

Income Inequality and the Informal Economy in Transition Economies¹

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For transition economies, income inequality is positively correlated with the share of output produced in the informal economy. Increases in income inequality also tend to be correlated with increases in the share of output produced in the unofficial economy. These hypotheses are supported significantly by empirical data for 16 transition economies between 1987 to 1989 and 1993 to 1994. Various causal mechanisms may operate in both directions, an increasingly large informal economy causing more inequality due to falling tax revenues and weakened social safety nets, and increasing inequality causing more informal activity as social solidarity and trust decline. *J. Comp. Econ.*, March 2000, 28(1), pp. 156–171. James Madison University, Harrisonburg, Virginia 22807. © 2000 Academic Press

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1. INTRODUCTION

Transition economies have experienced contrasting outcomes with regard to income distribution since the late 1980s. Some, e.g., Slovakia, have maintained income distributions as equal as prior to the beginning of the transition. Others, e.g., Russia, have seen startling increases in income inequality. Many transition economies have seen substantial increases in income inequality, with some reported Gini coefficients approximately doubling. These increases in inequality

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have combined with declines in total output to raise poverty rates sharply in many countries (Honkkila, 1997; Förster and Tóth, 1997; Spéder, 1998).

Russia apparently has a distribution of income more unequal than most advanced market capitalist economies. Smeeding (1996, p. 48) presents decile ratios and Gini coefficients for 25 countries in the early 1990s and finds Russia having the greatest income inequality on both measures with a decile ratio for 1992 of 6.84 and a Gini coefficient of 0.393. The United States is second on both measures with a decile ratio for 1991 of 5.67 and a Gini coefficient of 0.343. In his sample, Slovakia has the most equal income distribution on both measures with a decile ratio for 1992 of 2.25 and a Gini coefficient of 0.189. Brainerd (1998) shows Russia's inequality arising from increased wage dispersion, while Garner and Terrell (1998) show government policies largely offsetting increased wage dispersion in Slovakia.

Much literature exists suggesting that many societies face a choice of two sharply divergent equilibrium patterns, one marked by social solidarity, horizontal linkages, and mutual aid and trust; the other marked by class conflict, vertical hierarchies, and general mistrust (Sugden, 1986; Putnam, 1993). Putnam attributes this to the concept of social capital, which is related to trust and levels of involvement in civic activities and groups. He argues that this concept explains the different patterns of economic development in the regions of Italy. Similar arguments are made relating total output to degrees of internal organization or coordination (Blanchard and Kremer, 1997; Rosser and Rosser, 1997). Rarely does this literature discuss income distribution as an integral part of these patterns.³

A related literature focuses on the relationship between the share of the informal economy⁴ in output and the performance of the public sector. The crucial point is that tax revenues decline with a rising share of informal activity (Loayza, 1996; Johnson et al., 1998; Schneider and Enste, 1998). Hence, there exists the possibility of either a good equilibrium, i.e., one with a small informal sector and high tax revenues, or a bad equilibrium, i.e., one with a large informal economy and low tax revenues. When the informal economy increases and tax revenues fall, governments may raise tax rates. However, this simply pushes more economic activity into the informal sector. Not surprisingly, low tax revenues make it hard to support social safety nets and thus exacerbate income inequalities. Johnson et al. (1997) make these arguments specifically for the transition economies, although they do not discuss income distribution.

³ Knack and Keefer (1997) find, for a group of OECD countries, that trust and cooperation correlate with economic activity. Trust and cooperation also correlate with constraints on executive authority, education levels and income, degree of ethnic homogeneity, and the degree of income equality.

⁴ Other adjectives besides informal include unofficial, shadow, irregular, underground, subterranean, black, hidden, and occult. Although possibly having distinct meanings, we view these as referring to economic activity not reported to governments and on which taxes are not paid.

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