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Income Inequality in Western Balkans

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Abstract

This paper analyses the evolution of income inequality in the Western Balkans (WB) from a long- run perspective based on the top 1% income share. Exploring the relationship between economic integration and income concentration we target to contribute substantially to the debate on gradual reforms, at the political and economic level, in view of the accession of the Western Balkan countries to the European Union and in particular the effects of dismantling barriers to trade, capital, and labor mobility. There is evidence that during the last four decades the business cycles of the top 1% income share are not synchronized among the WB countries while the top 1% income share is increasing in almost all of them.

Keywords: Top 1% income share, Income inequality, Time Series, Western Balkans, EU Enlargement
Jel codes: C22, F02, F50, C2, E6.

1. Introduction

Across countries, the unequal distribution of income and resources among the population is one of the defining challenges of our time. Given the increasingly economic and political interest in the globalisation of income inequality (F.Bourguignon, 2015) as well as the scientific research analysis of the widening of inequality gaps in the most developed countries (Alvaredo et al. 2018, Alvaredo et al., 2013), the investigation of relevant trends in six Western Balkan countries (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia) from a long-run perspective using the best available statistical evidence, is of particular importance: it will contribute substantially to the debate on gradual reforms, at the political and economic level, in view of their accession to the EU and in particular the effects of dismantling barriers to trade, capital, and labor mobility (Mara & Landesmann, 2022).

Also, there is the crucial question whether there is a safe European perspective for the Western Balkans (WB). The EU is the leading trade partner for Western Balkan economies, with 70% of the region's total trade. From 2011 to 2021, EU trade with the Western Balkans has grown by almost 130%. In the same period, Western Balkans exports to the EU have increased by 207%. EU businesses are also leading investors in the region. In 2018, EU companies accounted for over 65% of foreign direct investment in the region (EU External Action, 2022). The EU also provides the Western Balkans partners with political, financial, and technical support, to help them implement necessary reforms and align with EU rules and regulations. Moreover, as recent research has shown by the Open Society Foundations (Open Society Foundations, 2021), there is an argument by civil society actors, that "confidence in the EU's ability to ensure good standards is greater when people see those standards being applied to current member states if problems arise".

There is a fruitful literature for the WB economy and specifically for the determinants of inequality. The 1990s was marked as the years of transition across WB. Many studies (Zsoka Koczan, 2016 IMF) suggest that in early 2000s we notice steady increases in incomes across WB countries but at the same time this growth has been followed by uneven benefits. In the 2000's there was a large increase in inequality (as measured using the Gini index), caused mainly by increases at the top. While in absolute terms everyone appears to have been made better off, disparities increased as the share of the top rose relative to the share of the bottom. Inequality continued to increase until 2005 across all the WB countries. Koczan (2017) comments that the share of the top decile declined after 2005 in Albania, Bosnia and Herzegovina and Serbia and to a lesser extent in Montenegro, but continued to increase in N. Macedonia, with corresponding trends in inequality.

In this paper we present and discuss trends and cycles of income inequality in six WB countries based on the evolution of the top 1% income share. More specifically, Section 2 describes the data source and the methodology applied. Section 3 presents the evolution of trends and business cycles of the top 1% income shares during the last four decades for all six WB countries. Finally, Section 4 summarizes and concludes.

2. Methodology and Data

There is a variety of inequality measures. In recent years, researchers have used taxation statistics to estimate the share of total income held by the richest groups, such as the top 1%, suggesting and proving that there is a strong and significant relationship between top income shares and summary inequality measures, such as the Gini coefficient (C. Chu, Y.T. Wang, 2021). Income inequality time series data used in this study are the published annual estimates of pre-tax national top1% income share in World Inequality Database for 6 Western Balkan countries (Albania, Kossovo, Montenegro, Serbia, North Macedonia, Bosnia). We study the trend and the growth business cycle characteristics of the top 1% income share by applying the methodology of Kydland and Prescott (1990). The well-known Hodrick and Prescott's (HP) detrending technique (1980) is also applied. We adopt Lucas definition of the business cycle as a component of the variable examined by taking deviations from its smoothed trend.

3. Results: Top 1% in Western Balkans

Figure 1 highlights distinct divergences in the top 1% income shares across six WB. We notice that Serbia has the highest top 1% income share for the period 1980- 2021 while North Macedonia has the lowest one for the period 1980-2021(except a few years after 1995).

In Figure 2 the evolutions of top 1% income shares are presented separately for each country along with the trend computed by the HP filter for all six W.B countries. The figures of the top 1% income shares show: a rapidly increasing trend in Albania and Montenegro for the whole period 1980-2021 while the same holds for Kosovo only for the period after 2010. On the other hand, we notice an increasing trend with decreasing rate in Bosnia Herzegovina and Serbia till 2010 and for the period 2010 to 2021 the growth rate is almost stable for Bosnia Herzegovina and decreasing for Serbia. North Macedonia has a mixed trend with an increasing rate till 1995 and declining afterwards.

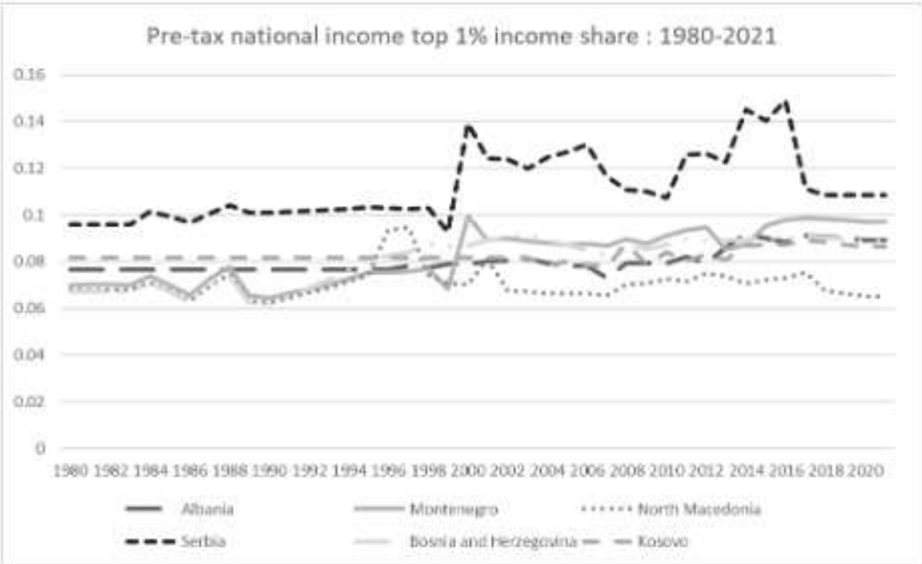

Figure 1. Top 1% income Share in Western Balkans during 1980-2021
Source: https://wid.world/country

Figure 2. Actual and Fitted Trend value of Top 1% income share in Western Balkans' countries during 1980-2021

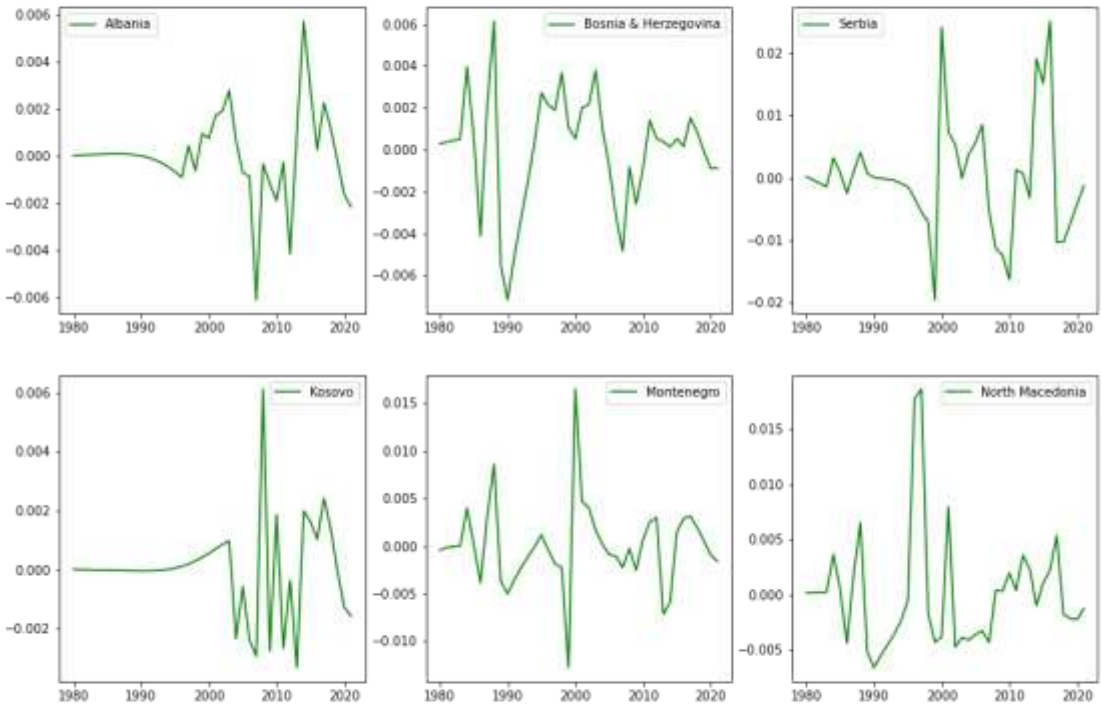

Figure 3. Business Cycles of Top 1% income share in Western Balkans' countries

As Figure 3 suggests during the period 1980-2021 the business cycles of the top 1% in the WB countries are not synchronized. The countries' graphs show that there are mainly three

Business cycles of the top 1% in Albania, Bosnia & Herzegovina, Serbia and Montenegro with different peaks, troughs and cycle duration in each country.

From 1981 until the early 1990s, Montenegro and Serbia ranked first in National Income, compared to the rest of the Western Balkans. Montenegro has an upper-middle-income economy and ranks 48th on the Human Development Index. The sharp drop in National Income in the early 1990s was experienced by all six countries. After the shock of the dissolution of the Socialist Federal Republic of Yugoslavia (SFRY) and the collapse of the communist regime, all the states of the Western Balkans returned to the development trajectory, while Albania has transformed from one of the poorest countries in Europe to an upper-middle -income country. In our days, the country is implementing important reforms to revitalize growth and job creation while advancing the European Union integration agenda. It is now widely accepted that high-income inequality is detrimental to economic growth both directly and as a potential source of significant political and social instability (IMF 2014; OECD 2015).

The theory of Simon Kuznets (1955) hypothesized that economic growth would first be accompanied by a rise in inequality and then by a decline in inequality. This does not seem to be the case in any of the Western Balkan countries. For example, Montenegro subsequently opened up many of its economic sectors to privatization and introduced a value-added tax (VAT) to raise funds for public projects. This is in accordance with the latest literature regarding the classic Kuznets' hypothesis which has been discussed extensively the past decade (Sayed, Adham & Peng, Bin, 2020).

The case of Serbia is typical: since the 1980s it has been higher than the next five countries of the Western Balkans, with a sharp increase after 1998, while the pre-tax national income (top 1%) of the other countries remained at the same level. The data suggest that income inequality has increased since 2000 and is currently the highest among Western Balkans countries. And the question remains: what drives high-income inequality in Serbia? There is no systematic official procedure for the assessment of the distributional impact of policy reform measures. The Government's main concern, recently, has not been to tackle inequality and poverty, but rather to carry out fiscal consolidation, preserve macroeconomic stability and incentivize growth and investment.

One of the causes of high inequality in Serbia is the high percentage of persons who have an exceptionally low work intensity. The share of these persons aged up to 60 years old in Serbia (21.2%) is much higher than the European average (10.5%) and individual EU countries, (with the exception of Ireland at 21.1%).

A second interpretation is the low coverage of pensions for the female population. Where social transfers are concerned, the largest difference in the impact on income inequality in relation to the EU is recorded for pensions. The effect of pensions on inequality is significantly lower in Serbia than in the EU (10.9 vs 17.2). One possible explanation is the smaller coverage of the population by pensions in Serbia than in the EU since 93% of men and only 79% of women in Serbia receive a pension according to 2012.

A third interpretation is found in the low progressivity of the income tax system and low spending on social transfers. Other social transfers are slightly less efficient in reducing inequality in Serbia which is the result of the low coverage of monetary social assistance and child benefits and the low amounts of these benefits in Serbia. This difference is even higher for taxes which is explained by the exceptionally low level of progressivity of the Serbian income tax system.

A fourth answer lies in the labor market. The troubled labor market situation is mirrored by the increasing number of individuals aged under 60 with very low work intensity (Krstic 2021). The majority of them are unemployed or pensioners and most have low levels of education. The results show that the biggest impact on reducing income inequality is achieved by a reduction of income inequality within households with different work intensities. Boosting employment might be expected to reduce income inequality as the number of people with no salary or relying on unemployment benefits falls. However, it is important to increase the number of good quality, full-time jobs in the formal sector as only these can lead to decent wages, provide social security coverage, and offer good working conditions. Policies that contribute to greater employability of individuals with a very low work intensity are particularly important.

The original hypothesis is confirmed: the transition from socialism to capitalism in the former Yugoslav republics has been marked by a notable increase in inequality, with a slight deviation in North Macedonia where income inequality did not increase alarmingly and even showed signs of decline after 2012. UNDP (2021) study, beyond income inequality in North Macedonia, concludes that “income inequality in the country is not significantly driven by wages, but 40.5%, 89.6%, and 94.2% of rents, dividends, and interest, respectively, go to the top 1%. The dichotomy between labor and capital in the earnings of the top 1% is a clear sign of the source of income inequality in North Macedonia.”

However, the strange thing is that the starting point for the deterioration of the lower income groups was not the dissolution of the SFRY, as it turned out for the rich income classes, but the process had started in 1975, with Serbia and Montenegro again "champions", while North Macedonia, after 1995, showed signs of improvement. Moreover, the most important thing is not in the income inequality per se, but in the inequalities of opportunities that arise from differences in circumstances beyond any individual’s control, such as family background, location of birth, ethnicity, race, and gender. Such inequalities, together with individual effort and talent, typically determine – or at least correlate with –inequalities in outcomes (income and wealth). Dabla-Norris et al. (2015) argue that it is not easy to separate effort and talent from opportunity, especially in an intergenerational context. Inequalities in access to healthcare and use also exist in the Western Balkans. Despite the simplistic conclusion, it seems that the reality is even simpler, at least in theory, while the empirical study confirms that the transition from socialism to capitalism in the ex- Yugoslav republics has redistributed national income from the bottom 50% to the top 1%.

4. Conclusion

This paper contributes to a better understanding of the evolution of income inequality in the Western Balkans from a long-run perspective. Given the increasingly scientific, but also political, interest of the widening of inequality gaps in the most developed countries, the investigation of relevant trends in the Western Balkans, is of particular importance. Exploring the relationship between economic integration and income concentration will contribute substantially to the debate on gradual reforms, at the political and economic level, in view of the accession of the Western Balkan countries to the European Union and in particular the effects of dismantling barriers to trade, capital, and labor mobility. After 2002, the divergence of the average European per capita income from the per capita income of the Western Balkan countries continues to grow, worryingly, despite the increase in income in these countries, especially after 1995. Using time series analysis (estimation for every country of Western Balkans) we examine the trend and the business cycle in six WB countries. There is evidence that during the last four decades top income shares have in most cases an increasing trend. At the same time, the business cycles of the top 1% income share are not synchronized among the WB countries for many non-uniform reasons.

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