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

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- Globalization, technological change, and aging, have created opportunities, but also intensified cleavages within societies.

- Four main contributions:
  
  1. Draw attention to the *changing nature of inequality* and provide new evidence that insecurity and risks are not shared equally (beyond income).
     - Rising ‘horizontal’ inequality (disparities among groups); and persistent inequality of opportunity.
  
  2. Domestic institutions of conflict-management are *not anymore very effective* in reducing emerging distributional tensions.
  
  3. *Perceptions* of inequality and demand for corrective action are rising;
     - Gap between subjective perceptions of inequality and objective inequality.
  
  4. Principles for redesigning the social contract: universalism, security, progressivity.
Why Social Contract?

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Why “Social Contract”?

A stable social contract is achieved when there is an dynamic ‘equilibrium’ among:

1. Distribution of resources generated by market forces;
2. Public redistribution and social protection against risks;
3. Social preferences for equity-redistribution, which are the complex product of beliefs, perceptions, social values and social norms;

Social contract a la Binmore (1998) as an equilibrium of a game; or Kanbur (1999), in the context of optimal taxation; also see Rodrik (1999): shocks, distributional conflict and growth.
Different from Hobbes, Locke, Rousseau.
A stable social contract

Market-generated distribution of resources

Perceptions and societal preferences

Public policies

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Market-related Distributional Tensions

Contribution 1:
Draw attention to the changing nature of inequality and provide new evidence that insecurity and risks are not shared equally.
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Vertical Inequality


- Baltic States
- Central Europe
- Continental Europe
- Northern Europe
- Southern Europe

Average Gini index of per capita household income

Distributional tensions

Horizontal inequality

• Disparities across three key groups:
  • Generations (or birth cohorts);
  • Workers;
  • Regions;

Inequality of opportunity - Fairness
Intergenerational divide: The incidence of Non Standard Employment

a. Southern Europe

b. Western Europe

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The declining fortunes of the young

Southern Europe
Annual income by cohort (30-34 age group)

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An intergenerational divide: within-cohort inequality

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Note: Calculations using a Deaton-Paxson cohort-age-time decomposition regression, and assuming log-normality.
Occupational Polarization

Change in employment shares, by occupation category

Germany 1994-2013
Poland 1992-2013
Spain 1990-2013

Source: Bussolo, Torre and Winkler (forthcoming background paper)
An example of insecurity: Vulnerability of the middle class

Source: EU-Silc data. Note: the figure shows the results as averages across EU countries (excl. Germany) and participating non-EU countries (Iceland, Norway Switzerland).
How has vulnerability increased? Assets required at or near the middle class threshold have shifted

<table>
<thead>
<tr>
<th>Group</th>
<th>Level</th>
<th>Proportion of those near threshold</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2005-2008</td>
<td>2011-2014</td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary or less (HH head)</td>
<td>23.6%</td>
<td>18.3%</td>
<td>-23%</td>
</tr>
<tr>
<td>Lower secondary (HH head)</td>
<td>13.8%</td>
<td>12.0%</td>
<td>-13%</td>
</tr>
<tr>
<td>Upper secondary (HH head)</td>
<td>37.2%</td>
<td>35.6%</td>
<td>-4%</td>
</tr>
<tr>
<td>Post-secondary (HH head)</td>
<td>1.7%</td>
<td>3.5%</td>
<td>107%</td>
</tr>
<tr>
<td>Tertiary (HH head)</td>
<td>23.7%</td>
<td>30.6%</td>
<td>29%</td>
</tr>
<tr>
<td><strong>Occupation (for HH heads working)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managers, professionals, technicians (HH head)</td>
<td>41.1%</td>
<td>45.6%</td>
<td>11%</td>
</tr>
<tr>
<td>Support, service, sales workers (HH head)</td>
<td>22.6%</td>
<td>23.1%</td>
<td>2%</td>
</tr>
<tr>
<td>Craft, trades, elementary occupations (HH head)</td>
<td>22.3%</td>
<td>17.5%</td>
<td>-21%</td>
</tr>
<tr>
<td>Plant/machine operators/assemblers (HH head)</td>
<td>9.5%</td>
<td>9.9%</td>
<td>5%</td>
</tr>
<tr>
<td>Skilled and unskilled agricultural/etc. (HH head)</td>
<td>4.4%</td>
<td>3.7%</td>
<td>-16%</td>
</tr>
</tbody>
</table>

Source: EU-Silc data. Note: the figure shows the results as averages across EU countries (excl. Germany) and participating non-EU countries (Iceland, Norway Switzerland).
Near the middle class threshold is defined as those with a predicted income between 35-39 USD PPP.
Inequality of Opportunity (IOp)

• Evolution of IOp over a long period in 5 EU countries (Italy, Germany, France, Great Britain and Switzerland).

• Parametric approach to measure IOp, and a simple theoretical model to decompose IOp into its constituting components:
  • intergenerational persistence in education
  • labor market returns to education
  • networking activity associated to parental background
Decomposing IOp

• By considering parental education as the only circumstance, we propose an extended mincerian equation:

\[ \log(Y_{i\theta}) = \alpha + \beta E_{i\theta} + \gamma E_{i\theta-1} + \omega_{i\theta} \]

\[ E_{i\theta} = \delta + \eta E_{i\theta-1} + \epsilon_{i\theta} \]

Where:
- \( \beta \) is the return to education;
- \( \eta \) is a measure of intergenerational persistence;
- \( \gamma \) family networking in labor market;
Inequality of opportunity: results

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Regressors include gender, age, age², born in South Italy and foreign citizenship
Public policies

Contribution 2:
Domestic institutions of conflict-management are not anymore very effective
Horizontal redistribution

Regressive and progressive tax changes across age groups

Note: data and simulations from EUSilc and Euromod microsimulations

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Preferences and Perceptions

Contribution 3: Perceptions of inequality and demand for corrective action are rising

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Perceptions signal rising inequality, even if...
Equity Preferences

- Abundant experimental and representative surveys evidence on the negative relation between well-being and inequality
  - Clark and D’Ambrosio 2015; Ferrer-i-Carbonell and Ramos 2014
- Yet large variation across and within countries
  - Alesina and Angeletos 2005; Alesina and Glaeser 2004
- Percent of people believing the poor can escape poverty on their own:
  - 70% in the US
  - 40% in Western Europe
  - 24% in Eastern Europe
Perceptions of inequality (also driven by insecurity)

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Source: Life in Transition Survey data. Note: the figure shows the results as averages across all LITS countries.
Imbalance?

Market-generated distribution of resources

Perceptions and societal preferences

Public policies

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Cracks in the social contract?

Workers facing less demand for their skills tend to vote for extreme parties

Turn out for the young cohorts is declining
Toward a New Social contract

Contribution 4: Principles for redesigning the social contract
Three principles

1) Seeking universality in the provision of social assistance, social insurance, as it is for basic public services (education, health); [WDR progressive universalism, UBI]

2) Leveling playing field in the labor market; equal protection of all workers, no matter their type of employment, while promoting labor markets’ flexibility;

3) Supporting progressivity in a broad tax base that complements labor income taxation with the taxation of capital.
Three principles (the IPSP version)

1) Rescue the losers (post-market redistribution)
   • Universal programs: better coverage, larger support
   • Basic income: inverting the timing of taxes and subsidies --> more secure
   • Respect freedom (low marginal tax rate on low income? Fleurbaey-Maniquet JEL 2018)

2) Prepare the players (pre-market predistribution)
   • Education:
     • Select, train and reward teachers at their social value (compare with home care)
     • Transition toward lifelong education system due to quick technical change
   • Inheritance:
     • (Atkinson) move toward a recipient tax: there is nothing wrong about leaving a large bequest, but it is unfair to receive a large one

3) Changing the rules of the game (in-market predistribution)
   • Promote competition
   • Promote productivity via minimum wage
   • Promote democratic organization (esp. firms)
   • Directing technological innovation (slow down? Excessive risk and obsolescence)
   • Curb/tax social and environmental externalities
   • Tax rents (market power, capital gains, CEO pay, legal and banking services, male bonus)
   • Reform electoral system and consultation procedures (funding, lobbying, media, voting rules)
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For more details, data and the full report, please visit: