Public Disclosure Authorized

Public Disclosure Authorized

WPS 1380

POLICY RESEARCH WORKING PAPER 1380

# Transfers and the Transition from Socialism

## Key Tradeoffs

*Kathie Krumm*
*Branko Milanovic*
*Michael Walton*

Every society faces a choice between security and growth. Here, the tradeoffs between the two in the formerly socialist economies are spelled out.

The World Bank
Europe and Central Asia Regional Office
Office of the Regional Vice President
and
Policy Research Department
Transition Economies Division
November 1994

## Summary findings

The old day. in the now transition societies were characterized by stagnant incomes, rationed goods, and few civil liberties, but a high degree of income security. The early days of reform have brought crashing incomes, more goods, civil liberties, and rising insecurity. Most countries are set on a course toward some form of capitalism, which by definition means greater risk-taking, less security, and almost certainly greater inequality in income distribution.

Should transfers be used to compensate for increasing insecurity and poverty? The short-run drop in incomes, the heritage of cradle-to-grave state protection, and the Western European vision of the welfare state provide compelling motivation for using transfers.

But, argue Krumm, Milanovic, and Walton, there are significant tradeoffs between moving to a welfare state and shifting to dynamic, growing economies. The transition economies don't have the real levels of productivity or the tax bases needed to sustain the kind of tax effort a large-scale system of transfers would require. Short-run gains in security could in the long run mean insufficient private and public capital accumulation and lack of competitiveness. The result could be financial collapse (as witnessed in Ukraine) or an extreme form of Eurosclerosis (a possibility for Hungary or Poland). Under either scenario, those whom the transfers are supposed to protect — the old, the poor, the disabled, and the unemployed — are most likely to suffer disproportionately over the medium to long term, and probably even in the short term.

In any viable scenario, transfers are likely to be important for both welfare and political reasons. Some options for providing transfers are more likely to be consistent with macroeconomic imperatives and to have relatively low adverse-incentive effects — for example, flat-rate (or flatter) pensions at quite low replacement rates, and local rather than general (income-tested) social assistance.

Krumm, Milanovic, and Walton recommend using intrinsically temporary measures — such as temporary employment schemes — in the transition. This avoids a permanent transfer burden while recognizing the severity of the interim transition period. In sum, the alternative of less reliance on comprehensive transfers puts more pressure on private coping mechanisms and will, in the short run, increase risk. But it may be the price of a viable transition to the growth that is essential to success.

---

This paper — a joint product of the Office of the Regional Vice President, Europe and Central Asia Regional Office and the Transition Economies Division, Policy Research Department — is part of a larger effort in the Bank to study social protection in the transition economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Kathie Krumm, room H12-081, extension 34263 (49 pages). November 1994.

*The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be used and cited accordingly. The findings, interpretations, and conclusions are the authors' own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.*

Produced by the Policy Research Dissemination Center

Not for Quotation

# TRANSFERS AND THE TRANSITION FROM SOCIALISM: KEY TRADEOFFS

Kathie Krumm, ECAVP
Branko Milanovic, PRD
Michael Walton, PRD
World Bank

---

This paper was presented at a World Bank seminar in April, 1994. We would like to thank the participants and, in particular, Alan Gelb, Timothy King, Robert Liebenthal, Costas Michalopoulos, Marcelo Selowsky, Michal Rutkowski and Sandor Sipos for helpful comments. Thanks to Sushenjit Bhandyopadhay and Pedro Rodriguez for research assistance.

## TABLE OF CONTENTS

Page

INTRODUCTION

I. THE SOCIAL TRANSFER LEGACY -- AND INITIAL CHANGE .... 1

*The Legacy: high income security; stagnant incomes* .................. 1
*Early days of reform: heightened insecurity; falling incomes* ............ 3

II. THE ROLE OF TRANSFERS IN THE TRANSITION AND BEYOND: CHOICES AND TRADEOFFS .......................... 9

*Requirements for income growth and implications of present policy path -- sclerosis or collapse?* ........................ 10
*Transfer needs during the transition* .......................... 17
*Cross-country experience and evidence* ........................ 18
*Growth, security and transfers* .............................. 30

III. MAJOR DESIGN ISSUES FOR TRANSFERS: UNEMPLOYMENT INSURANCE, PENSIONS, AND SOCIAL ASSISTANCE ...................... 32

*Unemployment insurance and temporary employment-related assistance* .... 32
*Pensions* ......................................... 37
*Social assistance* ................................... 43

CONCLUSION ....................................... 48
BIBLIOGRAPHY ...................................... 49

# TRANSFERS AND THE TRANSITION FROM SOCIALISM: KEY TRADEOFFS

## INTRODUCTION

There were many things wrong with the socialist systems that evolved this century. They brought, however, three significant benefits relative to market economies of a comparable income level; high levels of health and education; a relatively high degree of income security; and low incidence of income aspects of poverty. Of course, the failures of the economic system meant the prospects for income growth were dim; and income security is only some comfort when you can't buy the goods you want. Yet a rise in insecurity is a striking feature of the initial phase of the transition to capitalism.

A rise in income insecurity occurred because of the combination of macroeconomic crash and the beginnings of the removal of comprehensive security via labor contracts. It coincided, of course, with a rise in psychological insecurity brought about by the profound changes. At the same time, private and community based coping mechanisms were weak while the relative size of the dependent old was large. The interaction between these features and inherited institutional support schemes has led to a high reliance on state transfers for those without labor income. The result bears considerable similarity to Western European style welfare states. There are, however, sharp tradeoffs faced by these economies that may make the maintenance of large transfer levels tough. This is already vividly apparent in the macroeconomic realm, with the two, inter-related tradeoffs of fiscal resource allocation, and ensuring enough resources for investment in human and physical capital accumulation. There are also likely to be more subtle tradeoffs in the effects of transfers on labor allocation.

This paper reviews the transfer situation in the context of these tradeoffs. Part I sketches the institutional features of the legacy that brought these benefits, and the changes in the early days of the Brave New post-socialist World. Those familiar with this context may wish to skip this. Part II describes the principal tradeoffs, with a primary focus on the macroeconomic context; and then discusses how market economies have responded to these tradeoffs. Part III looks at two programs that will be key to any solution to the tradeoffs--pensions and social assistance.

# I. The Socialist Transfer Legacy -- And Initial Changes

## *The legacy: high income security; stagnant incomes*

*Social insurance and the role of enterprises.* Social insurance in the rich Western economies manages insecurity (and usually also redistributes to the poor) mainly through a tax and transfer system. It is a response to the fact that the underlying economic system generates uncertain and changing outcomes for households--and the scope for households to manage these changes on their own is often limited. The socialist system was different: socializing such risks was taken care of directly through a labor "market" that provided an employment guarantee with low wage dispersion. This was complemented by a range of transfers, mainly implicitly or explicitly part of the employment contract, included family allowances, maternity benefits, disability benefits, various benefits in kind and, most importantly, pensions.

Full employment was ensured in part as a matter of direct policy. Job security was guaranteed and unemployment usually actually illegal. However, full employment was only feasible because of structural features causing chronic excess demand for labor. Production by target with no budget constraint led to unlimited demand for labor in the enterprise sector. There was every incentive to expand employment, and none to economize on labor use. Labor turnover was actually quite high, but this was because workers operated in a seller's market. Full employment obviated the need for unemployment insurance. Employees were paid relatively low net wages with particularly low returns to education. In addition to their central role in providing the employment guarantee, a number of social functions devolved to enterprises, particularly in the countries of the former Soviet Union, including provision of many social services. The enterprises often provided to their employees goods in short supply, and a considerable amount of compensation was in-kind (housing, food, other subsidies) rather than as part of the explicit wage package. The enterprises were responsible for paying out family allowances and pensions (although the financing came from the state). Economic risk-taking was discouraged. The environment was one of very low risk in almost all spheres -- except when failing to toe the political line.

Pay-as-you-go (PAYG) pensions were received by all those who worked in the state sector, as well as generous sickness allowances and family benefits. These were financed in large part by payroll taxes, that had reached levels ranging from above 30 percent in parts of the former Soviet Union to close to 50 percent in much of Central and Eastern Europe at the time of transition, with supplements as required from the national budgets. Pensionable age was low (commonly 55 for women and 60 for men), with a large number of privileged groups enjoying even earlier retirement rights. Compounding this, dependency ratios are higher because of declining birth rates and relatively mature population profiles across the region. Pensions were not actuarially calculated. In Eastern Europe, pensions as a percentage of state-sector wages tended to be high (around 60-65 percent), while in the former Soviet Union they were relatively lower (around 40 percent). Because of the virtual absence of private ownership of wealth and

limited context for interhousehold transfers in a largely urbanized and small family society, the elderly relied heavily on pensions.

*The poor; and attitudes to them.* Social assistance for the poor played a highly subsidiary role. The employment guarantee, widespread transfers, free or almost free health and child care and education, combined with high labor force participation rates for women and subsidization of essential products, were the principal instruments for prevention of poverty. Neither in terms of its size nor concentration on the poor did social assistance have the role that it typically has in the rich Western countries. In part this was due to the fact that poverty was not widespread, and in part to the ideological taboo that preferred not to see poverty, since in an ideal socialist system poverty would be eliminated. Anti-poverty policy thus dealt only with "excess" cases of alcoholics, handicapped, etc. and was undertaken half-heartedly by local authorities or, if tolerated, by charitable organizations (e.g. in countries where Church involvement, as in Poland, was impossible to prevent).

While there was sympathy for those amongst the poor that were perceived to be the victims of the previous system (e.g. rural illiterate and poor, unskilled urban workers etc.) there was little sympathy for the "socialist poor"--people without steady jobs, the old and/or handicapped. The former, the poor from the previous regimes, were often helped by the Communists. During the first 10-15 years after the Communist revolutions all socialist countries achieved significant progress in the eradication of diseases, improved literacy and school enrollment, overall social mobility, that is in the indicators where the main beneficiaries were precisely the underclass from the previous system. Not surprisingly, the "capitalist" poor, who, under the new system, were given the chance to educate their children, migrate to cities, or make successful careers in state- or Party-sponsored institutions, often proved the strongest supporters of socialist regimes.

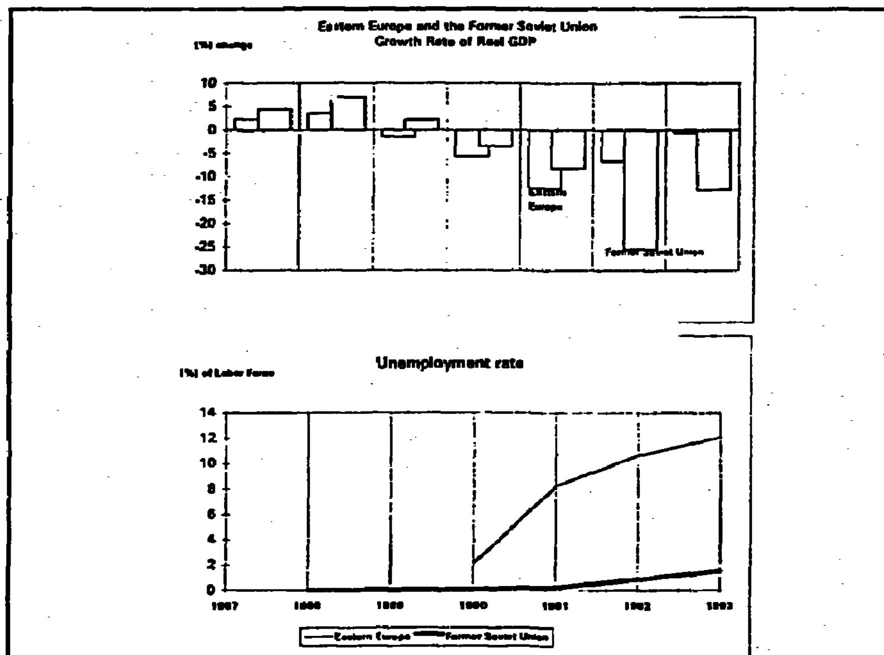
But, in regard to the "socialist poor" the authorities were generally cool. Not only did the existence of the poor mock the regime's claim that poverty was a capitalist phenomenon, communist ideologues genuinely regarded such people as aberrations. They argued that if everyone was guaranteed free schooling, to be followed by a steady state job and all the benefits that go with it, if everyone could avail of generous family allowances, and, after retiring, could enjoy adequate pension, then the fault for being poor lay with these people and not the system. Poverty was not only viewed as social pathology and an implicit denial of the "perfectness" of the system but--not unlike in Calvinist ethics and Victorian attitudes to the poor--rather as an explicit *anti-social choice* by the poor ("the poor do not want to work" hence "they do not want to contribute to the building of the new society" hence "they are anti-social elements, parasites"). The communist view had a logic: if perfect society is here, and its virtues are self-evident, only the ill-disposed and wicked people can refuse to participate in such an endeavor. Communist authorities therefore encouraged the stigma in which other citizens anyway tended to hold the poor. And, to make their plight worse, communist authorities discouraged non-government organizations from helping them, because they distrusted all non-governmental initiatives and viewed them as politically motivated ploys to acquire influence by helping the disenfranchised.

The negative attitude toward the poor had practical consequences. The authorities entirely lacked experience in identifying the needy and in delivering social support. The "social minimum" lines were defined mostly by the "armchair" economists and nutritionists and were unrelated to any social policy. Anti-poverty policy was haphazard, and local efforts were unintegrated into the overall economic and social policy: the poor were viewed as a "foreign body" in an otherwise perfect system.

## *Early days of reform: heightened insecurity; falling incomes*

Households were hit by multiple shocks in the early days in the Brave New World. For a variety of reasons output and incomes crashed--mostly tied up either with the loss of external markets following the collapse of Comecon or the disorder in resource allocation in the vacuum between plan and market. And with the removal of the structural basis for excess demand for labor, the employment guarantee disappeared and Western-style unemployment emerged in all countries. (See Figure 1). Countries in Eastern Europe are well on the way to high

**Figure 1. Income decline and unemployment rise.**




Note: Unweighted average of country information as reflected in the official statistics. Trends are similar for population and GDP-weighted information.

unemployment. Those of the former Soviet Union are at much earlier stage in the shakeout, probably because managers hesitated to lay off workers in light of the social service network provided by the firm, and workers preferred to keep formal ties to firms to increase chances of participation in the privatization carve-up.[1/] Nonetheless, hidden unemployment (those effectively laid off or without pay, but not registered as unemployed) has begun to emerge, estimated at 9 percent in Ukraine in 1993 and over 10 percent in Russia in 1994.

Government revenues have also come under pressure, owing to the fall in real incomes and the pressure on enterprise profits--the traditional source of state cash--from higher wage shares and reduced capacity utilization with the loss in markets. Revenues fell sharply in Eastern Europe, while information on the historical base for the former Soviet Union makes analysis of trends tough. (See Table 1.) Early results for 1993-94 suggest sharper additional revenue declines in some countries of the former Soviet Union.

**Table 1. Government revenue and spending in Eastern Europe and the former Soviet Union (in percent of GDP; unweighted[a])**

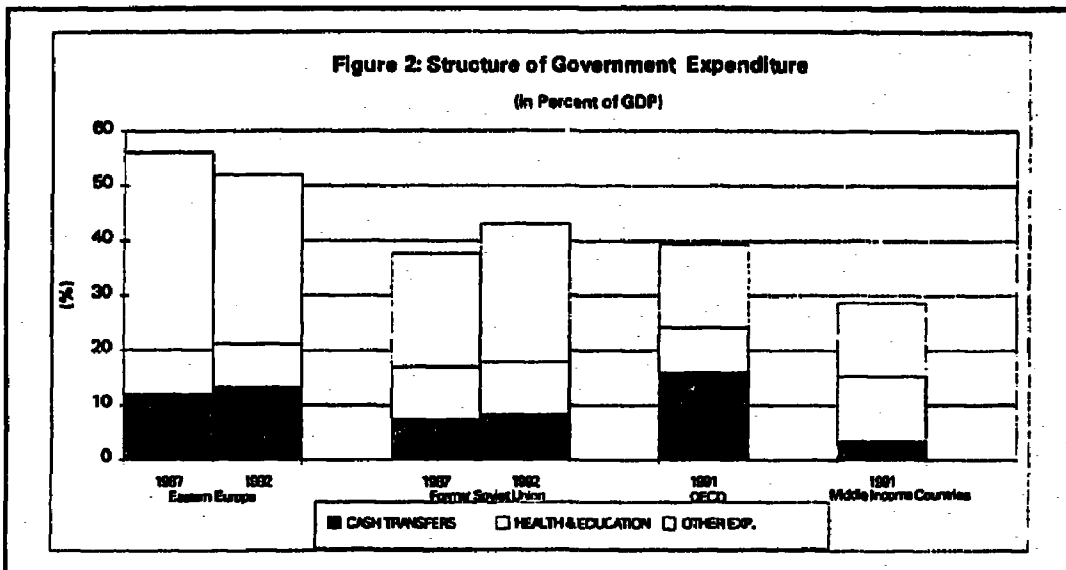
| | Eastern Europe[b] | | Former Soviet Union[c] | |
|---|---|---|---|---|
| | 1987 | 1992 | 1987 | 1992 |
| Revenues[d] | 55 | 43 | na | 33 |
| Spending[d] | 54 | 49 | 37 | 43 |
| Cash transfers | 10 | 15 | 7 | 8 |
| Health and education | 6 | 9 | 10 | 10 |

<u>Note</u>:

a. Given the volatility of exchange rates it makes little sense to use GDP weighing. Any kind of weighing makes a big difference for the FSU, in view of dominance of Russia; for example, the population-weighted change in spending was from 32 to 59 percent of GDP between 1987 and 1992.
b. Excludes the Czech Republic and Slovakia, because of difficulties of comparison with 1987.
c. Excludes Armenia and Belarus because of difficulties of comparison with 1987.
d. Consolidated general government revenues and spending plus extrabudgetary social funds.

1/ Most firms in the transition period shifted to some form of de facto worker ownership operating in collusion with managers--of course with unclear long-term property rights. There is widespread unpaid leave in the former Soviet Union, that is a temporary substitute for unemployment.

**Figure 2. Trends in major government spending components, 1987-92**




Note: Unweighted average of country data. Trends are similar for population and GDP-weighted data.

How did countries respond? Most sustained shares of resources going to spending and remain to a large extent transfer societies. Total spending was still close to 50 percent of GDP in Eastern Europe in 1992, and actually rose in the countries of the former Soviet Union. As a share of GDP cash transfers increased in Eastern Europe, and held steady in the former Soviet Union. (See Table 1 and Figure 2).

Total spending as a share of GDP remained higher than in OECD economies, and substantially higher than in market middle income economies--an issue we'll return to in the next section. This reflects a combination of the legacy of cradle-to-grave public support system and the new shocks of the transition.

The table and Figure 2 only account for explicit transfers: formal transfers to households are of the order of 8 percent of GDP for the former Soviet group and 15 percent for many Eastern European countries. There were relatively marginal reforms of inherited socialist systems combined with introduction of the dole for the unemployed. But a large component of transfers are implicit. State enterprises remain in many ways part of the broader transfer mechanism. A significant part of the workforce is in unproductive activities, so wages (often financed by quasi-fiscal resources) are tantamount to a transfer. Where high inflation persists, as in Russia, credit to enterprises and arrears are *de facto* transfers from a public sector banking system to households with wage earners in unviable jobs. Eventually the rest of the population pays, whether via inflation or other taxation. These continuing larger transfers to enterprises offset--most likely more than offset--the lower share of explicit transfers in the former Soviet Union as

compared with most Eastern European countries. At the crux of the debate is how to contain the overall magnitude of explicit transfers while moving the responsibility away from the enterprise sector to enable it to adopt a commercial orientation.

At the same time, some of the social transfer responsibilities have begun to shift from the enterprises to the state. Facing harder budget constraints and elimination of tax benefits that favored "collective consumption" (i.e. fringe benefits rather than cash wages) the enterprises began shedding these functions. They stopped subsidizing canteens and charging below-market prices, and started selling vacation homes and reducing access to free child care. Ideologically, enterprises are also pushed in that direction because their new role in a capitalist system, is to be producers of goods and services--not appendages of the state protection system. Some services have not been replaced. For child care, the state has reduced subsidies, and the new privately-owned child care is extremely expensive. The cost of child care may often be equal to the wage that a mother may expect to receive. Incentives to leave the labor force can be strong, and in many countries there has been a reduction in labor force participation, especially of women and those near retirement age.[2/]

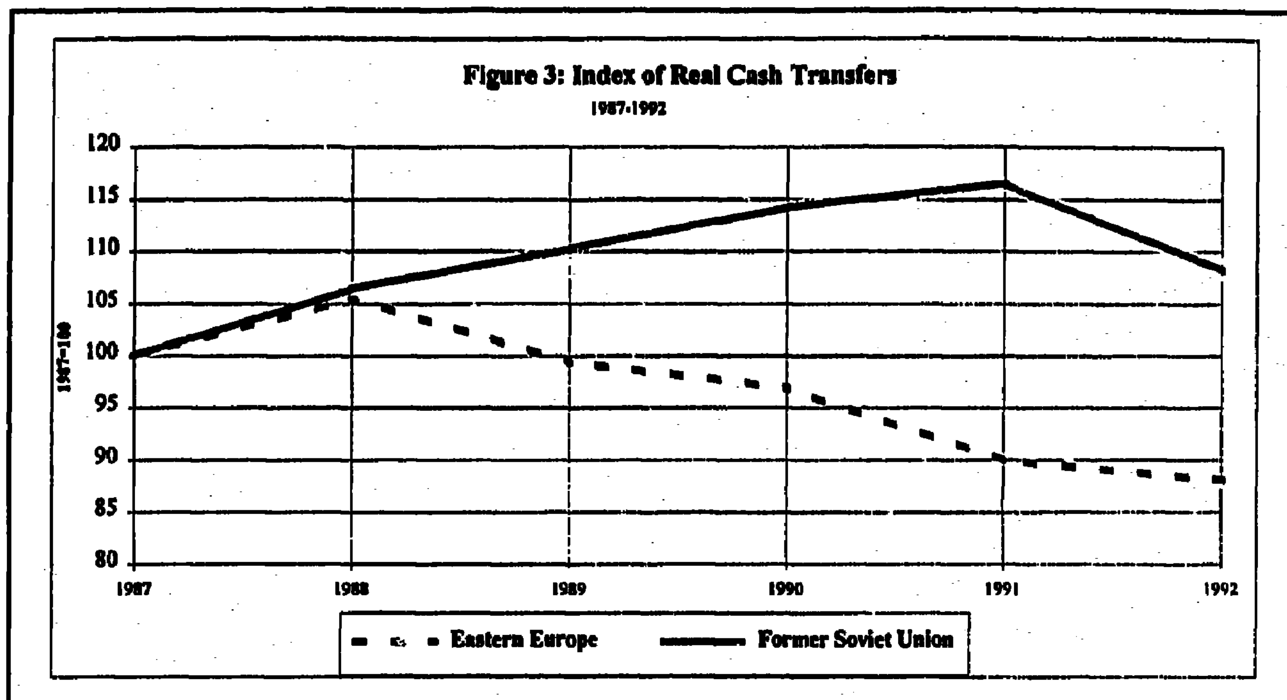
While explicit transfers have been rising as a share of GDP, real transfer levels have fallen, largely as consequence of the real fall in incomes. Another contributing factor is the extent to which the removal of subsidies (that were huge in many countries, e.g. an estimated 15 percent of GDP in Bulgaria in 1989-90) were not compensated with nominal adjustments in transfer levels. (See Figure 3). At the same time, this decline is partly offset by the shift away from scarcity of goods with the liberalization of prices.

The most important component of the cash transfer system continues to be pensions. In most countries no major changes in the pension systems have been made, partly because of the difficulty of changing a system that directly affects the acquired rights of a large segment of the population. However, pension schemes have come under pressure everywhere, with outcomes mainly dependent on the extent to which benefit levels have been eroded by inflation. In most Central and Eastern European countries, pensions have been rising as a share of GDP, with early retirement and better protection of pensions than wages (for example, between 1987 and 1992 from 7 to 15 percent of GDP in Poland, 9 to 10 percent in Hungary, 7 to 11 percent in the Slovak Republic). In most of the former Soviet Union, unanticipated inflation has not been matched by increased benefits levels or there have been delays in payments, with dramatic declines and compression in real pension levels. This temporarily has kept pension expenditures down, and pension-related funds in some countries have temporary surpluses.

---

2/ There are, of course, often problem of measurement, given the weak state of data collection on informal activities, and the less-than-clearcut distinction between the openly unemployed and discouraged workers.

## Figure 3: Real Levels of Transfers in Eastern Europe and the FSU




Note: Unweighted average of country information. Real cash transfers increased in 1991 and 1992 in Eastern Europe on a population-weighted basis. The decline in FSU began in 1991 and was steeper in 1992 on a population-weighted basis.

A few countries have introduced modest changes. Estonia, Romania and Slovenia have started to increase the retirement age. While pensioners who continue working have not been excluded in any of the reforms, Poland and Romania have made adjustments for other income. Some attempts have been made to protect the minimum pension levels to reduce the emergence of poverty among the elderly, frequently relating the minimum pension to the minimum wage. Administratively simple benefit schemes have been introduced in the Baltic countries with the introduction of flat-rate minimum pensions, but as these economies stabilize, pressures are reemerging to restore entitlements. Perhaps of greatest quantitative significance, the Baltic states have effectively inflated away pension "entitlements" linked to historical work experience. However, in all the transition economies, the system's main characteristics remain in place--pay-as-you-go, state-run and state-mandated pensions with only a limited role for private pension schemes, and with some redistribution.

Attempts have also been made to restrict some other cash transfers, such as sickness benefits, maternity leave and sometimes family allowances. For example, sickness allowances are being paid, for the early part of the sick leave, by enterprises rather than by social insurance

funds and maternity leave has been reduced in duration. Some countries have introduced income-testing for family allowances, for example, a single income trigger after which family allowances will cease to be paid (in Kyrgyzstan). In some cases, family allowances are being discontinued for children older than (say) 18 years of age (currently they are often paid in respect of children up to 25-26 years of age).

All but absent in the previous system, the dole is being introduced via two new instruments, unemployment insurance and, effectively, through social assistance. Unemployment insurance was in almost all countries introduced at the beginning of the transition--only some 3 to 4 years ago. Its design raised difficult questions on the interaction between social insurance schemes (family allowances and unemployment benefits) and social assistance. Initially in Eastern Europe the problem was whether unemployment benefits, fixed after some period of unemployment (say, after 9 to 12 months) at the subsistence level, should be used in lieu of social assistance. The idea was appealing because it would dispense with the need to introduce yet another new scheme (income-tested social assistance). The drawback, however, was that the unemployed and the poor were not necessarily the same. The idea of open-ended unemployment benefits was soon abandoned, and replaced everywhere with benefits whose duration was limited to about a year or less. (Poland recently increased the period of coverage for some regions to one and a half years). Most systems of unemployment insurance provide earnings-related benefits, though the Baltic countries and Poland provide flat-rate benefits (15-20 percent and 36 percent, respectively of the average wage). In the former Soviet Union, benefit levels have been extremely low, for example, about 13 percent of the average wage in Russia compared with replacement ratios in the range of 50-70 percent in most of Eastern Europe. While eligibility has been tightened since the introduction of the system, it remains generous in most countries, with effective coverage exceeding 60 percent of the unemployed in Romania, Poland and Hungary, while the Czech Republic has imposed relative strict requirements. In a number of countries, unemployment compensation is preceded by severance payments financed by the enterprises. This ranges from payments of 2-6 months wages mandated in the former Soviet Union and countries such as Slovakia and Poland to more limited use in countries such as Hungary.

As for social assistance, at the beginning of the transition, some countries considered introducing income-tested social assistance. Such systems are in place in the Czech and Slovak Republics, embryonic in Poland and Hungary and under serious consideration in a number of other countries.

## II. THE ROLE OF TRANSFERS IN THE TRANSITION AND BEYOND: CHOICES AND TRADEOFFS

Most formerly socialist countries had large transfers under socialism and are relying heavily on transfers in the transition, with growing explicit transfers in Eastern Europe and implicit transfers through the enterprise sector abating only gradually (with the financial sector an intrinsically temporary staging post) in the former Soviet Union. What are the strategic choices for transfers? What are the key tradeoffs among them?

The key issue is the relationship between transfers, security and growth. After all, being market-based is pretty pointless, from an economic perspective, if it confers greater insecurity without growth. All the countries of Eastern Europe and the former Soviet Union have had to suffer rapid initial declines in recorded output, so large future gains are going to be essential to restore welfare (under a narrow definition--there have already been gains in liberty). We look at this from three angles here. In the first subsection, we look at the potential overall tradeoff between comprehensive transfers and growth--we argue the costs could be quite high, with economies risking a scenario of either a collapsing economy (and collapsing transfer systems) or of a slow-growing, sclerotic economy (but with continuing transfer systems).

At the same time, aren't there "needs" for high transfers during the transition that would then decline once the transition to a market-based economy has been made? This is reviewed in the second subsection. If there is an initial sharp reduction of income, the value of transfers rises--since the income fall increases the depth and extent of poverty. Political economy considerations are also of great importance here. This is clearly a case of weighing the present against the future, but with the tradeoff considerably sharpened compared with conditions of "normal" growth.

So what are the strategic options for recognizing the particular transitional needs consistent with a medium-term growth strategy? In the third sub-section we see what international experience may have to offer. Much of the focus in comparative analysis to date has been with mature OECD economies. This is seductive. An important part of the group in transition are European and some of the features of their transfer systems are like the welfare states that OECD countries have to varying degrees. However, the similarities may be misleading (with the exception of the large share of old). Many of the OECD economies who themselves have been at the forefront of transfer societies--Germany, Sweden--also are actively reconsidering the generosity of their welfare system. Hence, we also look at what other successful middle-income economies do in the way of support mechanisms and transfers. We discuss the applicability of both OECD and middle income country experiences to questions of transfers strategy for formerly socialist countries.

***Requirements for income growth and implications of the present path – sclerosis or collapse?***

Most people in both rich and poor countries would agree that both growth in living standards and security are desirable. What goes into living standards and security will be a mixture of many things, including incomes, public services, the environment in which people live and political and personal freedoms. We concentrate on two objectives:

* providing for income growth;
* providing for income security.

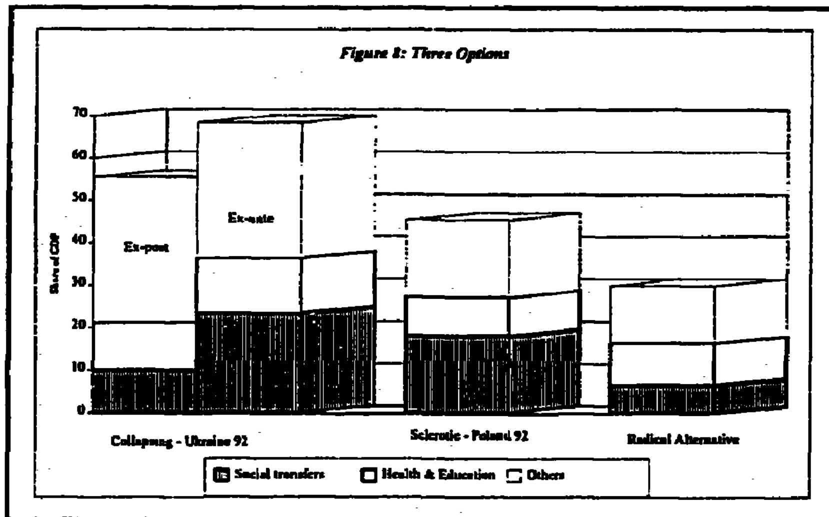
These are dependent on each other. Providing income security may prove difficult without income growth; and some degree of income security may be necessary to provide an environment for investment, to allow restructuring and prevent losses in human capabilities. The income security objective is actually frequently used to conflate two related issues (notably in the social insurance schemes of developed economies): insurance against declines in incomes of a household; and the avoidance, or reduction, of poverty. For the former, protection against income declines, the link with income growth in the economy is particularly strong for economy-wide shocks. For example, the value of the assets set aside for insurance purposes would be negatively affected by negative shocks to the economy, just when households would want to liquidate those assets to protect their income. The latter, poverty reduction, can be effected by redistributive transfers, but here the links with growth are even stronger. All the international experience suggests that the most effective way of permanently reducing poverty is through success income growth. In assessing tradeoffs, for example across alternative categories of public spending, it is important to take account of both growth and security effects. Education spending may be competing with pensions for the use of (declining) public revenues. While education has little short-run effect on the incomes of the poor, it may be central to future poverty declines.

What is the growth framework underpinning the transition? It is useful to put the choices and tradeoffs into a simple accounting framework. The government extracts a certain fraction of GDP in revenues that finance government spending on current services, transfers or investment. Since publicly managed social security is never linked to individual insurance contributions in transition economies, we can think of them as tax-financed transfers to various groups, not necessarily poor (with, as we have seen, payroll taxes being the principal source of finance). The remaining part of GDP in the non-government sector in allocated between current consumption and investment. Future growth will be driven by investment of the private sector in productive activities, by households in human capital and by government spending in (market-friendly) physical investment, especially in economic infrastructure and human capital investment, especially in education and health. It may be useful to think of provision of transfers involving a tradeoffs with higher taxes and lower spending related to capital accumulation. The latter interaction can either work via the government budget, with higher transfers leading to lower market-friendly infrastructure, public health and education spending for given revenues; or via private investment behavior, through the costs of higher taxation or the lower returns due to less publicly provided capital. Of course, it always desirable to reduce wasteful spending in

nonproductive activities, whether by public, state enterprise or private activities, but that tends to be a less interesting choice (and often a relatively elusive one).

Given the growth framework, how could things unfold on the present policy path? Two illustrative scenarios can be envisaged, that depend on the initial political and institutional conditions, the extent of external shocks and the effectiveness of reform in other areas. These are illustrated in Figure 4 and outlined below.

**Figure 4. Collapse, sclerosis and radical reform**




*Sclerotic economy; continuing transfer systems.* For some of the transition economies--in Eastern Europe Poland, the Czech Republic and Hungary--the economy looks reasonably solid. Enterprises and others pay taxes. The unemployed and pensioners receive transfers, albeit some of them at a reduced rate. The private sector is taking off, especially relative to the state enterprise sector. However, there is a more subtle potential problem. Private sector growth becomes confined to once-off adjustment to new opportunities or, at best, the grey economy because of the weight on competitiveness of payroll taxes for formal sector workers, and insufficient resources for public sector related capital accumulation. There is significant hysteresis in unemployment (i.e. an irreversible once-off rise) and permanently high transfers levels. Broad-based pay-as-you-go pension schemes are a permanent burden on the economy. The economy looks like a caricature of the Eurosclerotic state--with slow growth especially in formal employment, continuing deep pressures on public finance, and periodic fiscal crises, but at a much lower level of income.

This result can be put quite starkly in terms of the growth accounting framework. Taxes are absorbing 45 percent of GDP in many Central and Eastern European economies (see Table 1). These go almost entirely to current spending and transfers, with almost zero savings and investment (with the small amounts largely financed by government's foreign borrowing). To get dynamic private sector growth, investment of 25-30 percent of GDP is not inappropriate, say 10 percent from the government and 15-20 percent from the private sector (mainly enterprises, but also households). These numbers clearly don't add, either for the fiscal or private sector accounts. Taxes are if anything on the way done; raising them, even if feasible, would absurdly squeeze a private sector that is supposed to be favored in the transition. Alternatively, full financing of the investment from private sources would leave only 25-30 percent of GDP for consumption out of nongovernment income, implying a savings ratio for the private sector of the order of 50 percent! With a 45 percent tax ratio and close to zero government savings, even an impressive 30 percent savings rate out of private income would only generate a 15 percent investment rate. This might be enough to produce positive per capita growth, but not for a narrowing of the income gap with higher income countries.

*Collapsing economy; collapsing transfer systems.* For many transition economies, attempts to continue extensive transfer systems merely contribute to crisis and a disorderly loss of entitlements. This is the more likely scenario for countries incapable of sustaining the very large public intermediation of funds required of a high tax-high transfer economy. The attempt to maintain aggregate spending levels in the 40-50 percent range fail, in the wake of the enterprise profits collapse and the broader flight from tax payments, compounded by attempts to finance implicit transfers via credit to the enterprise sector. A number of things are then likely to happen: financing of the government and enterprise sector is increasingly by arrears; sooner or later there is a fiscal-financial crisis; there is some combination of crowding out of many "discretionary" categories of public spending (like investment, schooling and drugs!) and inflating away wage and transfer claims; finally there is a severe *de facto* loss of entitlement for transfer recipients and creation of an extreme form of an Italian tax mentality. One of the characteristics of this state is that actual public sector payments, including for transfers, fall short of planned levels. Components of such a scenario are in the making in a number of transition economies. Ukraine's disorder has already taken the economy to the brink of financial collapse and erased seeming entitlements for transfers. Russia runs the risk of letting credit to enterprises cause a fiscal crisis that could radically cut into spending for services and transfers. Bulgaria has already partly inflated away many claims, and is heading toward an arrears-financed economy, and a financial collapse in the enterprise sector could precipitate a broader fiscal crisis.

In terms of the growth accounting framework, tax revenues are collapsing to, say, 30 percent of GDP. Government spending--again, almost exclusively on current spending and transfers--declines to, say, 35 percent of GDP, with a heavy reliance on the inflation tax. Transfers decline sharply *ex post*--as inflation quickly erodes the value of nominal transfer payments--to under 10 percent of GDP. But this decline is disorderly and not targeted on the most vulnerable groups. But in addition, the quasifiscal accounts are large, including subsidies to enterprises channelled through the central bank. Therefore, total extraction of resources from

the economy and total spending by the public sector may, for some periods, be even larger than the 45-50 percent or so in the sclerosis scenario. Whether the private sector receives more or less of a share of GDP than under the sclerosis scenario, the incentive for private investment is shot through by the lack of credibility of overall economic management, and private investment will be much lower than the 15 percent of GDP that seemed to be the maximum attainable in the in the sclerosis scenario (which itself was inadequate for the growth requirements of the transition).

If these indicative scenarios are right, the comprehensive transfer systems in place can jeopardize the ability to shift resources into investment to provide for reasonable growth (sclerosis scenario) and can also fail to utilize the *ex post* lower level of transfers in an orderly and equitable fashion (collapse scenario). Figure 4 also illustrates a third alterative, of more radical reform, perhaps best exemplified by the Baltic countries. We discuss the ways to achieve this below. But first, let's go beyond the simple growth accounting framework to examine the tradeoffs faced. The choice between allocations of resources between transfers and investment is about the respective value attached to these spending categories and the costs incurred by the need to tax to effect the transfers. An overall intertemporal framework for a middle income market economy is provided by Bourguignon (1990). On plausible assumptions for the distortionary costs of taxation, Bourguignon found that the costs of transfers in income growth once an economy reached its steady long run growth path were very small.[3/] Transfers make sense if the society places a higher value on raising incomes of the potential transfers recipients than others, even after the tradeoff between present consumption and investment in future consumption is accounted for. (Note that Bourguignon sets the issue up in terms of poor and non-poor, but the same applies if the consumption of any potential transfer recipient--e.g. a non-poor pensioner--is relatively highly valued.)

But as we move away from such a long-run growth path, things change, even for the relatively moderate transitions experience by market economies . First, if there is a need to move to a new growth path (whether due to a permanent adverse shock or because the existing growth path is distorted) the value of spending that speeds the move to the new path rises. Delays in such a transition mean a longer period on an unsatisfactory growth path. This can be thought of in terms of spending on the kinds of (human and physical) capital that will be needed on the new path.

Think now of the conditions of a transition economy that we outlined above. The structure is exactly the same but with sharp differences in the (probable) values of the

3/ Bourguignon used values for initial conditions, of revenue, incomes and investment rates approximating that of a middle income country (Venezuela was taken as an example) and plausible values for the distortionary costs of taxation, leakages to the non-poor from transfers and the return and investment and moderate transfers (in the 2-5 percent of GDP range) and a long run equilibrium framework to demonstrate that the costs of transfers in income growth could be very small in such a context.

parameters.[4/] Because of the initial conditions, the tradeoff between the future and present is going to be steeper, for three reasons. *First*, revenues are so high as to be highly distortionary. The difficulties governments have in preventing revenue declines--even with VAT and payroll tax rates that are unusually high--is a clear indication that they are in a situation in which the marginal costs of taxation are very high. (This is only another way of saying that it makes sense for the economies to move to lower revenue efforts.) *Second*, the scale of transformation required is very much greater, and the key to this is expansion of private sector activity. The costs of delays in the transition to a new growth path are correspondingly higher. *Third*, while both public infrastructural capital and the human capital of the population may be above average for market developing countries of comparable income levels, there are quite large open questions as to the value of this capital. Some of the infrastructure may be inappropriate for new economic directions (e.g. transport routes heading toward Comecon rather than the West) and skill mixes were designed to suit the economies with over-developed smokestack industries and underdeveloped service sectors. Even with substantial private activity in these areas, public investment will be important.

These three factors all point to a much greater need to shift resources into investment in the future, relative to the market developing case, and relatively high costs of the allocation of resources to transfers (we turn in the next subsection to the benefits of transfers in the transition). The tradeoffs between growth and transfers faced by transition economies are the same in character, as for those of other economies. But they are steeper. As we discuss below the need is greater, but the costs are higher, since the success in moving to productive structures that can compete in the global economy will critically determine future income growth and security (and poverty decline) and because large changes in the capital stock are necessary.

Comprehensive transfers also have important tradeoffs with labor market incentives. They are likely to affect a range of household choices. For example, the option to retire early leads to more people choosing to become pensioners. Unemployment benefits allow more to remain unemployed. More broadly, public transfer schemes can substitute for a range of coping mechanisms to the adverse shock of, for example, losing a job in a state enterprise. It sounds harsh to emphasize coping over caring. Certainly some transfers will be essential. But the whole thrust of this paper is that there are steep tradeoffs that have to be faced.

For a relatively poor country, transfers are even more problematic--and not only for financial reasons. If benefits are introduced at the subsistence level, the gap between the minimum benefits and the minimum wage (which, in turn, cannot often be pitched much higher than the subsistence) becomes so small as to discourage work effort. Such a small difference in income between working and not working will then require extremely detailed policing of individual circumstances (in order to weed out people who should be disqualified for the

4/ There is next to no evidence on the marginal distortionary costs of taxation in market developing countries (Bourguignon's modeling work used a rough figure derived from estimates of the average cost), let alone in transition economies. But in the meantime, judgments on policy choices have to be made.

guaranteed income). This effort is not only beyond administrative capacities of transition economies, but beyond the capacities of probably any economy. This is because the incentive afforded by higher work income (compared to not working) which exists in developed countries and leads people to select work, thereby "eliminating" them from the purview of transfer programs, will be absent in a poor economy with guaranteed minimum benefits.

Table 2 illustrates this point. The gradient of incomes--moving from guaranteed income to average wage--is much sharper in developed economies. The ratio between minimum wage and poverty line ranges from 8 in the UK to more than 3 in the US. It is not, nor can it be, much above 1 in transition economies. **Developed economies can afford guaranteed social protection not only because they are richer (and thus can pay people not to work), but because wages are much higher and many people voluntarily choose to work rather than try to claim the benefit.** In other words, many people in the West, even if offered the guaranteed minimum income would not take it since it would entail substantial losses of income (true even for people who earn minimum wage). But if faced with the choice of practically equal minimum wage or guaranteed income, many people would choose the latter. And this would precisely be the situation in transition economies.

Hence, the nature of the tradeoffs suggests that continuing (or attempting to continue) extensive transfer systems could create intrinsic long-term problems. These are likely to interact nastily in the transition with the enterprise and labor market problems that characterize most transition economies.

**Table 2. Dollar incomes per day (1992-93)**

| | Poverty line | Minimum pension | Unemployment benefit | Minimum wage | Average take home manu-facturing wage | Ratio minimum wage:poverty line |
|---|---|---|---|---|---|---|
| France | 7 | 17 | | 33 | 47 | 4.7 |
| US | < 10 | | 21 | 31 | 65 | 3.1 |
| UK | 5 | 6 | 9 | 32 | 47 | 8.4 |
| Sweden | 8 | 19 | 56 | | 63 | |
| W.German | 9 | | | | 82 | |
| Portugal | 3 | 3 | 8 | 8.5 | 18 | 3 |
| Russia | 1 | 0.8 | n.a. | 0.2 | 3 | less than 1 |
| Latvia | 0.6 | 0.85 | 0.8 | 0.8 | 4 | 1.3 |
| Estonia | 0.6 | 0.5 | 0.5 | 0.8 | 3 | 1.3 |
| Poland | 2 | 2 | 2.5 | 3 | 7 | 1.5 |

Notes: Poverty line per capita for a family of four individuals. The US effective poverty line is less: approximately $10 per capita per day is the federal ("accounting") level which is not used for payments in all states. For Russia, Ministry of Labor line; for Poland and Portugal, this is minimum pension (not a guaranteed income); for Latvia, the WB suggested poverty line.

Unemployment benefits in the UK, Poland, Latvia and Estonia (6 months only) are flat. For the US average unemployment benefit (but lasting 9 months against 12 months in other countries); for Sweden average benefit for 1989. For Russia, the data are from November 1993. For minimum wage, hourly amounts are converted into monthly amounts (assuming 22 working days) and then divided by 30. For all East European countries and Russia, the data are at the end of 1993. Estonian data from Vodopivec (1994).

### *Transfer "needs" during the transition*

So far the discussion focused on the opportunity costs of devoting resources to transfers. These look to be high. We now turn to the value and importance of transfers for the transition economies. These are also unusually high. Where there is an initial reduction the value of transfers rises--since the income fall increases the depth and extent of poverty.

For transitional economies, there are three factors that point in the direction of heightened transitional needs. *First*, demographics: the combination of a large old population and, for most countries, the limited character of extended family networks, implies a *prima facie* need for provisioning for the old that is likely to be larger than in middle income market economies. *Second*, the scale of shock has had much more radical effects on the extent and depth of poverty. With average income declines in the range of 20-30 percent, it is probable that most measures of poverty have gone up by 50-100 percent.[5] *Third*, the political economy of the transition is fragile, especially in the wake of the aggregate shock to incomes: in a society that placed a high value on reducing poverty, the clear priorities would be to shift resources away from the old stuff both into investing in the future and transfers to the poor. However, this may be offset by a combination of a need to reduce income insecurity of the middle class and in practice, greater opportunities for income rises of some of the new (or old) rich.

Hence, the transitional period itself is different. The changes are wrenching at the level of households and private adaptive mechanisms to this kind of adversity may be weakly developed. Moreover the aggregate fall in output constitutes a coincident shock to much of the population and economy, limiting the scope both for adjustments through inter-household transfers and for labor movement to new areas and activities. There are exceptions to this picture--the sudden opening up of opportunities in services probably being the most important, migration to other countries being another.[6] However, the basic picture is one of widespread rises in "needs" for transfers at a time when short-run pressures on revenues add to the underlying and desirable structural decline in the tax efforts (sharpening further the tradeoffs). This is clearly a case of weighing the present against the future but with the tradeoff considerably sharpened. Resources for raising incomes of the targeted group in the present are in competition with resources that invest in the future.

This is a tradeoff for the poor and others temporarily disadvantaged by the transition, as well as for society as a whole, since all the international evidence shows that success in poverty reduction comes fundamentally from getting on to sustainable, broad-based growth paths--that is how East Asia got on to a fast path to eradication of absolute poverty. For other targeted

---

5/ This is purely illustrative. For economies with available information in the 1980s the elasticity of poverty changes with respect to average income or consumption changes was about two (Ravallion, *Poverty Comparisons*, 1994). Given the flatness of the income distribution (and the probable disequalizing changes) elasticities in transition economies are probably higher.

6/ Movement of ethnic Germans to Germany. Emigration of Bulgarians (mostly ethnic Turks) is another.

groups in society (such as retirees) which may not benefit from future growth, the tradeoff is more problematic and depends on the value they place on future generations. If both the value of transfers to the targeted group and for investment has risen, the relative value of other spending must have gone down. What kind? In a simple framework, it is the consumption of the non-poor. In the real world, it can be thought of the whole set of consumption and investment spending tied up with the status quo: examples are wages of an overextended public sector; rents to owners, managers and workers in inefficient protected activities, investment in capital that is only of high value on the old growth path. Once we shift to the real world another point becomes clear: the inter-generational choices in different countries will be reflected in "political feasibility" and shape the nature and extent of the reform of the social transfer society.

*Cross-country Experience*

In the last section we saw that transition economies face sharp conflicts, between the need to reduce transfers for adjustment and growth, and the need to keep or raise them to manage welfare declines and political economy. What does cross-country experience have to say? In this section we briefly review the debate on the role of the state, we compare spending levels between transition and market economies and survey how other groups have dealt with the need to manage insecurity. We look at both OECD and middle income experiences: some of the institutional and demographic features of most of the transition group are like the OECD group; but their incomes are those of middle income developing countries, so both sets of experience may be relevant.

*How much state action?* The transition economies are sharply reducing the role of the state. There has been an ongoing debate on the appropriate role and size of the state for a long time. It is useful to go back to the two objectives of promoting income growth and promoting income security in reviewing this. It is frequently said that the lessons of development history support a high degree of consensus.[7] However, this is probably clearer for the objective of income growth than for the objective or providing for security.

The consensus position on how to promote growth goes something like this. Sustainable income growth and poverty reduction depends on a development process that involves both employment growth and expansion in human capabilities. For employment growth, private sector performance and reliance on markets is key, though the public sector is often important in the provision of economic infrastructure. For expansion in human capabilities, the public sector is key, especially in provision of basic health and education services, though this is often best in combination with private provision and finance, especially for the non-poor. This position both applies to the historical record of OECD economies, and the extraordinary rapid development of the high-performing East Asian group. [8]

7/ The 1991 World Bank *World Development Report* described a version of this consensus.

8/ See World Bank (1993), *The East Asian Miracle*.

There is less consensus, however, on where to draw the line between state and private action on issues relating to income security. For developing economies, the 1990 World Development Report on poverty argued for a role for state transfers, especially where this was to prevent a rise in poverty due to an adverse shock, whether at the household, community or economy level. However, it did not recommend the kind of comprehensive system of social security characteristic of many European developed economies, and in its most developed form in Scandinavia. Such systems always involve a mixture of insurance (e.g. against old age and ill-health) and redistribution (often within one instrument, as in most pay-as-you-go pension schemes, sometimes explicitly via a separate instrument, as with means-tested benefits).

Others, most notably Drèze and Sen[9], have also argued the case for active governmental involvement in provision of income security against adverse risks, and for the use of transfers as one mechanism for reducing poverty. They, in particular, contrast the "growth-mediated security" of countries such as Korea with the "unaimed opulence" of the Brazils of the world. For Korea an effective growth strategy has gone hand in hand with widespread provision of public social services and government activism to deal with adverse shocks. For Brazil growth was also fast, at least until the 1980s, but social services and security lagged seriously behind. Drèze and Sen also argue that poor countries can pursue a strategy of "support-led security" through widespread public provision of social services and transfers, to achieve broad-based improvement in the living conditions of the poor. Sri Lanka's famous achievements in social indicators are an example. However, they, like the World Bank, do not recommend for developing countries the introduction of the social security systems characteristic of rich European countries.

Countries in transition have a different set of initial conditions, as the previous sections outlined. The state took charge of both growth in incomes and security. However, while the state failed, at least for the long run, with respect to income growth, it did a pretty good job with respect to income security and social indicators (though progress was stalling in the latter years of socialism.) Most transition economies have bought into the consensus position on income growth.[10] Reduction of the role of the state, creation of a private enterprise sector, provision of the institutional basis for functioning markets, are all viewed as at the core of the transition to a growing market economy. Not all appear to have the same model in mind. The Czech Republic looks like it heading toward something rather more market-oriented than Chile; others, perhaps Kazakhstan, appear to be tempted by a somewhat more activist East Asian model. However, the direction is clear and broadly in line with the consensus position on how to promote growth. Moreover, there are models of successful middle income capitalist/mixed economies to draw on.

---

9/ See Drèze and Sen, *Hunger and Public Action*.

10/ China is a partial exception, at least in rhetoric, but is not an area of focus here.

As we have seen, things are different with respect to income security. Since most countries have an inheritance of a high degree of state-provided security via the employment guarantee, it is scary to move to greater insecurity--for both political and social reasons--and the response has been to undertake relatively marginal reforms of inherited socialist systems to deal with the post-socialist world. Here the model is closer to the OECD than middle income countries. We've argued above that they face sharp tradeoffs. While different societies may have different preferences for security (for examples, most European societies appear to place a greater value on security than the United States), the question is how much can be afforded without large losses in growth, and provision of other public services, whether for drugs, schools or roads.

Let's first look at spending levels across countries. The share of total resources devoted to public spending varies enormously, but is strongly linked to both incomes and socialist status. As Table 3 shows, there are wide variations in spending, but some clear patterns.

**Table 3. Revenues, spending and social transfers by country group (in percent of GDP; unweighted[a])**

| | Eastern Europe[b] | Former Soviet Union[c] | OECD[d] | Middle income[d] |
|---|---|---|---|---|
| Revenues | 42 | 33 | 35 | 25 |
| Spending | 49 | 43 | 40 | 29 |
| Cash transfers | 15 | 8 | 16 | 3 |
| Health and education | 9 | 10 | 8 | 12 |

Notes:

a. As noted for Table 1, population-weighted numbers are not significantly different for EE and FSU; we avoid GDP-weighted for the transition economies because of issues with exchange rates so we do the same for the other groups for consistency; population and GDP-weighted numbers are not significantly different for OECD countries, and, if anything, indicate even lower state involvement for middle income countries, i.e.,, spending at 21-22 percent of GDP, cash transfers at 2 percent of GDP, and health and education at 5 percent of GDP.

b. 1992, excludes Czech Republic and Slovakia.

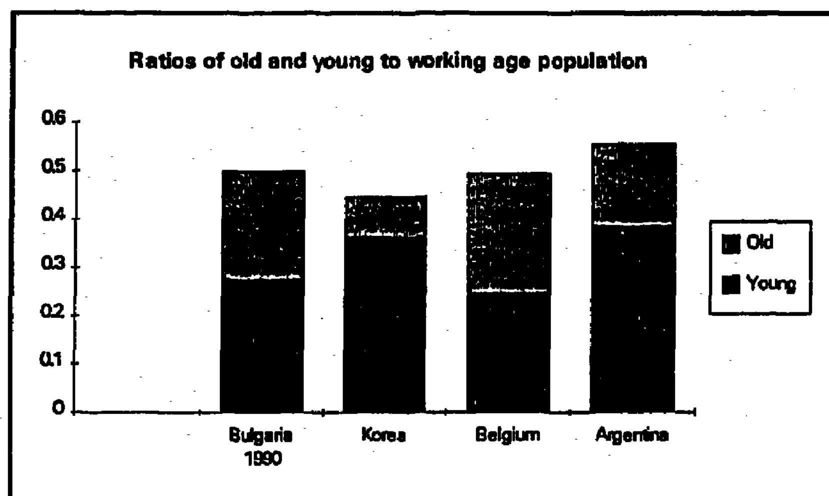
c. 1992, excludes Armenia and Belarus.

d. 1991, 18 OECD countries and 34 middle income countries.

In 1992, total spending as share of GDP in Eastern Europe was above OECD levels, and in the FSU about the same (even before substantial continued "hidden" spending in the enterprise sector of FSU). But there are very sharp differences with middle income countries. Total spending in transition economies is nearly double the levels in market developing economies; the comparison is even sharper if one uses population- or GDP-weighted middle income country figures.

It is clearly a central question whether the transition group should be looking more to the middle income or OECD group to gauge what level of spending on transfers is affordable--i.e to illuminate the steepness of the tradeoffs faced. In demographics most of the transition group are more like the OECD: they have gone through the demographic transition, and consequently have high ratios of old to working age people. However, it is worth noting that overall dependency ratios are not unusually high for transition economies, compared with either the middle income or OECD group. What is different is that share of the old is very much higher. Figure 5 illustrates this for Bulgaria (with Hungary, probably the maturest transition country, demographically speaking), Argentina, Belgium and Korea. This should imply savings on some transfers to children (most of which are in the form of subsidies to education). There is a question of why the old should need more state-mediated transfers than the young, though we take that as a given, at least for the medium term, and especially for the group that have moved more toward a nuclear family mode of social organization. In the third section (see Box 4 on Bulgaria) we illustrate some of the implications for the level and structure of transfers. The fact that there is a high old age dependency ratio only strengthens the necessity for the labor force to be on a path toward rapidly rising productivity.

**Figure 5. Dependency ratios for Bulgaria, Argentina, Belgium and Korea**

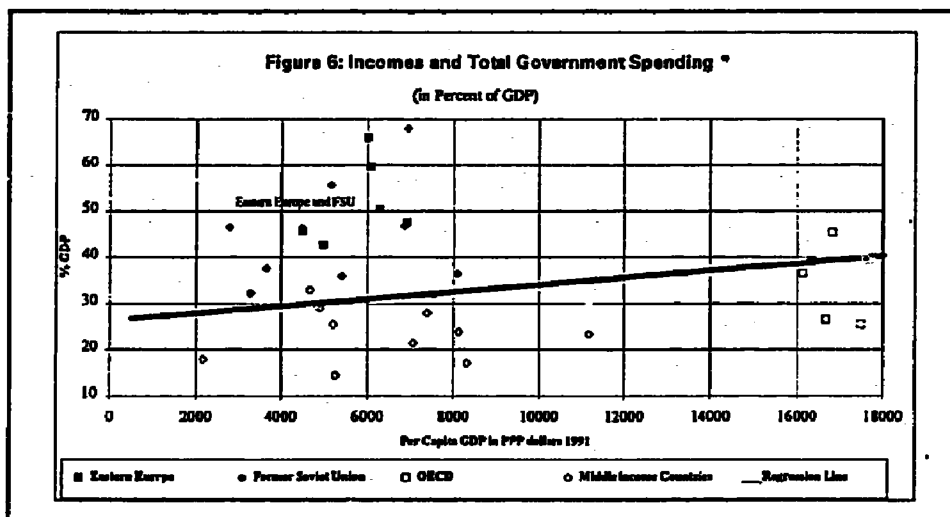



With respect to incomes, however, the transition group are close to the middle income group of market developing economies (and substantially below some, such as Korea). As Figures 6 and 7 shows from plotting total and cash public spending against incomes[11], the socialist group continues to be a clear outlier with respect to income levels, with spending in 1992 substantially greater than other economies of comparable income levels. Revenue is

11/ This uses the World Bank's estimates of Purchasing Power Parity incomes. These are known to be fraught with difficulties, but are the best we have for now. For the FSU group, comparison at official exchange rates would push them further toward the low income group.

already falling (Table 1) and must sooner or later pull spending down with it. A central question is whether the income fall is temporary or permanent. There are reasons for expecting part to be temporary: old tax bases are disappearing while new taxes, such as VATs, take time to be introduced. But they are moving toward a level closer to that of countries of a comparable income level. Is this desirable, or an unhappy consequence of poor tax administrative structures, that could, in principle, be improved over time? We take the view here that it is a desirable move: realization of the income-promoting objective will require an overall tax burden that is consistent with competitive and productive labor forces i.e. more like that prevailing already in East Asian middle income economies, and showing strong signs of prevailing in the Latin American successes of the 1990s. This is confirmed by recent research which indicates that growth is 1-1.2 percent less for every 10 percentage points of GDP in extra spending (see Easterly, 1994). If we take an average expenditure for middle income countries at 25 percent, the transitional countries' expenditures are some 20 percentage points higher. **This translates into an expected loss of 2 percent of GDP growth per year** -- taking into account that the high levels of spending are not now caused by high investment levels.

**Figure 6. Incomes and total spending; transition, OECD and middle income countries**

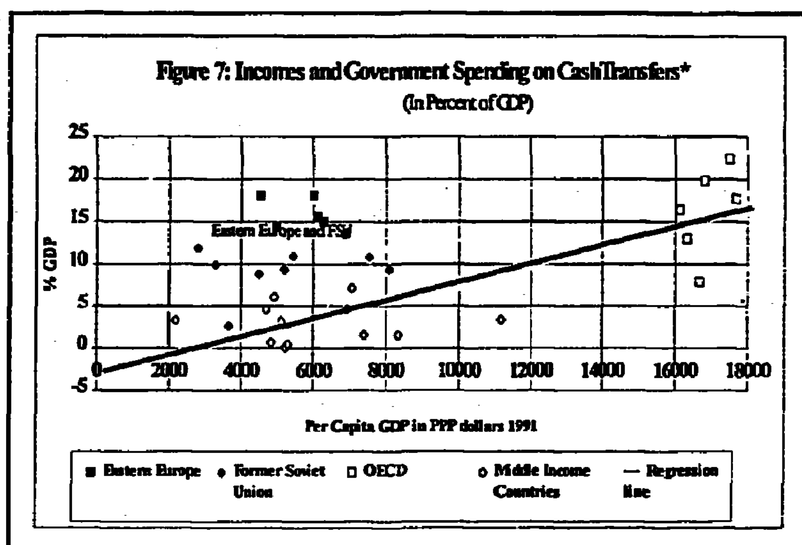



Note: 1991 for OECD and Middle Income Countries, 1992 for Eastern Europe and the Former Soviet Union

What did high spending mean for relative spending on transfers? In general the share of national income devoted to direct transfers was somewhat below OECD standards, but, from the limited amount of information available for middle income countries, appears to be unusually high for the income level. The average level of resources devoted to cash transfers was 15 percent of GDP for Eastern Europe and 8 percent for the countries of the former Soviet Union

(and this excludes implicit transfers through the enterprises), compared with 16 percent for OECD and a mere 3 percent for the middle income developing economies. (Table 3.) Even relatively high transfer Latin America countries are substantially lower, with 3 percent for Costa Rica and 4 percent for Argentina. Korea, with a substantially higher income than the transition group, devoted 2 percent; in the Middle East, Tunisia spent 5 percent of GDP.

**Figure 7: Government Spending on Cash Transfers, Various Countries**

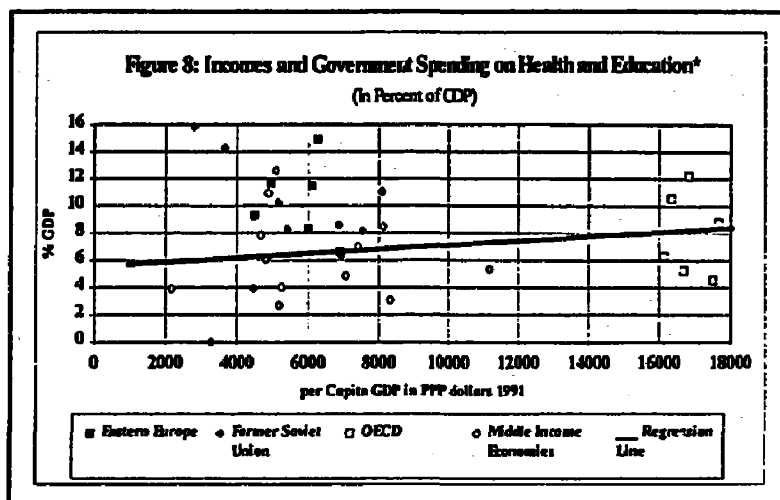



Note: 1991 OECD and Middle Income Countries, 1992 for Eastern Europe and Former Soviet Union.

The story on social spending in kind is somewhat different. The socialist economies had high levels of government spending on health and education, but do not appear to be significant outliner with respect to income levels (Figure 8). Total levels of spending (including private and enterprise spending) on these sectors would probably show a similar story, though it is tough to get information on this: the socialist group also had substantial levels of spending by the enterprise sector, while the market group have substantial levels of private spending.[12] Moreover, in some countries, these have been heavily squeezed, owing to the real decline in government spending, and, perhaps of greater importance, a decline in quality because of problems with provision of non-salary inputs, especially drugs in the former Soviet Union.

12/ For example. for developing countries only half of total spending on health (of some 5 percent of GDP) was by the government (WDR93).

**Figure 8: Government spending on health and education, various countries**




Note: 1991 OECD and Middle Income Countries, 1992 for Eastern Europe and Former Soviet Union.

---

It is not possible to precisely define the best size of state spending. This depends on preferences, and different market economies have similar degrees of success (or failure) with differing levels of public spending. However, it does depend on taxable capacity, and the extent to which higher taxes have costs for efficiency and growth. Almost all the transition economies (with the partial exception of Russia) are essentially small trading nations whose future growth in labor incomes depends critically on competitiveness in the international markets. There simply isn't sufficient physical capital to sustain the productivity necessary to support competitiveness and large tax burdens. In addition, a high tax system provides an incentive not to pay taxes, creating the basis to move toward a pernicious form of dualism, with a (probably protected and stagnant) formal segment with high labor costs and high security for workers (for a while), and an unprotected small-scale sector, and high unemployment. Hence, an appropriate strategic direction for overall spending could be in the range of 20-30 percent--perhaps somewhat more for the Central and Eastern European group and somewhat less for many in the FSU.

One aspect of the tax structure needs to be highlighted: payroll taxes on formal (largely public) sector employees are high by international standards; and very high in relation to income levels (although comparable to levels facing larger industrial enterprises in some middle income countries). Average payroll tax rates for Eastern Europe and the FSU were 40 percent or more in 1992 compared with an average of 25 percent for OECD economies (in 1990). This source of money is generally the milkcow of the pension and employment funds. It has held up

reasonably well in the short term, but at the cost of a high tax on labor, that could constitute a threat to a competitive labor-demanding strategy.[13]

Overall, the international numbers suggest the transition group were high public spenders for their income level. In the transition there may be either a sharper dip, or the need for more distortionary taxation (depending on the cost of spending cutbacks versus the costs of raising money). They are also unusually high spenders, for their income level, on transfer payments, but much less so on health and education. Transfer payments are rising as a share of national resources--explicitly in Eastern Europe, implicitly via credit subsidies to enterprises in the former Soviet Union. Non-transfer spending--notably that related to physical and human capital accumulation--risks being squeezed between falling taxes and high transfer demands.

*How other countries provide for income security*. While few societies have faced the scale of output crash of the transition group, many have faced the question of how to provide for transfers to the old, unemployed and needy. How do they manage?

First, there is the OECD, and especially Western European, paradigm. This is the classic high transfer welfare state. Total cash transfer levels are some 11 percent of GDP for Portugal and over 20 percent for Sweden (and 35 percent if all transfers are included). There is widespread state provision of both (modest) redistributive transfers and (large) social insurance for health, disability, unemployment and old age, plus to varying degrees family allowances for children and social assistance for the poor. Insurance-based transfers are generally on a pay-as-you-go basis, mediated by the government or public fund. Box 1 illustrates the situation in Sweden that probably has the most developed transfer state. What are the issues of importance to transition economies?

- transfers are indeed high (as we just saw, higher than in most transition economies), financed by high taxes. But this is feasible only because of the enormously greater productivity of these economies, because of the larger physical capital stock per worker, and much more efficient functioning and greater human capital.

- transfers have had a very large impact on reducing poverty, but with very large transfers to the non-poor: between a third and 60 percent of all transfers are paid out to the non-poor (see Mitchell 1991, p. 86).

- the OECD economies have indeed grown with high taxes and transfers, but even these countries are debating the appropriateness of their comprehensive systems (see Box 1 on Sweden). The issue now is how to move forward in an

13/ A key question is whether the tax gets shifted to workers, affecting the composition of their remuneration, but not labor costs to the firm. The more this occurs, the less the impact on labor demand; but the incentive to not pay taxes remains.

**Box 1 - SWEDEN: Reducing Entitlements**

GDP per capita in $PPP (1988): $14,941 (about 4 times that of Poland)
Cash social transfers (1987) (excluding pensions): 9.1% of GDP.
Public health care and education spending (1987): 14.5% of GDP.
Inequality: Gini coefficient (1991) 20.

The Swedish welfare system is, of course, the prototype of the "cradle to grave" comprehensive social protection. Many countries, some of them in Eastern Europe, aspire to become "Swedens". "Sweden" conjures the image of high income level, absence of poverty, social solidarity, full security, and low income inequality. This was achieved by sustained growth of GDP and social transfers (and taxes to finance them) since the early 1930s, and particularly fast growth in the period 1960-1983 when the share of cash transfers and health care costs in GDP expanded from 11% to almost 35% of GDP.

The share of social transfers in GDP and household income is higher in Sweden than probably any country in the world. Cash social transfers account for almost 40% of household gross income against 20% in the UK and Germany and less than 10% in the US and Canada. Transfers achieve massive reduction in income inequality. In effect, it is not sufficiently appreciated that income inequality of original (or market) income in Sweden is almost the same as in the United States (the Gini coefficients of about 41-42) implying approximately the same distribution of ownership of physical and human capital. However, after cash transfer Gini coefficient in Sweden is only 24 against 37 for the US. After deducting personal income tax, Swedish inequality drops further to 20 (probably the lowest Gini in the world) and the US disposable-income Gini becomes 32. Thus, cash transfers and direct taxes "cut" market income inequality in half in Sweden, and reduce it only by a quarter in the US.

The existence of generous welfare system was predicated on high income and relatively fast growth resulting in low unemployment rates). With negative growth in the last three years, increasing unemployment, and increasing share of the aged (18% of the population is over 65 years of age) the system is showing strains. For example, the current open unemployment is almost 8.5% of labor force with an additional 5% of labor force enrolled in various retraining programs. This is almost 10% higher than the previous peak (open plus hidden) unemployment registered in 1978. Relatively expensive active labor market policies (retraining, part-time employment in public sector, wage subsidies) for which Sweden is famous are much more affordable while overall unemployment is low. In 1987 with the rate of open unemployment at 2%, Sweden was spending 2% percent of GDP on retraining and 0.5% of GDP on unemployment compensations. The US with an unemployment rate of 6% was spending also 0.5% of GDP on unemployment compensations and one-quarter of percent of GDP on active labor market policies. A simple extrapolation of Swedish numbers indicates that with the current level of unemployment, total cost of active and passive unemployment policies would exceed 10% of GDP. This is not feasible and in consequence the share of resources spent on relatively cheaper income maintenance increases, while the share used for active labor market policies declines. The recent changes in entitlements are relatively modest, but are indicative of the trend since it is the first time since the welfare state was established that the eligibility rules had been made tighter and amounts of transfers reduced. The unemployment benefit was lowered from 90% to 80% of the previous earnings with the first five days unpaid. The receipt of the benefit is conditioned on non-refusal of "suitable" job offers and display of "sociable" behavior (e.g. non-alcoholism). Retirement age was increased from 65 to 66 years. Sickness benefits were reduced from 90% to 80% of earnings with the first day unpaid. Health care user fees were raised.

Source: Based on: Assar Lindbeck, *The Swedish Experience*, Seminar Paper No. 482, Institute for International Economic Studies, Stockholm University, December 1990; Deborah Mitchell, *Income Transfers in Ten Welfare States*, Studies in Cash and Care, Aldershot:Avebury, 1991; Branko Milanovic, "Cash Social Transfers, Direct Taxes and Income Distribution in Late Socialism", *Journal of Comparative Economics*, 1994, forthcoming.

increasingly competitive world--including how to moderate the costs of the tax-transfer system for competitiveness and ensure the human capital advantages are maintained.

- to varying degrees pay-as-you-go pensions are in crisis because of the combination of the demographic transition and slower than anticipated growth; and health care is heading toward crisis because of steadily rising costs.

- there is growing interest (in the UK in particular) in shifting toward private provision of insurance-type transfers.

Second, the East Asian group achieved very large reductions in poverty and improvements in social indicators primarily through a combination of strong support for human resources and a growth strategy that emphasized openness, in products and technological transfers. Some, including Korea, experienced sustained rapid growth in wages and employment (with only small setbacks, e.g. after the second oil shock) with little economy-wide worker protection. There have been use of transfer instruments (apart from the large publicly financed social services) of two broad kinds: first, a gradual introduction of old age and health insurance mechanisms, and more recently, unemployment insurance, but only for the formal labor force; second, government transfers for particular needs, including public works in the 1980-81 recession.

Third, a number of other countries have demonstrated how adequate coverage can be achieved in a non-comprehensive way, with a combination of effective targeting and informal support. Chile is also in the midst of rapid takeoff, but this is in the wake of almost two decades of up and down growth and adjustment. It made much more extensive use of transfers targeted by various kinds of means, including willingness to work for public works; nutrition and health spending have been very well targeted to the poor. (See Box 3). Chile also pioneered the transformation of a pay as you go pension system to a fully funded one. Jordan is an example of a country that has used selective transfers with some success to provide a safety net for the poor.

What are the characteristics of success in balancing the objectives of income promotion and security? Korea is an undoubted leader amongst higher middle income countries; current OECD countries have clearly brought (most of) their populations to high incomes and moderate security, if at a much slower pace than the recent stars; Chile is now at the point of takeoff. These experiences suggest that "growth-mediated security" requires high priority to in-kind transfers in education and basic health (though with rising scope for insurance mechanisms for health as incomes rise); tax revenues to GDP in the 20-30 percent range; high levels of capital accumulation; moderate levels of cash transfers and use of clearly temporary instruments for shielding from recession type shocks e.g. public works schemes.

**Box 2 - EAST ASIA: Growth Mediated Security with Low Cash Transfers**

When it comes to progress in the long haul of catching up with developed capitalist countries, the group of high performing East Asian economies stand out. Hong Kong, Japan, Korea, Singapore and Taiwan, China all made extraordinary strides in catching up with Europe and the US in both income and social indicators. Malaysia, Indonesia and Thailand are now following this first group. Hong Kong's income and life expectancy is now slightly higher than the United Kingdom's, and Japanese have higher incomes and live longer than Germans. Korea's income per head exceeds that of the Czech Republic and Hungary; and Malaysia's exceeds that of Bulgaria, Poland and Russia.[14] In almost all cases growth has been broadly distributed, with a high degree of participation of the poor and middle classes in development. Korea has been characterized as an example of successful "growth-mediated security".[15] Broad-based, rapid growth was effected by two characteristics of their development path: immense expansion in education and health services and enormous growth in the demand for labor over time (at steadily rising skill levels). Also necessary to their success was a strong commitment to macroeconomic stability (with effective response to shocks), export push and openness to foreign technology.[16]

The importance of labor-demanding growth and investment in skills are clear. Are there lessons on cash transfers and social security? There are two categories of lesson. First, transfers were kept low, especially in the periods of rapid growth, facilitating resource allocation to human resource development and prudent fiscal management (in Korea formal cash transfers were less than 2 percent of GDP in 1991). Second, there may be some lessons from the approach to cash transfers, though these are more complex because of the diversity across countries. Also, in one important respect East Asia is different: with the exception of Japan the countries are young. Only 6 percent of Malaysians are over 60 compared with 20 percent of Bulgarians. Nevertheless, the approach to social security had a number of features that are of interest[17]:

- Coverage is relatively limited and linked to formal sector employment. For pensions, coverage is of the order of a third of the labor force in Korea, 40-45 percent for Malaysia and 75 percent for Singapore. However, because of the relative youth of the systems, coverage of the old is much less: 5 percent of the over 60s receive pensions in Korea, 13 percent in Malaysia and 16 percent in Singapore.
- With respect to pensions, none has a dominant plan that is earnings-related, defined benefit and pay-as-you-go. Elsewhere, notably in Latin America, earnings-related public pillars have set off the worst pressures for overly generous benefit levels. Singapore and Malaysia have defined contribution schemes. Hong Kong has a flat, means-tested program, with a large voluntary private occupational pension sector. Japan has a defined benefit scheme, but it includes both a flat-rate benefit (and payment) and an earnings-related component with the possibility of opting out. Korea has only recently started a scheme with a flat-rate and earnings related component--it is flush with funds for now, since hardly any benefits are being paid, and it could well run into the problems now plaguing mature systems as the population ages.
- There has been a pragmatic use of temporary transfers to smooth shocks. For example, Korea used locally based social assistance and public works schemes to help mitigate the shock of the 1980-81 recession. Malaysia temporarily raised rice subsidies to smooth the 1984-87 adjustment period.

The East Asian funds are publicly managed (apart from the occupational schemes), but East Asian governments are outliers in the prudence of their public resource management. Even so, the returns to the Singapore and Malaysia

14/ All incomes in PPP terms.

15/ See Drèze and Sen, 1989.

16/ See World Bank, *The East Asian Miracle*.

17/ Some of this comes from the background work to World Bank, *Income Security for Old Age*, 1994.

**Box 3: CHILE: Efficiency in Targeting**

GDP per capita in $PPP (1988): $4,719 (equal to Poland's)
Cash social transfers (incl. housing subsidies but not pensions): 2.5% of GDP.
Public health care and education spending: 4.0% of GDP.
Inequality: Gini coefficient (1989) 57.

Following the 1973 coup, real wages in Chile decreased by some 30 percent. Trade unions were banned and, when allowed in 1979, severely repressed. Income distribution "worsened" with the Gini coefficient incr-asing from less than 50 to 57. However, at approximately the same time, the government introduced a number of social programs (ranging from public works to hot meals for the poor children) whose objective was to alleviate poverty and reduce social tensions. Chilean approach clearly falls under the category of residual welfare: while the free market was let to determine incomes, welfare spending were to be directed to the poorest of the poor.[18] Targeting came to the forefront of government interest, and lots of effort were expended to devise the "best" programs and --very importantly-- to follow up their implementation. Monitoring enabled the authorities to improve the existing programs and to introduce the new ones. Thus Chile became, somewhat unexpectedly, associated with some of the best practice in the field of poverty targeting.

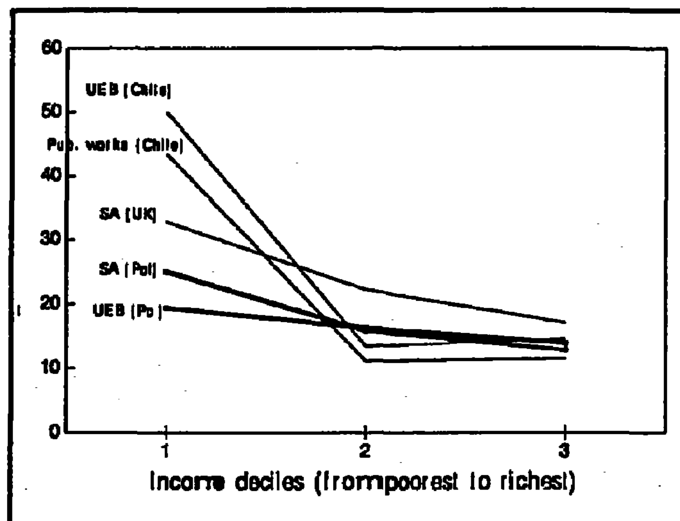
Box 3, figure 1 illustrates the targeting efficiency of five Chilean programs. They are public works, unemployment benefits, school lunches (not shown in the figure), special family allowances paid to the poorest, and state pensions. The last two are means-tested ("means" here represents a combination of information on ownership of durable, education, employment etc, but *not* income), school lunches and public works rely on self-selection, and unemployment benefits are paid to those with contribution records. The five programs accounted in 1987 for almost 60 percent of total government cash transfers (excluding the contributory pension system) or just over 1 percent of GDP. The two poorest decile of the population typically receive between 50 and 60 percent of the total amount of each transfer, with the very poorest decile receiving between one-third and one-half of total transfers. It is noteworthy how strongly targeted on the poorest decile are unemployment benefits and public works: the share of the transfer received falls from about 50 percent for the poorest decile to 10 percent for the second poorest. Expressed in terms of a synthetic indicator like the concentration coefficient, the efficienc_ of the five programs was very high: for each program, the concentration coefficient (in absolute terms) is higher than or about -50. (The more negative the value, the greater the concentration on the poor.[19]) For comparison, the best targeted programs in the UK (income support, family credit and housing benefit) have the concentration coefficients ranging between -45 and -55. However, the best targeted programs in Eastern Europe (child care and family allowances) have concentrations coefficient between -25 and -30 where the poorest decile of the population receives less than one-fifth percent of the total amount of transfers (see Box 3, Figure 1).

---

18/ This approach is reflected even in the title of the book from which most of the calculations presented here are derived: *Effective social expenditures: an instrument for a definitive overcoming of critical (sic) poverty.*

19/ Efficiency is defined following Beckerman (The Impact of Income Maintenance Programs on Poverty in Britain 1975, *The Economic Journal*, June 1979, p.261) as the reverse of the "leakage", i.e. of benefits received by the better off (the "non-poor). Thus, higher (in absolute amounts) the concentration coefficient higher the efficiency.

**Box 3 Figure 1. Targeting of Social Transfers in Chile, UK, and Poland**




Note: Chilean data for 1987. UK data for 1991. Polish data for 1993.

*Growth, security and transfers*

We have surveyed the tradeoffs between the needs for growth and restructuring and the needs for transfers of transition societies. What does this all mean for transfer level and design? First, there is a strongly non-linear relationship between the two objectives of providing for income growth and providing for income security. Figure 9 summarizes in a stylized form the nature of the relationship that would be indicated by the above discussion. On the vertical axis we have put growth--say the *medium-term* growth rate following the immediate shock and decline with the collapse of communism and the internal Comecon market. On the horizontal axis, we have put "security", as a catch-all for the avoidance of income declines in the *short run* through the use of state-mediated transfers. Both are deliberately without numbers since the pattern of tradeoffs will depend on institutional features of the economy, notably the extent to which taxes can be raised without causing severe distortions. The stylized line is divided into four segments:

- at low levels of security, there is a positive relation between more growth and more security (from A to B). In the transitional social contract some security is conducive to growth: to provide at the societal level enough assurances of stability; to avoid a pensioner revolt that would pull down governments; and to provide the safety net that will facilitate firm restructuring. And at small levels of transfers, adverse affects on growth are very limited.

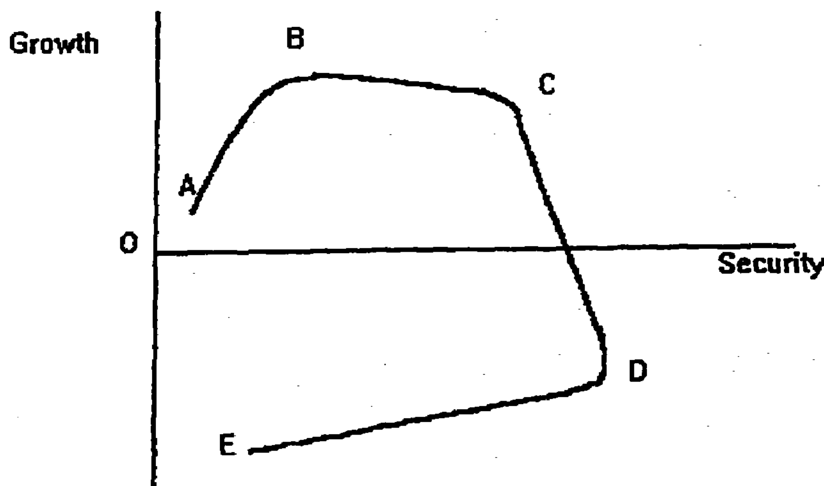
- at moderate levels there will be a tradeoff with growth, but this is likely to be relatively flat (from B to C). Probably much of the OECD falls within this part of the curve--societies may choose where they want to be along this line (e.g. most European countries clearly prefer more security, if at some cost in growth), but the tradeoff is not very steep.

- at high levels the tradeoff steepens sharply (from C to D)--for the reasons discussed above. Most transition economies are somewhere along this segment.

- when growth collapses, security is also hit (from D to E). This will often be associated with attempts to have high levels of transfer *ex ante*, that fail *ex post*, as in the collapse scenarios.

Second, to some extent the relationships may shift depending on the design of transfers. We have emphasized that some of the transfers should be intrinsically transitional, and designed to avoid adverse incentives for economic restructuring and the labor market. However, the macroeconomics of the tradeoff is largely a function of aggregate transfers levels, for which design is relatively unimportant, especially in the short run. (In the longer term, funded pension schemes, for example, may have more favorable savings properties than PAYG schemes.) We turn next to key issues in managing the level and design of transfers.

Figure 9: Stylized Relationship Between Growth and Security



## III. MAJOR DESIGN ISSUES FOR TRANSFERS: UNEMPLOYMENT INSURANCE; PENSIONS; AND SOCIAL ASSISTANCE

There is indeed a case for higher levels of transfers during the transition relative to the long run vision of transfers consistent with growth--for both poverty and political economy reasons. Supporting consumption of those that may be hurt is a good investment, provided it buys the required policy and institutional changes. However, this argues for transfers that are an intrinsic feature of the transition, and that automatically fade away. This would suggest transfers that facilitate restructuring of firms but not those that encourage permanent withdrawal from the labor force and long-term entitlements. Severance pay or short duration unemployment benefit are good by this criterion, early retirement bad. Because of the complex problem of balancing the creation of new jobs with the destruction of old jobs--and the irreversible costs of long unemployment spells--there is case for designing some of the temporary transfers to make them conditional on work, whether in form of wage subsidies or public works. To illustrate what a significant cut in transfers levels might mean, we undertook a simple quantitative exercise for Bulgaria (see Box 4). In this section, we then discuss three of the major categories of transfers, relating to unemployment (and employment), pensions and social assistance.

### *Unemployment Insurance and Temporary Employment-Related Assistance.*

Most transition countries have introduced unemployment insurance, with benefits for workers who lost their jobs for a limited duration (usually up to a year), combined with severance payment obligations of enterprises. These are quite appropriate to the transitional labor market shocks.

Question: Should unemployment benefits be earnings-related or equal for all?

General practice so far has been to have earnings-related unemployment benefits. This is also the practice in Western Europe and the USA. However, it may be useful to consider the alternative of flat-rate unemployment benefits (as introduced in Poland and Estonia), combined with a modest supplemental earnings-related severance payment upon unemployment, at a level not inhibiting initial hiring (equivalent to, say, 3 months income). The rationale for earnings-related unemployment benefits is that they are indeed insurance premia—paid out of earnings-rated individual contributions. Thus if contributions are unequal, it is only fair that the benefits be unequal. This rationale, however, does not hold in transition economies because there was no unemployment insurance prior to transition—no one paid anything toward that. Furthermore, because of the sudden and massive character of unemployment, unemployment benefits have more in common with temporary welfare payments to a specific set of individuals (one can think of them as categorical social assistance) than with unemployment insurance in its strict sense.

**BOX 4. AN EXAMPLE OF ALTERNATIVE TRANSFER LEVELS--BULGARIA IN THE MID-1990S**

In Bulgaria, transfers already accounted for over 12 percent of GDP in 1992, with pensions by far the largest component, at 9 percent of GDP. Bulgaria has an old age dependency ratio comparable to Belgium's, yet it also has a retirement age of 55 for women and 60 for men (with special earlier retirement for selected occupations.) Fiscal pressures are immense: despite a revenue ratio of the order of 50 percent of GDP and sharp falls in government wages. The social security and unemployment funds have not yet gone into deficit, but only with a payroll tax rate of 49 percent. This source is under pressure owing to a rapid decline in its base: the share of public wage employment in the total labor force has dropped from around 95 percent to 60 percent by 1993, and there are few collections from small private firms.

We constructed two scenarios, illustrated in Box 4, Table 1 that represent potential outcomes in the mid-1990s. For both we divide the population into children (below 15), potentially working age (15-65) and old (over 65). In the first, we take the 1992/93 position as the base and assume that there is no change in the share of transfer recipients from each group, including no change in the age of retirement. We do assume a continuing fall in the share of the formal sector (tax-paying) in employment, to about 50 percent. The result is a share of transfers to GDP of about 13.5 percent of GDP and contributions of almost 9 percent of GDP.

For the second scenario, we aimed to cut back transfers in a manner that most protected the poor. We were guided in part by evidence on the distributional incidence of different transfers from the 1992 household expenditure survey. This found pensions to be by far the most equitable transfer instrument (especially for the over-65s), child allowances mildly disequalizing, and unemployment benefit having the same impact as the underlying wage income. We then explored the implications of cutting child allowances to 50 percent of children (e.g. through some rough means-testing), reduced eligibility of the under-65s (through rapid rises in the retirement age), and reducing replacement ratios on all transfers (to the average wage) by about a quarter. We then increased the social assistance program by about 2 times--this could be used for public works schemes at low wages, for example. Finally we cut payroll taxes in half, but assumed that at the much lower rate the share of formal wage employment would recover to some 75 percent of the labor force.[20/] These measures cut total transfers to 8-9 percent of GDP and payroll taxes to slightly below 7 percent of GDP.

This can be viewed as an exercise of what could be feasible over a period of a few years, assuming that some gains could be achieved from raising the retirement age, but without withdrawing pensions from those already retired but below 65. Over a period of 5-10 years, raising the retirement age to 65 for both men and women, would reduce the number of below-65's receiving old age pensions to close to zero, and total transfers to some 7 percent of GDP.

20/ Two effects could operate: more firms choosing to be within the tax net; and, if payroll taxes affect labor costs to the firm (theoretically an open question), higher labor demand in the formal sector.

**Box 4. Table 1. Transfer levels under alternative assumptions**

| Age | Share of population | Current policies | | | Radical reform | | |
|---|---|---|---|---|---|---|---|
| | | % of group receiving transfers | Replacement ratio | % of GDP | % of group receiving transfers | Replacement ratio | % of GDP |
| 0-14 | 19 | 100 | 12 | 1.9 | 50 | 10 | .8 |
| 15-64 | 66 | | | | | | |
| Unemployed | | 3 | 32 | 0.6 | 3 | 25 | .5 |
| Old age pensioners | | 15 | 37 | 3.0 | 10 | (30) | 1.7 |
| Other pensioners | | 6 | 37 | 1.2 | 6 | 30 | .9 |
| Sick and maternity | | - | - | 1.5 | - | - | 0.5 |
| 65 and over | 15 | 100 | 37 | 4.8 | 100 | 30 | 3.3 |
| Social assistance | | - | - | 0.4 | - | - | 1.0 |
| Total | | | | 13.4 | | | 8.7 |
| Payroll tax rate | | | | 49 | | | 25 |
| Share of wage employment in labor force | | | | 50 | | | 75 |
| Tax receipts | | | | 8.8 | | | 6.7 |
| Net financing | | | | 4.6 | | | 2.0 |

Eligibility for unemployment compensation should be quite restrictive, for example, excluding school leavers and requiring extended previous employment.

Question: Who should bear the cost of severance pay?

Severance payments are generally obligations of enterprises. This has some advantages. If the government is always expected to pay, moral hazard problems may emerge: enterprises may either recklessly or intentionally hire and fire workers in order to collect (or split with workers) the severance payments. Government obligations could be confined to cases of enterprise liquidation and as financier of last resort; and that limited role may even prove infeasible where economies are heading toward fiscal collapse. The option of receiving severance and unemployment insurance payments in a lump-sum fashion should be encouraged so as to

increase the probability that some of the otherwise unemployed will enter and succeed in self-employment, for example, in the expanding services and trade sectors. There is thus a trade-off even with severance pay. Its positive feature is that it provides the unemployed with a sum of money they would be unlikely to have saved otherwise and opens the possibility of starting a small business. Its disadvantage is, when paid by the state, the moral hazard issue, and when paid by enterprises, its deterrence to hiring (if the worker turns out to be redundant later, the cost of lay-off is increased, and firms may try to avoid this by simply hiring fewer people).

Question: Are there chances for the unemployed to start their own businesses?

It is still too early to say how common are such opportunities. It depends on the country (how easy or difficult it is to start a small business) as well as on characteristics of the unemployed (a semi-skilled steel worker in his 50s is less likely to go into small business than a thirty-year old computer programmer). Preliminary evidence indicates that there are job opportunities available in the private informal sector. Many are being tapped already as a source of secondary income, including by the unemployed. But small business creation, while it can alleviate the unemployment problem, is unlikely to represent a full solution. Greater demand for labor and retraining are more realistic options.

Question: But since greater labor demand and retraining either take time or are very expensive, what else should be done in the short run?

In recognition of the particularly insecure situation facing workers in the next couple of years (when massive enterprise privatization and restructuring gets underway and until the emerging private sector invests heavily), special but temporary measures are entirely appropriate; unemployment compensation and/or severance packages may not be enough. Particularly in hard-hit regions and one-company towns, one should encourage experimentation in a variety of programs to see what works best under different circumstances. Experimentation could include temporary employment programs, either public works schemes paying below market wage or wage subsidy programs (marginal employment subsidies for new hires by the private sector from the pool of unemployed). In Spain, for example, workers were given a menu of options, including whether to take severance payment or carry a wage subsidy to prospective employers. Evidence from Poland and elsewhere indicates that employers demand better skilled workers under wage subsidy programs (so that the low-skilled long-term unemployed are often not picked up) but also—on the positive side—that the likelihood of finding the "real" job is greater than with public works. There may well be a *prima facie* case for experimenting with discretionary programs of transitional protection of employment in isolated depressed regions (e.g., one-industry towns) in the non-negative value added activities. The focus would be on overcoming resistance to enterprise and farm restructuring through use of temporary measures, avoiding putting in place welfare mechanisms extending beyond the immediate transitional period.

Question: What could be the role of public works?

Public works schemes may be targeted to the residual long-term unemployed. They are an effective option to prevent poverty and slow-down skill obsolescence. A difficulty with such

programs is that the ability to self-target via the wage, which is one of the main advantages of public works as it economizes on the scarce administrative capacity of the state,[21] is limited in those countries where many workers are already bunched around a low market wage. This indicates that such programs are likely to be more successful in isolated pockets of high unemployment among lower educated workers. This reinforces the point that experimentation, including the role played by the public works, should be decentralized.

To maximize collateral effects and avoid the selection of inefficient infrastructure supported under the program, the programs would need to be limited to clear cases of public underinvestment such as environmental clean-up. Simple public works (such as roads and irrigation) are also likely to be more appropriate in rural areas than in urban areas.

Question: Wouldn't these programs crowd-out private labor demand? What is the tradeoffs between the possibility of crowding out and letting more people be unemployed for longer time than necessary?

There is indeed the potential that public "job creation" programs simply substitute for jobs that would be anyway created by private and public enterprises. Evidence from Poland indicates, however, that participation in both public works and temporary wage subsidy programs is negatively correlated with the level of demand in a locality, supporting the view that these programs do not crowd out other employment and would naturally decline as labor demand recovers. This evidence also reduces the concern that the wage subsidy would be paid for employment that would have been given anyway. The alternative of not having such a program risks higher and longer unemployment, combined with faster skill obsolescence (than if people do some work) and growing discouragement and frustration. All of these are socially costly effects.

Question: What role does training play?

The problem in the transition is primarily lack of aggregate labor demand. Such employment-related programs are designed to make up for temporarily insufficient labor demand, as the process of resource reallocation to the private sector takes time. It is important to recognize that in that context training may merely displace one worker for another. There is indeed a shortage of market-oriented skills, e.g., in accounting, banking, diverse services. However, private returns for such market-oriented skills appear to be sufficiently high to encourage private sector provision. It is less likely that the long-term unemployed will have the background to compete for such training. Evidence from Poland indicates that the long-term unemployed are largely young low-skilled workers or older people, often older women, with low educational attainment and with low or narrow skills. Such groups would need to be assisted through efforts to raise basic human capital in combination with psychological and vocational counseling to address issues such as low morale.

---

21/ See Dreze and Sen (1989, pp. 113 ff).

Question: Isn't housing the most serious constraint to mobility and, hence, employment opportunities?

Mobility is one of the most important constraints to employment in the transition period, and, in this regard, housing is a major constraint. The employment-related programs would need to be complemented with an urgent reform of housing policy to encourage both the release of the existing housing stock onto the market and the completion of new units.

*Pensions*

Pensions are both a central and difficult area for reform. They are central for two reasons: the sheer size of pensions in total transfers (if total transfers are unaffordable, something has to be done about pensions); and the longevity of this form of transfer. Throughout the world pension "entitlements" do get lost or eroded, [22/] but it is obviously implausible to think of pensions as a transitional feature of the next few years! They are difficult because of the nature of the tradeoffs. Given the need to lower the claim of public pensions on current and future economy-wide resources (both benefits and contributions), how can governments substantially pare down the inherited publicly-funded PAYG pension schemes? At the same time, how can the economy provide for older groups who have worked all their lives and formed expectations with regard to their pensions?

The process and dilemmas are likely to be different for the economies already wrecked by inflation or heading toward collapse and those headed toward sclerosis. In many of the FSU countries, notably the Baltics and Russia, and in Bulgaria in the Eastern European group, reducing entitlements under the previous system has already largely been done through inflation whittling down--in some cases excessively--the level of real benefits. Replacement rates are closer to 30-40 percent and there have been large real declines in pensions. For the collapse economies such as Ukraine the inability to pay benefits has resulted in disprotection and non-fulfillment of previous social contracts, such as arrears in paying benefits at the same time that near hyperinflation is reducing the value of those benefits. In both cases entitlements by and large are being eroded in an unplanned and ad hoc manner. The full extent of the problem remains for the lower inflation countries and those where indexing has become the practice such as Poland--those where transfer systems are continuing, pensions represent a sizeable share of GDP, and sclerosis may be setting in.

It is useful to distinguish between the pension system for existing and soon-to-retire pensioners, and younger workers. Long-term reforms for future retirees is essential, since this will affect the behavior of wage-earners now and the income position of both the government and

22/ See World Bank, *Income Security for Old Age*, 1994, for documentation of erosion of seemingly government-guaranteed entitlements.

pensioners for decades to come. We come to those tradeoffs below. But decisions on reforms for existing or near retirees are key for the short run: whatever the nature of long-run reform over the next five to ten years, there are important tradeoffs in assessing the savings that can come only from reforms within the existing public system. The approach to pension reform raises some contentious issues, particularly for the older cohorts, but also for younger generations.

More important, the failure to address those contentious issues squarely can have grave consequences. An unstrategic and ad hoc response to the pressures of fiscally unsustainable pension schemes tends to hit precisely the groups most in need of protection during the transition. One of the strategic objectives is that categorical programs such as pensions play a role in transferring income to otherwise poor households. In the face of high inflation, benefits levels are reduced by the same proportion for all pension income groups, (in fact, after taking into account increasing nominal transactions costs of picking up a pension check, levels are reduced more for those receiving the minimum pension). Similarly, in the case of arrears, all pension income groups are affected in the same way. Those households which rely solely on pension income are being pushed into a desperate situation and are disproportionately affected by the lack of a strategy for a sustainable pension program. Also, a failure to deal with the provision of benefits or to restrict eligibility means that in an ad hoc manner there are less pension fund resources for adequately funding the minimum pension levels or for providing pensions to those--generally older--pensioners without alternative sources of income.

Given the potentially grave consequences of failing to face the tradeoffs squarely, we now turn to the contentious short-run issues which need to be addressed, focusing first on the question of eligibility and retirement age and then to the question of entitlements and benefit levels.

*Restricting eligibility.* A significant increase in the retirement age (say to 65 with gender equality) and elimination of most early retirement schemes is the critical step for the sustainability of the public PAYG system for the medium-term. This is already under discussion in most countries (e.g. the Bulgaria white paper recommends gradually raising retirement to 63 for both men and women; Slovenia and Estonia already raised the retirement age).

Question: How fast and far can eligibility be restricted? What are the tradeoffs?

The faster and further the retirement age can be increased, the more room for manoeuvre there is for maintaining the real value of pensions. It is also desirable from a labor market viewpoint, except from a very myopic perspective. Reducing the size of the labor force is bad, not good, for growth[23/]. It reduces contributors to social insurance schemes, when this takes the form of payroll taxes, as well as raising outflows to pensioners. It is also bad for macroeconomic management to the extent there is a tradeoff between inflation and labor market

23/ Of course, to the extent pensioners remain in the labor force--as many do, in the informal sector--there is not an economic loss, only a double fiscal burden, through the increased transfer and the reduced contribution.

pressures. (See below for the question of competition between the young and old for jobs.) The problem with raising the retirement age quickly is that the previously near-retirees would have little chance to adjust to a situation where retirement would be delayed and that the inequity between those who just retired and those who were soon to retire would be sharp. In view of this, several countries in the region have adopted a more gradual formula, eg, increasing the retirement age by 6 months every year, but that means more adjustment having to come from elsewhere.

Question: What to do about early retirement?

Early retirement is an expensive option relative to other measures of supporting restructuring, including severance payments for the unemployed discussed below. To the extent support to unproductive workers is required in the transition, it is much better if this is temporary. For example, wage subsidies are a less costly option than early retirement because the affected workers eventually return to full-paying jobs at a later stage as conditions improve (and wage subsidies are generally lower than the cost of a pension while they are used).

Question: If retirement age is raised would young people have more problems finding jobs?

In general, inexperienced new entrants to the labor force are not close substitutes for experienced ones. Evidence from transition economies indicates that levels of youth unemployment relative to unemployment of older workers are comparable to those of non-transition economies. At the same time, there may be a number of older workers who are without the technologies and skills required to be absorbed into the emerging labor markets and who are not easily retrainable. Unless the young have opportunities for education and training, the old workers could well compete with the young for the low-skilled jobs. This strengthens the need to refocus expenditures on human capital development to avoid such a problem. The much-admired German system indeed has strong links between education and training and the transition to work. But another feature is that it allows companies to pay lower effective wages for young workers, in exchange for the lack of experience and training.[24/] It makes sense to relax minimum wage rules for the young. Other pro-labor elements,,such as lower labor taxation, also will increase aggregate labor demand and so offset competition between older and younger workers.

*Confronting benefit levels and replacement ratios.* In any case, it is unlikely that raising the retirement age will be sufficient for an immediate impact. To have a significant impact on spending it would have to be combined with reduced replacement ratios (and even more reduced real levels) relative to inherited entitlements. Where there have already been real reductions through inflation, as in the Baltics, the issue is one of holding on to the adjustment that has

---

24/ See Heckman, Roselius and Smith, *US Education and Training Policy: a Reevaluation of the Underlying Assumptions behind the New consensus.*

occurred. These changes would then allow significant reductions in contribution rates or tax allocations (see below for the issue of payroll taxation). If pension contributions are designed to be of the order of 20 percent of payroll with benefits targeted at 30-40 percent of average wages, this would represent 4-6 percent of GDP for a country with a moderately mature population such as Bulgaria or Poland, or somewhat less for a country with a relatively young population such as Uzbekistan or Kazakhstan.[25/] After an initial adjustment, there should be some form of indexing, preferably linking pensions partially to changes in consumer prices (to give the guarantee of some real protection) and partially to average wage developments (so pensioners share in economy-wide losses and gains).

<u>Question:</u> How to ensure intergenerational equity between the current young and the current old?

The old and young have conflicting interests. The old have an interest in maximizing their share of the (currently declining) cake; pensioners worked all their lives under socialism and may reap few of the benefits of a capitalist future. Pensioners also tend to be big on voting. The young, on the other hand, have an interest in investing in their future wages, via education and through fast transition to a development path consistent with rising labor productivity.

Which way income transfers between generations goes depends a lot on how quickly and how strong the recovery is. If pensioners are relatively protected (as in Poland, for example) and especially if this also slows the pace of transition and recovery, then present and future workers are going to be transferring income to current retirees. If pensioners take a large hit, as in the Baltics, and the economy bounces back, but pensions stay low, then the transfer implicitly goes the other way. Even in the latter case, it is highly likely that the current groups of workers will have to both start building savings for their retirement (e.g. via funded schemes) and finance transfers to the old.

This is an issue of balance, that will vary from country to country. But in all a simple principle is likely to make sense: that pensioners should share some of the aggregate income decline that is occurring in the transition, and should also share some of future wage growth via the partial linking of pensions to average wages.

<u>Question</u>: Aren't the old pensioners now generally in a less favorable position than the young?

The old are more likely to be both relatively poor (especially when pensions are linked to previous wages without an adequate inflation adjustment!) and relatively ill-equipped to work. But for pensioners in their 50s and early 60s, the scope for returning to work is both higher and already occurring. (In many countries of the former Soviet Union some 15-20 percent of pensioners work.) But if anything, pension schemes are discriminating against older pensioners.

---

25/ In the Bulgaria case (Box 4, Table 1), a 30 percent replacement ratio leads to a pensions of slightly above 3 percent of GDP for the over-65s, but Bulgaria's wages are only 80 percent of per capita GDP. We also expect there to be some pensions for the below-65s in the short to medium term.

To the extent earnings-related components of benefits are linked to nominal values and in the face of inflation, the earnings-related base is far lower for older pensioners than for younger pensioners. Early retirees among pensioners are being favorably treated in an actuarially unfair manner given that benefit levels in most countries are not related to contributions, and sometimes not even to years of contribution. Introducing a link between benefits and years of contribution could go some way in redressing that actuarial inequity as well as encourage near-retirees to stay on the job longer and enhance their labor force contribution.

Question: What are the tradeoffs between flat-rate and earning-related benefits?

Flat-rate pensions are attractive from an administrative perspective. They are also most likely to encourage those with higher capabilities to stay in the labor force (formally or informally). However, some differentiation is probably a necessity to preserve social cohesion--and avoid pensioners voting reformist governments out of office. In most countries some version of the formula: pensions = flatrate component + b* past earnings, (where b is a fraction) will be appropriate. However, the value of b has to be quite low for overall affordability.

An additional way of compensating existing pensioners for lower and more compressed incomes could be through participation in the distribution of wealth--the wealth that they did indeed help create in their working lives. This is happening already with respect to housing in some cases (in Bulgaria most housing was in effect given away to incumbents, with the old disproportionately represented). Consideration could also be given to preferred allocations of shares in privatized enterprises. This will depend on the form of the privatization scheme, and there may be competing uses for this source from future retirees: e.g. in Latvia there are plans to use part of the shares of privatized companies to contribute to a funded pension plan (something of potential importance to middle-aged workers who will not have much time to build up savings for their future pensions via a funded scheme). In Moldova vouchers are being given in relation to years of work.

Question: What is the tradeoff between cutting back on pension schemes and creation of a poverty group of pensioners, thereby exacerbating poverty in transition economies?

Evidence in many countries indicates that pensioners now are not disproportionately amongst the poor, though the situation is very different in Poland, where they have been relatively protected and are half as likely to be poor as other groups in the population, and in Russia or Bulgaria, where they have been relatively hard hit. Even in Russia, recent results suggest that pensioners are, if anything, slightly underrepresented amongst the poor.[26/] As already noted, many pensioners continue to work, especially in the 50-65 years cohort; some even in the same job. While it is true that pensioners over 65 years may have little opportunity to enhance their income through jobs, many pensioners of both cohorts have access to housing,

26/ Preliminary results from a probit analysis of poverty in Russia by Mark Foley from the 1993 RSLMS "Determinants of household income level and poverty profile for Russia".

providing in-kind income for their households, although there continue to be problems converting this wealth into income. In addition to maintaining a basic pension for all as a safety net for pensioners, public spending on basic health services will be of especially importance for the old.

Question: Is there a tradeoff in terms of reneging on benefit entitlements, jeopardizing the credibility of the remaining contributory scheme and, hence, increasing evasion?

To remain credible and maintain intergenerational cohesion, the younger generation should maintain some flow to older generations. But it should be made clear that the system was not going to be economically able to provide the promised high benefit levels for so many post-retirement years. The transitional PAYG system would be expected to gradually shift to a first pillar, in principle redistributive and general revenue-financed. Additional pillars would have the characteristic of stronger linkages between contributions and future benefits. The credibility of such schemes will have to be earned over time. However, this is not a good reason to maintain unaffordable benefit levels now: since these require large and rising payroll tax rates on an already declining tax base, these are as likely to raise as reduce tax evasion.

Question: With the earnings-related component significantly reduced, how will pensions help the labor force achieve its objective of smoothing income over the lifetime?

Some differentiation of pensions is probably desirable on political grounds for existing and soon-to-retire pensioners, but significantly more compressed than the wage structure. For current workers there is certainly a need for schemes to smooth income, but these should as far as possible be linked to individual contributions. As discussed above, this could be through mandated funded schemes, company or individual based private savings schemes, or contribution-related public schemes.

So what of longer-term reforms? As pressure grows to reinstate those entitlements once the economy stabilizes, as in the Baltics, more permanent arrangements will need to be made to sustain some realization of the gains from the squeeze on previous entitlements and the increase in retirement age. Possibly, the nature of longer-term reforms also can reinforce the willingness of workers to confront the other tradeoffs associated with the current PAYG system. The twin objectives of providing a safety net for the poor and consumption-smoothing for the non-poor is probably best served by a system with more than one "pillar".[27/] Any system should have at least a modest public PAYG pillar with a significant redistributive component to meet minimum income objectives. This would then have to be complemented by mechanisms to provide for higher pensions for the non-poor via earnings and contribution-related mechanisms. There are various ways in which this can be done: through use of individual accounts in a public scheme, through a mandated privately-managed fully-funded or through the encouragement of occupational-related schemes. There are good general arguments for having funded, privately managed schemes forming part of the long-run package, but the choice over this, its design and

27/ See World Bank, *Income Security for Old Age*, 1994, for a full discussion of issues in pension reform.

timing will often be country-specific. Three considerations will often apply. First, the more expected benefits are linked to contributions the less are the incentives to evade (that is key for public finance) and adjust labor demand or supply (that is key for growth and employment)--this clearly favors funded schemes. Second, however, while funded schemes have attractive properties, it may be tough to mandate significant contributions in the early phase of the transition when incomes are declining or stagnant (not least because workers will still be financing existing retirees). There may also be limitations on introducing privately managed funded schemes where capital markets are weak. Third, it is important that occupational schemes operate within a well-developed regulatory framework to protect workers from future collapses, and protect governments from *de facto* entitlements--and with requirements on funding and (preferably) vesting and portability, it is unlikely that they will make a major contribution to pensions in the short run.

### *Social Assistance*

One of the policy areas with significant trade-offs is the design of social assistance with the objective of alleviating poverty. How can a program avoid covering too many households, with negative fiscal consequences combined with negative labor market effects? At the same time, how can a program minimize the risk of failing to reach the poor with truly no alternatives? At one extreme a comprehensive program of means-tested monetary assistance aimed at guaranteeing a minimum income runs the risk of covering too many households. An alternative approach emphasizes the role of households and the community in preventing households from falling into poverty, with the state narrowly targeting its assistance.

Question: What are the tradeoffs with respect to the labor market?

As graphically pointed out in the discussion of choices and tradeoffs in section II, public transfer schemes generally, and guaranteed income programs particularly, can substitute for a whole range of mechanisms to cope with adverse shocks, such as loss of a job. In many of the countries of eastern Europe and the former Soviet Union where minimum wages have fallen and where the resulting gap with the subsistence minimum is quite small, guaranteed income programs provide a strong incentive not to search for work and engage in other income-generating activities. Other coping mechanisms are likely to be used extensively by households. For example, according to survey data from the Czech Republic, Slovakia, Bulgaria and Russia, the majority of households grow some of their own food, engage in do-it-yourself activities and exchange services with friends and relatives.[28/] A comprehensive program runs the risk of, for example, transferring income to a household with able workers in their thirties. Where further support is required is in removing the impediments to some of these activities, for example,

28/ See Richard Rose, "Divisions and Contradictions in Economies in Transition: Household Portfolios in Russia, Bulgaria and Czechoslovakia", August 1992. At the same time, it should be recognized that being unemployed may result in loss of alternative uncivil sources of income, for example, the inability to receive bribes or provide special favors in carrying out official jobs, also cited in the paper.

giving some of the complementary assets of the enterprises, such as farm plots, to the formally unemployed households.

Question: What are the administrative tradeoffs?

Another risk of means-tested social assistance is that of covering households whose incomes are higher than reported. In transition economies informal sector income is widespread and cannot be monitored. Households with such income may end up receiving social assistance for which they should not qualify. Developing a more reliable monitoring capability is extremely costly: hundreds of thousands of individual circumstances will have to be assessed. In addition, social workers could be swamped by claimants and the need to check every one of them would detract from the equally important qualitative inputs (counselling, help with finding the right kindergarten for children, dealing with alcoholism in the family etc.) Also, administering means- or income-tested systems has proven to be feasible only in countries where personal income tax systems are well-developed, which is not the case in most of the transition economies. Some of these problems, however, can be minimized by using asset testing, which is being piloted in a number of countries.

Question: What are the tradeoffs between social assistance and other non-government channels of support?

Another risk is that government income transfers will substitute for inter-household transfers, and, on a temporary basis, using financial savings or other assets. Household financial savings throughout the former Soviet Union have been reduced to insignificance via high inflation. However, many households have assets in the form of housing, and efforts should focus on removing impediments to making these liquid through, for example, clarification of the legal framework for rental, leasing and sales. The shortage economy associated with the former socialist state also provided households with opportunities to develop informal interhousehold networks and mechanisms for coping with adversity, albeit with barter transactions of a very different nature and origin than under present circumstances. Recent evidence from Poland indicates that private transfers will substitute in part for government transfers. It is important for the medium-term strategy to recognize the tradeoff of means-tested social assistance programs in terms of discouraging the development of non-governmental charitable organizations and other channels for assisting households that may develop in the future.

Question: What are the tradeoffs between cash social assistance and access to critical social services?

Access to key social services is vital, in the transition and beyond. Excessive attention to comprehensive income support programs may lead to the crowding out of social services (vaccination, schooling, running water, sewage system). Enhancing the resource base of poorer regions, including fiscal federalism considerations, would play an important role in strengthening their ability to protect such services.

Question: What are the tradeoffs between a more narrow approach to social assistance and possible failure to reach poor households?

A more narrow program is, of course, less costly and less distortionary (in terms of incentives). It is also easier to administratively implement. However, it would, by definition, reach fewer people than a more comprehensive program. Experience with comprehensive programs in developed countries indicates that means-testing fails to reach sizeable proportion of the poor, and that the "leakage" to the non-poor is high (between 40 and 60 percent of total spending is paid to the non-poor). The former risk is greater under the "narrow" approach, but the latter is less. Also, many otherwise vulnerable households would be covered by various categorical schemes or, in severely depressed regions, by temporary employment-assistance programs outlined above. Public works in Chile employed, at their peak, about 13 percent of the labor force. Social assistance would be targeted to those who have both low income and are unable to improve their standard of living through their own efforts (such as the handicapped), with discretion given to local offices on the extent of income gap filling and emphasis placed on social counselling and in-kind assistance to reverse or target the dysfunction if at all possible. For example, in Ukraine, the government has introduced a social assistance program for the elderly living alone without family support, including rural women. Throughout Russia, local social assistance offices have developed some well-targeted programs despite tightly constrained resources. An increase in resources to local social assistance efforts would minimize the risk of failing to reach those households unable to help themselves.

Question: Should consumer subsidies be used for social assistance objectives?

While massive and untargeted subsidies prevailing until recently in the transition economies clearly contradict a transition to a market economy, selected use of subsidies may be appropriate. In conditions of very high inflation, the automatic indexing inherent in assistance in kind, such as food coupons, is an advantage. In-kind transfers can be appropriate to influence the intrahousehold allocation of resources, such as school feeding programs. Some essential foodstuffs may indeed need to be subsidized for a transition period. Efforts would need to be made to identify inferior goods to facilitate self-targeting and contain fiscal impact. If bread or milk are undifferentiated currently, consideration should be given to introducing inferior goods, for example, through coarse grain or low-quality packaging. This should be done particularly in poorer --Central Asian and Balkan-- countries. (See Box 5 for an example from Jordan). Housing or utility costs can be covered in part by local offices for those who qualify (have low income and dysfunctionality) as part of assistance in kind, with experimentation in targeted voucher programs. In all cases, the level of the subsidy would have to remain modest to avoid significant distortionary impacts on consumption, such as use of bread as animal feed. Hence, there may be a role for targeted consumer subsidies.

*Family allowances* can also be regarded as part of social assistance. This is particularly the case since during the transition larger families were disproportionately affected by poverty (Figure 10 illustrates the impact on the example of Poland). However, family allowances are still not a well-targeted tool to combat poverty. Lots of money "leaks" to the families that are relatively well-off.

Question: How can payments of family allowances paid to well-off people who don't need them be limited?

Several (not-mutually exclusive) options to reduce the leakage may be envisaged: (a) simple income-testing of family allowances at relatively high level of average wage (for example, where one of the members has a wage three times in excess of the average) so that the error of exclusion be minimized,[22/] (b) increasing family allowance as number of children rises since poverty rates increase with family size, (c) increasing family allowances for some categories of households, e.g. single mothers as was recently implemented in Russia.

Question: Should family allowances be taxed?

They should be treated like any other type of income so as to further reduce leakage to higher income households that are generally being taxed at higher marginal rates. Existence of family allowances, whether universal or income-tested, combined with their taxation is much more progressive than tax deduction or tax credits on account of children.

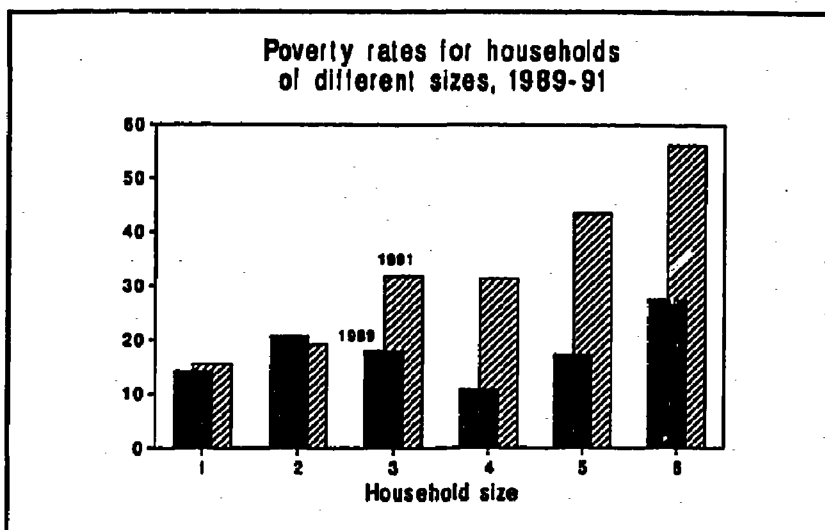
Question: Can family allowances be harnessed to achieve some added objectives?

For example, family allowances can be made conditional on performed vaccination of children. This approach was used in Chile with notable success. However one need not worry that they may send the wrong signal, namely that it matters more to have more children than to work hard. Such worries are displaced for two reasons: family allowances as proposed here would be a much smaller proportion of wage than they were in the socialist past (say 4-5 percent of average industrial wage instead of 8-10 percent) and wage differentiation that goes on hand-in-hand with transition to market economy will further erode importance of family allowance in relation to wage for many middle- and better-paid households.

---

29/ It is preferable to have wage than income test because it is much simpler. One of the main reasons *not* to support an income-tested social assistance system is precisely difficulty in ascertaining incomes.

**Figure 10**




Question: How would the collapse of child care provision by enterprises be addressed?

One possibility would be the introduction of vouchers to be used to defray the costs of child care, both private and state-provided. The vouchers would be either paid to all recipients of family allowances or to all poor families (if family allowance is not income tested) whose child is between the ages of, say, 2 and 6, or only to working mothers with "low incomes" (to reduce "cost" of joining the labor force). Work-test may be necessary to avoid the danger of a poverty trap: without a work-test, people whose wage is just above the poverty line may be better off if they "remain poor" and collect welfare payment plus the voucher than if they work—thus losing both social assistance and the child-care voucher.

## CONCLUSION

Transition societies face acute conflicts. The old days were characterized by stagnant incomes, rationed goods and lack of liberties, but they did have a high degree of income security. The early days of reform have brought civil liberties, lots of goods, crashing incomes and rising insecurity. Most countries are set on a course to some form of capitalism. This intrinsically involves greater risk-taking and less security--and almost certainly greater inequality in the primary distribution of incomes.

Should transition societies use transfers to substitute for this rise in insecurity and poverty? The short-run crash in incomes, the heritage of cradle-to-grave state protection and the vision of the West European welfare state all provide compelling motivation for widespread use of transfers. But we argue here that there are significant tradeoffs between a move to a comprehensive welfare state and a shift to dynamic growing economies. The transition economies don't have the underlying productivity levels (in terms of real productivity in a global market) or tax bases to sustain the tax effort needed to provide transfers on a very large scale. Short-run gains in security could be at high long-run costs--in insufficient private and public capital accumulation and lack of competitiveness. This could pan out either in terms of financial collapse--Ukraine is an early example--or an extreme form of Eurosclerosis at low levels of income. Under either scenario it is likely that the poor, the old, the disabled, the unemployed--precisely those that transfers are supposed to protect--will suffer disproportionately over the medium- to long-term, and probably even in the short term.

The choice between security and growth is one that each society faces. The purpose of this paper has been to illustrate the character of the tradeoffs. In a viable scenario, it is, of course, likely that transfers will be important for both welfare and political reasons. We discuss some of the options for providing transfers that are more likely to be consistent with macroeconomic imperatives and have relatively low adverse incentive effects -- for example, flat-rate pensions (or flatter) at quite low replacement rates, a lower dole or severance pay, and localized rather than generalized (income-tested) social assistance. We emphasize the use of intrinsically temporary measures--such as temporary employment schemes--to deal with the transition period. Such an approach inevitably puts more pressure on private coping and will, in the short run, increase risk. This could be the cost of a viable transition to the future rapid growth that is key to overall success.

**BIBLIOGRAPHY**

Beckerman, W., "The Impact of Income Maintanance Programs on Poverty in Britain 1975", *The Economic Journal*, June 1979.

Bourguignon, Francois, "Optimal Poverty reduction, Adjustment, and Growth", *The World Bank Economic Review*, May 1991.

Dreze, Jean and Sen, Amartya, *Hunger and Public Action*, Oxford: Clarendon Press, 1989.

Foley, Mark "Determinants of Household Income Level and Poverty Profile for Russia", World Bank, mimeo.

Heckman, Roselius and Smith, "US Education and Training policy: a Reevaluation of the Underlying Assumptions behind the New Consensus", mimeo.

Mithchell, Deborah, *Income Transfers in Ten Welfare States*, Averbury, England, 1989.

Ravallion, Martin, *Poverty Comparisons*, Philadelphia: Harwood Academic Publishers, 1993.

Rose, Richard "Divisions and Contradictions in Economies in Transition: Household Portfolios in Russia, Bulgaria and Czechoslovakia", mimeo, August 1992.

Vodopivec, Milan, "A Sector Note on the Labor Market and Social Safety Net in Estonia", mimeo, January 1994.

World Bank, *The Asian Miracle: Economic Growth and Public Policy*, World Bank and Oxford University Press, 1993.

World Bank, *World Development Report 1990*, World Bank, Oxford University Press, 1990

World Bank, *World Development Report 1991*, World Bank, Oxford University Press, 1991

World Bank, *World Development Report 1993*, World Bank, Oxford University Press, 1993

World Bank, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, World Bank, Policy Research Report, June 1994.

## Policy Research Working Paper Series

| | Title | Author | Date | Contact for paper |
|---|---|---|---|---|
| WPS1358 | Patterns of Behavior in Biodiversity Preservation | Andrew Metrick<br>Martin L. Weitzman | September 1994 | A. Marañon<br>39074 |
| WPS1359 | When Method Matters: Toward a Resolution of the Debate about Bangladesh's Poverty Measures | Martin Ravallion<br>Binayak Sen | September 1994 | P. Cook<br>33902 |
| WPS1360 | Are Portfolio Flows to Emerging Markets Complementary or Competitive? | Sudarshan Gooptu | September 1994 | R. Vo<br>31047 |
| WPS1361 | External Shocks and Performance Responses during Systemic Transition: The Case of Ukraine | F. Desmond McCarthy<br>Chandrashekar Pant<br>Kangbin Zheng<br>Giovanni Zanalda | September 1994 | M. Divino<br>33739 |
| WPS1362 | Regulation, Institutions, and Commitment: The Jamaican Telecommunications Sector | Pablo T. Spiller<br>Cezley I. Sampson | October 1994 | B. Moore<br>38526 |
| WPS1363 | Brazil's Sugarcane Sector: A Case of Lost Opportunity | Brent Borrell<br>José R. Bianco<br>Malcolm D. Bale | October 1994 | M. Bale<br>31913 |
| WPS1364 | Why Do Some Economies Adjust More Successfully Than Others? Lessons from Seven African Countries | Ishrat Husain | October 1994 | J. Schwartz<br>32250 |
| WPS1365 | The Macroeconomics of Adjustment in Sub-Saharan African Countries: Results and Lessons | Ishrat Husain | October 1994 | J. Schwartz<br>32250 |
| WPS1366 | Distributive Concerns When Replacing a Pay-As-You-Go System with a Fully Funded System | Salvador Valdés-Prieto | October 1994 | E. Khine<br>37471 |
| WPS1367 | The Economics of Cash Shortage | Patrick Conway | October 1994 | L. Suki<br>33974 |
| WPS1368 | Sustained Inflation in Response to Price Liberalization | Patrick Conway | October 1994 | L. Suki<br>33974 |
| WPS1369 | Economic Policy Reform, Government Debt Guarantees, and Financial Bailouts | Philip L. Brock | October 1994 | P. Sintim-Aboagye<br>38526 |
| WPS1370 | Is East Asia Less Open than North America and the European Economic Community? No | Sumana Dhar<br>Arvind Panagariya | October 1994 | J. Ngaine<br>37959 |

## Policy Research Working Paper Series

| | Title | Author | Date | Contact for paper |
|---|---|---|---|---|
| WPS1371 | The Evolution of Trade Treaties and Trade Creation: Lessons for Latin America | Sarath Rajapatirana | October 1994 | J. Troncoso 37826 |
| WPS1372 | Administrative Charges in Pensions in Chile, Malaysia, Zambia, and the United States | Salvador Valdés-Prieto | October 1994 | E. Khine 37471 |
| WPS1373 | Firm Behavior and the Labor Market in the Hungarian Transition | Simon Commander<br>Janos Kollo<br>Cecilia Ugaz | October 1994 | B. Keller 35195 |
| WPS1374 | Infrastructure Finance: Issues, Institutions, and Policies | Anand Chandavarkar | November 1994 | M. Geller 31393 |
| WPS1375 | Policy Lessons from a Simple Open-Economy Model | Shantayanan Devarajan<br>Delfin S. Go<br>Jeffrey D. Lewis<br>Sherman Robinson<br>Pekka Sinko | November 1994 | C. Jones 37699 |
| WPS1376 | How Trade, Aid, and Remittances Affect International Migration | Maurice Schiff | November 1994 | J. Ngaine 37947 |
| WPS1377 | Macroeconomic Adjustment to Capital Inflows: Latin American Style versus East Asian Style | Vittorio Corbo<br>Leonardo Hernández | November 1994 | R. Vo 31047 |
| WPS1378 | Mexico after the Debt Crisis: Is Growth Sustainable? | Daniel Oks<br>Sweder van Wijnbergen | November 1994 | S. Harbi 37143 |
| WPS1379 | Financing Infrastructure in Developing Countries: Lessons from the Railway Age | Barry Eichengreen | November 1994 | WDR 31393 |
| WPS1380 | Transfers and the Transition from Socialism: Key Tradeoffs | Kathie Krumm<br>Branko Milanovic<br>Michael Walton | November 1994 | K. Krumm 34263 |