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The Political Sources of Income Inequality in Russia

Income inequality in Russia has almost doubled since the end of the communist era. It has risen in waves: first as a sharp burst in the early years of the transition; then, following a decline in the late 1990s and early 2000s, it rose again slowly and steadily for much of the 2000s as incomes increased for all strata but more rapidly for those at the upper end of the scale. The deepening of inequality in the 1990s and 2000s also had a strong regional dimension as some regions prospered whereas others were stuck in poverty. The economic crisis of 2008–2009 halted the growth of incomes and cost millions their jobs. Since incomes leveled off more at the top end than the bottom, the crisis has also temporarily halted the increase in inequality. As of 2008, Russia's Gini index stood at 42.3, same as in 2007, according to the state statistical agency, whereas the ratio of the income of the top decile to that of the bottom was 16.9 (up from 16.8 in 2007). The richest quintile received about 47.9% of total income, the same share as in 2007. Overall inequality in Russia is comparable to that of the United States and greater than that of most other postcommunist countries – comparisons we will explore in more detail later. First, however, let us consider what the trends in income inequality in Russia tell us about the political and economic transition the country has undergone since the end of the communist regime.

At first glance, it might appear that the growth in income inequality in Russia is simple to explain. In the early years of the transition, 40% or more of the population fell into poverty as a result of unemployment, the lag of earnings behind prices, and the failure of the state social safety net. Meantime a small number of well-positioned individuals gained enormously from the transition. The economic recovery following the 1998 financial crash briefly narrowed the gap between rich and poor. Then the prolonged boom of the 2000s raised incomes across the board but boosted those at the top faster than those at the bottom. Similarly, in both waves, interregional differences widened. Regions that entered the postcommunist era with usable endowments of natural resources and human capital and that were centers of trade and banking benefited disproportionately from the opening to a market economy, whereas regions that lacked these advantages lagged.

Political institutions have also shaped earnings and incomes by determining the minimum-wage level and the degree of redistribution effected through taxation and social spending. These political mechanisms operate both at the federal level and at the level of each of Russia's eighty-three federal territories, called "subjects of the federation." The far-reaching decentralization of power in the 1990s brought about wide differences in governing arrangements at the regional level following the end of the planned economy. Formal and informal institutions of coordination and consultation among government, business, and labor varied widely from one region to another. Inherited endowments of human and physical capital changed much less rapidly than did the political relations among policy makers, enterprise directors, and other organized actors. These relations, I intend to show, were reflected in considerable variation in income levels and distribution, social welfare spending, poverty rates, investment, and overall economic performance. Thus analyzing the political sources of income inequality operating at the regional level sheds light on the structure of power in the postcommunist state more generally. This is the task I undertake in the present study.

1.1. Inequality and Globalization

Russia is certainly not the only country in the world to experience rising income inequality over the past two decades. The growth of inequality in many developed and developing countries has engaged the attention of scholars and policy makers around the world. The older conviction that economic development would bring about a convergence of incomes across and within societies has faded with the realization that global inequality has grown in recent decades, whether measured by mean national income or aggregated globally across households.[1] The dramatic rise in mean incomes in China and India mitigates the trend toward rising inequality by the first measure but not the second. The once widely accepted Kuznets economic growth model predicted that inequality within societies would first rise and then decline with industrialization. The reasoning was that the early stages of development would see higher returns to capital than to labor, where in later stages of economic development, the returns to skilled labor would increase relative to the returns to capital. This would raise the share of wage income in Gross Domestic Product (GDP) and thus reduce the gap in income between workers and owners of capital. Convergence, however, has been elusive, both within and across countries. Branko Milanovic observes that since 1960, rich

[1] Branko Milanovic distinguishes among three distinct measures of global inequality: by simple unweighted measures of inequality across national mean income levels; inequality among population-weighted national income means; and as a global aggregate where all households or individuals in all countries are treated as if they belonged to a single society. Branko Milanovic, *Worlds Apart: Measuring International and Global Inequality* (Princeton, NJ: Princeton University Press, 2005).

countries have tended to remain rich and poor countries to remain poor, and most countries in the middle have tended to lose ground.[2] The Asian countries are the exception. Globally, treating all households as if they belonged to a single society, Milanovic calculates that the Gini index of inequality rose from 61.9 in 1988 to 65.2 in 1993 and fell slightly to 64.2 by 1998[3] – a level roughly equal to that of Brazil. He speculates about the consequences of living in a world with a shrinking middle class: Only 17% of the world's population lives on incomes that fall within 75% and 125% of the world median income.[4] Given the persistent growth of inequality within and across national societies despite increases in the mean incomes of developed and many developing societies, the World Bank recently concluded "that no straightforward relation between income and inequality can be established."[5] Instead, institutional factors affecting the relative bargaining power of labor and capital in the marketplace and the ideological orientation of governing coalitions determine whether earnings differentials in the labor market are high or low, how progressive the tax structure is, and how much government welfare policy equalizes incomes.[6]

Russia's transition to a market economy occurred at a time of intensified worldwide competition in markets for finance, labor, products, and ideas. Russia not only replaced a system of state ownership and central planning with one oriented to private ownership and market competition, but exposed its economy to the same forces of globalization that have affected all countries in recent decades and that, in many, have tended to widen income differentials. Globalization widens the gap between the relative returns to human and physical assets. A large literature has demonstrated that the economic returns to skill and education are growing everywhere relative to the returns to unskilled labor.[7] Many fear a "race to the bottom," as countries compete in the international marketplace by reducing their tax and social spending obligations and suppressing wage levels and other production costs. The literature shows that, except in the East Asian newly industrializing countries (NICs), greater exposure to international trade and investment tends to increase income and

2 Milanovic, *Worlds Apart*.
3 Milanovic, *Worlds Apart*, 108.
4 Milanovic, *Worlds Apart*, 128.
5 World Bank, *Governance Matters 2006: A Decade of Measuring the Quality of Governance* (Washington, DC: The World Bank, 2006), p. 44.
6 Gøsta Esping-Andersen, *The Three Worlds of Welfare Capitalism* (Princeton, NJ: Princeton University Press, 1990); Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001); Torben Iversen, *Capitalism, Democracy, and Welfare* (Cambridge: Cambridge University Press, 2005); Jonas Pontusson, *Inequality and Prosperity: Social Europe vs. Liberal America* (Ithaca, NY: Cornell University Press, 2005).
7 Claudia Goldin and Lawrence F. Katz, *The Race between Education and Technology* (Cambridge, MA: Harvard University Press, 2008); Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work* (Washington, DC: Overseas Development Council, 1999).

wealth inequality within countries.[8] Dani Rodrik cites Chile as a particularly notable example: "During the period of liberalization, the Gini coefficient in Chile registered a 12-point increase (from 0.46 in 1971 to 0.58 in 1989), one of the largest jumps ever witnessed in any country over such a short period."[9] In the United States, Goldin and Katz argue that trends in wage inequality reflect "a race between education and technology": Advances in technology bring relative gains in the return to education, but periods of rising levels of educational attainment mitigate the resulting wage inequality, whereas periods when educational attainment levels stagnated – as has been the case since the early 1980s – have seen renewed increases in wage inequality.[10]

In the case of Russia and other postcommunist states, globalization deepened the shock of the transition from state socialism to capitalism. Globalization's impact on income and income inequality depended on the way economically relevant assets (natural resources, physical capital, and human capital) were distributed at the point of transition. The end of price controls on many products and liberalization of markets resulted in rapid short-term differentiation in incomes by region, social stratum, or economic branch as the relative value of assets shifted markedly. For example, the ability to sell natural resources on world markets gave the holders of those assets the opportunity to realize windfall profits and sharply raise the earnings levels of workers and managers in the energy sector. A similar boom in financial activity in the 2000s pushed salaries of managers in the financial sector through the roof: As of early 2008, the starting salary of the director of a financial institution in Russia was around $120,000 per year, more than the base salary of a government minister, and fourteen times greater than the average compensation in the country.[11] Meantime, industries and regions built around obsolete production technology and high production costs could not survive except through heavy government subsidies.

The same point applies, albeit less dramatically, to the relative value of human capital on the global marketplace: Those with professional and managerial skills that could be applied to the new conditions benefited, whereas many strata (including some that had been relatively favored under the old system) possessed skills that were ill-suited to the new environment. Aggregated across the workforces of enterprises, branches, and regions, these differentials in the relative market value of inherited human and physical assets contributed to sharp increases in income inequality in Russia and other postcommunist countries.

1.2. Income Inequality in the United States and Russia: Toward Convergence

It is instructive to compare Russia with the United States with respect to income inequality. In inequality, if in little else, the old prediction of convergence

[8] Rodrik, *The New Global Economy*: 13.
[9] Rodrik, *The New Global Economy*: 14.
[10] Goldin and Katz, *The Race between Education and Technology*.
[11] Polit.ru, March 6, 2009, citing figures from a survey of 185 firms in several branches.

between the two countries has been realized. The United States and Russia are alike both in the overall level of income inequality and in the distribution of income shares by population quintile. Both have far outpaced their peers in inequality: The United States' level of inequality is greater than that of every other advanced industrial democracy, and Russia's inequality is greater than that of nearly every other postcommunist country. To be sure, the differences are also considerable. Not only is personal income in the United States about three times that of Russia, but the trendlines differ between the two countries. In the United States, inequality has risen gradually and steadily since the late 1970s, whereas in Russia, it has risen in waves – a sharp hike in the 1990s was followed by a brief leveling off, then a slower rise in the 2000s.

In the United States, after a period following World War II when inequality fell, a protracted period of rising income inequality since the 1970s has brought the Gini index for aggregate household income inequality from 39.7 in 1967 to 46.6 in 2008.[12] As many observers have pointed out, the increase in inequality is above all driven by a sharp increase in incomes at the high end. Between 1979 and 2002, the average after-tax income of the richest 1% of Americans more than doubled, from $300,000 (in 2002 dollars), to more than $630,000.[13] By the end of the 1990s, the top 10% of income earners received more than 40% of all income (up from about 30% immediately after World War II); the top 1% earned about 15% of all income.[14] Piketty and Saez show that the increase in inequality is primarily driven by increases in the earnings of the top 10%, and particularly the top 1%, rather than changes in the earnings at the bottom. Inequality in the distribution of wealth is even more skewed than inequality in income: The top 1% of American households hold 38% of the wealth.[15] By 2006, Saez finds that the top decile in the United States received 49.7% of total income, a higher level of income concentration than at any time since 1917.[16] Moreover, income volatility has risen even more

[12] U.S. Census Bureau, "Income, Poverty, and Health Insurance Coverage: 2008," U.S. Department of Commerce, Economics and Statistics Administration (Washington, DC, 2009), p. 30.
The Gini index represents a cumulative total deviation from perfect equality of distribution of a given quantity such as income. A society in which income was distributed completely equally, such that every person or household received the same share, would have a Gini index of 0. A society in which a single person or household received 100% of the income would have a Gini index of 1 (100%). Therefore, the Gini index is technically expressed as a percentage between 0 and 1. For simplicity's sake, however, it is often expressed as an integer between 1 and 100. I will follow the latter convention in this book.

[13] Jacob S. Hacker and Paul Pierson, *Off Center: The Republican Revolution & the Erosion of American Democracy* (New Haven, CT: Yale University Press, 2005), p. 112.

[14] Thomas Piketty and Emmanuel Saez, Income Inequality in the United States, 1913–1998. *NBER Working Paper Series* (Cambridge, MA: National Bureau of Economic Research, 2001), pp. 60, 62.

[15] Jacob S. Hacker, Suzanne Mettler, and Dianne Pinderhughes, "Inequality and Public Policy," in *Inequality and American Democracy: What We Know and What We Need to Learn*, ed. Lawrence R. Jacobs and Theda Skocpol (New York: Russell Sage Foundation, 2005), pp. 156–213, esp. p. 164.

[16] Emmanuel Saez, "Striking It Richer: The Evolution of Top Incomes in the United States (Update using 2006 preliminary estimates)," March 15, 2008, unpublished manuscript.

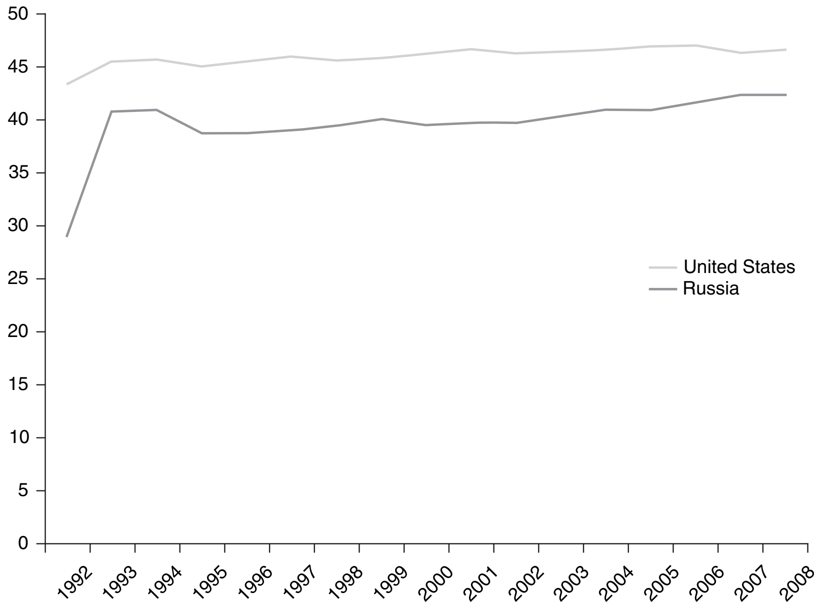

FIGURE 1.1. Gini index of income inequality, United States and Russia, 1992–2008. *Source*: United States: U.S. Census Bureau, Current Population Survey, 1968–2009 Annual Social and Economic Supplements. Table A-3: Selected Measures of Household Income Dispersion, 1968–2008, http://www.census.gov/hhes/www/income/histinc/f04.html; Russia: Federal Service for State Statistics, http://www.gks.ru/free_doc/new_site/population/urov/urov_32g.htm (last accessed January 3, 2010).

rapidly than inequality. The severity of oscillations in household incomes over a lifetime has grown as a result of the deterioration of shock absorbers such as health insurance protection and unemployment insurance. Both risk and reward, in short, are more unevenly distributed across the population. As a result, struggles over redistributive policies have grown intense and have fueled political conflict between the two major parties.[17]

Postcommunist Russia has undergone an increase in income inequality greater in magnitude than the United States, and over a far shorter span of time (the Gini index rose from about 29 in 1992 to 42.3 in 2008) (see Figure 1.1). But from different starting points, the two countries have reached comparable aggregate levels of income inequality. Figure 1.1 shows the trends in the estimated Gini indexes for the two countries (the U.S. figure reflects household income dispersion).

[17] Larry M. Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age* (Princeton, NJ: Princeton University Press, 2008); Nolan McCarty, Keith T. Poole, and Howard Rosenthal, *Polarized America: The Dance of Ideology and Unequal Riches* (Cambridge, MA: MIT Press, 2006).

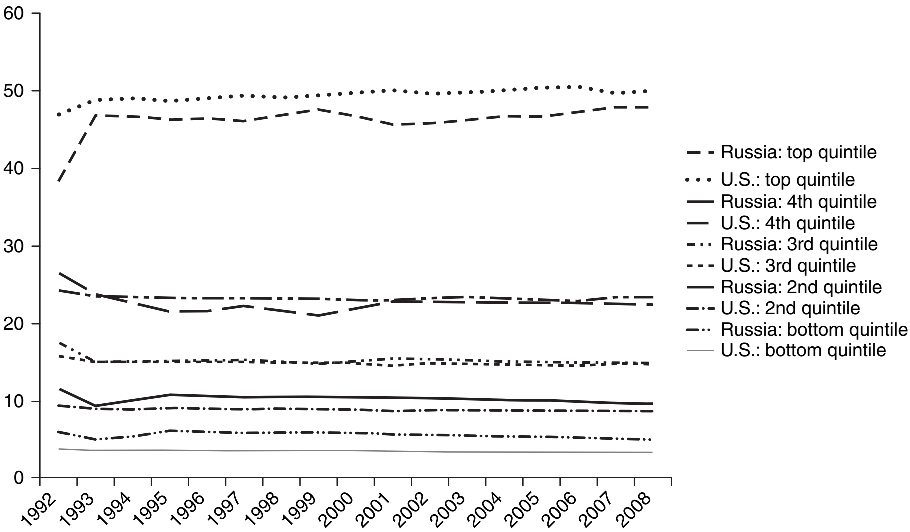

FIGURE 1.2. Income distribution by quintile, Russia and United States, 1998–2008.
Source: United States: U.S. Census Bureau, Current Population Survey, 1968–2009 Annual Social and Economic Supplements. Table A-3: Selected Measures of Household Income Dispersion, 1968–2008, http://www.gks.ru/free_doc/new_site/population/urov/urov_32g.htm (last accessed January 3, 2010).

More striking is the similarity in income distribution by quintile. In both countries, the increase in inequality has come about because the income of the richest quintile has risen whereas the incomes of the middle and poorer strata have remained flat or declined. The result is that the distribution of incomes by quintile in the two countries is nearly identical, with around half of the income going to the richest top 20% of the population and 3–5% going to the poorest quintile (see Figure 1.2).

If we focus on another measure of inequality, however, the ratio of the income of the 90th percentile of the population to that of the poorest decile, Russia has pulled away from the United States (Figure 1.3).

On the other hand, the two countries have converged in their levels of poverty. Figure 1.4 indicates that poverty has tended to fall in Russia to the point where the official reported share of the population living below the poverty threshold was virtually identical to that of the United States.

Both countries stand out among their peers for their high levels of inequality. Although inequality in wage and salary incomes (sometimes called "market income inequality") has risen in other capitalist economies beside the United States, incomes after taxes and transfers remain significantly more unequal in the United States than in other Organization of Economic Cooperation and Development (OECD) countries. According to Brandolini and Smeeding, most OECD countries "experienced a modest increase in the inequality of disposable incomes in the latter 1980s through the 1990s, but then showed a

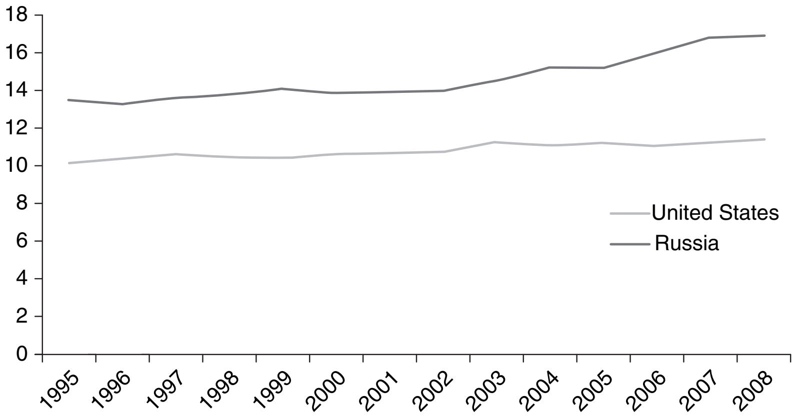

FIGURE 1.3. Decile ratios, United States and Russia, 1995–2008.
Source: See Figure 1.2.

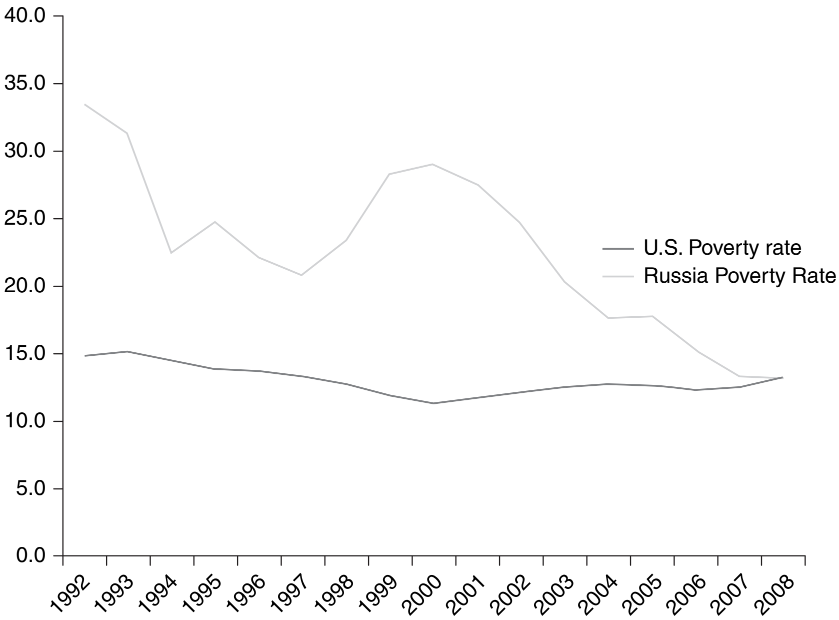

FIGURE 1.4. Official reported poverty, United States and Russia, 1992–2008.

flattening trend as they approached the end of the century."[18] They conclude that "national policies and institutions can and do make a difference … the

[18] Andrea Brandolini and Timothy M. Smeeding, "Patterns of Economic Inequality in Western Democracies: Some Facts on Levels and Trends," *PS: Political Science and Politics* 39:1 (2006): 24.

FIGURE 1.5. Gini index, 1987–2005: Selected postcommunist countries.
Source: World Development Indicators.

United States appears an outlier with the least effective redistributive policies either at a point in time or over the past 25 years."[19] The Gini index of income before government taxation and spending ("pre-fisc income") in France is 49, in Germany 43, in the United Kingdom 45, in the Netherlands 42, in Belgium 50, but the highly redistributive taxation and spending policies of continental Europe bring post-fiscal income inequality down significantly compared with the United States (29 in France, 25 in Germany, 37 in the United Kingdom, 25 in the Netherlands, 26 in Belgium).[20] Alesina and Glaeser also note that the minimum wage in the United States is lower relative to the average wage than in Europe, and that the poorest strata are much poorer relative to the median than are the poor in Europe.[21]

Likewise, Russia's level of income inequality is higher than that of most of its postcommunist neighbors. Figure 1.5 compares Russia with eleven other postcommunist countries, using World Bank Gini index figures, which for Russia tend to be lower than those reported by Russia's state statistical service. Inequality rose in all the postcommunist societies that opened their economies to market competition, but Russia stands out even among the former Soviet states: No country underwent a steeper initial rise, and Russia remains the highest in the group (see Figure 1.5).

The World Bank estimates are substantially lower than Russia's own reported inequality figures, but the trends are clear: Inequality resumed its

[19] Brandolini and Smeeding, "Patterns": 26.
[20] Timothy M. Smeeding, "Public Policy, Economic Inequality, and Poverty: The United States in Comparative Perspective," *Social Science Quarterly* 86:S1 (2005): 972.
[21] Alberto Alesina and Edward L. Glaeser, *Fighting Poverty in the US and Europe: A World of Difference* (New York: Oxford University Press, 2004), pp. 38, 47.

growth in Russia in the 2000s (as it did in some other postcommunist countries), and Russia's aggregate level was the highest in the region.

Obviously the economic processes driving the changes in the distribution of incomes are very different in the United States and Russia, and the two countries differ sharply in their levels of income and development. GDP per capita in 2007, using the purchasing power parity method and expressed in current international dollars, was 45,592 in the United States and 14,690 in Russia. Mean nominal per capita income in dollars in 2007 was about $6,000 in Russia, whereas mean real income in the United States in the mid-2000s was $33,000.[22] Russia underwent a wrenching decline in incomes and living standards in the 1990s as a result of the transition from communism, and then experienced a decade of 7–8% average annual increases in economic growth from 1999 to 2008 before succumbing to the global economic crisis. Russia's economic performance therefore has not only occurred at a much lower level of overall economic development, but has been far more volatile than in the United States.

Notwithstanding the differences, the rising gap between rich and poor is a concern for policy makers in both countries. In his address to the State Council on February 8, 2008, President Putin declared that the current level of income inequality in Russia was "absolutely unacceptable" and should be reduced to more moderate levels; he called for measures that would bring about an expansion of the middle class. Its share of the social structure, he declared, should reach 60% or even 70% by 2020.[23] The co-chair of one of the discussion clubs of the dominant party, United Russia, commented in November 2008 (after the effects of the worldwide economic crisis were beginning to be felt) that "the crisis is a chance for the middle class, to protect it against excessive taxes and collections. Maybe the crisis will force us to build a country of the middle class, and not a country of rich and poor, such as Russia has always been. It is necessary to create the possibility for every office employee to start his own business, to become master of his own future."[24] Soon after this, another United Russia leader echoed the same thought: "[T]he so-called office plankton, and ordinary working stiffs, are the first victims of the crisis; but in fact they are the guarantee of the future of Russia as a normal European country, a country in which there are no longer any rich or poor."[25] Shortly

[22] GDP figures from WDI. U.S. median household income figures from OECD: http://stats.oecd.org/Index.aspx?QueryId=11112&QueryType=View; Russian income figure from *Regiony Rossii: Sotsial'no-ekonomicheskie pokazateli, 2008*, Table 5.2, http://udbstat.eastview.com.ezp-prod1.hul.harvard.edu/catalog/readbook.jsp?issue=818876. The Russian figure is estimated on the basis of an average per capita monthly nominal ruble income of 12,601 and an exchange rate of 25 rubles to the dollar.

[23] Quoted from Vladimir Putin's address to an expanded session of the State Council, February 8, 2008, "On the strategy of development of Russia to 2020," http://president.kremlin.ru/text/appears/2008/02/159528.shtml

[24] Polit.ru, November 20, 2008.

[25] Polit.ru, November 27, 2008.