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**Economic Transition and Social Protection—Issues and Agenda for Reform**

Prepared by Sanjeev Gupta<sup>1</sup>

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**Abstract**

This paper briefly describes the factors constraining the social protection policies in the Baltics, Russia, and other countries of the former Soviet Union (BRO). The analysis considers public spending in social programs, including generalized subsidies for goods and consumer services, pensions, unemployment-related and social benefits, and education and health care. The paper then lists policies that can help mitigate the worsening living standards of the poor and the vulnerable in a fiscally sustainable manner.

JEL Classification Numbers: H53, I31, I38, P35

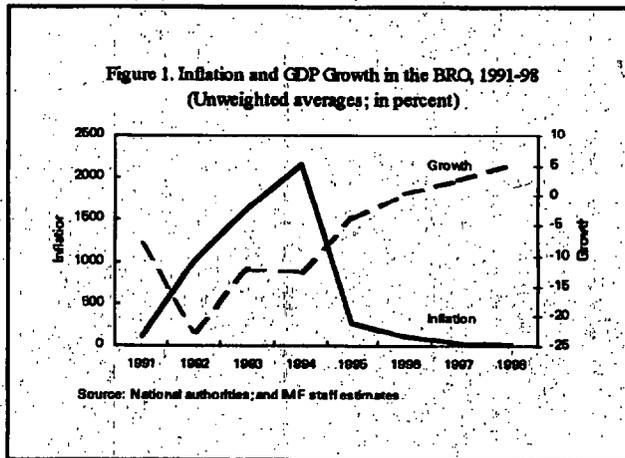
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Author's E-Mail Address: SGupta@imf.org

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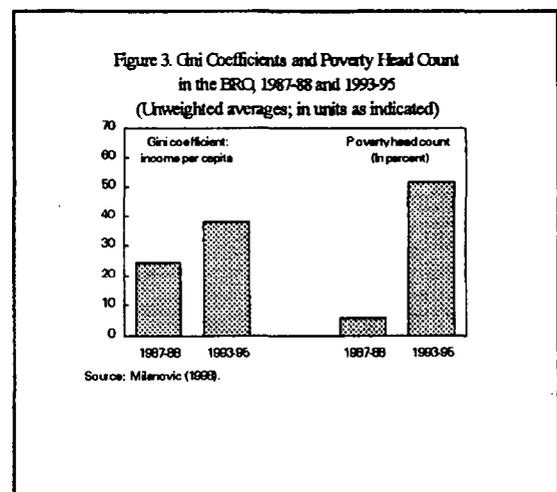
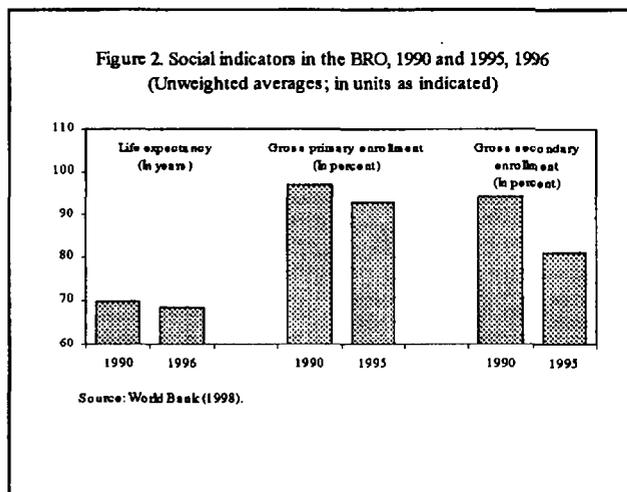
Since early 1992, most former centrally planned economies in the Baltics, Russia, and other countries of the former Soviet Union (BRO) have implemented economic reforms to engender market orientation of their economies. Economic transition, while correcting price and other distortions in the face of a more binding macroeconomic constraint, has been accompanied by sharp declines in recorded output and high rates of inflation in the initial years of reform, followed by falling formal sector employment in more recent years. Inadequate reforms and their slow pace have prolonged the output-deterioration with important implications for social protection. Declining government revenue in relation to GDP, combined with insufficient attention to targeting of public programs to the truly needy, has worsened the plight of the poor and vulnerable households.<sup>2</sup> This has resulted in severe hardships for many households, particularly those with large numbers of children and those headed by single pensioners, the unemployed, and females.



Although output decline has been reversed in most of the BRO, and prices have stabilized (Figure 1), policymakers are faced with the challenge of addressing deteriorating social indicators, rising unemployment and underemployment, increasing incidence of poverty, and

<sup>2</sup>See Chu and Gupta (1998).

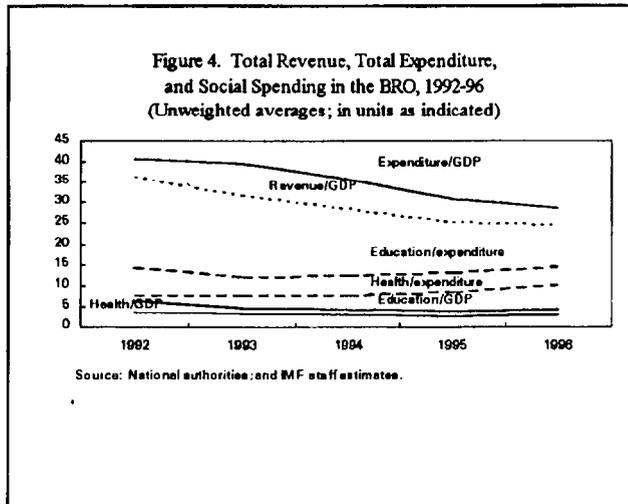
widening income inequality (Figures 2 and 3).<sup>3</sup> This paper briefly describes the factors constraining these countries' social protection policies to shield the poor and vulnerable. It then lists policies that can help mitigate the worsening living standards in a fiscally sustainable manner. The analysis in this paper considers public spending on social programs, including generalized subsidies for goods and communal services, pensions, unemployment-related and social benefits, and education and health care.



### Factors constraining policy choices

*Declining taxes and social contributions have weakened the ability of the BRO to provide the needed social protection.* In most of the BRO, revenues in relation to GDP, including those from taxation of wages to finance social benefits, have fallen (Figure 4).

<sup>3</sup>The worsening of income inequality in the BRO on average has been significantly higher than the comparable average for countries such as Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia (see Milanovic, 1998).

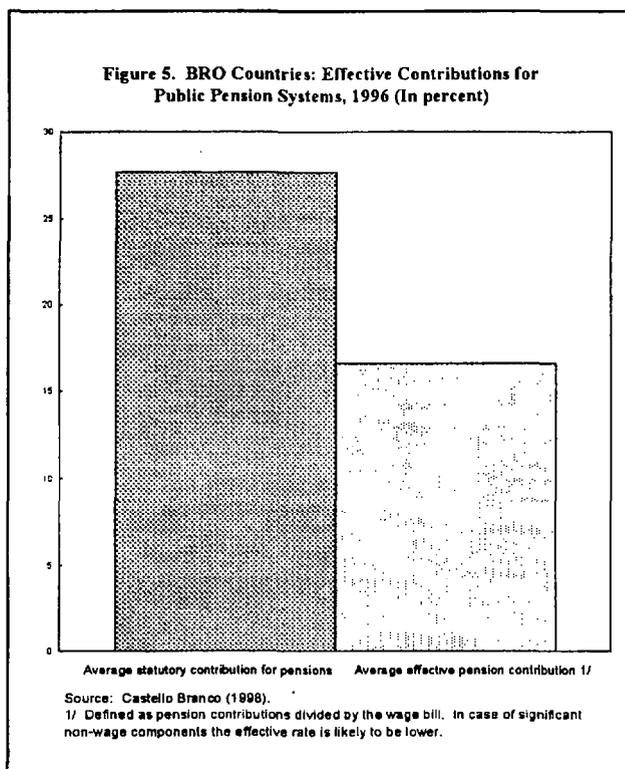


The principal reasons for the decline are:

- The tax systems, in general, are unable to capture a substantial amount of the growing private sector economic activity, partly because of weak tax administration. This has affected not

only the collection of earmarked contributions for financing social benefits, but also the yield of general budgetary revenues that finance education and health care, other social programs, and cover the deficit of social funds.

- Relatively high statutory social contribution rates in general and a weak link between contributions and benefits have created a wedge between the cost of labor and employees' take-home pay. Together with weak tax administration, this has encouraged tax evasion. High statutory payroll tax rates are also creating incentives for employers to shift some components of labor compensation out of the wage fund. As a result, the effective social contributions in these countries are, on average, around half the statutory rates (Figure 5).



- Social contributions have also fallen because rates continue to be differentiated according to disparate criteria, with lower rates applying to the growing number of self-employed, agriculture, and enterprises employing the handicapped. Demographic trends, combined with early retirement and disability provisions, have caused a substantial increase in

beneficiaries. The shift in employment out of the formal sector has reduced the number of workers making contributions. The resulting surge in old-age dependency rates has compounded the problems facing the social protection system.

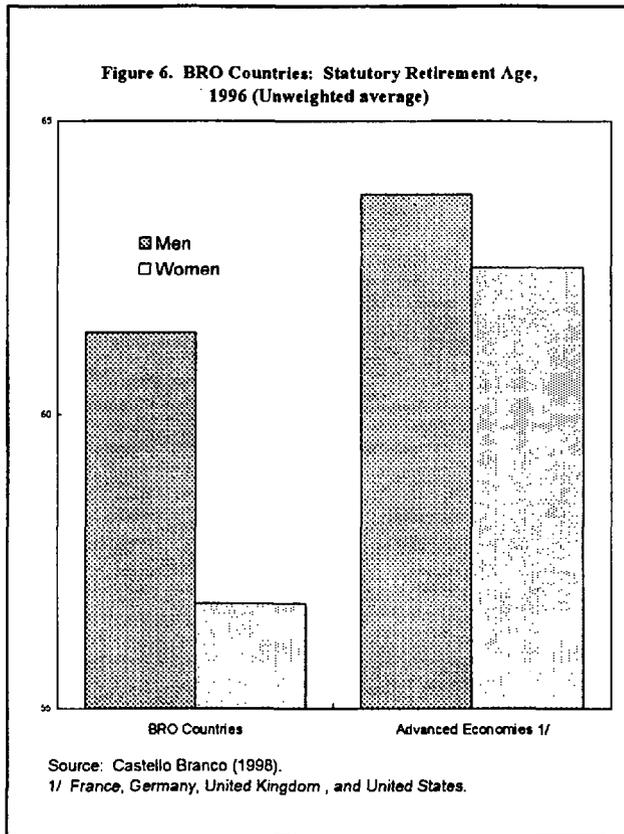
- The practice of collecting taxes and social contributions in kind and the use of nonmonetary means to settle tax arrears has effectively reduced cash available to governments for high priority spending, including social protection. Offsetting tax obligations of enterprises against obligations of the government—not necessarily of high social value—has risen to high proportions (over 40 percent of the total revenue in some countries) and limited the ability of many governments to pay wages and

social benefits. In-kind tax payments have also led to disbursement of social benefits in the form of goods, which are highly imperfect substitutes for money.

*Excessive privileges to numerous groups are straining budgets and distorting resource allocation.* In many countries, privileged consumers are entitled to reduced tariffs for energy, telephone, housing, communal services, and transportation. Low prices have created incentives for overconsumption and misuse. These benefits accrue not only to those eligible but also to their family members. Consequently, large segments of the population benefit from these privileges, at a high cost to the budget and the enterprises providing these services. In addition, some generalized subsidies, both implicit and explicit, continue to be provided for certain types of goods.

*Many countries continue to provide benefits that should not be part of the social insurance system.* A significant share of the resources collected through social contributions are still allocated to spa and recreation facilities that are only offered to certain population groups.

*The benefit structure has yet to be reformed in many countries.* Pension systems in many of the BRO allow workers to collect pensions at a relatively young age, and workers in certain occupations are eligible for pensions even earlier. In general, the normal pension age for both men and women is low by international standards—especially in comparison with life expectancy at the time of reaching pension age (Figure 6). Pensions are based not only on the



number of years of contributions but also on years spent studying or taking care of a young child. Some of the pension system reforms have not improved their short-term financial viability. Unemployment benefits are relatively small, difficult to obtain, and/or paid with a long lag. This has discouraged the unemployed from applying for benefits. A large proportion of social contributions collected for assisting the unemployed continue to be wasted on low-priority programs as well

as on administration of benefits. A relatively small proportion of the unemployed actually receive assistance in any form.

*The reform of the education and health care sectors has been slow in most of the BRO despite significant allocations from the budget.*<sup>4</sup> In most of these countries, about 70 percent of government employment is in these two sectors.<sup>5</sup> The average wage in both

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<sup>4</sup>The average public spending on education and health care in relation to GDP in the BRO countries fell from 6.4 percent and 3.5 percent in 1992 to 4.1 percent and 2.7 percent in 1996, respectively (Chart 4). This decline, however, understates the resource squeeze facing these sectors in light of large contraction in real GDP since the onset of economic transition.

<sup>5</sup>Employment in both education and health sectors has increased in recent years (see IMF, 1998).

sectors is low in relation to the economywide average wage. The education sector is facing the following constraints:

- A Relatively large share of total spending is allocated to preschools, which are essentially day care centers for working parents;
- Per-student spending on higher education tends to be many times greater than per-student spending on general secondary education;<sup>6</sup>
- Expenditure allocations for textbooks and other teaching materials as well as for maintaining educational infrastructure have been gradually reduced. A high level of allocations for utilities (e.g., heating) in countries that are net importers of energy has further squeezed such spending;
- In many countries, the normal workload for a secondary education teacher has been gradually reduced, and is low by international standards. This is reflected in relatively low student-teacher ratios and small class sizes;

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<sup>6</sup>This is reflected in a relatively high level of spending on tertiary education in these countries. For instance, on average, 22 percent of the education budget is allocated to tertiary education in a sample of six countries in the BRO in comparison with 13.7 percent in nine countries in Asia (see Gupta, Clements, and Tiongson, 1998).

- The number of nonteaching staff is excessive, resulting in a high level of spending on wages for these employees; and
- Informal user charges limit the access of the poor to the educational system in many countries. Surveys suggest that the increasing private cost of public education is adversely affecting enrollment rates in primary and secondary schools and increasing absenteeism among the poor.

In the same vein, the health care sector is faced with the following constraints:

- The existing system generally overemphasizes curative health care services at the expense of preventive treatment and health promotion.<sup>7</sup> Budget allocations have historically been made on the basis of the number of beds in an institution. This has led not only to an oversupply of beds, but also medical personnel needed to treat hospital inpatients. As a result, there has been an incentive for hospital administrators and doctors to increase the number of beds and keep them occupied. The oversupply of medical personnel has reinforced the heavy role of hospitals in the system;
- Little has been done to improve treatment protocols or to use preventive medicine and primary health care and health education to improve the population's health status;

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<sup>7</sup>The average spending on hospitals is estimated at 56 percent of total health care expenditures in a sample of five countries in the BRO.

- Relatively small budgetary allocations are made for medicines, the purchase of new equipment, and the repair of existing infrastructure. This situation has been aggravated by rising cost of imported energy;
- Informal user charges limit the access of the poor to health care. Because of falling incomes, many households choose not to seek formal health care, and, when they do, they lack resources to buy the necessary medicines; and
- The reform proposals under discussion or those that have been implemented, such as establishing compulsory medical insurance financed from taxation of wages or giving control of health infrastructure to employees, are not sufficiently aimed at correcting the above-noted distortions.

### **What can be done?**

The implementation of most of the following reform options would help shield the poor and vulnerable from the adverse consequences of the transition to a market economy, while ensuring macroeconomic stability.

- A unification of contribution rates for social benefits would enhance revenues. Increasing the share of employee contributions would highlight the link between contributions and benefits, and, together with stricter enforcement, would improve

compliance. Large enterprises, including different government ministries and agencies, must honor their statutory obligations to pay wage-based and other taxes. In many countries, the system of identifying and registering new enterprises needs to be strengthened, and a nationwide audit strategy for enforcing wage-based and other taxes should be developed;

- An increase in pension age, together with elimination of early retirement and disability provisions, would help improve the financial position of the social funds and generate resources for paying adequate pensions to all. Eliminating untargeted benefits, such as coupons for spas and recreation facilities, would also save resources. Considerable thought needs to be given to implementing reforms of existing pay-as-you-go pension systems, which have been affected by population aging and increasing unemployment. The switch to multipillar systems, including a mandatory funded one, should seek to ensure the financial viability of the reformed systems in both short and medium terms through collection of contributions, promote saving and capital formation, and adequately address concerns for low-income population groups;<sup>8</sup>
- Elimination or a significant reduction in the number of privileges for a large proportion of the population would generate resources as well as improve resource allocation;

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<sup>8</sup>There are seven countries in the BRO that have legislated a reform of the first, pay-as-you-go pillar (see Rutkowski, 1998).

- Elimination of generalized subsidies and their integration with programs targeted to the poor would strengthen both social protection and the budget;
- Reform of unemployment benefits would help support economic restructuring and provide protection to the unemployed during the transition period. The benefit level should be adequate in relation to the prevailing wage, it should be paid in time and fully funded for a duration that allows job search. Adoption of more active labor market policies (e.g., job search assistance and labor retraining) would also help absorption of the unemployed; and
- In the education and health care sectors, the high levels of attainment achieved before the economic transition should be protected. Many politically difficult measures would have to be considered, including gradually reducing the excessive number of staff by not replacing all workers who leave, and reducing the number of students that enroll in teacher- and medical-personnel-training schools. This would create room for raising wages in the social sectors.

In the education sector:

- The normal teaching load must be increased and the size and scope of the public preschool system substantially reduced;

- Private sector provision of education and health care services should be promoted. In particular, the role of private financing in higher education and vocational schools could be increased.

**In the health care sector:**

- Resources for primary health care could be increased by consolidating facilities and eliminating excessive hospital beds;
- Resource use can be improved by shifting to a system of capitation-based budget allocations;
- The poor should be shielded during transition by defining and funding a fiscally sustainable package of basic health care services for all;
- Conditions should be created for the development of private medical insurance systems and private entry into the health care sector; and
- The quality of health care can be improved by adoption of more effective treatment protocols, including more rational use of prescription drugs.

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