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Income Inequality in Early Transition: The Case of Hungary 1987–1996[1]

Paul Kattuman

Department of Applied Economics and Corpus Christi College, University of Cambridge, Cambridge CB3 9DE, United Kingdom
E-mail: paul.kattuman@econ.cam.ac.uk

and

Gerry Redmond

Social Policy Research Center, The University of New South Wales, Kensington 2052, New South Wales, Australia
E-mail: G.Redmond@unsw.edu.au

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We analyze household budget survey data to examine income inequality in Hungary between 1987 and 1996. Inequality did not increase significantly between 1987 and 1991. However, after 1991, the increase was substantial. Falling real incomes and taxes and state transfers may have held back inequality in the early transition. However, growth in earnings inequality, and increasing diversity in sources of household incomes, interacted to increase inequality between 1991 and 1996. This was exacerbated by an emerging polarization in state transfers, i.e., between earnings-related pensions and other benefits. In the context

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of sustained economic growth, the increase in inequality could accelerate. *J. Comp. Econ.*, March 2001, **29**(1), pp. 40–65. Department of Applied Economics and Corpus Christi College, University of Cambridge, Cambridge CB3 9DE, United Kingdom; Social Policy Research Center, The University of New South Wales, Kensington 2052, New South Wales, Australia.

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1. INTRODUCTION

It was widely anticipated that post-Communist economies would experience greater income inequality over the period of their transformation into market economies. Increased dispersion of market incomes was seen as a principal driving force in the transition process; incentives bloom when workers who invest in skills are able to command a market wage and people who invest in assets are able to realize a market income from them (Barr, 1994). Measurements reported in an emerging literature on inequality in transition suggest that it has indeed increased (Förster and Tóth, 1998; Milanovic, 1998; Flemming and Micklewright, 1999). As well as measuring changes in inequality, analysts have also begun to attempt to explain the factors that have driven these changes (Milanovic, 1999). Our paper contributes to this body of knowledge by focusing on Hungary in the years 1987 to 1996.

Our main sources of information are Hungarian Household Budget Survey microdata for the years 1987, 1989, 1991, 1993, and 1996. Using these data, we measure and decompose household income inequality to gain a fuller picture of the principal forces that drove increased inequality through the early transition years in Hungary. Our analysis builds on the work of Jenkins (1996); we compare his analysis of the growth in inequality in the UK over the 1980s with the growth in inequality in Hungary in the 1990s. Our work also builds on that of Milanovic (1999), who argues that increased household income inequality in Central and Eastern Europe over the early transition years was driven largely by greater inequality in the earnings of employees. Our analysis supports that of Milanovic, but with some important nuances.

With reference to changes in overall inequality, we cannot find any conclusive evidence that household income inequality increased between 1987 and 1991; indeed, it may even have fallen. After 1991, inequality certainly grew, although most of the growth appears to have taken place between 1991 and 1993, with little growth between 1993 and 1996. Regarding the evolution of components driving inequality between 1987 and 1996, we report three major findings. First, the contribution of employee earnings to household income inequality peaked in 1989 and 1991 when inequality was stable or falling. Our analysis shows that, as the importance of employee earnings declined after 1991, greater diversity in income sources began to play a more prominent role in generating inequality in Hungary.

Second, we suggest that the institution of a progressive personal income tax regime in the late 1980's moderated the growth in inequality in Hungary, at least