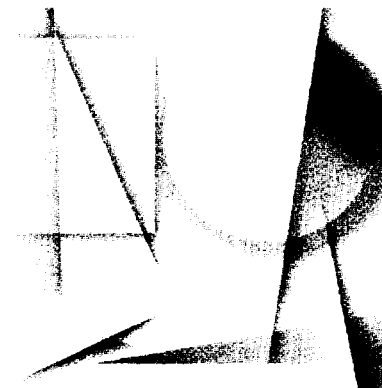


People and Transition



In the end what matters is people. In the end a country's transition will be judged by whether its citizens live better than they did before. Equity—how people share the benefits and the pains of transition—is important. But how people fare during transition is not just an equity issue. Labor productivity, critical for economic growth, depends on workers' knowledge, skills, motivation, and health. Therefore relieving extreme poverty, maintaining human capital, and adapting it to the needs of a market system support growth as well as social justice and political sustainability. This is especially true in transition countries, where policymakers may be unable to sustain vital, growth-enhancing reforms if large parts of the population feel that transition has left them behind.

How has transition affected living standards, and what do these changes mean for employment and for redesigning income transfers? (The corresponding questions relating to investment in skills and health are taken up in Chapter 8.) The answers vary by country and depend on the interplay of four factors: the widening distribution of income and wealth, economic growth or the lack of it, the mobility of labor, and age.

Greater disparity of wages, income, and wealth is—up to a point—a necessary part of transition, because allowing wages to be determined by the market creates incentives for efficiency that are essential for successful reform. More-efficient workers must be rewarded for their contribution to growth. But increased inequality can raise poverty in the short run, because some people or (especially in China and Russia) some regions inevitably benefit more than others. But the “losers” will not necessarily be forced into poverty; it depends on whether the economy is growing—the second factor—and on whether governments restructure social safety nets to provide effective poverty relief.

Negative growth, especially when as severe as that in CEE and the NIS, contributes to rising poverty and aggra-

vates the uncertainty associated with a dramatic change of system. As tax revenues fall sharply with the decline in output, governments face fiscal pressures to spend less and, simultaneously, political pressures to spend more. To escape this dilemma, policymakers must restore growth through effective reforms (Chapter 2). They must also ensure that losses early in transition are indeed transitional and not transmitted from one generation to the next. By contrast—and this is central to the East Asian story—where growth has been rapid and broadly based, poverty has declined sharply. As China and Vietnam show, some transitions can reduce poverty even in the short run.

Mobility—the freedom of individuals to seek better options elsewhere—is the third factor. As Chapter 2 showed, moving to a market system involves a vast reallocation of labor across firms, sectors, and regions. Yet the labor markets inherited from central planning, at least for movement between different skills, effectively sacrificed labor mobility for greater individual security. For working people, security largely took the form of a guaranteed job or, in rural China, guaranteed land. In a market system employees move between employers, between types of work, and between places—and they may experience unemployment. Income transfers (for example, unemployment benefits) in transition countries therefore need reform, not only to reduce poverty and contain costs but also to assist mobility. This means, in particular, supporting the unemployed and getting enterprises out of the business of delivering social benefits. Otherwise labor will remain immobile, raising the costs of transition by creating pockets of poverty in declining regions, and by pressuring enterprises and governments to defer necessary restructuring.

Older people have also been affected by the fall in output in CEE and the NIS. Like the rest of the population, they have experienced a fall in their average living standard. Unlike the young, they will reap few of the long-

term gains of reform, and many have also lost savings because of inflation. This poses important questions for pensions. There is a case for being generous to today's elderly, and in many countries they have been relatively well protected. But the cost of pensions can create major problems at a time when government revenues are falling sharply.

How does transition affect people's well-being?

People's well-being depends on their income, on their wealth—possession of a house or land, for example—and on less tangible factors, such as a fair degree of security. It also depends on access to public goods and social services. This section looks at the well-being of different groups, focusing mainly on changes in income.

Poverty, growth, and inequality—the unfolding story

Although many of their people have experienced material and nonmaterial gains (some of which are hard to quantify; see below), the CEE countries and the NIS have experienced an increase in poverty. Comparisons across countries and over time are very approximate (Box 4.1), but some

clear patterns emerge. As the CEE countries and the NIS went through a simultaneous decline in output and increase in inequality, poverty rose sharply. Inequality has risen throughout the region: because of wage liberalization; because of increasing income earned in the private sector, where incomes vary greatly; and because of increased individual wealth. Evidence from Poland shows that, as growth resumed, poverty rates tended to stabilize; however, it is too early to assess how rapidly they will decline. In contrast, in later reformers in the NIS (such as Belarus) output continues to fall and poverty to rise. As Figure 4.1 shows, income inequality is not out of line with that in comparator market economies and therefore may not fall significantly. The key to containing and reducing poverty, therefore, is resumed growth. However, for some people, such as those with outdated skills, the elderly, or children in large families, growth is not a complete solution. For such groups explicit remedial programs are needed. Even for the rest of the population, growth will need to be sustained to have a major impact on living standards.

In China the interactions between growth, inequality, and poverty produced very different results. The initial

Box 4.1 Why poverty and inequality are hard to measure

Measuring poverty is difficult because of conceptual problems and data deficiencies and because *all* definitions of poverty involve social judgments. Measuring inequality involves parallel difficulties.

How is poverty defined? *Absolute* poverty is defined by comparing personal or household income (or expenditure) with the cost of buying a given quantity of goods and services, *relative* poverty by comparing that income with the incomes of others, and *subjective* poverty by comparing actual income against the income earner's expectations and perceptions. There is no scientific, unequivocal definition of who is and is not poor.

Measuring poverty is difficult enough even in a stable economy with regular and continuous statistics. Transition economies pose additional major measurement problems. Many data on income and consumption are highly questionable, not least because of serious deficiencies in the conduct of household surveys and because of growing informal activity, which goes unrecorded. Interpretation is further complicated by huge changes in relative prices and by the increased availability of goods that accompanies a shift to the market. Improving the quality of data can itself create problems. Just as better reporting of crimes may result in a rising measured crime rate, so efforts to improve the collection of poverty and income data may lead

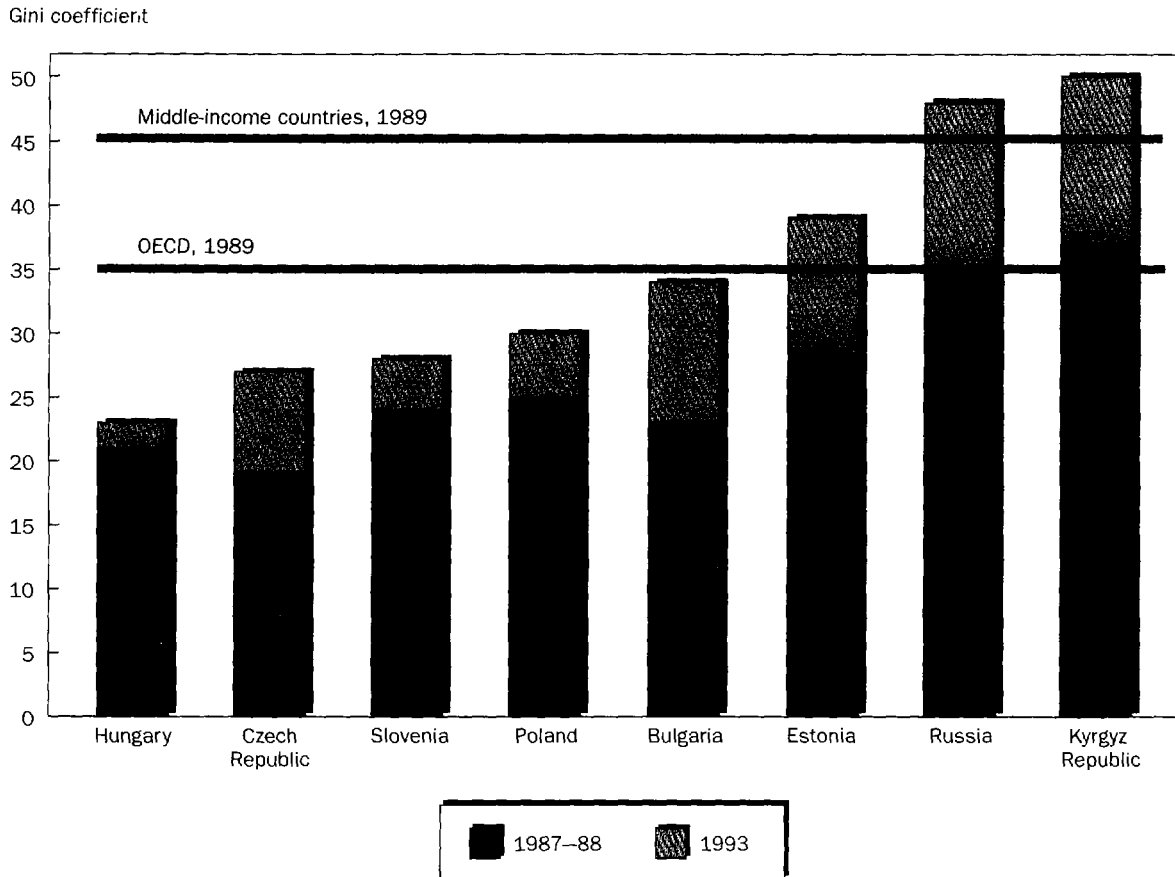
observers to exaggerate the effects of transition, if they are comparing the latest data with highly incomplete figures from prereform years. For all these reasons, comparisons of living standards before and after transition will be very approximate—at best.

Even where a definition of poverty has been agreed, measurement is problematic because poverty has several dimensions. Policymakers are interested in *how many* people are poor (the head count), *how far* below the poverty line their incomes fall (the poverty gap), and for *how long* they are poor—in other words, whether their poverty is transient or long run.

These are not just technical issues but inescapably involve social judgments. The figures in Table 4.1, except those for Estonia, are based on income per capita. If instead children were given a lower weight, the poverty line for a household of five, three of whom are children, might be (say) three times that for a single person. Investigation using income per capita will find more poor children and fewer old people than with a poverty line in which children receive a lower weight. Similarly, the choice of a household definition of income assumes that older people share the resources of younger family members and thus finds fewer poor old people. The findings on poverty in this chapter should be interpreted with these issues in mind.

Inequality in transition economies is rising toward market economy levels.

Figure 4.1 Gini coefficients in eight transition economies



Note: For the NIS no reliable data exist for 1987-88 that would allow consistent comparison of income distributions over transition. Levels for middle-income and OECD countries are simple averages. Source: Milanovic, forthcoming.

phase of rural reform led to both increased growth and reduced inequality, lifting 200 million people out of poverty. But after 1985, as reforms centered on the industrial sector, inequality rose markedly, mainly because of increased urban-rural disparity (see below), and the number of poor stopped falling. Rural poverty is a continuing problem. In Vietnam strong growth, due to the combined effects of land reform, stabilization, and liberalization, helped reduce the poor from 75 to 55 percent of the population between 1984 and 1993.

How does transition increase inequality—and why?

The most frequently used measure of income inequality is the Gini coefficient, which ranges from zero (meaning that everyone has the same income) to 100 (one person receives all the income). By this measure, inequality has increased in Bulgaria, the Baltic countries, and the Slavic countries of the former Soviet Union, to levels broadly similar to those in the less-equal industrial market economies, such as the United States (Table 4.1 and Figure 4.1). Russia's Gini now appears similar to the average

Table 4.1 Inequality and poverty in selected transition economies

Country	Gini coefficient		Poverty head count ^a		
	1993	Change from 1987–88	1987–88	Income ^b (1993)	Expenditure (1993)
<i>Central and Eastern Europe</i>					
Bulgaria	34	11	2	33	..
Czech Republic	27	8	0	1	1
Hungary	23	2	1	2	6
Poland	30	5	6	12	12
Slovenia	28	4	0	1	1
<i>Newly independent states^c</i>					
Estonia	39 ^d	16 ^{d,e}	..	23 ^{d,f}	21 ^{d,f}
Kyrgyz Republic	about 50	9–33 ^g	..	76	57
Russia	48	14–24 ^g	..	38	35
			Change in poverty head count (percentage points)		
			1978–85	1985–93	
<i>East Asia</i>					
China	38 ^h		–24	+1 ⁱ	
Vietnam	34		..	–20 ^j	

.. Not available.

Note: All data, and especially those for the NIS, are subject to major statistical difficulties; changes in Gini coefficients and poverty head counts should be regarded as only indicative. Any differences in Gini coefficients between this table and Table 5 in the World Development Indicators are due to differences in samples, time periods, definitions, or other technical assumptions.

a. Percentage of population below the poverty line. Poverty estimates for CEE and the NIS are based on a common poverty line of \$120 at 1990 international prices per capita per month for CEE and the NIS. This is high for the poorer NIS, such as the Kyrgyz Republic. Estimates for the East Asian countries use much lower, country-specific poverty lines: \$18 per capita per month for China, and for Vietnam a World Bank-determined poverty line based on a daily diet of 2,100 calories plus nonfood essentials.

b. Calculated from household survey data, adjusted upward where necessary to ensure compatibility with national income data.

c. For the NIS, no data exist that allow consistent comparison of income distributions over transition, and pretransition estimates of poverty head counts are unreliable because of data deficiencies.

d. Data are for 1995.

e. Based on Goskomstat data for the beginning and household survey data for the end of the period (Goskomstat end-of-period data are not available).

f. Calculated from 1993 PPP data for household size adjusted for equivalent adults.

g. The lower figure is based on Goskomstat data for both beginning and end of the period; the higher figure is based on Goskomstat data for the beginning and household survey data for the end of the period.

h. Figure is for 1992.

i. Datum is for 1985 to 1990.

j. Based on backward extrapolation from a 1993 household survey.

Source: Dollar, Glewwe, and Litvack, forthcoming; Milanovic, forthcoming; World Bank 1992; World Bank data.

for middle-income countries, although data for Russia (as for many other countries) probably do not take adequate account of the highest incomes. Inequality has increased less dramatically in some CEE countries, to levels similar to those in many Western European countries.

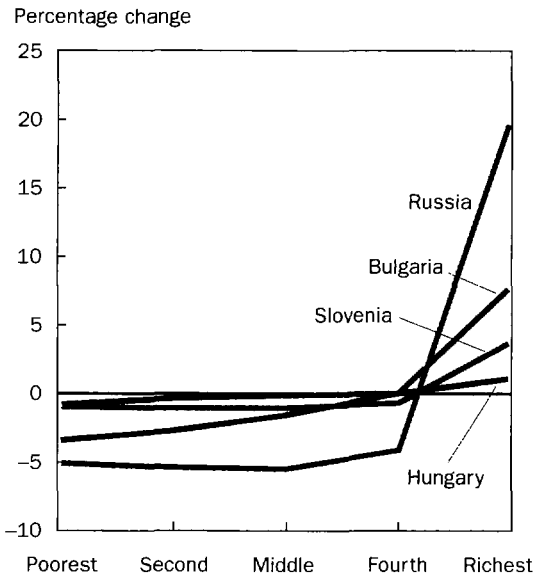
What have these overall changes in inequality meant for people of different incomes? Hungary made strenuous—and costly—efforts to offset rising inequality and has seen little change in income shares by population quintile, from that of the poorest 20 percent to that of the richest (Figure 4.2). The change was greater in Slovenia and greater still in Bulgaria and Ukraine. In Russia, where inequality rose sharply, the top quintile in 1993 received fully 20 percentage points more of total income than the top quintile in 1988, mainly because of an explosive

increase in the relative share of the very richest but also because of increasing wage dispersion. Income dispersion between sectors in Russia has also risen. The energy, banking, and related sectors all made major gains, with the biggest losers being agricultural workers, followed by workers in culture, education, and health.

China's rise in inequality has largely been driven by a different mechanism, one that has also been important in Russia, namely, differences in growth between regions and (critically in the case of China) between urban and rural areas. Income disparities within regions and cities in China remain relatively low. But the southeastern coastal area, for example, has been growing at an annual rate of over 13 percent, compared with the national average of 8.5 percent; meanwhile growth in populous central

Increasing income inequality is mostly at the upper end.

Figure 4.2 Changes in income by income quintile in four transition economies



Note: Data represent the percentage change in the share of each income quintile in total income from 1988 to 1993.
Source: Milanovic, forthcoming.

China has been around 6 percent. By 1992, household expenditure by urban families in the south was 75 percent higher than that in the north. A similar picture has emerged in Vietnam, where the area around Ho Chi Minh City, whose market memory helps it respond to reforms, is growing about 40 percent faster than the national average.

In addition to the emergence of previously suppressed comparative advantage, trade and investment policies have overwhelmingly favored China's coastal provinces, and the radical decentralization of the budget has reduced transfers from wealthier to poorer areas. The smaller transfers, higher foreign investment, and faster TVE development (Box 3.4) in the coastal provinces have all contributed to investment rates four times higher than in poorer regions. In response, the Chinese government has moved to equalize the treatment of different regions and

has reinforced its central revenue capacity with the 1994 tax reforms, opening up the possibility of increased transfers to poor areas. But given China's outward-oriented economic strategy, the natural advantages of the south remain, and unofficial migration has already responded.

Regional inequality, significant even before the reforms, increased in Russia, with poverty rates of 70 percent in the Altai territory of Russian Central Asia but less than 10 percent in Moscow, St. Petersburg, and Murmansk. In June 1995 the richest 20 percent of territories (predominantly areas rich in natural resources, plus Moscow) received 44 percent of total income, compared with only 5 percent for the poorest 20 percent (largely ethnic republics in the North Caucasus and the Volga region). Regional inequality is almost inevitable in a country as large as Russia, but it has been exacerbated by the economically irrational siting of industries prior to reform and by constraints on mobility, which are less a matter of legal restrictions than of deficient housing markets. Limited mobility will remain a major source of inequality for the foreseeable future.

How does transition affect poverty?

The poverty estimates in Table 4.1 are based on a common poverty line for CEE and the NIS. This approach allows comparison across countries—although results are sensitive to a range of factors such as exchange rate fluctuations—but means that fewer people will be counted as poor in better-off countries like Slovenia than in poorer countries like the Kyrgyz Republic. The Visegrad countries, apart from Poland, experienced the smallest rise in poverty, but this does not mean that nobody in the Czech Republic has become poorer—merely that few Czechs fall below the common poverty line. Nor does it mean that there are no poor people; there are pockets of deep poverty in Hungary, for example. The Balkan countries, except Slovenia, experienced larger increases in poverty, and the NIS larger still. In the Kyrgyz Republic poverty is less high when measured in terms of expenditure; if one uses a lower, country-specific poverty line, its poverty head count is in the 30 to 45 percent range. Although all these results are subject to the strong cautions in Box 4.1, in the early transition poverty undoubtedly increased—in many countries substantially; however, as mentioned earlier, poverty levels have tended to stabilize in countries where growth has resumed.

In China and Vietnam the story is very different. They are much poorer countries, and their poverty line is therefore much lower. Both countries embarked on reform with large numbers of poor but experienced significant reductions in poverty over the course of reform. In both, the improvements resulted from rapid growth and a shift in policy favoring agriculture. Most people in China and

Vietnam are farmers, who were taxed under the old system but now benefit from price liberalization.

How deep is poverty in transition, and is it transient or enduring? Most poverty in CEE and the NIS is shallow. In 1993 the average income of those below the common poverty line fell roughly 25 to 30 percent below that level; relative to country-specific poverty lines the poverty gap was smaller, perhaps 10 to 15 percent. Even the higher figure is less than the average shortfall in many Latin American countries, relative to the same poverty line. Much poverty in CEE and the NIS is also transient: people often move repeatedly into and out of poverty. The same is true in rural China.

Which groups are most likely to be poor? In CEE and the NIS the risk factors include:

- *Belonging to a large or single-parent family.* In 1993 about 60 percent of families with three or more children were poor in Russia, and a similar proportion of single-parent families were poor in Belarus. As elsewhere, single parents are predominantly women.
- *Being out of work.* In Russia in 1993, 63 percent of households headed by an unemployed person were poor. In Hungary, with higher unemployment benefits, only 17.5 percent of such households are poor.
- *Lacking education.* The effect of education is striking. A person with little formal education in Poland is nine times (and one in Romania fifty times) as likely to be poor as someone with a college education.
- *Being old.* Here experience has differed. Because of political pressures, governments have tried to minimize the decline in real pensions. In some countries, such as Poland, pensioners have been relatively protected. Nevertheless, in most their living standards have declined sharply. Poverty in old age disproportionately affects women—in 1990 four out of five Russians over 80 were women. Very old people living alone are particularly at risk.
- *Lacking access to assets.* In particular, access to plots of land has been a critical safety net for many households, for example in Armenia and Ukraine.

The number of poor in a country depends also on how many people are in each high-risk group. Although only a modest fraction of pensioners are poor, there are many pensioners and thus many poor pensioners. For the same reason, in the Kyrgyz Republic and Russia about 65 percent of the poor are workers, and in Poland 60 percent. Children stand out as a group that is both at high risk and large, and they constitute an increasing share of the poor in transition economies. Rising child poverty is manifest, for example, in a decline in infants' nutritional status in Russia between 1992 and 1993.

In China and Vietnam, both predominantly rural, the risk factors are very different. Most of the poor (about 9 percent of the rural population in China) are concentrated in remote, resource-deficient areas, primarily in upland regions of interior provinces, where they typically make up entire communities. Although poor people in these regions—often populated by minorities—have land use rights, the land is of such low quality that even subsistence production is generally impossible. Furthermore, since the land is some of China's most ecologically fragile, the poor are often both the perpetrators and the victims of upland environmental destruction. In the face of these problems, provision of social services has stagnated in China's poorest regions. For example, about half the children of households at or below the absolute poverty line are at least mildly malnourished.

Nonmonetary gains and losses

Transition's effects on well-being go far beyond those measured by income. People now have a vastly wider array of goods to choose from, especially imports and high-quality consumer durables, and no longer must wait hours in line to buy them. In Poland, for example, between 1990 and 1993, ownership of videocassette recorders rose from 5 to 53 percent of working households, and ownership of durables has risen throughout the region. Liberalization has created individual wealth in the form of vouchers, enterprise shares, small businesses, land, and housing—although capital, credit, and other markets are needed to realize their value. Private land has been particularly important to well-being during transition. Survey evidence suggests that home food production has increased in many countries, boosting household consumption and sometimes income as well.

Political reforms have brought dramatic social liberalization in many transition economies. New laws and revised constitutions grant wide-ranging civil liberties, a fact that people clearly recognize. In fourteen European transition economies an overwhelming majority of survey respondents believe that their country's current system is better than the old regime at allowing people to choose their religion, and a similarly high share perceive greater freedom to join organizations, to say what they think, and to choose their political affiliation. Large majorities also say that their country's current system is better at allowing people to travel and live where they want (68 percent) and in ending fear of unlawful arrest (59 percent).

But drastic change, wherever it occurs, also brings stress and insecurity. It is well known that major upheavals in people's lives—even happy events such as marriage or a new job—are stressful. The stress is much greater when the entire structure of society is in flux, when attitudes and values are changing, and when people in great numbers face actual or potential poverty and great uncertainty.

A study of displaced U.S. steelworkers in the 1980s shows that four years after the first plant closures, many steelworkers—still without a new job—reported continuing depression and anger and a growing sense of futility; these problems led to alcoholism, deteriorating family relations, and domestic violence. In many transition economies the uncertainty of life after central planning is associated with an even broader range of ill effects. There is increased familial stress as incomes fall and food prices rise. Women are especially affected (Box 4.2), working long hours in paid employment and performing the bulk of domestic chores. Partly as a result, divorce rates have risen (in Belarus, for example, from 35 percent of marriages in 1990 to 55 percent in 1994). Birthrates fell in all the European transition economies, including eastern Germany, and birthrates and marriage rates declined in every region in Russia between 1990 and 1993. Alcoholism and illegal drug use are also on the rise. As discussed in Chapter 8, health deteriorated in many of the NIS, although not in the Visegrad countries, and poor health is itself a source of stress for the families affected. Crime and corruption have increased, as discussed in Chapter 5, further reducing peo-

ple's security. Finally, there has been the stress of adapting to a new culture. Women in the Kyrgyz Republic report that selling home-grown produce is stressful: in their culture a household with extra food always gave—not sold—food to neighbors in need.

As reforms take hold, poverty, uncertainty, and stress will decline, but in many countries neither quickly nor easily. Progress for most people—as the rest of this chapter discusses—will come through growth or better-targeted transfers.

Reforming labor markets: Helping people help themselves

Although people were both hired and paid wages under central planning, labor markets did not work anything like those in market economies. In CEE and the Soviet Union, firms faced incentives to employ as many as possible, so labor shortage, rather than unemployment, was the norm. Wages bore little relation to individual performance: “Work was somewhere we *went*, not something we *did*.” Wage structures were rigid and varied little from top to bottom; as much as half the compensation package

Box 4.2 Women and work: Has transition helped?

Transition affects women much differently in some ways than it does men. In considering whether transition has increased welfare for women, the real test is whether it has left them freer than before, or more constrained. So far, at least, the answer in many transition countries appears to be the latter.

Under the previous regime women were expected to work full-time, but the state provided day care and health care. Women are no longer seen as having a social duty to work, but reform has also brought a dramatic decline in affordable child care facilities and a deterioration in health care systems. In addition, economic hardship and uncertainty during transition make it more difficult to feed and clothe the family—responsibilities that have always fallen predominantly to women in these countries—although women have clearly gained from having to spend less time standing in shopping lines. These changes can constrain women's choices in two ways: women who would choose to work may be forced to stay at home because they cannot afford child care, whereas women who would choose not to work may have to because their families need the income. Moreover, women's employment choices may be constrained by increased labor market discrimination, as evidenced by layoffs

of women before men and open discrimination in job advertisements.

Many women have dropped out of the labor force. Nevertheless, in most transition economies women account for a disproportionate share of the unemployed. Part of the drop in labor force participation reflects women's free choice. But much of the decline represents women being forced to stay home by more burdensome domestic responsibilities or becoming discouraged workers. Survey data for several CEE countries show that the vast majority of women prefer to work outside the home. Besides the personal satisfaction and social interaction it provides, work gives them connections to the informal economy, vital for coping during transition. In some countries the social pressures restricting women's choices have merely changed direction: previously expected to work, women are now expected to stay at home. Russia's labor minister made this clear by asking, “Why should we employ women when men are out of work? It's better that men work and women take care of children and do housework.” Policy should focus on increasing choices for women so that they can contribute to productivity growth. It should also increase choices for men—for example, by allowing paternity leave.

came in the form of benefits, including housing. To move toward well-functioning labor markets requires that people be paid at least broadly in line with efficiency. And it requires that people be free to move across types of work and, at least to some extent, geographically. How far have wages and employment adjusted to the requirements of a market system, and what policies can assist labor mobility while offering workers some protection against falling wages, exploitation, and job loss?

Adjusting to market forces

At the start of transition many doubted the ability of labor in CEE and the NIS to adjust rapidly to the enormous structural and macroeconomic changes. But labor *has* responded, in a variety of ways. Labor market adjustment has had three elements: changing wage levels and structures, changing sectoral and regional employment patterns (including increased work in the informal sector), and adjustment through unemployment.

WAGE ADJUSTMENT. Wages are starting to assist reform by creating incentives to work hard and acquire skills. Almost everywhere in CEE and the NIS in the early years of transition, wages fell relative to official consumer prices, often substantially. Initially there was little change in relative wages. But in CEE the distribution of wages is beginning to resemble that of a market economy. Evidence from Poland and the Czech Republic suggests an increase in the wage premium for white-collar skills and a significant increase in returns to education. In Russia, too, differentials based on skills have increased. In urban China wages are moving toward market patterns, with a shift from basic wages plus benefits (often in kind) to wages plus bonuses related to productivity or profitability. Relatively higher wages are also making jobs in joint ventures more attractive than those in Chinese state enterprises.

Transition has affected women's wages differently across countries. In Russia greater wage dispersion has meant that women, always disproportionately employed in low-wage jobs, now earn even less relative to men than before transition. In contrast, the earnings gap between men and women has narrowed in several countries, including Poland and Slovenia.

ADJUSTMENT THROUGH CHANGES IN EMPLOYMENT AND UNEMPLOYMENT. As earlier chapters have shown, the inherited distortions and the steep output decline in CEE and the NIS made labor shedding from the state sector unavoidable. Workers face four potential outcomes: staying in the state sector, moving to the new private sector, becoming unemployed (and possibly undergoing training), or dropping out of the labor force altogether (for example, through early retirement). But the employment story is complicated, particularly in the NIS, by the tendency toward informal activity. Where a household works

in several sectors, adjusting is less a simple choice between employment and unemployment than a matter of changing the mix of household members' activities (Box 4.3).

Transition labor markets show three broad patterns of adjustment. In the first, that typical of the CEE countries, employment in the state sector declined sharply. In the leading reformers labor shedding continued through the turnaround in output, leading to a recovery of labor productivity (see Figure 1.6). In Poland, Hungary, and the Czech Republic the private sector expanded strongly, whereas in Bulgaria and the Slovak Republic the state sector's decline was sharp and private sector growth weaker. In almost all the CEE countries registered unemployment rose sharply very early. It later declined, partly because of resumed growth and, more important, because people took early retirement or stopped registering as unemployed once their unemployment benefits expired. By the end of 1994 registered unemployment exceeded 10 percent in all of CEE except the Czech Republic.

Female employment has been hit particularly hard in CEE (and many of the NIS). Women were laid off in much larger numbers than men in the early transition, because their tasks were considered nonessential, because inherited social legislation like generous maternity leave made women more costly to employ, and sometimes because of outright discrimination (see Box 4.2).

Long-term unemployment (that persisting for a year or more) increased rapidly in CEE with transition, as did youth unemployment. Geographical mismatches between jobs and workers produced large and persistent regional differences in unemployment. All three problems derive from the inherited industrial structure, the mismatch between workers' skills and those demanded in a market economy, inadequate housing markets, and inadequate job information. Although wages in areas with high unemployment have fallen relative to the average, the decline has been insufficient to stimulate much movement of labor. For all these reasons the pool of the unemployed shows little turnover. The private sector draws most new employees directly from the state sector rather than from the mass of unemployed. A key conclusion for policymakers is that unemployment, by itself, has not been a major contributor to restructuring.

The second pattern of adjustment—that in Russia, Ukraine, and many other NIS—is very different. There employment has so far fallen much less than output; instead wages have borne the burden of adjustment (Figure 4.3). Because firms were reluctant to resort to mass layoffs, workers remained formally attached to their firms, receiving low or zero wages but continuing to enjoy some enterprise benefits while working increasingly in the informal sector. At least in their formal sector activities these workers are only marginally employed. Would it

Box 4.3 Household coping mechanisms

Households have a variety of ways of coping with the hardships of transition. Many produce food; others sell family possessions through personal contacts or at bazaars (in Hungary such sales doubled between 1989 and 1995). Car owners often supplement their incomes by giving taxi rides. And some families rent out their summer homes or extra rooms in their apartments.

Households also cope by relying on private income transfers. In Poland and Vietnam about two-thirds of households either give or receive transfers (see table). The amounts can be large: in the Kyrgyz Republic and Vietnam private transfers were 7 percent

and 12 percent of total income, respectively, and more than 25 percent of the incomes of recipients.

Private transfers are most likely to go to households that are poor, have experienced a debilitating event such as illness or job loss, or are headed by the young, the very old, or women—in short, the very households that are the main target of safety nets. Could these private transfers reliably substitute in part for some public transfers? Simulations for Russia indicate that if public pensions were eliminated, private transfers would replace about 19 percent of their amount. The converse is also true: increasing pensions would not cause a ruble-for-ruble reduction in private support.

Private transfers in selected transition economies and the United States
(percentages of total)

	Kyrgyz Rep. (1993)	Poland (1992)	Russia (1993)	Vietnam (1993)	United States (1979)
Households giving or receiving	21.0	65.0	36.0	68.0	30
Transfers as a share of total income	7.4	3.2	4.4	11.9	2
Transfers as a share of recipient income	41.1	7.2	20.1	27.0	6

Source: Cox, Eser, and Jimenez, forthcoming; Cox, Fetzer, and Jimenez, forthcoming; Cox, Jimenez, and Jordan 1994; Cox, Jimenez, and Okrasa 1995; Cox and Raines 1985; Gale and Scholz 1994.

speed transition in the NIS if such workers became explicitly unemployed, as in the CEE countries? Keeping people on the payroll may reduce pressures to restructure. But if labor is immobile, as in Russia, increased unemployment does little to help match workers with jobs. Thus the argument that the NIS should follow the CEE pattern is not entirely clear-cut.

In the third pattern, that of China, state sector employment continued to grow until 1993, declining very slightly thereafter. During the first phase of urban reform, in 1985–90, the state sector provided about 70 percent of all new jobs, but by 1993 it provided only 9 percent of new urban employment. The engine of employment growth is the TVEs, where employment grew ten times faster than in the public sector (Figure 4.4). But growing nonstate employment will not be enough to pull labor out of the state sector. Including benefits, pay in the state sector is about 60 percent higher than in the nonstate sector, and because of continued migration from poor (particularly rural) regions into nonstate employment, the gap is unlikely to narrow. Policymakers will therefore have to find ways to deal with redundant state labor, estimated at some 20 percent of state sector employment.

Employment adjustment in Vietnam has followed the CEE pattern, although state sector employment never

exceeded about 15 percent of total employment. The key to creating additional employment will be continued trade liberalization and other policies to encourage labor-intensive industries.

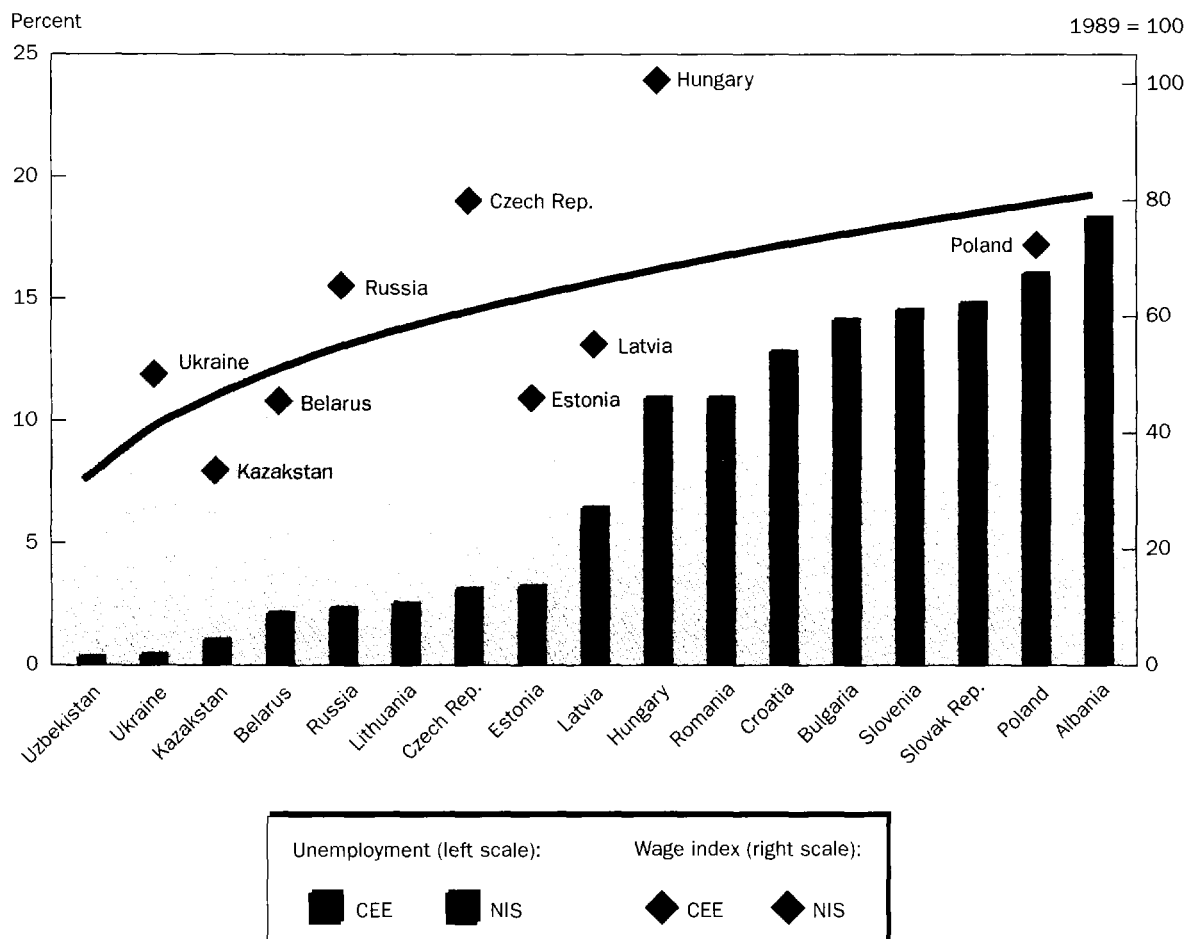
Policy directions

An important lesson of reform to date, both economic and political, is that market forces alone cannot always drive the restructuring process forward. Greater market determination of wages and employment must be supported by policies to minimize adverse incentives, improve occupational and geographical mobility, and protect workers, both through labor market regulation and through policies to combat unemployment.

MINIMIZING ADVERSE INCENTIVES. As discussed in the next section, income transfers have an important redistributive role. But their structure, in terms both of benefits and of contributions, has important implications for the efficient operation of labor markets. In the early transition unemployment benefits were a large fraction of the recipient's previous wage (often up to 75 percent, and in Ukraine and Belarus 100 percent), and some countries set no time limit on benefits. Not surprisingly, this reduced incentives to find work. By 1995 benefits in all countries were low, largely for fiscal reasons, and some countries,

Wages have fallen further in the NIS than in CEE, but more workers have kept their jobs.

Figure 4.3 Unemployment and wages in CEE and the NIS



Note: Data are for 1994. Unemployment is measured by the registered unemployment rate; nominal wage data are deflated by the country's consumer price index. Because of the ending of shortages and improvements in the quality of goods, changes in deflated wages may not be a good index of changes in real purchasing power. The regression line is that for the regression of the wage index on countries' rank by unemployment level. Source: Official data.

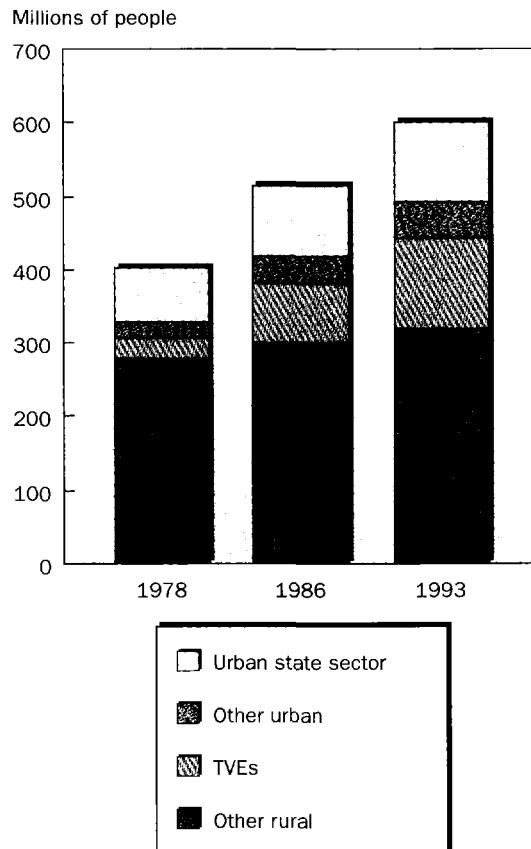
including Hungary and Poland, paid benefits at the same flat rate to all recipients. Such an approach simultaneously improves work incentives, minimizes costs, and eases administration. All countries now limit the period for which unemployment benefits are paid, generally to a year or less. Once their entitlement has expired, unemployed

workers must rely on poverty relief. The result is a high incidence of poverty among the unemployed in countries where poverty relief is patchy.

Incentives on the contributions side are also important. In CEE and the NIS payroll contributions that finance income transfers (including unemployment bene-

China's TVEs have produced most of the new jobs.

Figure 4.4 Composition of employment in China



Source: China Statistical Publishing House 1995.

fits) are high, hindering new employment, encouraging workers and employers to collude in fraud, and creating incentives for unofficial employment (Chapter 7). The employer contribution can be reduced in three ways: by reducing benefits, by financing through general taxation benefits that do not relate to any insurable risk (such as benefits for children), and by dividing the contribution between worker and employer (under the old system the employer paid the entire contribution, a fact regarded as one of the victories of socialism). “Sharing” contributions between worker and employer may make little difference

to who actually ends up paying it. But it has the great advantage that workers immediately see a larger deduction on their pay slip if benefits increase; this helps reduce pressure for higher benefits. Separately, governments also need to spread the tax net to include new private firms; otherwise the burden on larger firms increases and, with increased evasion, the tax base shrinks further. In all these areas progress has been scant.

IMPROVING LABOR MOBILITY. Many of the ingredients of a more mobile labor market in transition countries are more or less universal: well-designed unemployment benefits, improved job information, labor exchange services, adequate transport systems, and—even more important—an active housing market. But transition countries face a unique challenge in creating a labor market that frees workers to move from job to job and place to place, namely, how to dismantle structures of social support that tie workers to a single enterprise while simultaneously building a new system to replace them.

Decoupling delivery of a wide range of services from enterprises—housing and day care are particular problems—will be vital to allow workers to move readily. But the pitfalls are many, and progress has varied. If divesting of services is slow, reform is impeded; if rapid, it can lead to a breakdown in service provision. In the short run, therefore, municipalities have an important role in ensuring continued provision of key services, perhaps through underwriting part of enterprises’ cost of provision. A longer-term approach has three steps. First, require enterprises to separate their general accounts from those for social services. Second, for tax purposes allow enterprises to offset the costs of social services against the income those services generate, but not against income earned from the enterprises’ main activities. This gives enterprises strong incentives to charge for services and might encourage the spinoff of new service firms. Third, help families meet those charges through higher wages (in place of non-monetary compensation) and through targeted income transfers such as family allowances. Over time, service-providing entities could become freestanding providers, could be taken over by the municipality, or could disappear. With finance decoupled from the enterprise, the last outcome would not be a problem, at least in urban areas with multiple providers, because provision would no longer be exclusively for enterprise employees. Indeed, providers would face incentives to attract new customers.

Migration, another aspect of mobility, is an important issue, particularly in China where enterprises provide pensions and health care on the assumption that people keep the same job for life. Legal controls on where people can live have been eased, and price reform, market development, and high urban demand for labor have led to enormous migration in search of employment. This “floating

population," mostly single men and young women, makes up 20 to 25 percent of the population in most cities. But this migration remains temporary, in large part because migrants are not eligible for education, health care, or subsidized housing. Both restricted mobility and completely free movement have costs: the former in lost opportunities for beneficial migration, the latter in strains on urban infrastructure, the breakdown of rural communities, and the risk of creating an urban underclass. But the present situation in China is unambiguously bad: mobility exists in practice, but institutions are based on the assumption that it does not.

PROTECTING WORKERS THROUGH REGULATION. Governments have a distinct role in setting the legal and regulatory frameworks within which trade unions and firms can operate and in ensuring that those frameworks encourage their positive contributions to growth. Governments also need to define minimum standards and prevent exploitation and discrimination. Successful labor policies are those that work in harmony with the market and avoid providing special protection and privileges to some labor groups at the expense of the poorest.

CEE and the NIS have inherited heavily unionized labor markets. Under the old regime, trade unions were in essence part of the government apparatus (as they are still in China and Vietnam). Their role needs to change if they are to support a market system in the ways explained in *World Development Report 1995*. Encouraging the beneficial side of trade unions in transition countries will be no easy matter, and the precise policies needed will vary considerably across countries. But there are two constants. The first is free competition in product markets, so that unions cannot capture economic rents. The second is ensuring that parties engaged in bargaining face the costs of its outcome. In Poland, for example, legislation in the early 1990s required that workers be paid even when on strike—a clear disincentive to compromise.

Another thorny issue is whether to have a minimum wage. This is a hotly debated question worldwide. But whatever the balance of general arguments for or against, a minimum wage could be particularly problematic for transition economies. Limited government capacity, aggravated by the tendency toward undeclared employment, makes it very difficult to enforce. Moreover, the difference between subsistence and the average wage is much smaller than in rich countries, creating a tension between a minimum wage high enough to avert poverty but low enough not to reduce employment. In Russia, where the minimum wage is the basis of the entire public sector wage structure, the government, to reduce inflationary pressures, has exerted downward pressure on the minimum wage. As a result it no longer protects the lowest-paid workers. To the extent that poverty among

the working poor disproportionately affects families with children, a family allowance (discussed in the next section) might be a more effective way of combining employment opportunities with poverty relief.

ADDRESSING UNEMPLOYMENT. Two questions are of particular relevance to CEE and the NIS regarding unemployment. Should governments continue to assist enterprises? And what should be the role of active labor market policies (policies aimed at improving work opportunities)? The speed and effectiveness of transition depend on the pace of restructuring in state and privatized firms. Where local unemployment is high and labor mobility severely constrained, a case can be made for temporary employment subsidies for firms that may survive in the long run or whose closure would devastate a region. But governments should ensure that such support is phased down on an established schedule (Chapter 3) and that financing is concentrated on employment. Finally, where explicit employment subsidies are provided, governments should also work to increase labor mobility and give workers information on job opportunities elsewhere.

Active labor market policies are of three broad types: employment services (placement, counseling) to "recycle" existing skills more effectively, training to increase human capital, and direct job creation. The usefulness of such policies during a general collapse in output is severely circumscribed, however. Except on a small scale and very selectively, they are likely to be beyond the means of CEE countries and the NIS, even though they can be an effective response to industrial decline and the corrosive effects of long-run unemployment. The Czech government instituted a package of labor market reforms in 1990–92 with three elements: a computerized job information system, reduced unemployment benefits, and job creation programs. The reduced unemployment benefits and the country's low initial level of unemployment made the job creation programs financially feasible, and the evidence suggests that they helped reduce the spread of long-term unemployment. However, the main driving force behind continuing low unemployment in the Czech Republic has not been specific labor policies but strong private sector growth.

Reforming income transfers: What redistributive role for the state?

In all middle- and high-income countries the state has an important role in organizing income transfers. These have several purposes: to redistribute income, to maintain political stability, to promote efficient labor markets, and to insure against important risks where private markets cannot.

The specific objectives of income transfers include *insurance*, protecting people against risks such as unemployment; *income smoothing*, allowing people to protect their living standards in old age by redistributing income

from their younger years; and *poverty relief*, ensuring at least a minimum standard of living. The changes in labor markets that transition brings require a fundamental reform in the old system of income transfers: a widening wage and income distribution means that transfers must be targeted in ways that take more account of differences in circumstances; the loss of job security makes developing unemployment benefits urgent and means that transfers can no longer be administered by enterprises. Both these changes call for strengthening the administration of income transfers.

Inherited transfer systems

Inherited systems of income transfers in transition economies differ greatly but share some common tendencies: support is poorly targeted, much administration is devolved to enterprises, and some rural populations are neglected.

CEE AND THE NIS. Although relatively well adapted to the old regime, the system of income transfers in these countries failed in important ways to accord with the needs of a market economy. It distributed roughly equal benefits to all in the urban population rather than focusing them on the poor. In most countries poverty relief was rudimentary, and because officially unemployment did not exist, neither did unemployment benefits. Enterprises had a major role in benefit administration (for example, paying contributions en bloc for their workers, with the result that governments have no individual records), and no distinction existed between risk-related benefits (such as unemployment benefits) and others (for example, family allowances). A single social insurance contribution financed the whole gamut. Administrative capabilities, moreover, were limited. Pensions, for example, were paid in cash through the postal system.

There has been some progress. All the CEE countries and the NIS now have working systems of unemployment benefits, and many have established a broadly based, income-tested benefit of last resort, usually at low levels. Benefits, nevertheless, remain badly targeted. In Russia in 1992 only about 19 percent of transfers served to reduce poverty directly, compared with an average of 35 percent in the OECD countries and 50 percent in Australia.

High spending on benefits, particularly pensions, has been a central issue. The core of the problem is that pensioners are numerous. Pensionable age in CEE and the NIS is generally five years lower than in the West, and large groups such as miners and teachers were able to retire even earlier. As a result, the typical woman pensioner in the Czech Republic enjoys five more years of retirement than her American counterpart, and seven years more than her German counterpart. For men the difference is closer to one year. The comparison for Hungary, Poland, and Russia is broadly similar.

The multitude of pensioners can create a vicious circle in which high pension spending (16 percent of GDP in Poland in 1994) leads to high payroll contributions, to incentives not to declare employment, and thus to still higher contribution rates (Box 4.4). Yet pensions in most countries remain low because there are so many pensioners. The combined effects of unemployment, widespread informal activity, low pensionable age, and, in some countries, lack of rural coverage have led to low ratios of contributors to pensioners (Table 4.2). Poland, for example, has 4.6 people of working age for each person aged sixty or more, but only 1.9 of them contribute. Bulgaria has little more than one contributor per pensioner. Medium-term projections in many countries show that present arrangements are not sustainable.

Breaking this vicious circle is one of social policy's main challenges. So far there has been much debate but little change in policy (the Czech Republic and Latvia are among the few exceptions). In fact, the average age at which a pension is first paid has *declined* in most countries. Making the political economy of pension reform more difficult is the fact that employers pay the bulk of pension contributions, whereas pensioners as a group have the power to swing elections.

CHINA. Social protection in China differs from that in CEE and the NIS in several important ways: the country's population is still young (although the average age will rise rapidly over the next thirty years), its urban system of social protection is a series of enterprise-based islands rather than a unified system, and it has a large rural population (80 percent of the total population) with very limited social protection.

The urban system of income transfers (labor insurance) faces many problems parallel to those of the CEE countries and the NIS. Pensionable age, for example, is low and the social insurance system excessively fragmented. Workers in government agencies and state enterprises enjoy comprehensive benefits, while a parallel, less generous system serves employees in collective enterprises. By contrast with CEE and the NIS, Chinese enterprises have been responsible for administering *and* financing benefits. This arrangement ties workers—and pensioners—even more closely to the enterprise and slows enterprise reform. Furthermore, the generosity of benefits depends on the enterprise's financial capacity and on its age (newer enterprises have fewer pensioners). Some income pooling between enterprises has been introduced at the municipal level, but this is only a partial solution.

China's rural labor force remains outside the system of labor insurance, creating two sets of problems. First, more than 100 million people working in rural industry have only patchy access to health care and no pension rights unless they buy them privately. The huge rural population has relied on the extended family for old age support and

Box 4.4 Reforming income transfers in Hungary and Latvia

Hungary illustrates the potential vicious circle in financing income transfers. In 1992 about 90 percent of households received some sort of transfer, and transfers made up over 40 percent of household income. The problem arises in part because pensionable age is low and because registered employment fell by 20 percent between 1990 and 1995. High social spending may have helped prevent change in the income distribution (Figure 4.2), but it led to high contribution rates. These, coupled with limited enforcement capacity, increase incentives for evasion and informalization, thus reducing the number of contributors. Despite high spending, benefits are often inadequate, and additional, undeclared earning is becoming the norm. Reform is politically contentious, but the potential payoff to reduced informalization is huge: if 100,000 workers (about 1.9 percent of the labor force in 1990) moved from registered unemployment to registered employment, the fiscal balance would improve by about 0.5 percent of GDP.

Latvia has introduced major reform intended to break the vicious circle. State pension spending is to

be reduced by abolishing favorable treatment for special groups and by paying lower benefits to people who retire earlier and higher benefits to people who defer retirement and continue to contribute. It is estimated that, if the reforms are successfully followed through, the savings by 2000 will equal roughly a quarter of expected contributions. Those savings will be channeled to a second, funded system in which the contributions will be held in reserve or invested by private managers. In essence, Latvia's older and younger generations have made a deal. Pensioners have agreed not to press for larger benefits, and workers have accepted the burden of higher contributions in the hope of greater security for themselves in old age.

If successfully followed through, the reforms will bring major benefits. They will reduce public pension spending. They will do away with arguments about the age of retirement, because workers can choose when to retire. And because pensions bear a direct relation to contributions, they will encourage people to come out of the informal economy.

poverty relief, but with a trend to smaller families and increasing labor mobility, these ties are weakening. The 30 million to 40 million absolute rural poor are on the margin of subsistence. Many would face starvation were it not for China's highly effective grain relief system, which provides them with just enough grain to live on. It is essential that this system survive transition. Beyond this, sustained economic growth should continue to aid poverty reduction. And because the poor make up a relatively small share of the rural population, the government should be able to target relief to the very poorest communities.

The second set of problems relates to a blurring of the distinction between urban and rural workers and the emergence of a growing migrant rural labor force. The social insurance system, still based on the assumption of low labor mobility, has yet to recognize that workers move between types of employment and between locations. One quarter of rural workers are now wage earners, yet still lack the labor insurance coverage of their urban counterparts. Likewise the growing "floating population" of migrant workers remains largely without coverage. Although most migrants do well, some do not, and they may represent the first of an emerging group of poor in areas that have not traditionally had large poor populations.

Table 4.2 Population structure and contributors per pensioner in selected transition economies

Country	Persons of working age per person over 60	Contributors per pensioner
<i>Central and Eastern Europe</i>		
Albania	7.9	1.0
Bulgaria	2.9	1.2
Czech Republic	3.5	2.0
Hungary	3.2	1.5
Poland	4.6	1.9
Romania	3.6	2.0
<i>Newly independent states</i>		
Russia	2.9	1.9
Kyrgyz Republic	5.0	2.6
Turkmenistan	6.6	3.6
Uzbekistan	6.3	3.0
Memorandum:		
OECD average, 1990	3.6	2.6

Note: Data are for 1993.

Source: World Bank Social Challenges of Transition data base; World Bank 1995k.

Policy directions

Broadly, social safety nets can take two forms: transfers, whether in cash or in kind; and programs that give people earning opportunities. There is a strong presumption that, where transfers are paid, they should be in cash wherever possible: cash payments leave buying decisions to the recipient, they are more transparent in budgeting, and they do not interfere with market prices. In some circumstances, however, benefits in kind have advantages: they usually maintain their value during inflation, and in specific cases—some of which are discussed below—they may be well targeted. Transition economies have very different incomes, administrative capacities, family structures, and social priorities. Some have much larger informal sectors than others, and some remain substantially rural. Their systems of income transfers will therefore differ widely.

PRIVATE INSURANCE. Many people are poor only for particular periods in their lives—for example, while unemployed. Should the state leave coverage of such risks to private insurance? The answer, as discussed in Chapter 7, is usually no. Private insurance deals badly, if at all, with certain risks, including unemployment. It may be an option for some risks (such as health-related absence from work) and for some people (the urban middle class). But even in the West, where the institutional framework is stronger, private insurance is no more than a supplemental source of income support.

SOCIAL INSURANCE. Social insurance benefits are paid on the basis of a worker's contributions (usually a fraction of his or her wages) and on the occurrence of a specified event, such as becoming unemployed or reaching a given age. Because participation is compulsory, social insurance can protect against risks that the private market cannot cover and can redistribute from rich to poor. Although all the CEE countries and the NIS have well-established systems that would be politically difficult to withdraw, social insurance may not be the way forward for all countries. Whether it is depends on the answers to several questions. Are the causes of income loss relatively clear-cut and in principle insurable? Is administrative capacity adequate? Can income be accurately measured for purposes of calculating contributions? And is it possible to enforce contributions and calculate benefits? In countries such as the Czech Republic, Hungary, and Poland the answer to these questions is yes. In some of the NIS, particularly the poorer Central Asian economies, it is probably no. Because much employment is informal, enforcing contributions is virtually impossible, and low administrative capacity makes enforcement problematic even in the formal sector.

Pensions pose special and difficult problems. Should members of the current older generation receive special

treatment? In much of CEE and the NIS inflation destroyed the financial savings of the elderly. Unlike the young, they will not have the opportunity to recoup their losses in the market economy. A case can therefore be made on equity grounds for special treatment. In part this has already happened: many people have been allowed to retire early, and pensioners in many countries have held their ground relative to wage earners. Another possibility is to favor the elderly in distributing such assets as shares, vouchers, and housing. Wealth can empower the older generation: an elderly pensioner who owns her house can leave it to her children, trade it for regular income transfers from her children, or use her house as security for a loan or an annuity.

However, the inherited pension systems in CEE and the NIS need major reform. Benefit spending, like public spending generally, must be made compatible with a smaller public sector, to create room for private sector-led growth. In many countries spending on pensions has to be cut, either by reducing individual benefits or by reducing the number of pensioners—for instance, by raising pensionable age and stemming abuse of disability pensions. In the short run poverty relief should take precedence over other objectives; in some countries this may mean paying flat-rate benefits. This cuts spending but may create discontent. As always, policymakers have to strike a balance between what they cannot afford to do—and what they cannot afford not to do.

In the medium term, as fiscal and administrative constraints start to relax, the system can evolve toward one that more explicitly relates contributions to benefits. This will strengthen incentives to contribute—indeed, to the extent that it reduces perceptions that the contributions are a tax, it may also improve the incentive to work in the formal sector. Special arrangements for the current elderly should not be carried over to the younger generation, who have time to build up pension entitlements and other forms of wealth. Political difficulties notwithstanding, gradually raising the retirement age is inescapable, and this has started in a number of countries. Reform of state pensions should be accompanied by development of a complementary system of private pensions (discussed below).

In China there is broad agreement that a unified system, including rules for adjusting benefits for inflation, should cover all urban enterprises, state and private. For the same reasons as in CEE and the NIS, benefit administration and delivery should be shifted away from enterprises, and the retirement age should be raised. Contributions by employers and the different levels of government should be clearly delineated and, for the same reasons as elsewhere, worker contributions introduced.

Countries will need additional ways to relieve poverty, but that requires first identifying who is poor. There are

three broad ways to do so: by measuring income (that is, by using an *income test*); by using an *indicator of poverty*, such as age or illness; or by devising programs with incentive properties that induce only poor people to participate.

INCOME-TESTED SOCIAL ASSISTANCE. Assistance to individuals or families with incomes below a specified level is appropriate for the lifetime poor and where contributions cannot be calculated or enforced. But broadly based, income-tested social assistance presents several problems: it creates important disincentives against work, the necessary tax rates are unsustainable for poor countries, determining eligibility is administratively demanding and costly even in wealthier countries, and income testing can be stigmatizing and intrusive and thus politically contentious. These problems are serious for many transition economies, especially where poverty is transient and often shallow, so that many people move into and out of poverty.

One alternative is to organize poverty relief locally and allow local officials some discretion in administering it. Uzbekistan has introduced a scheme of this sort. The smaller the locality, the better the information on applicants, which assists targeting. Localities can be given a fixed budget, so that spending can be controlled. Discretion, however, is administratively demanding at both the central and the local level. A mechanism is needed to ensure that the neediest localities receive greater resources than less needy ones. This requires both the technical capacity to make informed decisions and the ability to avoid discrimination and corruption.

TARGETED RELIEF USING POVERTY INDICATORS. It is sometimes possible to identify the poor through an indicator of poverty that is easier to measure than income. With services such as child care being withdrawn, family allowances are likely to be particularly well targeted in the European transition economies. An income test for all families with children is administratively costly, and the larger the informal sector, the less accurate it would be. Family allowances—a fixed amount per child per month—are paid without income tests throughout Western Europe and in several Latin American countries. Other uses of indicator targeting include help for pregnant women and infants through nutrition programs and medical checkups, and for schoolchildren through free meals and health checks. Old age, particularly in single-person households, is another good indicator of poverty and is administratively relatively undemanding (Box 4.5).

SELF-TARGETED POVERTY RELIEF. Some countries try to subsidize goods consumed mainly by the poor. But such commodities are few, and the list of subsidized commodities can be “hijacked” by the middle class. Another approach is to offer subsistence cash payments in return for work. In Estonia able-bodied people are eligible for

Box 4.5 Innovative pension delivery in South Africa

Each month on pension day in Kangwane, a former black homeland in South Africa, a thin line of grandparents walk across the rural wilderness clutching banknotes dispensed by some of the most sophisticated cash machines in the world. The cash machines arrive mounted on unmarked trucks and escorted by armed guards. Under makeshift awnings, each pensioner swipes a plastic card through the machine, then rolls a finger across a tiny scanner that checks the fingerprint against a digital template and then dispenses the monthly pension. The service now pays pensions to about 400,000 South African senior citizens.

The system works well in both social and administrative terms. It empowers the elderly, usually women, and it can be a good way, through a grandmother’s discretion, of offering family support. And when a person dies and is therefore unable to collect the pension, payments cease automatically.

unemployment benefits only if they perform eighty hours of public service a month. Such “workfare” has advantages: the only people who participate are those for whom it is genuinely the least-bad option, and it may allow recipients to preserve their dignity by working. Broader benefits may accrue where the work creates useful infrastructure such as roads. But the approach is hard to implement, and it may face political opposition.

CONCLUSION. The experience even of the advanced reformers highlights the difficulties of targeting poverty relief effectively and shows the importance of devising simple eligibility criteria, of devolving initiatives to the community level, and of engaging a wide range of interested parties, including disadvantaged groups and community leaders in partnership. In this context nongovernmental organizations (NGOs) can have a valuable role, for example by providing shelter for the homeless. To encourage these activities, however, governments must first make them explicitly legal where they are not already, and possibly provide them with tax advantages or some explicit funding. NGOs can often relieve poverty and provide services more efficiently than state institutions, as well as encourage local participation and generally promote the development of civil society.

Pension reform—and the role of private schemes

State pensions, as discussed earlier, require fundamental reform in every transition country. Many of the less

advanced reformers should probably focus solely on getting their state systems in order. But some transition economies are developing private pensions or considering their introduction. Most state pensions operate on a pay-as-you-go basis (current pensions are paid out of current contributions), whereas most private schemes (whether compulsory or voluntary) are funded by the savings people accumulate during their working lives. Some elements are essential to any pension reform. Beyond these, policymakers in each country face a range of options. These, however, will be subject to the interplay between choice and initial circumstances highlighted in Chapter 1.

ESSENTIAL COMPONENTS OF REFORM. The first and central element of pension reform in transition economies is ensuring that public pension spending is compatible with economic growth. Problems with public spending must be addressed directly; private pensions are no solution to excessive state spending, especially when the public schemes are as overextended as they are in most transition countries. Second, any pension reform needs to be financed in some way. Adding a funded scheme to an existing scheme requires building up capital to pay future pensions while continuing to pay current pensions. This is rather like asking people to pay mortgages on two houses—their own and their parents'—at the same time. If the parents' home is small and the children's income rising (as in Chile and China), the added payment is not a major problem. But if the parents' home is large—and mortgaged to the hilt—and the children's income low or shrinking (as in CEE and the NIS), the parents' home will have to be financed in some other way. Alternative ways of funding pensions include taxation, asset sales, or borrowing. Introducing private pensions therefore needs to be part of a strategy that also embraces public pension spending (see the discussion of Latvia in Box 4.4). Indeed, as noted above, controlling public pension spending ought to be the driving priority for many less advanced reformers for the time being, since they are still some way from acquiring either the economic or the institutional basis for more ambitious, long-term reforms.

A third essential element is regulation and enforcement to protect contributors and pensioners; this in turn requires effective government. In many transition economies the necessary financial market regulation, including agreed and enforced accounting standards, is not yet in place. Putting it in place is a large task, but an essential first step in building private pensions. Especially where there are large pension funds, government also must be barred from trying to politicize the allocation of investment. Finally, funded pensions need time to mature; it takes up to forty years for workers to accumulate enough to support themselves in old age, although

this might in some cases be speeded by endowing pension funds with privatized assets (Box 4.6).

POLICY OPTIONS. Eventually, transition governments are likely to settle on a pension system that combines three elements: a state component, normally pay-as-you-go; a funded component, normally private; and, where the funded component is compulsory, a third component consisting of funded schemes to which individuals can make voluntary additional contributions. Within this framework, every country will have some strategic choices to make about the relative size of the three components and the design of each.

How large and how redistributive should the state pension be? Poor countries cannot afford to spend much on pensions. The cheapest way to maximize poverty relief in such cases is through flat-rate pensions. As fiscal constraints relax, other policy options become possible, including a higher flat-rate pension (as in the Netherlands) or a pension that is at least partly related to previous contributions (as in the United Kingdom and the United States).

How should private, funded pensions be organized: through individual accounts (as in Argentina and Chile), or should it also be possible for employers to organize schemes, as in many European countries? The choice depends in part on how broadly policymakers want risks to be shared. As a separate issue, how and how far should pensioners be protected against loss and high inflation—particularly salient risks in an economy undergoing major reform? The state might underwrite at least some of the inflation risk—pensioners should not face substantially more risk than wage earners, and the collapse of private pension schemes during the infancy of a market economy could undermine the political consensus underpinning economic reform.

Should membership be compulsory? Pay-as-you-go schemes are so by their nature. Some experts argue for small public pensions and compulsory membership in private schemes. But requiring membership raises tricky issues. The Czech Republic has an above-subsistence public pension and is bringing spending under control, in part through funded schemes, with tax advantages to encourage contributions. But the Czechs did not consider it politically feasible to take the further step of mandating contributions to the new private schemes. Many other transition countries will also find this difficult, given that inflation has so recently all but wiped out private savings.

PENSION PACKAGES. How should transition countries choose which mix of pension schemes is right for them? A typical system in Europe and North America has a state pay-as-you-go pension covering more than subsistence, complemented by a variety of regulated, privately managed, funded pensions. Where these are compulsory, individuals

Box 4.6 Can state property be used to fund pensions?

Governments enter transition with large obligations—but also with considerable property. In market economies the total value of wealth is roughly four times GDP: land, housing, and other structures (including commercial buildings) are each about equal to GDP; equipment, inventories, consumer durables, and livestock make up the remainder. Can transition governments use some of this wealth to fund obligations such as pensions?

Experience elsewhere suggests that it is possible. In Bolivia government shares in majority privatized companies will be placed in privately managed pension funds. In theory governments in transition economies could do the same. And enterprise shares are not the only asset they could use. Bonds placed on the books of some enterprises (with the government as beneficiary) are another available asset. Bonds have a steady payback, are more secure than equity shares, and may subject firms to creditor monitoring. Real estate could also be used to fund pensions. For example, some Chinese enterprises unable to pay pensions have considered transferring the housing they own to a property management subsidiary, which could borrow against

the housing to pay the pensions. On the death of the pensioners the housing would be auctioned.

Although attractive in principle, these schemes are not easy to implement. The first problem is that not all state wealth is controlled by central governments. Subnational or municipal governments control much commercial real estate. Tenants often have strong presumptive rights to their homes, even if they are owned by government or state enterprises. A second problem is that funded pension schemes require regulatory oversight, liquid asset markets, and a pool of independent professional managers, and all take time to develop. But the alternatives are not necessarily easier. Governments could instead sell the property for revenue, but this is difficult if buyers with capital are scarce (see Chapter 3). Governments may sell property quickly and cheaply, hoping to collect property or capital gains taxes from the new owners; in practice, however, tax administration also takes time to develop, particularly for these complex taxes. Given the difficulties of any course of action, using state assets to fund pensions may be worth considering, but any scheme requires careful attention to both design and implementation.

may also make voluntary additional contributions to funded schemes. The three components address different purposes: the state scheme is concerned mainly with poverty relief and (often imperfectly) with redistribution, the second tier helps people redistribute their income across their lifetimes, and the third allows for differences in individual preferences. This approach accords a significant role to social solidarity and shares risks fairly broadly, but it can come under severe financial pressure from the twin threat of a slowly growing economy and a rapidly aging population. An alternative approach, used in Chile and Singapore, has a smaller public component. In Chile the state pension is a minimum guarantee for private pensions; people whose benefits are above the minimum receive no state pension. For most, pensions are provided by one or more funded, regulated, individual schemes. Individuals can make voluntary additional contributions. This approach does not redistribute from rich to poor or between generations other than through the minimum pension guarantee. Recent reforms in Latin America (Argentina, Colombia, and Peru) adopt something of a middle ground between the European–North American and the Chilean approaches.

The precise choice depends on a country's objectives and its constraints. Chile and several of the high-perform-

ing Asian economies gave priority to economic growth and therefore adopted more individualistic systems that encouraged high saving. Some transition economies face tighter constraints—economic, political, and social—than these countries, which have long-established market systems, relatively sophisticated banking systems and capital markets, and relatively stable prices (and Chile introduced its reform at a time of budgetary surplus). Moreover, government capacity in those countries is high. Social constraints also differ. The extended family is still important in the high-performing Asian economies, and strong family support structures also exist in the Central Asian republics; they are weaker in CEE and the other NIS. In the Kyrgyz Republic, for example, elderly ethnic Russians are worse off than elderly Kyrgyz, for whom the extended family support network still exists. Most of these constraints, and others elsewhere in the economy, can be overcome through consistent reform—indeed, that is one of the major purposes of reform. But they cannot be ignored in the short run.

The agenda

Some widening of the gap between rich and poor is an inescapable part of transition. Especially where rising inequality has also involved rising poverty, governments

have come under pressure to narrow the gap once again. Over the long haul the only way to reduce poverty is to foster economic growth, largely by pursuing the pro-market policies—including lower public spending—described in Chapter 2. Tackling chronic labor immobility would encourage growth and reduce poverty at the same time. But freeing workers to respond to market signals will be tougher than freeing the markets themselves. It will involve not merely market-determined wages, but governments taking on the other hindrances that keep workers from freely changing jobs—in particular, the coupling of social benefits to enterprises and the lack of a functioning housing market. Growth and greater mobility would help most of the present losers from reform to make up their recent losses. However, policy must recog-

nize the true extent to which large numbers of people are suffering from poverty, insecurity, or both. Policymakers have to find a meeting ground between fiscal pressures and political and social imperatives. People left behind even after growth rebounds and labor markets become more flexible should be able to count on continued government support, including well-targeted social benefits. The elderly in transition countries stand much less chance of recovering their losses, and this generation presents a strong case for special treatment. But runaway spending on pensions in transition countries cannot be allowed to continue. Governments can address the problem now, by raising the age at which the next generations can retire, and over the long term, by building a pension system that can sustainably support the many generations to come.