	77
Distributional Tensions and the Path to a Middle-Class Society.	87
Annex 2A. Statistics Tables	100
Notes	101
References	105
3 Are Public Policies Equipped to Respond to Distributional Tensions?	113
Labor Markets Are Changing, and Policy Is Not Ensuring Equal Protection	114
The Impact of Tax and Transfer Systems on Income Redistribution	128
Limited Labor Mobility Affects the Opportunities in High-Productivity Areas	148
Annex 3A. Decomposition Analysis: Drivers of Change in Redistribution	152
Annex 3B. Policy Changes that Have Contributed to Redistribution	157
Annex 3C. The Impact of Taxes and Transfers on Redistribution	158
Notes	169
References	171
4 The Social Contract: Do Distributional Tensions Matter?	175
Introduction	175
The Third Component of the Social Contract: The Preference for Equity	177
There Are Fissures in the Social Contract in the Region.	189
Notes	196
References	198
5 How Can the Stability of the Social Contract Be Restored?	201
Introduction	201
Promoting Growth and Protecting People	202
Extending Social Protection to Everyone	205
More Progressive Taxation	217
Reducing Inequality of Opportunity through Improved Services.	220
Conclusion	221
Notes	222
References	223

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