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Social Security and Poverty Reduction Reforms in Slovakia and in the rest of the Central Europe

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This paper summarizes, in an extremely brief fashion, experiences of Slovakia and other Central European countries (Czech Republic, Hungary and Poland) in reforming their social security systems, with focus on poverty reduction. The paper proceeds along the following logic. First of all, it examines preconditions for successful reduction of poverty – macroeconomic stability and sustainable growth. It then looks at definition of antipoverty objectives and selects ones appropriate to the Central European and Ukrainian situation. It then focuses on potential instruments to achieve these objectives in the area of employment and social inclusion.

The experience of Central European countries shows that macroeconomic stability is absolutely necessary, but not in itself sufficient to achieve a successful reduction of poverty. If fiscal and monetary policies are unsustainable or make the economy vulnerable to external and internal shocks, it is generally the poor and the vulnerable who pay a disproportionate part of the price. Fiscal deficit, high inflation, high interest rates and uncertain currency hurt the economy as a whole everywhere in the world, but they hurt the poor in transition countries more for two reasons. Transition countries usually lack markets where individuals and firms could protect themselves against macroeconomic instability (currency hedging, diversified investment portfolios) and where they exist, the poor and the less educated usually do not have the social capital and the skills to protect themselves. In other words, the poorer part of any society needs stability more than other groups.

There are two essential features of macroeconomic stability relevant to transition countries - sustainability of the public finance and adequately anti-inflationary monetary policy. Lack of either one sooner or later requires a massive policy correction and it is the experience of Hungary after the 1994 crisis, of the Czech Republic after the 1997 crisis, of Slovakia after the 1998 crisis and of Poland during the recession of 1999-2001 that delayed adjustment tends towards overshooting, exacerbating effects of any necessary fiscal restructuring, particularly on the poorer elements of the society.

The second precondition for a successful poverty reduction policy is a high level of sustainable growth, but such a topic is beyond the scope of this paper. Therefore, I would just point to one aspect of sustainable growth important for poverty reduction policies - diversification of the economy and attenuation of the economic cycle. Economies based on a small number of crops or industries which face a highly cyclical world market are bound to go through very sharp cycles of growth and decline in external demand. Slovakia was such an economy in mid-1990s, relying on its export of steel, chemical products and other intermediate manufactures. These disturbances have similar effects on the poor as overall macroeconomic instability.

Now let us turn the attention to actual aims of poverty reduction policies. While it can seem that defining objectives of poverty reduction is a straightforward exercise, it is the experience of Central European countries that both the public and the policy-makers emphasize inappropriate and misleading objectives within the context of middle-income economies such as Ukraine.

First of all, how should we define poverty? There are two schools of thought in economic and social policy. The first one focuses on relative poverty – for example, the European Commission looks, in some of its assessments, at what percentage of the population has income below 60% of the median income in the country. The second school bases its analysis on absolute poverty – setting a benchmark of subsistence (such as USD 2 per day) and then determining what percentage of population in individual countries is below the benchmark. While both yardsticks are of value, I would argue that it is the second one that makes sense for poorer and rapidly growing countries. Relative poverty measures look at equality within any society rather than at actual poverty of individual. Based on this yardstick, more people are poor in Britain than in Bulgaria or Romania. Also, inequality tends to rise in rapidly growing countries, which is not a cause for serious concern as long as fruits of growth are distributed across the whole population even if not absolutely equally.

Secondly, employment and unemployment tend to be key objectives of any antipoverty policy as risk of poverty is very closely correlated with unemployment in transition countries (of course, with the exception of the elderly). Most societies focus on the unemployment rate. While this, in theory, has the advantage of measuring the available labor force and concentrating the attention of policy-makers on those who want to work, but cannot find it, in practice this is not so. What is truly important for the economy is how many people actually work as measured by the employment rate (for example the % of people between 15 and 64 who are in employment), because only these people actually produce goods, service and taxes. More importantly for the social policy, focus on formal unemployment rate creates incentive to promote economically and socially wasteful policies such as early retirement, easy access to the disability status etc. This is not a trivial issue. Slovakia and Hungary have the same employment rate of approximately 57%. However, Slovakia has a much higher unemployment – higher by 10% according to some measure. While this creates additional social pressure in Slovakia at the moment, this country will find it much easier to expand its labor force as the economy continues growing. For Hungary, it will be much more difficult to get people back into labor force from retirement or disability. At the same time, the Hungarian system is much more costly as the pensions are usually significantly higher than unemployment benefits.

Last but not least, poverty is easier to bear and its social costs are minimized if poverty tends to be of short-term nature, is not reproduced across generations and individuals feel they can realistically rise from it.

To summarize, for the Central Europe and probably for Ukraine, it makes sense to focus on three key objectives of antipoverty policy: increasing employment rate, reduction of absolute poverty and prevention of long-term poverty and improvement in social mobility.

Now that we have explored key preconditions for poverty reduction and made our objectives clear and specific, let us focus on ways to achieve them.

Our discussion of instruments will be divided essentially into two parts. The first one is concerned with stimulating employment in the formal economy. The second one focuses on other specific policies of social inclusion that seek to reduce absolute poverty and its reproduction in addition to a robust employment policy.

Stimulation of employment in the formal economy is a lynchpin of any antipoverty strategy in middle-income countries such as Ukraine. The strategy must focus both on migration of jobs from the informal economy to the formal one as well as creation of jobs in the latter. It is important to emphasize that any repressive element (police, tax authorities etc.) must play only a complementary part in the strategy. The key is to make creation of jobs in the formal economy more attractive. This can be usually achieved by a mixture of the following:

- **change in tax system**.

  These steps usually include decrease of tax rates, broadening the tax base, improvements to tax administration to achieve better collection, shift of taxation from labor to consumption and introduction of tax systems that make avoidance more difficult. In other words, successful strategies usually entail elimination of most if not all targeted breaks and subsidies in taxes in favor of a relatively low rate for everybody; focus on VAT and excise taxes as the key source of revenue; reform the expenditure side to allow a corresponding decrease in the revenue and relatively low rates of personal income tax and social security contributions. Slovakia is a good example of this strategy – it has unified its VAT at 19% as of January 1, 2004, allowing it to create a unified flat personal income tax of 19%, eliminate double taxation (such as dividend tax) and cut social security contributions by more than 3 percentage points.

- **incentives for individuals to participate in the formal economy**.

  As long as there is limited relationship between payments made by the individual (taxes and social security contributions) and what he gets back from the state, there is no incentive to participate in the formal economy as there is nothing in return. Therefore, reforms in Central European countries have contained elements that strongly link social payments by the state to contributions by the individual. In Hungary, Poland and Slovakia, the so-called second pillars of the pension system have been set up where a significant part of contributions is diverted into individual pension accounts. Even in the remaining public pay-as-you-go pension systems, there is a tendency to strengthen the link between contributions and pensions, sickness benefits and other payments, again with Slovakia being a prime example and the Czech Republic now also contemplating strengthening the link.

- **access to business and individual financing**.

  One of the great barriers to business development and economic growth in developing and transition countries is insufficient access to financing, be it in forms of loans or capital infusions. As Hernando de Soto has identified, these problems are to a large extent related to problems in having a collateral, which is, in its turn, caused by faulty legal systems and unclear property rights. Most people even in poorer countries have assets, sometimes very significant ones, but either their ownership is not formalized or there are problems in pledging it effectively as a collateral for loans. The other frequent problem is general underdevelopment of the banking sector, extensive state involvement in banking activities as opposed to banking regulation and "protection" of borrowers from creditors which makes private banks reluctant to lend. Radical restructuring and privatization of banks has been, sooner or later, a key pillar of all successful economic policies in Central Europe.

The countries that have done it sooner – such as Hungary – have been more successful and did it more cheaply than laggards such as Poland, the Czech Republic or Slovakia. Slovakia has been a world leader in setting up a working system for using movable property (trucks, cars, inventory etc.) as collateral. Use of mortgages as a source of financing for business start-ups has been ever more frequent in recent years. The clear message is that creating these systems allows many more people to start or develop a business than any specialized state lending or grant programs and is much cheaper, and these small businesses tend to be principal drivers of employment in the formal economy. Additionally, such systems also create a huge incentive for existing informal economy businesses to switch to a formal sector because there are rewards for owners, such as access to bank financing.

- **regulatory environment, particularly labor market legislation**.

It is paradoxical that poorer countries with weaker state tend to have much more complicated regulations, especially in the labor market. A survey shows that some of the poorest countries in the world (e.g. in Africa) have some of the most rigid labor market legislations. Of course, this has the double problem of both not being enforced very well and driving employers into the informal economy. It is therefore essential to have labor legislation that is actually applicable in a given country under given circumstances and that does not prevent employers from hiring individuals by making it very expensive to lay off them when necessary. At the same time, the experience of Central Europe shows that decrease of employment in large, formerly state-owned enterprises cannot be stopped or prevented, only slowed down. The delay is usually either very expensive for the government (if it pays enterprises subsidies to retain employment) or can bring the whole enterprise under (if the government forces the employer to preserve employment). In the end, the money would be much better spent on retraining, infrastructure or social assistance. With this in mind, Slovakia has in 2003 reformed its Labor Code to increase flexibility in working time and in hiring and firing and to limit trade union power.

In addition to a robust employment policy, there are other policies of social inclusion needed to reduce absolute poverty and its reproduction. Such policies take many forms appropriate to local circumstances, so let us discuss principles on which they should be based rather than policies themselves.

The principal issue with regard to the Ukrainian experience is the issue of in-kind transfers, especially the so-called privileges. Central European countries have never had an extensive privilege system to begin with and they have progressively sought to eliminate whatever privileges remained and made sure that the government is paying for the ones that remain. There are several reasons for this approach. Non-monetary privileges tend to be costly either for the government or for the provider, they are usually badly targeted and overly generous. At the same time, they tend to create traps for individuals because they very often cannot change housing, job or something else without effectively losing a part of the privilege.

On the other hand, some Central European governments (e.g. in Poland or Slovakia) have emphasized in-kind and conditional financial transfers as a complementary instrument for the poor in addition to basic poverty relief. Provision of shelter or food for the long-term unemployed by municipalities, subsidizing school lunches, textbooks and other necessities for poor children, housing subsidies conditional on payment of rent and utility prices or child benefits conditional on school attendance are all part and parcel of welfare systems in these countries. In-kind and conditional financial transfers can be efficient if there is a high probability that unconditional cash transfers would not be spent in a way that reduced future poverty (such as education or housing costs) and if they complement a basic financially-based welfare system.

One issue that has been of paramount importance in the EU as a whole and in Central Europe in particular is designing tax and benefits systems so as to create incentive to work. Slovakia and Germany have started ambitious reforms in this area in 2003 and 2004, with the Czech Republic now following. These reforms, such as tightening of the welfare benefits, conditionality of welfare benefits on public works, child tax credits and cuts in social security contributions seek to make work pay, even work with relatively low salaries. In Ukraine, due to the low level of unemployment benefits, this issue is likely to be somewhat less relevant than the others mentioned here.

Another important issue concerns the targeting of social programs. Middle-income countries such as Ukraine cannot sustain the same level of taxation as EU countries and, at the same time, grow strongly enough to reduce poverty. Therefore, it is very important to avoid universal welfare states of the nature that many Western European countries have and to target social programs accordingly. There is a widespread illusion that since almost everyone is poor in countries such as Ukraine, the state needs to subsidize all. This illusion ignores the fact that, in the end, subsidies are financed out of taxed paid by the same poor citizens but decreased by all the costs and inefficiencies of the government. In this respect, successful non-European countries such as Chile or Korea can be a better role model. Housing, health-care and education programs need to be carefully targeted to a guarantee of minimum care and access that is in line with what the country can afford. A very good targeting method is to focus on children from lower-income households. Integrated, effective and efficient programs from childbirth to adulthood that ensure reasonably equal access to health care, nutrition and education for all children have been shown to be among the best investments a public sector can make.

In the conclusion, let me emphasize one issue where no Central European country has been very successful, which is likely to be relevant for Ukraine. There is a high number of losers in transition who are above 45 and very often with quite low levels of education. Ability of such individuals to adjust to the new environment, especially if they lose their jobs is limited. Their reintegration into the labor market has not been very successful and they either remain among the unemployed (e.g. in Slovakia and Poland) or have been sent into disability or early retirement (Czech Republic, Hungary).