Income inequality, economic development, and the EU accession process: towards a better future for all

Serbia records among the highest levels of income inequality in Europe. These poor results have their roots in the transition process started in the late 1980s, which was characterised by policy failures, corruption, and political struggles. In order to be an outstanding candidate for EU membership, however, Serbia’s economy needs to demonstrate sustainable and strong development, with a high level of economic growth as its driving force. As high inequality is devastating for economic development, this issue needs to be addressed in a comprehensive development strategy.

Nevertheless, little interest has been shown by national and international stakeholders regarding inequality in Serbia, which is why Serbian policymakers have yet to properly tackle this issue. Recognising its profound importance, the aim of this paper is to raise awareness about the problem of income inequality and to suggest three areas in which government action can lead to positive impacts - the tax system, the labour market, and the education system.

I. Inequality and economic development

High income inequality is not necessarily a direct result of the development process per se and can, in fact, seriously harm economic growth. At present, this concept is slowly gaining acceptance among policymakers worldwide. Simon Kuznet’s famous work from the 1950s, which argued that a trade-off between economic growth and inequality is required throughout the development process, has been influential for some time now. Recent data, however, shows a rising trend of inequality even in developed countries and empirically denies this idea. In fact, inequality is not only an unnecessary output of the development process, but it also limits economic growth. High inequality can produce social conflicts which distress the inflow of investments and economic activities. In addition, inequality depresses domestic demand, which also plays an important role in the economic development process. A high level of inequality therefore negatively affects economic growth as well as, indirectly, social and political stability.

II. Inequality in Serbia

The context of inequality in Serbia

In 2019, the World Bank classified Serbia as an upper middle-income country. Nevertheless, in relative terms, Serbia’s GDP per capita expressed in Purchasing Power Standards (PPS) represents only 37% of the EU average. The Serbian GDP has grown in the past four years, but this growth is not enough to make up for the wide development gap with the Union at large. In addition, this moderate growth is highly correlated to external factors, such as the recovery of the EU economy from the 2008 global crisis and its generally positive trends recorded in the last couple of years.

In any case, without long-term economic growth at least two to three times higher than the current EU average, Serbia's convergence with the EU is at risk. Consequently, analysis of core problems in the functioning of the Serbian economy and the ways in which Serbia can achieve stable and continuous economic development deserves proper consideration.

In spite of Serbia’s acute income inequality, its impact on economic performance is often neglected in policy discussions. This inaction is regardless of the fact that data shows that for four years in a row, Serbia has recorded a higher Gini coefficient\(^4\) value than all EU member states.\(^5\) Information from 2016 – the latest year for which a full range of data is available – shows a value of 39.8 for this index, which is far behind the EU average (Figure 1).

The situation is equally alarming when looking at Serbia’s income quintile share ratio (S80/S20 ratio),\(^6\) a second indicator of inequality (Figure 2). The value of this ratio was in 2016 more than double the EU average (11 versus 5.2).\(^7\) Even though there are methodological differences between the EU-SILC method which produced the above-mentioned data and the HBS method (used until 2013 to measure inequality in Serbia, showing a moderate level of inequality in the past), inequality is nevertheless a concern, requiring the attention of Serbian authorities.

For instance, in the basic document which outlines economic governance for enlargement countries, the Economic Reform Programme 2019-2021 (ERP), there seems to be no ambition to tackle this issue. In fact, the ERP only mentions in one sentence that inequality of income distribution in Serbia is high. Similarly, another document relevant to inequality discussions, the Employment and Social Reform Programme (ESRP), astonishingly only references the different methodologies for the calculation of inequality (EU-SILC vs. HBS methodology).

The policy measures presented in these documents touch upon poverty, social security, and the labour market, which can only have indirect and limited impacts on inequality. Most of these measures are supply-side oriented and deal with active labour market policies, poverty, and social protection expenditures, yet inequality is neither the same as poverty nor exclusively a social issue. The lack of straightforward policy measures and action plans aimed at reducing income inequality in any comprehensive way is a huge gap in Serbia's economic development strategy. Without devoting attention of the Serbian policymakers to the problem of inequality, citizens’ aspirations for better lives and EU accession are less likely to be realised.

Additionally, the latest EU Commission 2018 Progress Report for Serbia does not focus sufficiently on the issue of inequality. Instead, the report put emphasis on analyses of, and recommendations for, active labour policies. Even though these topics may be important to address, they are an insufficient and uncertain means to deal with inequality.

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\(^4\) Gini coefficient is a statistical measure of income distribution. The coefficient ranges from 0 to 100, with 0 representing perfect equality in the income distribution in society and 100 representing perfect inequality.


\(^6\) The ratio of total income received by the 20 % of the population with the highest income to the total income received by the 20 % of the population with the lowest income.

The EU Enlargement Strategy for Western Balkans published in 2018 mentions the idea of implementing a new social dimension throughout the negotiation process, based on the European Pillar of Social Rights. This is a good initiative, at least insofar as it can help raise more attention to the topic of inequality among domestic policymakers. Nevertheless, concentrating only on employment and social reform will not be sufficient to address the already high level of inequality seen in Serbia.

### III. Prospects for tackling inequality in Serbia

#### Taxes, labour and education reform to the rescue

This paper proposes that the three areas most important to address in order to mitigate inequality in Serbia are the tax system, the labour market, and the education system.

In terms of fiscal policy, so far, the Serbian Government has been concerned with fiscal consolidation, the budget deficit, and public debt. When it comes to the tax system, the focus has been on the efficiency of tax collection. Nevertheless, the redistributive capacity of the current tax system in Serbia is low and negatively influences the country’s level of inequality. Even if this relationship is not evident at first glance, a theoretical explanation which links domestic demand and disposable income works to clarify it. Namely, this is largely because the share of society with low income is likely to spend more with additional funds than those with a higher incomes, whose needs tend to already be satisfied. In other words, the marginal propensity to consume is usually greater for households with low incomes than for those with high incomes. With a higher redistributive effect, tax policy can thus stimulate a greater consumption demand on the domestic market. In this way, increased demand plays an important role in the growth of production, which fosters employment and an overall rise in economic dynamics. So, a more even distribution of income and wealth in society can contribute to economic growth through the rise of domestic demand.

As far as labour market reform is concerned, the greatest level of inequality is found between employed and unemployed persons. The Serbian Government has implemented a set of labour market policies which contributed to a decrease in the unemployment rate from 20% in 2014 to 13.3% by the end of 2018. This reduction in the unemployment rate did not, however, influence the level of inequality, as the value of the Gini index stayed nearly the same (Table 1). In addition, salary cuts in the public sector, where salaries are higher than in the private sector, should have contributed to a reduction in inequality. Yet, again, the level of inequality was not affected by these measures. Since the intensity of work also remained low (Table 2), the set of policies introduced apparently emerged as inadequate. In a situation like this, inequality cannot be mitigated.

#### Table 1: Gini coefficient, 2006-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Serbia</th>
<th>EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>35.4</td>
<td>30.2</td>
</tr>
<tr>
<td>2007</td>
<td>34.1</td>
<td>30.6</td>
</tr>
<tr>
<td>2008</td>
<td>32.1</td>
<td>30.8</td>
</tr>
<tr>
<td>2009</td>
<td>31.2</td>
<td>30.0</td>
</tr>
<tr>
<td>2010</td>
<td>33.0</td>
<td>30.5</td>
</tr>
<tr>
<td>2013</td>
<td>38.0</td>
<td>30.5</td>
</tr>
<tr>
<td>2014</td>
<td>38.6</td>
<td>31.0</td>
</tr>
<tr>
<td>2015</td>
<td>38.2</td>
<td>31.0</td>
</tr>
<tr>
<td>2016</td>
<td>38.6</td>
<td>30.8</td>
</tr>
</tbody>
</table>

Source: Krstić, G. (2016). Why Income Inequality is so high in Serbia: Empirical evidence and a measurement of the key factor.

#### Table 2: Share of people living in households with very low work intensity

<table>
<thead>
<tr>
<th>Year</th>
<th>Serbia</th>
<th>EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>18.1</td>
<td>11.0</td>
</tr>
<tr>
<td>2014</td>
<td>20.5</td>
<td>11.3</td>
</tr>
<tr>
<td>2015</td>
<td>21.2</td>
<td>10.7</td>
</tr>
<tr>
<td>2016</td>
<td>21.5</td>
<td>10.5</td>
</tr>
</tbody>
</table>

Source: Eurostat

In terms of inequality of opportunities, this paper proposes that the Serbian education system is confronted with three main problems: a still underdeveloped vocational education (referred to as dual education) system, the moderate accessibility of all income strata to higher education, and the low overall quality of education. The Serbian Ministry of Education launched an initiative in 2017 introducing the “dual system” in high schools. This policy has the goal of making the education system and the demand of the labour market more compatible, in this way decreasing unemployment. While a move in the right direction, this reform is not sufficient. Without well-planned industrial policy for building an economy in which university-educated people are in higher demand on the labour market, the potential for development is questionable.

In addition, granting access to higher education free of charge to all interested students, but on the basis of strict and clear rules for assessing student capabilities, has its value here. In this sense, the German higher education system offers an example of good practice, in that it limits the number of examination failures to three and two for undergraduate and master students, respectively. Beyond this number, a student can no longer study in the same field in that federal state.

Finally, the quality of the actual education provided is perhaps a key component of the education system reform.

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9. Source for increase of consumption demand can be also found across the border, but Serbian export capacities are not adequate to sufficiently contribute to the increase of consumption demand.
12. These are households where on average the adults (aged 18-59, excluding students) work 20% or less of their total work potential during the past year.
Serbian pupils recorded poor results on PISA tests (a general assessment test to determine the quality of education in a country) in 2009 and 2012, performing below the majority of their EU peers. Moreover, in the latest test conducted in 2015, Serbia did not even participate.

**A more skills-based focus in high school education, a greater accessibility to higher education, and a better quality of education at all levels of the system are indispensable to economic development based on knowledge.** All of this suggests that policymakers should pay more attention to the inequality of opportunities and undertake such measures to reduce future income inequality.

**What should be done?**

In the first-place, Serbian decision makers need to be more aware of the existing problem of inequality in the country. They should put it on the policy agenda and start planning how to deal with it. Otherwise, an incomplete national economic policy set will risk failing to deliver sustainable growth and prosperity, as it has many times in the past two/three decades. In addition, the EU should emphasise the question of inequality mitigation in the negotiation process and should also provide technical support to aspirant and candidate countries in tackling this problem, drawing on the experience of member states.

When Serbian authorities include inequality in comprehensive economic policy discussions covered by the ERP, a public debate about the most relevant policy measures to face this issue should be initiated. Three areas of reform which have a great potential to reduce inequality in Serbia are the tax system, the labour market, and the education system.

As a more even distribution of income plays an important role in economic growth by increasing domestic demand, Serbian authorities should start working on developing a more progressive national tax system as the first basic measure.

Labour market reform should work towards strengthening the position of labour and the collective bargaining process and on that way peg wages to the level of productivity. In addition, future measures should aim at increasing the general employment rate, as well as the intensity of work for those who are already employed. At the same time, Serbian industrial policy should aim towards the creation of higher value-added jobs.

In terms of inequality of opportunities, Serbian policymakers should step up efforts to improve the current education system. The introduction of vocational education is a positive change, but it has to be accompanied by well-planned industrial policy. Furthermore, anyone interested and capable should be granted access to higher education free of charge. Lastly, the transformation of the current system of education is needed through increased investment in the professional development of teachers and the modernisation of school curricula.

In short, although often considered as a social issue, inequality can have severe economic consequences for society at large. It is therefore high time that Serbian authorities recognise the persisting problem of high income inequality and adopt adequate policies to tackle it properly.

**Increased equity can bode well for the quality of life of Serbian citizens and also for the country’s prospects of EU membership.** Reforms in the tax system, the labour market, and the education system promise to help to achieve goals of both reducing inequality in Serbia and boosting its economic growth in support of its wider EU accession efforts.

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European Policy Centre - CEP - is a nongovernmental, non-profit, independent think-tank, based in Belgrade. It was founded by a group of professionals in the areas of EU law, EU affairs, economics and public administration reform, with a shared vision of changing the policy making environment in Serbia for the better – by rendering it more evidence based, more open and inclusive and more substantially EU accession driven. Profound understanding of EU policies and the accession process, the workings of the Serbian administration, as well as strong social capital combine to create a think-tank capable of not only producing high quality research products but also penetrating the decision making arena to create tangible impact. Today, CEP organises its work into four programme areas:

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2) Internal Market and Competitiveness;
3) Regional Policy, Networks and Energy;
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