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# *Income Distribution, Social Cohesion and Value Structure*

**SUMMARY:** My presentation deals with income distribution, social cohesion and value structure. Assuming that the future work of the Fiscal Council will also involve consultations with institutions that deal with forecasts for the macroeconomic path, I trust that during these consultations the forecasts of Kopint-Tárki (Kopint-Tárki, 2011) will also be put on the agenda. Here and now, following the presentation of past processes, I am going to discuss the significance of income distribution from the aspect of planning the next budget. The data used are based on data recorded about one year ago, and characterise the year 2009 (Tárki, 2010). To some extent they already show the effects of the crisis, but a review of the effects of the crisis and crisis management on social structure would require more recent data.\*

**KEY WORDS:** income distribution, social cohesion, value structure

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## THEORETICAL FRAMEWORK

According to common interpretation, the nature of income distribution is determined by the outcome of economic developments. In all probability, this is the case in general, but there is also a tighter interrelationship: the developments in income distribution and GDP are two different aspects of the same thing (the former is related to its distribution, the latter to its level). GDP (and its growth) comprises the aggregate of the incomes produced in the economy. When its value is compared between various social groups, we speak about income distribution.

The latter is important both in terms of social cohesion and from the aspect of the prospects for economic prosperity. At a given moment, the magnitude of the disparities typi-

cal in a country determines, and at the same time expresses, the interests, perceptions, values and attitudes along which various groups of the population formulate their preferences. This is then transmitted by the political system by forming policies out of the demand for redistribution, and then, through redistribution, the budget and other intermediary mechanisms, these policies again have an effect that creates disparities.

In this process, all the channels that eventually form fiscal redistribution out of individual desires and voters' wills, i.e. the political and redistribution institutions themselves, are determining factors. While, of course, personal guarantees are very important in the shaping of fiscal policy (i.e. it does matter how prepared the staff working on the budget is and to what extent they are guided by a public service ethos), even more important are the prudential guarantees for how a permanent and sustainable redistribution system can be set up on that basis. In this respect it is very important that the Fiscal Council as an

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institution should also have a clear mandate and a say in addition to adequately prepared personnel.

Relevant theoretical and macroeconomic literature is increasingly pointing to the correlation between social cohesion and economic growth. In his impressive study, which examined the developments in economic growth in various countries of the world in the '80s and '90s, *Dani Rodrik* came to the conclusion that the lack of social cohesion and latent conflicts openly emerging entail a decline in potential growth for the countries (Rodrik, 1999). Earlier, following a thorough study of the experiences of developing countries, *Albert Hirschman* had come to the conclusion that there was a peculiar correlation between the dynamics of distribution and economic prosperity. It may happen that for a certain period of time, a sudden increase in disparities does not imply frustration and social conflicts. However, all that may occur later, when it becomes obvious that the lag will become prolonged for the country or for some major social groups within the country (Hirschman, 1973). A number of studies have demonstrated that social cohesion is important from the aspect of growth as well, because it creates stable and well-working institutions, which, in turn, definitely creates a positive environment for prosperity (Easterly, Woolcock and Ritzen, 2007).

## DEVELOPMENTS IN INCOME DISTRIBUTION IN HUNGARY

For a long time (between 1960 and 1982), the developments in income distribution in Hungary were characterised by a two-sided process of levelling. In this long period, the position of those with the highest incomes deteriorated, while the position of those with the poorest incomes improved. Starting

already prior to the democratic transformation, this was followed by a strong increase in the ratio of those with higher incomes, and varying degrees of deterioration in the position of the lower decile. Between 2003 and 2007, the weakening position of the upper decile and some degree of protection for the lower strata constituted the typical trend. In the hectic period between 2007 and 2009, amid a series of consolidation and crisis management policies, virtually everybody lost, including the poorest and the strata with the highest incomes (Tóth, 2010a).

Over the long term, one of the most significant phenomena of the change in social structure was the apparent thinning and sinking of the middle strata (Kolosi, Tóth, 2008). Simultaneously with an increase in the proportion of the poorest, a lower increase in the proportion of the richest was measured in the period following the democratic transformation (Tóth, 2005), which is obviously bad from the aspect of stable, solid and permanently well-functioning capitalism.

At the same time, international comparison suggests that what has been taking place in Hungary is not extreme. Examining economic development and poverty rates in Europe, countries can roughly be classified into four groups (Medgyesi and Tóth, 2009). One group comprises those old Member States of the European Union (the Mediterranean and Anglo-Saxon countries) where relative poverty is high in comparison. Another group comprises those old Member States of the European Union where poverty rates are lower (such as continental European countries and Scandinavian countries). Of the new Member States, where the stage of economic development is usually lower, the northern, Baltic republics and Romania have a high poverty rate, while relative poverty rates in Central and Eastern European countries are below EU average.

## INCOME DISTRIBUTION TRENDS IN HUNGARY

Between 1987 and 1992, the changes in income distribution in Hungary were basically determined by structural transformation. The analyses where income distribution was broken down to factors using methods of mathematical statistics revealed that the decline in employment and employment polarisation were the most determining factors.

Between 1992 and 2001, while the level of employment was frozen, the developments in income distribution were determined by the competition between schooling expansion and technological change. From this aspect, the decade of the 2000s was of a different nature, because in this period it was basically the (economic and social) policies that determined the changes in income distribution (Tóth, 2010a).

- Between 2002 and 2006, the lower middle strata and civil servants were the main winners of the so-called transformation to a welfare state.
- Between 2006 and 2008, economic policy characterised by various consolidation packages dominated, the losers of which were the upper middle strata and civil servants.
- 2008 and 2009, in turn, were shaped by the crisis and the developments in crisis management; clearly, the lowest income deciles and, to a lesser extent, the higher deciles were the losers then.

Following this process provides a clear picture of the unbelievably great damage that political fiscal cycles can cause to the society, especially if its amplitude increases significantly (Tárki and Kopint-Tárki, 2009). It is not possible to operate a stable economy and society over the long term if the circle of winners and losers changes significantly every year, mainly due to decisions and developments beyond their control.

## THE FIRST TWO YEARS OF THE CRISIS IN MORE DETAIL

What happened in the first two years of the crisis in terms of income distribution in Hungary? Although not in each band and not according to each relevant indicator, the relatively significant increase in poverty and inequality was the most important trend. In 2009, the extent of relative poverty was broadly the same as in the mid-90s, following the “Bokros package” (Tóth, 2010a). In the approximately two years that can be covered by the latest wave of the Tárki Household Monitor Survey, real income declined in practically all deciles. The 6th, 7th, 8th and 9th income deciles produced above-average increases in income (in fact, smaller falls in real value), and the tenth of the population with the lowest income suffered a loss in nominal terms as well, while in nominal terms, virtually no changes in value were measured for the top decile. This is, to some extent, “natural”: different strata were affected in the various periods of the economic crisis. In the first period, the financial crisis caused losses mainly to those who had considerable savings. Then the real economy crisis hit those in the middle strata who lost their jobs.

## MEASURES OF SOCIAL COHESION

Through transmissions, the structure of the economy, the structure of the society and the mode of income distribution strongly determine the way the whole economic and political system functions. It is appropriate to see what the measures of social cohesion show for Hungary.

One of the signs (measures) of cohesion is the extent to which members of society accept income disparities within the given country. In this respect, there are very significant dif-

ferences across European countries (Medgyesi, Keller, Tóth, 2009). The ratio of those frustrated by the magnitude of disparities is mostly high in other Member States as well, but Hungary is considered an outlier in this respect. Aversion to disparity is very strong in Hungary, one of the strongest among EU Member States. Long-term time series show that frustration over inequality was high in Hungary in the '90s as well, but continued to increase (so far as this was possible: today, almost everybody belongs to this category), while both confidence in one another and confidence in law and order declined considerably.

It is not surprising in this environment that paternalism – to which *János Kornai* already called attention in his work entitled *The Deficit* in the '80s (Kornai, 1980) - continues to exist. In Hungary, it is also not surprising how strong the expectation and commitment is that the government should ensure a more equitable distribution of wealth (Tóth, 2010b).

The assertion that one can become rich in Hungary only at the expense of others is also very strongly accepted in Hungary. This is no good news at all, either from the aspect of capitalism, or from that of cooperation between economic agents in general. If this is the basic attitude, the functioning of the society and the economy is much more expensive due to the lack of confidence and the lack of cooperation between economic agents.

Various earlier analyses demonstrated that, in addition to and in connection with this, Hungary struggles with rather serious cohesion problems (Tóth, 2010b). According to the Eurobarometer survey conducted two years ago, in Europe the proportion of those who thought that tensions were very high between the rich and poor, managers and workers, various ethnic groups as well as old and young, i.e. in any dimension, was the highest among the Hungarian population. One cannot know what

this 2009 survey would show if it was repeated in 2011. Presumably, it would not be much different: issues like this have some fluctuations in time, but they do not change the most important deep underlying social trends. Obviously, these trends are reflected in citizens' votes, one likely consequence being the momentum gained by the extreme right in recent votes.

## THE CHANGE IN INCOME STRUCTURE AND ITS IMPACT ON SOCIAL COHESION

From the aspect of social policy reforms, it is not a matter of secondary importance what income structure the middle class, in particular the middle strata in a political sense and the individual median voter, has. Elections are usually decided by the median voter, and if redistribution is high in the median voter's income package, he will also vote accordingly with regard to further redistribution proposals. In international comparison, Hungarian households are characterised by internationally average ratios of welfare redistribution as a proportion of GDP as well as by a relatively significant welfare dependence at micro level (if welfare dependence is measured by the share of incomes originating from the state). Of course, all this strongly varies, depending on the labour market linkage (the workers to dependents ratio within the household), age structure and educational level of households as well as some other similar characteristic features.

In 1987, in Hungary there was a strong correlation between age and becoming poor: older age meant higher risk of poverty as well. The situation has changed fundamentally by 2009 (Tóth, 2010a): the oldest "moved upwards" in income distribution. Of course, one may consider whether that happened because the young and those with many children "pushed them

up” from below, or because perhaps their income situation improved in absolute terms, or perhaps because the strengthening of the pension system paid off politically better than family policy, but all this does not change the fundamental trends.

Stratification according to the level of schooling is a very important parameter not only from efficiency and political aspects, but also in terms of social cohesion. The general rise in the level of schooling was primarily the result of the educational expansion of the ‘90s, but it also implied a strong differentiation: the differences increased between the incomes of those with higher levels of education and of those with lower levels. One interpretation may be that the return on degrees increased, but one should see that this quotient has two sides. In fact, it is equally possible that degrees pay off better, or that the lag resulting from a lower level of education increased significantly. Most likely, both factors play a role in the differentiation by level of schooling.

The increased in the return on degrees is undoubtedly significant in certain sectors, and this is not a big problem in itself: it gives signals to those who apply for admission to higher education, then, if the educational system adjusts itself in a flexible manner, a mechanism to balance supply and demand may take effect (higher education output increases, which may entail a decline in wage differences). The problem from the aspect of social cohesion would be for the massive disadvantages of those with low levels of schooling to become permanent and grow (due to, inter alia, the inflexibility of the school system and its inability to renew). If the mass output of those whose qualifications do not enable them to participate in the labour market within 10 years increases, it will lead to the permanent stagnation of employment and a significant GDP growth cost (actual GDP growth will permanently remain below the the-

oretically possible path). This is not advantageous at all either for the poor, or for the society as a whole.

## LESSONS LEARNED IN THE SUBJECT OF SOCIAL STRUCTURE AND BUDGET PLANNING

Overall, in the past decades the share of income from the state was high in the median voter’s income structure, the median voter became older and better educated, while the situation of the younger working population became extremely differentiated. This is the combined result of earlier budgeting practices, while determining the social limits of the developments in the budget.

Today the main social policy task is to reverse this trend in a way to reach the highest possible share of market income, especially in the income structure of the middle classes (and the median voter). This is a difficult acrobatic feat for any government or any budget. Indeed, it has given rise to perhaps the greatest dilemma of the democratic transformation, unresolved to date: how is it possible to change the structure of redistribution in a democratic manner, while the majority of the society is interested in redistribution?

In addition to the interests in specific redistribution, some kind of egoistic, non-cooperative urge of self-assertion is coupled in the value structure of the society with an attitude that basically expects solutions from the state. This makes it especially difficult to solve the social policy dilemma outlined above, as the task would be to create an environment where this sort of attitude is repressed instead of receiving confirmation. There are countries among the older EU Member States as well as among the Central and Eastern European countries where this kind of appetite for redistribution is smaller than in Hungary. In this comparison, the sit-

uation in Hungary is different from the respective situations in the Czech Republic, Slovenia or Slovakia. I think that the right way is for the process of preparing the budget to prefer strengthening the attitude that supports becoming independent of the state, rather than strengthening dependence on the state.

With regard to specific social policy reforms, first of all it is very important to shift the emphasis from subsequent problem management to preventive social policy. Actual increase in employment is important; not at the level of intentions, but in fact, in a measurable manner, in the labour market. And that exactly where it is the most difficult: among those with low levels of schooling.

Fundamental improvement is required in the level of schooling as well. The primary question is not whether expenditures on education should be increased or reduced in the budget: the task is to utilise taxpayers' money better. That is, in exchange for the same budgetary funds, education of improved quality should be provided. And that, at least according to relevant international experiences, does not depend on GDP share, but vice versa: it is the GDP growth potential that depends on the functioning of good-quality educational systems.

It is important to have career-based income smoothing programmes in place; a temporary loss of access to the labour market should not lead to the permanent leaving of the labour market, but to a return to the labour market as soon as possible. Of course, there are con-

ditions for this on both the supply and demand side. It is important to avoid having systems that support the leaving of the labour market for good, which was typical in the '90s in Hungary and many other countries in Europe.

It is essential to pursue an open, experimenting social policy, preferably according to feedback based on cost/benefit analyses. In the past decades in Hungary, social policy practice more or less meant the introduction of something, and when it did not work, something else was introduced, and when that did not work either, something else was introduced again. Obviously, this does not work, because it becomes unsustainable over the long term. It would be much more expedient to undertake the reforms of welfare systems in a pragmatic manner: if a practice or institution does not work, it has to be discontinued and something new has to be tried, something that works. Let us consider this to be the definition of open, experimenting social policy.

Here, and elsewhere as well, it is particularly important to emphasise that a balanced budget in itself (of course not necessarily within a given year, but on the average of a longer period) is also beneficial from the aspect of the society. The type of political budget cycle that has characterised Hungary in the past decade has been bad for everyone, especially for the poor.

In conclusion, public administration needs feedback at all levels: at the central and local levels alike.

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