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INCOME TRANSFERS IN TRANSITION: CONSTRAINTS AND PROGRESS

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INCOME TRANSFERS IN TRANSITION: CONSTRAINTS AND PROGRESS[1]

By Nicholas Barr[2]

Visiting the main employment office in Warsaw in late 1989, I asked how many people they were currently paying benefits to. The answer (in a city of 1.6 million people) was five. A year later, unemployment in Poland was more than a million, and by December 1993 was three million. There is no need to belabour the resulting strains on a social safety net designed for a very different régime.

This paper discusses how the safety nets in the reforming countries, though in many ways well-adapted to the old system, were poorly suited to the needs of a market economy, and what progress has been made in adjusting them. The problems faced by the system of income transfers need to be seen against the backdrop of broader constraints facing policy makers at the start of the reforms. The emphasis on these constraints is not intended to sound gloomy; rather the opposite – it shows how much progress has been made in very difficult circumstances. A former French Prime Minister invited fellow citizens to imagine that France had over a very few years to go through the Political Revolution of 1789, the Industrial Revolution of the nineteenth century and the decolonisation of the 1960's. That, he pointed out, was precisely what the world community is asking Russia to achieve.

1 Background Constraints

Though the distinction is often not watertight, it is useful to discuss separately economic constraints, political constraints and institutional constraints.

1.1 *Economic Constraints*

Macroeconomic constraints. The major problems are well-known. Initial conditions were unfavourable, first, in that, prior to the reforms, growth slowed down at levels of per-capita income far below those in the West. In addition, many countries had accumulated large foreign debts.

From this low starting point was superimposed in most countries an output collapse. The timing of this output decline varied and so did its extent. There is controversy about why output fell as sharply as it did (see Fischer and Gelb 1991; Gomulka 1991; Balcerowicz and Gelb 1994; Sachs 1994). Because of major measurement problems, not least over the extent of informal-sector activity, there is also controversy about the extent of the decline. Whichever view one takes, however, there is no doubt that output fell; and in many countries it fell by at least as much as the ouput declines of the Great Depression of the 1930s.

A third macroeconomic constraint, the fiscal crisis (taken here to mean a substantial budget deficit), is to a significant extent a consequence of the output decline. An obvious result is downward pressure on the resources available for income transfers and other social spending such as health care and education. The fiscal crisis may not be a completely unavoidable concommitant of transition in central and eastern Europe (CEE) and the former Soviet Union (FSU), as the broad budgetary balance of the Czech Republic in 1992 suggests, but it is difficult to avoid (for detailed discussion, see Miszei 1994).

The crisis arose because tax revenues fell faster than output, while expenditure fell more slowly. So far as revenues are concerned two features should be distinguished. First, when output falls, the tax base falls and tax revenues fall. If the tax structure is progressive, the tax base shrinks faster than output.[3] Second, and specific to the transition economies, the amount of tax which can be collected from each million forints (koruni, rubles) of wage payments declines: output falls most precipitously in the state sector, so that an increasing number of state enterprises start to delay/default on their tax and social insurance payments; and growth tends to be in the private sector, where tax enforcement is far from fully developed.

Expenditure cannot easily fall as fast as revenues. Rising unemployment and emerging poverty increase the demands on the system of transfers. In addition, some countries face the demands of servicing their international debt out of declining GDP; and the problem of debt service is worse if a country's exchange rate declines. Expenditure may also rise for political reasons: enterprise subsidies fell slowly in some countries; and in some countries, Poland for example, there was a major increase in social expenditure, particularly on pensions. Though there was significant variation between countries, throughout CEE and the FSU demands on the budget increased at precisely the time that revenues were falling, with obvious implications, which emerge repeatedly below, for income transfers and the social spending more generally. The resulting problem is twofold: devising a package to contain the government deficit; and how to obtain parliamentary and public support for the necessary measures. Sustainability of the reforms thus involves a balancing act of considerable delicacy between budgetary necessity and political imperative.

Microeconomic constraints. These arise, first, through an inherited misallocation of labour and capital. Much of the capital stock is outdated and in poor condition. Labour, to a signficant extent, was paid the wrong wages, had the wrong skills and lived in the wrong place, where ‘wrong’ in each case means ‘different from what would have occurred over the long term if market prices had been allowed to prevail’. Though wages can adjust fairly fast (and have done so in many countries), changing skills takes time; and geographic mobility is seriously impeded by the absence of a well-articulated housing market. A related aspect of misallocation is the major role of enterprises in large parts of the education, health and social welfare systems.

A second set of constraints is an inappropriate inherited incentive structure. The issue is wider than that of wage differentials. The old system, for example, created active disincentives to individual initiative. This will take time to change.

A final set of economic constraints – market imperfections – are not peculiar to the transition economies but apply in all market systems. A major lacuna at the start of the reforms were gaps in the structure of laws establishing key institutions such as the ownership and transfer of private property; the conduct of private enterprises; the operation of a western-style banking system; the operation of financial institutions; employment conditions in the private sector; and the development of a system of unemployment benefit appropriate to a period of high unemployment. A second and separate gap was the lack of the regulatory structure to prevent market failure. Examples in the West include hygiene laws connected with the production and sale of food, and similar laws relating to the testing and sale of drugs; laws relating to the abuse of monopoly power; laws concerning the conduct of financial institutions such as private pension funds; and regulation of total medical spending.

1.2 *Political Constraints*

Of many political constraints, three require particular discussion: the lack of an inheritance of rule of law; constitutional arrangements; and a shortage of expertise in the conduct of democratic politics.

Erosion of the rule of law. Under the old system, the distrust of government, together with the fact that legal provisions could, in effect, be overridden for political reasons, produced a lack of rule of law in the western sense that laws (by and large) are respected, enforced and obeyed. The result was a disrespect for law so pronounced that, according to the then Bulgarian Prime Minister early in his country’s reform process, it undermined the moral values of a civil society.

> ‘By imposing a great number of impractical and often illogical restrictions and limitations that were inevitably and routinely breached or disregarded, [the communist authorities] also cultivated in the individual a feeling of being an offender.... This served to blur the line between the permitted and the forbidden.... Honest and moral people

would think nothing of stealing from the state or cheating the authorities' (Dimitrov 1992).

The resulting constraint is that market systems rely heavily on the rule of law because decision-making is decentralised and economic relations founded on the principle of voluntary exchange. Individuals undertaking exchanges need to know that promises have a contractual basis, which provides some guarantee through the courts that the exchange will take place on the terms originally agreed to. A clear definition and enforcement of rights and obligations is a precondition for a well-ordered market system, particularly one intended to attract foreign investment.

Constitutional arrangements. Since constitutions in the West have taken hundreds of years to evolve it is not surprising that constitutional arrangements in the transition economies have at times created problems. This is true even in countries with pre-1939 democratic experience.

The respective powers and responsibilities of the legislature and executive may not be clear and explicit; or where they are clear they may work badly. In the early days of the reforms in Russia, it was possible for Presidential decrees and legislative Acts to be in direct conflict, with no constitutional rules for establishing which took precedence.

The electoral régime may yield indecisive results. The first democratic election in Poland was conducted under a system of proportional representation with no threshold, leading to a legislature with a fragmented party structure, hindering the formation of a stable coalition.[4]

The powers of the executive might be clear, but the executive might not be able to enforce them. In Russia, for example, the central authorities have experienced difficulties in persuading localities to remit tax revenues to the centre.

An additional problem is the potential for legislative overload. In part the problem is unavoidable, given the scale of necessary reform. A second source of overload is the inclusion of considerable detail in primary legislation. The level of benefits such as pensions was frequently included in primary legislation, so that changes (e.g. because of inflation) required extensive Parliamentary debate. A common result is a legislative bottleneck, leading to delays and badly-crafted laws.

Lack of experienced democratic politicians. The constitution sets out the rules of the game. But the reforms also need professional players of the democratic political game. The early transition was a revolutionary period, and many of the usual rules of politics could not apply. That period, however, is now over, and 'normal' politics is increasingly the rule. The range of depth of problems is daunting. Politicians facing a fiscal crisis have to reduce expenditure, e.g. by raising the age of retirement or by reducing medical salaries. The implementation of such policies is possible only if there is sufficient political support; and the development of such support requires an ability to manage the political dimensions of policy, particularly where it creates a significant number of losers. These are major problems even for experienced western politicians, so that the difficulties faced by politicians in CEE and FSU should not be surprising. The problem is made worse because the time scale for economic reform is medium term, but all the pressures of democratic politics are short term. This creates a vulnerability to populism which is greater the more painful are the policies.

Yet virtually no CEE politicians in the early reform process had any practical experience of democratic politics. Many early ministers were former academics who did not intend to stay in politics. Few of the early reform politicians had much idea of how western politicians operate, in particular (a) how they use the printed and broadcast media to seek to inform the public, to shape the political agenda and to acquire feedback of what the electorate thinks, and (b) how to use polls, encounter groups and similar devices to guage opinion in different constituencies. In the West, such skills are possessed by successful politicians, by leaders of pressure groups (e.g. Friends of the Earth), and by the best sorts of public relations experts.

In part these are diminishing problems. Virtually all of the CEE countries have had at least one election since the start of the transition, and political experience is building up. But the importance of political constraints, even so, should not be underestimated.

1.3 *Institutional Constraints*

The physical infrastructure in CEE and FSU is deficient in obvious ways. Somewhat less obvious, but at least as important, are major deficiencies in the human capital infrastructure.

Outdated skills. Inappropriate human capital is pervasive. The problem is not primarily one of *too little* human capital, but of the *wrong type*. Outdated skills are a widespread problem. There was no significant training in modern management under the old system. Training abroad was generally restricted to technicians who were to work with foreign equipment. Teachers and public officials had little or no contact with anything but the communist world. With a few exceptions in medicine, sciences and some technical areas, their knowledge became out of date.

'Oldthink' is pervasive and will not be overcome without effective education and publicity. The first major problem is that important concepts are missing. An implication of communist ideology was the absence of the notion that scarce resources have an opportunity cost.[5] Without such a concept, no sensible discussion of economic efficiency is possible. Another conceptual gap is that under state ownership there was no clear distinction between the property of the state and that of the enterprise, and hence no clear concept of taxation.

Communication problems result both from lack of training and from missing concepts. The lack of a common educational background, aggravated by the lack of western languages, creates difficulties in communicating with western experts. Training abroad on short courses and training of trainers by foreign experts are thus often less effective than had been hoped. A more subtle manifestion of the same problem arises because missing concepts lead to missing words. This creates major translation problems, both for oral interpretation and for translation of written documents. The term 'cash benefits', for example, initially proved a consistent problem for interpreters, since there was little understanding of the distinction between wages (mainly related to individual productivity for reasons of economic efficiency) and income transfers (mostly paid out of the state budget for distributional reasons). These, largely unrealised, communication problems act as a barrier to speedy and effective transfer of information and know-how.

The resulting institutional capacity constraints are major. Manifestations include a lack of knowledge of modern administrative theory and practice, and a lack of technical know-how. Administrative methods at the start of the reforms had changed little since the end of the Second World War. They were generally cumbersome, unnecessarily complicated and slow. In the early transition, administrative personnel in most CEE countries generally relied on pencil and paper; typewriters were often the highest available technology. The acute relevance for income transfers, which require extensive and sophisticated administration, is clear.

2 Inherited Problems and Progress

Income transfers historically made up a much smaller share of GDP in CEE than in the West, with a much larger role for consumer and producer subsidies and public investment.[6] The welfare impact of the cancellation of most of the subsidies and the dramatic fall in public investment is an important part of the context. Against this backdrop, this section discusses the major problems specific to the social safety net at the start of the reforms and progress in addressing them.

Throughout the rest of the paper, following conventional usage, cash benefits are divided into three types.

- *Social insurance* is awarded without an income test on the basis of (a) a person's contributions record and (b) the occurrence of a specified event, such as becoming unemployed or reaching a particular age. The essence of social insurance is that it offers protection against what, at least in principle, are insurable risks.

- *'Universal' benefits* are awarded on the basis of a specified event, without regard to a person's income or contributions record. Examples include family allowance and free health care.

- *Social assistance* is awarded on the basis of (a) an income test (see the Glossary), and (b) the occurrence of a specified event, without a contributions test.[7]

The strategy for reform needs to be rooted in the nature of the systemic change. Prior to the reforms, the structure of wages and income transfers were relatively well-adapted to the needs of the old system. Wages were low and fairly undifferentiated; and income transfers were awarded to broad groups of people, such as families with children (through family allowance) and the elderly (through pensions). That structure, however, is poorly-adapted to the needs of a market economy, which requires wages to be differentiated because of the resulting incentives to efficiency. But if the variation in wages and incomes across people gets larger, the system of income transfers can no longer be aimed at *groups*, but needs to be targeted in a more sophisticated way which takes account of differences in *individual* circumstances.

A key part of the strategy for reform, therefore, is improved targeting. This has two aspects:

- to ensure effective poverty relief, benefits should go to *all* who need them, i.e. there should be no significant gaps in coverage (this is known as horizontal efficiency);
- to contain costs, benefits should go *only* (or mainly) to those who need them, i.e. there should not be excessive 'leakage' of benefits (known as vertical efficiency).

These are discussed in turn in sections 2.1 and 2.2. Most political discussion focuses on the latter, in that it relates to the cost of benefits; but the first aspect is equally important, since it has a direct bearing on the effectiveness of poverty relief.

Alongside better targeting, it is necessary to ensure that income transfers, to the extent possible, assist the operation of the labour market. Improving incentives (section 2.3) is therefore essential. Finally, more sophisticated targeting requires an administrative structure capable of putting it into effect (section 2.4).

2.1 *Targeting 1: Relieving Poverty*

There is a mistaken view that accurate targeting is possible only by awarding benefits on the basis of an income test, i.e. where the amount of benefit is exactly related to individual or family income. It is important to realise that income tests have major costs. They are administratively demanding; they can be intrusive and hence stigmatising; and they can create major disincentives to work effort and to saving. Accurate targeting, moreover, does not always require an income test. There are two ways in which the poor can be identified: through an income test, or via *indicators* of poverty, i.e. possession by the individual/family of one or more easily observable characteristics which are highly correlated with poverty, for example ill-health, old age, or the presence of children in the family. Social insurance benefits are based on factors such as unemployment, ill-health or old age, and thus use indicator targeting. Similarly, family allowance, being based on family size, is relatively well-targeted, notwithstanding the absence of an income test.

The difficulties should not be underestimated, however: defining a poverty line is problematic; tight targeting can create a tension between economic and political sustainability of the reforms; and indicators of poverty may be imperfect. For all these reasons, targeting is a matter of considerable subtlety (see Atkinson, forthcoming).

Problems. At the start of the reforms, the system of poverty relief faced strategic problems: missing data, missing benefits, gaps in coverage, non-receipt of entitlement, and, in some cases, benefits which were too low.

Missing data. The absence of data on people's incomes comes on top of the well-known problems of defining and measuring poverty (see Atkinson 1987; 1989, Ch. 1; 1991; Barr 1993a, Ch. 6). Since communism, officially, had no poverty, there was no need to collect poverty data (indeed, the system discouraged such enquiry). This is an area in which real progress has been made, in that most countries now have a household survey of some sort.

Missing benefits. Since the old system officially had no unemployment or poverty, its systems of unemployment benefit and poverty relief were rudimentary or (in the case of unemployment benefit) sometimes non-existent. The theory was that everyone had a job whose wage, together with other transfers, kept them out of poverty; the only people who did not work were those with long-term health problems, whose needs were met by disability pension, or the elderly, who received a retirement pension. Thus, at least in principle, there was no reason for anyone to be poor unless, for example, they had a drinking problem, or emotional problems or were a 'social misfit' of some sort. There was no need in such a world for unemployment benefit or a broad-ranging system of poverty relief.

So far as unemployment benefit has been concerned there has been real progress, in the sense that all the reforming countries now have working systems. The development of social assistance has been more sporadic: for fiscal reasons; because growing informalisation makes targeting an even more difficult problem than normal; and because of limited administrative capacity. Poverty relief of last resort remains patchy throughout the region, particularly in the countries of the FSU.

Gaps in coverage. Under the old system, virtually all cash benefits were part of social insurance. As a result of the reforms, there are typically three sets of benefits, unemployment benefit, social insurance benefits and social assistance, organised by three separate authorities.[8] Gaps arise where the linkages between the three sets of benefits are incomplete, which is a particular problem for recipients of unemployment benefit.

A second gap is incomplete coverage of workers in the private sector. The problem is no longer one of eligibility (workers in the private sector typically face the same régime as workers in the state sector), but of enforcement. Throughout the growing informal economy, employment remains undeclared, resulting in incomplete or missing contribution records and hence loss of benefit entitlement. This is a continuing, almost certainly a growing, problem.

A third gap was inadequate coverage of some marginal groups by maternity benefit and family allowance. Maternity benefit depends on a contributions record in almost all the advanced industrialised countries and throughout Latin America.[9] In CEE/FSU, however, large agricultural populations and the self-employed were excluded or received significantly lower benefits. Declining agricultural populations and gradual extension of coverage improved matters, but gaps remain in some countries, for example Poland and Romania.

Family allowance had even greater gaps. Whereas social insurance is intended to offer insurance against risk, an important purpose of family allowance is to help a family redistribute across the life cycle. Precisely because having children is not in any sense an insurable risk, family allowance in most western European countries is universal (i.e. paid without a contributions record or income test (see Council of Europe 1992; Commission of the European Communities 1993). The richer countries in Latin America (Argentina, Brazil, Chile, Uruguay) also provide family allowance, usually for those covered by social insurance (Mesa-Lago 1990, Table 19). In CEE/FSU, family allowance was normally part of social insurance, and thus excluded families outside formal employment. During the 1980s coverage of family allowances gradually broadened, but the first country to introduce a universal allowance, Hungary, did so only in 1990.

Progress has been patchy. There has been some progress in smoothing the linkages between different benefits for unemployed people. In contrast, growing informalisation has tended to reduce coverage in the private sector. Coverage of family allowance remains far from universal.

Non-receipt of entitlement. Not everyone who is entitled to benefit may receive it. Take-up can be incomplete either because people do not apply for benefit, or because they apply and are wrongly refused (see Atkinson 1989, Ch. 1). Though evidence is scant, it is known that there have been problems, particularly with social assistance, but sometimes also with pensions, when funding sources have dried up.[10] Not least because of budgetary exigencies, the problem is a continuing one.

Inadequate benefit levels. The adequacy of the minimum benefit could be questionable. The problem arises because the minimum level of the major benefits is often not tied to a poverty line but either to the average wage or to the minimum wage. The problem if the minimum benefit is tied to the average wage is that it falls if average wages fall; and real wages fell significantly throughout CEE/FSU during the early transition. Indeed, the whole purpose of the incomes policies which normally accompanied the early transition was to ensure that wages were *not* fully protected against inflation. Alternatively, if the minimum benefit is tied instead to the minimum wage, the problem is that the minimum wage is highly political at the best of times, and even more when subsidies on basic commodities are being reduced. If there are additional knock-on effects for the minimum level of benefits, it becomes even more political.

Outcomes: trends in poverty. The wealth of literature on this topic (Cornia 1994; Cox, Eser and Jimenez 1995; Fajth 1994; Garner 1995; Milanovic 1995; Rutkowski, forthcoming; Torrey, Smeeding and Bailey 1995) is explained partly by the fact that, though the quantity of data is no longer a problem, its interpretation is fraught with difficulty. For well-known reasons, income is a highly imperfect yardstick of individual welfare even in the West; and in the transition economies the problem is even worse.

- Pre-transition figures on income took no account of the non-availability of goods, nor of the fact that access to goods was easier for some groups than others. The problem then is how to interpret changes in people's incomes.[11]

- The transition led to sharp changes in relative prices, making it difficult to estimate inflation and hence difficult to assess what happened to people's real incomes.[12]

- With increasing informalisation, significant amounts of income, particularly in the private sector, are not captured in official statistics. There is growing evidence (Cox, Eser and Jimenez 1995; Garner 1995; Torrey, Smeeding and Bailey 1995) that households adopt a range of informal coping strategies, including intra-household transfers, own production, and employment in the informal sector, which parallel formal sector activities. It has been suggested that official statistics may understate GDP by as much as 20 per cent, and in some countries even more (for general discussion, see Dallago 1995).

  Despite these measurement problems, a number of stylised facts emerge.

- In almost all the reforming countries there has been an increase in poverty, often a sharp increase (Milanovic 1995, Table 2; Cornia 1994, Table 10) and in inequality (Milanovic 1995, Table 2; Torrey, Smeeding and Bailey 1995, Table 4). As examples, the poverty headcount rose from low levels under the old system to an estimated 20 per cent in Poland in 1993-94, 17 per cent in Bulgaria, 32 per cent in Romania, an average of 36 per cent in the Baltics, and to 43 per cent in Russia (Milanovic, 1995, Table 2).

- The losers are disproportionately the unemployed and children (Fajth 1994).

- Pensioners, by and large, have held their ground (Milanovic 1995).

- The 'winners' are people who are better-educated and/or those with jobs in the private sector (Milanovic 1995; Rutkowski forthcoming).

2.2 *Targeting 2: Containing Costs*

Problems. Targeting can fail because benefits may be higher than is compatible with fiscal realities, because access to benefits (e.g. invalidity pension) may be too easy, or because work can be combined on generous terms with receipt of benefits.

High benefits arise, first, because many benefits are fully earnings-related. It is not self-evident that this should be so. Flat-rate unemployment benefits are becoming more common (e.g. in Bulgaria and Poland), and Estonia and Latvia have both flat-rate unemployment benefit and flat-rate pensions. Another possibility is to have a basic, flat-rate pension plus a second-tier earnings-related pension which rises less than proportionately with earnings. Furthermore, most benefits are uprated in line with changes in earnings. When real earnings fall, this reduces costs; however, it also reduces the minimum benefit, and thus reduces the effectiveness of poverty relief. On the other hand, when real earnings rise, the use of an earnings index adds to the cost of benefits. Thus, tying benefits to earnings hinders poverty relief if real earnings fall, and makes cost containment less effective if real earnings rise.

High family benefits. Family benefits in CEE in the mid 1980s cost over twice as much as the OECD average of 1.2 per cent of GDP (Sipos 1994, Table 10.1). Early in the transition, the family allowance for each child was eight per cent of the average monthly wage in Poland, and 11 per cent per child for a two-child family in Czechoslovakia. Across the OECD, the average level of support from all family benefits was 7½ per cent of average earnings *per family*. In addition in some countries, benefit was also paid for a dependent spouse. As a result, family allowance played part of the role which in industrialised countries is played by wages. The pattern in western Europe is to pay such benefits at a lower rate, complemented by income-tested family support (see Commission of the European Communities 1993).

Maternity benefits were generally at or close to 100 per cent of the mother's previous wage. Again, this is high compared with western countries (usually 50 - 85 per cent of the mother's wage), but similar to many Latin American countries (e.g. Argentina, Brazil, the old Chilean system, Costa Rica, Mexico and Uruguay – see Mesa-Lago 1991).

The high level of family benefits is understandable historically, when the distribution of earnings was flat, with differences in family size accommodated by generous family benefits, but is increasingly inappropriate as the economic reforms take effect and wages become the main source of family support.

Ease of access to some benefits is a further problem so far as containing costs is concerned. Early legislation tended to define unemployment broadly. The 1989 Polish law, for instance, awarded benefit to anyone without a job, even if they had no recent labour-market attachment. Access to pensions is also easy. Normal pensionable age in CEE (60 for men, 55 for women)[13] is low by western standards; and some groups (e.g. miners, teachers, ballerinas) are eligible for pension even earlier. These groups can be numerous. As discussed shortly, they can generally combine pensions with continuing work, often continuing in their old job. In addition, years of work *while receiving pension* count as years of service, and add to pension entitlement. These arrangements, again, are understandable in their historical context, given pervasive labour shortages. Their cost is high. In Poland in 1990, one third of expenditure on old age pensions was on individuals below the normal pensionable age (World Bank 1993, Ch. 4).

Invalidity pension raises parallel problems. Recipients are numerous for two separate reasons. First, little emphasis was put on safety at work, so that many individuals have genuine and serious health problems. This problem requires separate remedial action. Second, access to benefit is relatively easy, not least because the authorities typically have limited power to control access. Western European experience suggests that rising unemployment puts increasing pressure on invalidity pensions.

Cost containment can be ineffective also because of the ease with which receipt of benefit can be combined with work. Old age pensioners can generally work full time, or nearly full time, with no loss of benefit. Similarly, people can qualify for invalidity pension even if they have suffered no loss of earning capacity. An individual who loses a limb, but whose long-run health and working capacity is unaffected, will generally receive a *continuing* partial invalidity pension whilst performing his or her old job and receiving a full wage.

Progress to date. Family allowance and maternity benefit are paid at a lower real rate than in 1990 throughout the region. In the Czech Republic, family allowance is 80 per cent of its 1990 value, the smallest decline of any of the reforming countries; in many countries the benefit is half or less of its real 1990 value. Whether this is progress (benefits accord better with the fiscal situation and hence allow room for growing private investment) or not (benefits are too low to relieve poverty) is a matter for continuing debate.

On the pensions front there has been much debate but little has changed. The age at which pension is first paid has, if anything declined. By far the worst example is Poland. As Table 1 shows, half of all workers within five years of pensionable age receive a pension. Access to disability pension is also easier (though by a narrower margin) in Poland than in the other countries in the table, so that it is not suprising that social spending in Poland was about one fifth of GDP in 1994.

[Table 1 about here]

There is limited good news. Some countries are close to bringing in legislation to raise the retirement age, though the actual age of retirement has thus far continued to fall in all countries except the Baltics. The terms on which a person can receive a pension while continuing to work have been made less generous: the Baltics, Hungary, Poland and Russia have introduced a retirement test or have restricted access to pensions in other ways (for example paying a pension to someone who continues to work, but only if he/she is working in the private sector). In addition, many countries have partially or totally withdrawn pensions for special groups.

2.3 *Improving Incentives*

Problems arise both with respect to the structure of benefits and through the way social insurance contributions are organised.

Incentive effects of benefits. In many of the CEE countries, unemployment benefit was up to 75 per cent of the worker's previous wage (in Ukraine and Belarus early in the transition it was 100 per cent for the first three months of unemployment). Similarly, sick pay was often 100 per cent of the worker's wage. The resulting tendency to extended sick leave was aggravated by weak monitoring. The prevailing view in the large western literature on the incentive effects of the replacement ratio (i.e. the ratio of benefits to previous earnings) is that it should should not be given undue emphasis as an influence on the level or duration of unemployment.[14] Other factors, for instance the fact that unemployment benefit is cut off after (say) 12 months, are regarded as more important. That research, however, is based on the range of replacement rates typical in western Europe and the USA, and therefore cannot be applied uncritically to CEE/FSU. Other adverse incentives arise in CEE/FSU where the definition of unemployment is broad, where there is no limit to the duration of entitlement and/or where the 'actively-seeking-work' condition receives little attention.

The contributions regime also creates adverse incentives. The social insurance contribution is generally paid entirely by the employer, the absence of a worker contribution having been regarded as one of the victories of socialism. The problem if the entire contribution is paid by the employer (and even worse when employers faced a soft budget constraint) is that everyone thinks that benefits are paid by someone else. This is the classic third-party payment problem, in which there is no incentive for anyone to restrain benefits (see Barr 1994a, Ch. 2). There is an exact parallel with fee-for-service medical care financed by insurance.

A second problem with contributions is that they are large – typically 40-45 per cent of the gross wage, though they could be considerably higher (81 per cent in Ukraine in April

1992). Such high contributions interfere with the competitiveness of enterprises and depress the demand for labour and in particular, given the high cost of benefits for mothers with young children, the demand for female labour. They also create incentives for labour to migrate to the informal sector and/or for underdeclaration of workers' incomes.

A further problem is that contributions are fragmented. Throughout CEE there was considerable earmarking through multiple contributions (some payslips could have more than twenty separate contributions for different benefits). Such contributions used to be transferred to the general budget which allowed for sizeable redistribution between the insured and the general population. Governments routinely used social insurance resources for other purposes. One ill-effect is fiscal inefficiency (e.g. depending on how contribution rates are specified by legislation, some benefits may be over-financed and others under-funded); in addition, separate collection procedures for each of the funds are administratively costly.

Progress to date. Replacement rates, particularly for unemployment benefits, have been reduced in many countries. The definition of unemployment has been narrowed; all countries now have a maximum duration, usually not more than 12 months, for which unemployment benefit is paid. The Czech Republic, Hungary and Poland have flat-rate unemployment benefits, with advantages in terms of incentive effects, cost and ease of administration. The 'actively-seeking-work' condition, in contrast, is rarely well policed. On the contributions front there is little good news. Employers still pay the entire (or almost the entire) contribution; contribution rates are high, driving people into the informal sector, eroding the contributions base and thus further adversely affecting the finance of benefits.

2.4 *Strengthening Administration*

Problems. As discussed earlier, a widening income distribution necessitates more sophisticated targeting of benefits, which in turn requires greater administrative capacity. Yet benefit administration at the start of the reforms was lamentably underpowered in all the countries.

Excessively complex benefit structures. Benefits in the past were mostly long-term (family allowance, pensions). Individuals receiving short-term benefit from the public authorities were few and could therefore receive 'Rolls Royce' treatment. In addition, little emphasis was put on administrative efficiency. For both reasons benefit structures tended to be highly complex, an unsustainable situation with large-scale unemployment.

The role of enterprises in benefit administration. Enterprises provided information to employees about entitlement, assisted with pensions claims and organised the payment of family allowance and short-term benefits as part of an individual's pay packet. The first problem with this arrangement is that benefit administration by enterprises becomes increasingly unsustainable as job mobility increases, as enterprises increasingly face hard budget constraints, and as large numbers of people work for small-scale employers or become self-employed. These changes necessitate a major transfer of administration from the enterprise to the public benefit authorities. A second problem is the extent to which the social insurance authorities are ignorant of individual records. All but the smallest enterprises pay social insurance contributions *en bloc* for their employees. The social insurance authorities *have no knowledge whatever about individual contribution records*. Individuals approaching retirement, with the aid of their employer, must put together a dossier of their entire work history to establish their contribution record. For the same reason, the social insurance authorities generally *have no knowledge of individual recipients of short-term benefits and family allowance*. Both problems impose major limitations on the range of reforms which are administratively feasible in the short run.

Old-fashioned administrative methods. Administrative capacity was, and remains, limited. Records are generally of the pencil-and-paper variety. The main method of getting short-term benefits to recipients was through the employer. For benefits such as pensions, the main vehicle of payment was (and is) cash through the postal system.

Progress to date. There has been some simplification of benefits, particularly unemployment benefits, but little progress in moving benefit administration from the enterprise to the social insurance authorities. A number of countries (Hungary for example) have embarked on major projects to upgrade administrative capacity, including the development and installation of a computer system capable of maintaining individual social insurance records. Progress in a number of areas (e.g. whether pensions are paid electronically to the pensioner's bank account) must await progress in financial institutions and telecommunications.

3 Achievements and Limitations

This section summarises very briefly what has been achieved, and what remains to be done.

Microeconomic gains. Some gains were apparent surprisingly quickly, and contributed directly to individual welfare.

- Shortages disappeared rapidly. Price liberalisation reduced excess demand and encouraged additional supply. Queues largely disappeared and so did black market prices. What is surprising is not the results themselves, but the speed with which the introduction of market forces produced these gains.

- Not only did availability increase; so did the range and quality of products. The combined effect of price liberalisation with recession was to bring about a switch from a shortage economy to one with low demand, giving consumers more power and sellers an incentive to provide the goods which consumers wanted. Easier access to foreign goods further improved matters. Wider choice also started to manifest itself in the labour market, and in health care, education and training.

- The introduction of market-determined wages and prices, together with supply liberalisation, improved work incentives; and market-determined wages together with harder budget constraints gave firms incentives to hire only the quantity and type of skills they needed, and gave individuals stronger incentives to acquire those skills. Economic reform also liberated latent entrepreneurial talent, particularly in the emerging private sector.

Macroeconomic gains. Though the precise magnitude of the output decline can be disputed, output fell initially, generally sharply, in all the countries of CEE and the FSU. Growth has now resumed in almost all the countries of CEE. Output in 1994 grew at below 2 per cent in Bulgaria, Croatia and Lithuania, at 2 – 4 per cent in the Czech Republic, Hungary, Latvia and Romania and at 4 – 6 per cent in Albania, Estonia, Slovakia and Slovenia. Growth was still negative *inter alia* in Russia (–15 per cent) and Ukraine and Belarus (output declining by over 20 per cent).

Political gains. There were also major political benefits.

- A free press, including the broadcast media, grew rapidly. Just as opening the economies to foreign trade improved the incentives for domestic producers, so did opening up to foreign news (e.g. access to television satellite dishes, fax machines, and the like) create incentives for government to be open.

- Free, multi-party elections increasingly became the norm. These, together with a free press, started to build a political culture, the development of which is a key ingredient for effective democratic government.

- The protection of individual rights improved. This was less an outcome of constitutional guarantees (which, in a formal sense, existed under the old system) than of free elections and press freedom.

Income transfers: the good news and the bad.

- Despite the increase in unemployment in Poland over the first year of the reforms, from effectively zero to well over 1 million, the authorities *did* manage to get system of unemployment up and running, and actually paying benefits, roughly on time, broadly to the right people. The same is true in the other reforming countries.

- Despite the weakness, both fiscal and administrative, of formal systems of poverty relief, there is growing evidence that households have developed a variety of coping mechanisms, including work in the informal sector, own-production and intra-household transfers.

- That said, and notwithstanding measurement problems, many people suffered a large decline in their (often already low) standard of living. Poverty increased, often sharply; and the problem is compounded by uncertainty and (related, though separate) by stress. The fact that these factors are hard to measure does not make them any less real. The development of social assistance does not yet match up to the task.

- Much work is still needed: to streamline the structure of benefits; to target benefits in a much more precise way, for instance by raising the age of retirement; to strengthen social assistance; and to build administrative capacity. The problems listed in section 2 are a long agenda for reform. Some progress has been made, but much remains to be done.

NOTES

1. For further detail, see Barr (1994b), Barr, Gomulka and Tomeš (1994) and Sipos (1994), on which this paper is largely based. I am grateful to Tanya Proskuryakova for assistance in picturing progress since 1990.

2. Department of Economics, London School of Economics; currently on leave at the World Bank as a principal author of the 1996 *World Development Report*, whose theme is transition.

3. To illustrate the point with a simple example, suppose income tax is paid at 25 per cent on income above $2000. Someone with an income of $6000 will therefore pay $1000 in tax. If, during a recession, his income falls to $4000, his tax bill is $500. Thus if income falls by one third, tax revenues halve.

4. To deal with this problem, Poland introduced a threshold in 1993 of 5 per cent of total votes for single parties, and 8 per cent for coalitions. The purpose of the threshold was to reduce the number of political parties in Parliament.

5. I.e. that the cost of resources used for one purpose are the other uses to which they could have been put.

6. Kopits (1991) found that in CEE subsidies were up to 22 per cent of GDP, whilst cash benefits were only 10 per cent. In the European Union, the comparable figures were 6 and 16 per cent. See also Kopits (1992).

7. These are the pure cases. In reality the categories can become blurred: both social insurance and 'universal' benefits may be partly income tested, e.g. by being included in taxable income.

8. Some countries have avoided this problem. In Albania and Latvia, unemployment benefit was incorporated from the start in the social insurance arrangements.

9. 21 of the 22 Latin American countries had some sort of maternity benefits (see Mesa-Lago 1991).

10. During the summer of 1992, with rapid inflation and a consequent shortage of cash, President Yeltsin, visiting a number of Siberian towns, was reputed to have had a planeload of cash as part of his entourage, specifically for paying wages and pensions.

11. Suppose that before the transition, a pint of milk, when available, cost 1, and individual X had an income of 1000. After the transition, milk is always available, and costs 5, and individual X still has an income of 1000. On the face of it, individual X is poorer; but if he/she could rarely get milk under the old system, matters are much less clear.

12. There are at least two sets of problems. With non-market clearing prices (i.e. under the old system), both Paasche and Laspeyres indices may overestimate inflation, and hence also overstate the fall in real wages and living standards. Second, in the face of sharply changing

relative prices, the pattern of people's consumption changes, thus sharply changing the weights which are used to calculate a consumer price index. The use of a consumer price index to measure inflation in these circumstances is, to say the least, problematic.

13. Poland is an exception; pensionable age is 65 (60 for women).

14. For surveys, see Atkinson and Micklewright (1991); Layard, Nickell and Jackman (1991).

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TABLE 1: WITHDRAWAL FROM THE LABOUR FORCE ON PENSIONS, 1993

	DISABILITY PENSION % working age population			EARLY RETIREMENT % of population 5 years prior to retirement		
	Total	Male	Female	Total	Male	Female
Croatia	8.9	9.0	8.7	1.9	2.1	1.7
Hungary	7.2	7.6	6.7	5.8	11.4	1.8
Poland	9.6	13.9	6.7	50.3	62.6	41.3
Slovenia	8.5	10.4	6.6	25.9	30.3	22.2

SOURCE: World Bank, Social Challenges of Transition Database. [cite Andrews and Rashid]