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Social Protection in Transition Countries: Emerging Issues

by

Ke-young Chu and Sanjeev Gupta 1/

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Abstract

The paper discusses the social protection implications of the weakening financial and administrative capacity of countries undergoing economic transition. The formal sector is shrinking, and unemployment and underemployment are rising rapidly. This is affecting both the revenue base of social protection programs and the ability of these countries to target social benefits. These developments make it imperative for these countries to restructure social benefits, rely more on self-targeting mechanisms to deliver benefits, as well as take immediate steps to improve payroll tax compliance.

JEL Classification Numbers:

H20, H21, H53, H55

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I. Introduction

The former centrally planned countries undergoing economic transition have experienced a sharp decline in output, income, and employment in recent years. This has resulted in severe hardships for many households, particularly those whose members include the elderly, young children, or the unemployed. The plight of these households has been further aggravated by extraordinarily high rates of inflation stemming partly from lax financial policies.

Although the output decline has been or is expected to be reversed in some countries, and inflation has been somewhat tamed, transition countries are now facing the challenge of securing adequate resources for social protection. Governments in these countries are confronted with severe financial and administrative constraints. While the shrinking formal sector is aggravating governments' difficulties in mobilizing resources, the expanding informal sector is making it increasingly hard for governments to identify the poor and to administer targeted social protection programs. Furthermore, the provision of social benefits has become complicated as they cannot necessarily be provided through the place of employment. These developments have important implications for the design and financing of social protection programs for the transition.

The purpose of this paper is to analyze social protection issues concerning subsidies, pensions, unemployment, and other social benefits in transition countries, drawing on the recent experiences of ten of them: two Baltic countries (Estonia and Latvia), five other countries of the former U.S.S.R. (Armenia, Kyrgyz Republic, Russian Federation, Tajikistan, and

Ukraine), and three Eastern European countries (Albania, the former Yugoslav Republic of Macedonia, and Poland). 1/ The focus of the analysis is on the social protection implications of the weakening financial and administrative capacity of these countries. Sections II and III discuss recent economic and social developments and emerging social protection issues in these countries. Section IV presents a summary and conclusions.

II. Recent Economic and Social Developments

1. Background

The ten sample countries have diverse economic and social conditions. Some countries introduced economic reforms early (countries of Eastern Europe) while others embarked on reforms only recently (those in the former U.S.S.R.). The Baltic countries are more advanced than other countries in the former U.S.S.R. in implementing economic reforms. Despite some dissimilarities in the ten countries, some broad common features can be discerned from the economic and social indicators displayed in Tables 1 and 2. 2/

Prior to the beginning of reforms, in all ten countries, governments controlled virtually all prices and wages; guaranteed employment for all, at least in principle; and provided universal public pensions, child allowances, and other benefits for sickness, maternity, and childbirth. Governments did not have an explicit estimate of the economic costs of these

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1/ The paper does not discuss health and education expenditures.
2/ Also see Expenditure Policy Division staff (1995) for similar trends in other Eastern European and the former U.S.S.R. countries.

Table 1. Economic and Social Indicators in Selected Transition Countries, 1991-1995

	Real GDP Growth			Inflation, Annual Average (In percent)			Life Expectancy at Birth	Calorie Consumption Per Capita			Food Consumption 1/		
	1993	1994	1995	1993	1994	1995	1993	1991	1993	1994	1991	1993	1994
Baltic countries													
Estonia	-5.5	-0.1	3.0	89	48	29	69	...	...	...	...	31.9	29.2
Latvia	-16.1	2.2	--	109	36	25	69	2,496	2,375	2,293	42.5	50.5	51.5
Countries of the former U.S.S.R.													
Armenia	-14.8	5.3	...	3,732	5,273	177	73	2,210	1,690	...	56.2	71.8	...
Kyrgyz Republic	-15.5	-20.1	1.3	1,209	278	43	69	...	...	...	...	...	...
Russian Federation	-12.0	-15.0	-4.0	896	302	190	68	2,527	2,552	2,427	38.5	46.3	46.8
Tajikistan	-11.0	-21.5	-12.5	2,195	350	610	70	...	...	...	...	...	...
Ukraine	-14.2	-22.9	-11.8	4,735	891	376	69	3,445	2,868	2,895	43.8	54.5	64.7
Eastern Europe													
Albania	9.6	9.4	8.6	85	23	8	72	3,115 2/	...	2,550	...	78.8	72
Former Yugoslav Republic of Macedonia 3/	-8.4	-4.0	-4.3	230	55	9	72	...	...	...	...	...	...
Poland	3.8	6.0	6.5	35	32	28	71	2,767	3,126	...	45.8	44.4	42.8

Sources: Poverty, Children and Policy: Responses for Bright Future, Regional Monitoring Report No. 3, UNICEF (New York, 1995); World Population Projections, World Bank (Washington, 1995); Social Indicators of Development, World Bank (Washington, 1995); and IMF staff estimates based on data provided by the authorities.

1/ Percent of consumption expenditure spent on food.
2/ 1990.
3/ Revenue, expenditure, and social protection outlays as percent of GSP (Gross Social Product).

Table 2. Unemployment, Migration, and Demographics in Selected Transition Countries, 1993-94

	Registered Unemployment		Net External Migration (In thousands)		Percent of Population	
	1993	1994	1993	1994	Under 15 1994	Over 55 1994
Baltic countries						
Estonia	1.9	1.5	-13.8	-7.7	21.4	23.3
Latvia	5.8	6.6	-27.9	-18.8	20.9	24.9
Countries of the former U.S.S.R.						
Armenia	4.4	4.9	-20.9	-19.1	29.5	15.5
Kyrgyz Republic	1.7	4.1	...	...	37.9	11.5
Russian Federation	1.5	2.5	430.1	810.0	21.8	22.5
Tajikistan	1.2	1.5	...	...	44.5	8.5
Ukraine	0.3	0.4	50.0	-144	20.6	25.7
Eastern Europe						
Albania	22.3	19.2	...	...	31.9	12.4
Former Yugoslav Republic of Macedonia	20.0	...	...	...	24.5	17.5
Poland	14.9	16.5	-15.4	-19.0	23.5	20.2

Sources: Poverty, Children and Policy: Responses for Bright Future, Regional Monitoring Report No. 3, UNICEF (New York, 1995); World Population Projections, World Bank (Washington, 1995); Social Indicators of Development, World Bank (Washington, 1995); and IMF staff estimates based on data provided by the authorities.

benefits. 1/ In general, consumer subsidies were partly financed through general taxation and partly through implicit taxation of producers

1/ This is because controls on all prices and wages meant that the cost estimates in state budget and extrabudgetary social funds were grossly distorted.

(suppressed producer prices), while pensions, sickness, maternity, and childbirth benefits were financed through payroll taxes.

With the introduction of market-oriented reforms and the need for macroeconomic stabilization, governments faced more binding resource constraints, which were aggravated by the reduction in output and income. They sought to reduce the budgetary burden of subsidies by increasing the prices of the subsidized goods and services while mitigating the adverse effects of these price increases on household budgets through cash supplements to wages, pensions, and child allowances. Open unemployment has so far been largely suppressed, in part by providing only token unemployment benefits. But the high old-age or child dependency ratios have required these governments to set aside substantial resources for pensions or child allowances and limited the proportion of the population that contributed to payroll taxes. Estonia, Latvia, Poland, the Russian Federation, and Ukraine have a high proportion of the population above 55 years of age (between 20 percent and 26 percent). The Kyrgyz Republic and Tajikistan have a high proportion of the population below 15 years of age (around 40 percent).

Transition countries have reduced, but still maintain, budgetary subsidies for energy products, housing, and other communal and transportation services. As revenues for social funds have dwindled, governments have reduced average benefits more than minimum benefits. As a result, pension benefits have become largely flat, and have lost their envisaged link with recipients' earnings histories. In some countries, governments have substantial arrears in the payment of social benefits. Certain aspects of these benefits, nevertheless, remain generous, with loose eligibility criteria. For instance, in many countries, workers do not have to retire from a job upon reaching the statutory retirement age but can continue working; working pensioners continue to receive full pensions while receiving a salary and employer-provided benefits for health, education, and housing; the statutory retirement age is low by international standards; and many categories of workers can retire early. Individuals receive credit for pensions even while studying or staying home to take care of children. Workers are able to take subsidized vacations, and their sick leave benefits are financed out of payroll taxes, creating an incentive for abuse.

2. Recent economic, social, and institutional developments

Output, prices, and living standards. In 1994, transition countries continued to record a large decline in output. In six of the countries in the sample, the output decline accelerated. Only four of them registered an increase in output: Armenia and Latvia--for the first time since the beginning of market-oriented reforms, and Albania and Poland, which continued to bear the fruits of early reform efforts. In 1995, the output decline slowed in three countries and two that experienced a decline in real GDP in 1994 began to grow. Inflation continued to persist, although a few countries have reduced inflation somewhat through tight financial policies. In 1993, five countries (Armenia, Kyrgyz Republic, Russian Federation, Tajikistan, and Ukraine) had an annual average inflation of about 1,000 percent or above; by 1994, the number of such countries declined to two. In 1995, there was a reduction in inflation in all countries, with the exception of Tajikistan.

The output decline together with the elimination of consumer subsidies on food items have reduced real income of households. As a result, households are devoting an increasing share of their income to food (Armenia, Latvia, Russian Federation, and Ukraine). In a few countries the caloric intake per capita fell (Latvia and Russian Federation). Only two countries experienced a decline in the share of household income allocated to food consumption (Albania and Poland).

Population movements. Many transition countries are suffering from the consequences of adverse political and social developments. Many have lost a significant proportion of their active population through emigration (Armenia, Estonia, Latvia, Poland, and Ukraine) while others have been confronted with a large influx of refugees or a displacement of persons (Russian Federation and Tajikistan) (Table 2). Armenia lost at least 350,000 mostly working-age persons (9.3 percent of the population) by end-1993, and another 200,000 persons (5.3 percent of the population) were displaced because of the conflict with Azerbaijan. Ukraine lost 144,000 persons (0.3 percent of the population) through emigration in 1994. Tajikistan has had a large share of the population displaced by civil strife. Since 1992, the Russian Federation has experienced a large influx of ethnic Russians from other republics. However, these official estimates of population migration are most likely underestimates of the actual movements of the population in these countries.

Informal sector. Shrinking employment opportunities in the formal sector and pervasive government regulations are boosting informal sector activities. The migration of labor has increased private transfers between members of families. That informal sector activities and private transfers are now important is clear from household surveys, which point to the declining share of wages and government cash benefits in average household income. Table 3 displays the income structure of households in Armenia in 1993-94. In the first six months of 1994, formal sector wages and government cash benefits constituted less than 30 percent of average household income, with the remainder originating from other sources, such as informal sector activities and financial assistance received from relatives and friends. By contrast, the share of formal sector wages and government cash benefits in household income averaged 40 percent in 1993. 1/ A similar pattern emerges for Ukraine, where a household expenditure survey for 1995 indicates that reported incomes on average were less than half of reported expenditures, indicating a large share of informal sector incomes and private transfers in supporting household expenditures.

Tax system and administration. Transition countries are maintaining some old taxes (payroll taxes) as well as introducing some new taxes (personal income tax and VAT). Statutory tax rates are high, and tax bases tend to be narrow, partly because of the informal sector activity. High statutory tax rates, combined with weak administration, have resulted in tax evasion and a build-up of tax arrears. For example, the combined statutory

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1/ The financial assistance received from friends and relatives in Table 3 does not capture direct private transfers and humanitarian commodity assistance received from abroad because households were not required to report incomes from these sources. Armenian households received an annual average income transfer of US$210 per household in the form of commodity assistance in 1994, distributed by government agencies as well as by private and religious charities. In addition, an average household received private direct transfers of US$40 from abroad. These transfers were large in relation to average monthly wages or cash benefits of less than US$10.

Table 3. Income Structure of an Average Household in Armenia, 1993-94

(In percent)

	1993		1994	
	Average	First Quarter	First Quarter	First Six Months
Salaries and stipends	31.8	43.1	24.7	21.7
Other income	7.7	15.1	5.5	5.4
Of which:				
Pensions	4.3	8.1	3.0	2.9
Stipends	0.3	0.5	0.1	0.1
Allowances, etc.	3.0	6.2	2.3	2.4
Remaining income 1/	60.5	41.8	69.8	72.9
Total cash income	100.0	100.0	100.0	100.0

Source: Department of Statistics of Armenia.

1/ Includes sale of services, informal sector activity, rents, and assistance received from friends and relatives; does not include humanitarian commodity assistance from abroad.

rate of payroll taxes ranges between 37 percent (Russian Federation) and 52 percent (Ukraine). The capacity of transition countries to administer old taxes is fragile and has been severely weakened by expanding informal sector activities. Their capacity to administer new taxes is at an infant stage. Effective tax rates in these countries are thus only a fraction of the statutory rates.

III. Implications for Social Protection

1. Emerging social protection issues

These developments have important implications for social protection. The increase in unemployment and underemployment and the reduction in real wages have boosted the number of households in need. The expansion of informal sector activities has reduced the number of taxpayers and made it more difficult for government to identify the poor.

The decline in official incomes overstates the fall in living standards, making it harder to measure the number of households/individuals below a universally accepted poverty line. Single pensioners living alone, single parents, families with many children, individuals earning low or minimum wages, and unemployed not working in the formal sector are among the population groups that may have fallen below the poverty line in many of these countries. This, however, does not necessarily imply that the aggregate needs for social protection have increased; as argued in the paper, there is ample scope for improving the targeting of existing benefits and using the resulting savings for shielding the truly vulnerable.

Unemployment and underemployment. The collapse of output has drastically reduced the demand for labor. This reduced demand has increased open unemployment in some countries and underemployment in others. In 1993-94, registered unemployment ranged between 0.3 percent of the labor force in Ukraine, 2.5 percent in the Russian Federation, and 22.3 percent in Albania. 1/ The registered unemployment data mask the social impact of

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1/ In early 1996, it increased to 3.3 percent in the Russian Federation.

the decline in output and employment. Since the onset of reform in these countries, there has been a continuous decline in total employment. In the Russian Federation, total "official" employment, which stood at around 74 million in 1991, declined to 66.9 million by 1995 (Table 4). In Ukraine, total employment declined from over 25 million in 1991 to 22 million by end-1995. The workers who have "vanished" from the official employment statistics have either dropped out of the labor force, become unemployed, or entered the informal sector. For instance, it is likely that a significant proportion of 6.7 million of vanished workers in the Russian Federation have joined the informal sector.

At the same time, enterprises have been hoarding labor, which is reflected in the growing number of workers on short working days or partially paid or unpaid leave. The incentive for workers to stay with their current employer, despite little or no monetary compensation, has stemmed both from the attraction of employer-provided housing, education, and health benefits and from the inadequacy of unemployment benefits. The incentive for the employer to hoard labor has arisen from the legal obligation of severance pay and may also have arisen from the belief that the current situation is transitory. 1/ In a way, this is a reflection of the soft budget constraint facing many state enterprises. During 1993, the average number of days of administrative leave per worker in the Russian Federation rose from 14 days to around 23 days. In Ukraine,

1/ In the Russian Federation and Ukraine, there is a requirement that the employer give the worker three months' notice prior to dismissal. There is currently a move in Ukraine to eliminate this requirement. In the former Yugoslav Republic of Macedonia, laid off workers received six months' notice of termination in 1994.

Table 4. Trends in Employment in Transition Countries, 1991-95

(In thousands of persons)

	1991	1992	1993	1994	1995
Baltic countries					
Estonia	799	748	681	665	660
Latvia	1,397	1,350	1,265	1,205	1,191
Countries of the former U.S.S.R.					
Armenia	1,672	1,578	1,543	1,500	1,455
Kyrgyz Republic					
Russian Federation	73,600	72,300	71,000	69,600	66,903
Tajikistan	1,971	1,909	1,850	1,901	1,940
Ukraine	24,977	24,420	23,845	23,316	22,200
Eastern Europe					
Albania	1,400	1,021	954	1,083	1,144
Former Yugoslav Republic of Macedonia 5/	737	755	762	763	747
Poland	16,300	15,400	15,000	14,800	15,126

Source: IMF staff estimates based on data provided by the authorities.

the number of workers on administrative leave was 2 million (8 percent of employment) in 1995; the number of workers receiving partial wage payments was 1 million.

An increasing number of individuals who are not employed in the formal sector or not registered as unemployed are excluded from the provision of social benefits. In Ukraine, the unregistered unemployed are ineligible for the newly introduced housing subsidies and child allowances. While the rationale behind this policy appears to be that all individuals who are not registered as unemployed must be working in the informal sector, there is evidence that registration by the unemployed is not easy.

Difficulty in targeting benefits to those working in the informal sector is illustrated by the experience of the former Yugoslav Republic of Macedonia, where around 26 percent of the workforce (175,000) was registered as unemployed in 1993. Only 10 percent of the registered unemployed--mostly from bankrupt firms--received unemployment benefits. A significant proportion of the remaining registered unemployed were believed to be working in the informal sector. However, the registration provided such workers with the benefit of health insurance--effectively supplementing their earnings. Many had emigrated to other countries for work because the unemployed were required to register only every six months; many returned to the country only when they required medical attention.

Financial constraints. Social protection outlays in transition countries are coming under increasing financial pressure (Table 5). While these countries have eliminated or reduced generalized consumer subsidies on basic food items, the expenditure reduction in general has been achieved not through an improvement of expenditure efficiency and prioritization but through ad hoc cash rationing.

An important factor behind the expenditure squeeze in these countries has been weak revenue performance. Despite the implementation of discretionary revenue measures from time to time, the revenue-to-GDP ratio has declined for many countries, reflecting in part a significantly sharper fall in payroll taxes which finance major social programs. The growth of the informal sector, payment of partial wages and the phenomenon of unpaid

Table 5. Social Protection Outlays in Selected Transition Countries, 1992-94

	Total Budgetary Revenue 1/			Total Budgetary Expenditure 1/			Total Social Protection Outlays 2/		
	1992	1993	1994	1992	1993	1994	1992	1993	1994
					(As percent of GDP)				
Baltic countries									
Estonia	33.3	39.9	41.2	33.6	40.6	38.3	9.7	12.0	11.2
Latvia	28.2	36.4	35.5 3/	28.2	35.3	38.2 3/	9.6	14.2	16.0 3/
Countries of the former U.S.S.R.									
Armenia	20.8	20.8	15.8 3/	51.7	82.9	44.1	23.2	23.7	15.8
Kyrgyz Republic	16.5	15.2	15.3	33.9	36.8	28.1 3/	...	18.9	11.9 3/
Russian Federation	29.4	28.7	24.5	38.9	34.8	35.1	10.0	8.5	8.3
Tajikistan	26.6	27.1	15.2 3/	57.8	52.1	26.5 3/	13.9	17.5	10.9 3/
Ukraine	44.0	43.7	39.9 3/	73.3	55.5	44.9 3/	17.6	18.0	18.0 3/
Eastern Europe									
Albania	19.3	24.5	25.2	47.6	44.6	41.0	14.4	14.5	12.2
Former Yugoslav Republic of Macedonia	38.6	40.9	53.4	48.2	54.5	56.6	28.3	30.8	21.2
Poland	43.8	47.6	45.6	50.4	50.5	47.5	22.7	21.5	22.8

Sources: IMF staff estimates based on data provided by the authorities.

1/ General government revenue and expenditure, except Albania (central government); Armenia, Former Yugoslav Republic of Macedonia, Latvia, and Ukraine (Consolidated General Government).

2/ Includes outlays on explicit consumer subsidies, pensions, unemployment benefits, and child and other allowances.

3/ 1995.

leave have contributed to the narrowing of the revenue base. In addition, weaknesses in tax administration have drastically reduced tax compliance and effective tax yields. High statutory payroll tax rates are creating incentives for employers to shift some components of labor compensation out of the wage fund, which forms the payroll tax base. Labor payments have been made in-kind or even in the form of shares of enterprises (Ukraine). Differential rates or exemptions for different types of workers (self-employed, agriculture, and the handicapped) have further narrowed the tax base (Russian Federation). 1/

Many transition countries had a relatively high old age dependency ratio at the start of market reform (the former Yugoslav Republic of Macedonia, Russian Federation, and Ukraine). The increase in unemployment, the growth in informal sector activities, the emigration of workers, and low retirement age have further reduced the number of working age individuals who can contribute payroll taxes. For instance, in 1993, the ratio between the numbers of pensioners and workers had fallen to less than 50 percent in Armenia, the former Yugoslav Republic of Macedonia, and Ukraine. This ratio was above 60 percent in 1995 in Ukraine. In recent years, this development has contributed to a worsening of the financial position of pension funds of these countries. 2/

Consequently, the budget in many transition countries is unable to pay social benefits in time, to meet the legal obligation of transferring payroll taxes of government employees to the providers of social benefits, or to transfer budgeted amounts to social funds (Kyrgyz Republic, Tajikistan, and Ukraine). In some instances, social funds are being asked

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1/ For a discussion of social protection issues in the Russian Federation, see Gupta and Hagemann (1994).

2/ The present situation presents an interesting contrast with surpluses generated by pension funds in earlier years. The value of those surpluses was quickly eroded by high rates of inflation (e.g., Russian Federation).

to finance child allowances out of their payroll tax revenues (Ukraine). The decline in the compliance of payroll taxes has lowered their effective yields by 30-40 percent (Armenia, Kyrgyz Republic, and Russian Federation).

In the absence of major policy initiatives, the near-term prospects for pension funds in these countries are bleak. In reflection of a tight liquidity position in the economy, the pension fund of one country (Kyrgyz Republic) is receiving part of the payroll tax collections in-kind (flour, canned meat) and has also begun to pay pensions in-kind, creating new problems for the fund. There appears to be no scope for raising payroll taxes further without having a substantial negative impact on wages or labor demand. Furthermore, in the present difficult climate, budgets cannot be expected to fill the gap between pension fund obligations and revenues; budgetary transfers, if any, have been erratic (e.g., Kyrgyz Republic).

Inadequate social benefits and payment arrears. Falling revenues, together with the inability of social funds to restructure or rationalize benefits, have resulted in the emergence of arrears in benefit payments (e.g., the former Yugoslav Republic of Macedonia, Kyrgyz Republic, Russian Federation, and Tajikistan). A more pointed targeting of costly social benefits is being resisted, allowing relatively high income groups to receive social benefits. Combined with dwindling resources, this has caused the average benefit size (e.g., a pension or cash compensation) for the truly needy to become small with little differentiation between the minimum and the maximum benefit. The lack of targeting has also resulted in a shortage of budgetary resources to finance programs to assist the poor (e.g., Armenia). For instance, in 1993, the maximum pension was two thirds larger than the minimum pension in Ukraine and the average replacement rate--the average pension in relation to the average wage--was 43 percent. At end-1995, the maximum pension was merely 21 percent larger than the minimum pension, and the average replacement rate was reduced to 25 percent.

Remaining subsidies. Many transition countries still maintain substantial subsidies for housing, other communal services, and transportation. Attempts are being made to reduce the budgetary cost of these subsidies by gradually raising tariffs while mitigating the adverse effects of higher prices on household income through targeted schemes (e.g., Ukraine). Nevertheless, estimates of the cost of these services do not fully reflect all input costs. For example, cost estimates for housing services in Ukraine do not take into account the depreciation of housing.

Information and administrative deficiencies. For policy formulation, many transition countries lack adequate information in three areas. First, governments do not have adequate information on how many or who are in need. It is unclear how many workers are underemployed. It is also unclear how many among the unemployed or underemployed workers are engaged in informal sector activities. Second, in some transition countries, governments do not have adequate information on the number of persons receiving social benefits. Third, governments do not have information on the number of enterprises that are obliged to pay payroll taxes.

The expansion of informal sector activities makes the identification of the poor increasingly difficult. The use of officially recorded incomes for determining eligibility is inappropriate because it could lead to a mistargeting of benefits. The large share of nonwage incomes in household income suggests that the average size of government cash benefits ought to take into consideration these nonwage incomes, including informal intrafamily transfers. Determining the size of government cash benefits entirely on wages or formal sector incomes would result in an overestimation of the budgetary costs of social protection. Moreover, public social protection payments could crowd out these private transfers, which are voluntary, efficient, and well targeted, making an important contribution to social protection in many transition countries. 1/

Some transition countries are seeking to target the social benefits only on the basis of formal sector income, but are facing difficulties. In the Kyrgyz Republic, a whole range of benefits (bread compensation, child allowances, birth grants, and social pensions) were replaced by a single benefit on January 1, 1995, targeted on the basis of per capita household income to children under age 16 (under 18, if still in school), students, non-working pensioners, the handicapped, and the unemployed. The principal objective behind the new benefit is to target the truly poor, and thereby reduce its budgetary cost. Because this benefit's eligibility is based on official income and because the share of official income is declining, the number of eligible individuals as well as budgetary outlays are rising. Similar problems exist with the housing subsidy program introduced in Ukraine in May 1995, which limits household expenditures on housing and other communal services to 15 percent of declared family income. By end-

1/ For example, see Cox, Okrasa, and Jimenez, (1993) and Cox, Eser, and Jimenez (1994) for such networks in Poland and the Russian Federation, respectively.

1995, over 1.4 million households were receiving subsidies under this program.

2. Short- to medium-term social protection reform options

In transition countries, the primary objective of social protection programs at this time should be to provide minimal benefits for survival to the growing number of truly vulnerable households. It may not be possible for many of these countries to set more ambitious objectives in light of the severe financial and administrative constraints facing them.

Reforming the eligibility and benefit structure. Most transition countries have so far resisted reforms of eligibility conditions and the structure of pensions, unemployment, and other benefits. Needed reforms include raising statutory retirement ages, rescinding the system of special pensions, and reducing pensions for working pensioners. To receive pensions, individuals should be required to retire from their last job on reaching the retirement age. Some countries have initiated partial reform of the structure of benefits (e.g., Estonia and the former Yugoslav Republic of Macedonia), but these reforms are unlikely to fully correct the imbalance in their pension systems. For instance, Estonia has raised the retirement age by six months per year for men and women (from their former levels of 60 for men and 55 for women), to a maximum of 65 for men and 60 for women. However, the country continues to provide early pensions and credits time spent staying home to care for children or studying at the university toward pension eligibility. On the other hand, unemployment benefits are low in relation to the prevailing wage, while resources collected for assisting the unemployed are being diverted for granting questionable subsidies to individuals and enterprises (e.g., Russian Federation). A reform of benefits would evenly spread the burden of adjustment across different population groups, and also generate resources for social protection. Unless the social protection system is reformed, some pensioners or the unemployed--or both--may end up bearing the brunt of the decline in income as reflected in the declining ratio of the average pension to the average wage and low level of unemployment benefits. 1/ The long-term unemployed should be assisted, but not all of them need to receive benefits since some may be working in the informal sector. The issues that arise in targeting benefits in these circumstances are discussed below.

The design of social policies must take into account the decline in formal sector employment and the growing importance of informal activity. Social benefits, including compensation for higher prices and tariffs, and child allowances, should also be accessible to informal and private sector workers and the unemployed who do not register for unemployment benefits.

Securing financial resources. Securing resources requires at least three measures. First, laws would need to be strengthened to include untaxed elements of labor compensation in the wage fund. Unless this is done, the payroll tax base would be eroded, and there would be difficulties in the financing of social benefits in the near term with current levels of statutory tax rates. Exemptions from the payment of payroll tax or

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1/ There is evidence that recorded income differentials in Baltic countries have widened markedly to the levels comparable to those of Southern European countries (see Cornelius and Weder (1996)). This suggests the need for enhancing the targeting of different benefits.

differential rates for different occupations would have to be done away with.

Second, all-out efforts would have to be made to register new enterprises and businesses. This would improve financing for social protection by expanding the payroll tax base, strengthen the coverage of workers in the unregistered sector, and widen the tax base for other taxes, such as the VAT.

Third, other budgetary expenditures must be prioritized. It is inefficient and inequitable to continue supporting low-priority budgetary programs and projects while squeezing social protection outlays.

Minimizing the burden on administrative resources. Because of the difficulty of tracking incomes and growing informal sector activity, greater reliance would have to be placed on self-targeting mechanisms for the provision of benefits. Public works program represent one such self-targeted social assistance program, requiring an unemployed worker to tie his/her time to the receipt of food or wage. Other, simpler targeting mechanisms would have to be identified; these could target certain population groups such as pensioners, particularly older pensioners. In Ukraine, for instance, the housing subsidy could target, among others, single pensioners living alone, to ease the administrative burden. However, some targeting methods could be counterproductive. Publishing the names of all beneficiaries, while potentially enhancing the targeting of benefits, 1/ may stigmatize beneficiaries, forcing some truly needy to withdraw from social programs. Asking all recipients to physically collect

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1/ This has been successfully implemented in Sri Lanka.

benefits would tend to discriminate against the old and the handicapped, who may not be able to report to social agencies on a regular basis.

What is the likely financial impact of the above-noted reform options? Table 6 shows payroll tax revenue, pensions, unemployment benefits, child allowances, and social assistance, all expressed in relation to GDP for the ten sample countries. 1/ They have been derived by using (mostly) 1994 average wages, total employment, the shares of old and young in the population, and the registered unemployed in these countries. For the sake of simplicity, it is assumed that these countries provide an average pension equal to 40 percent of the average wage, an average unemployment benefit equal to 30 percent of the average wage, an average child allowance equal to 15 percent of the average wage, and an average social assistance benefit equal to 20 percent of the average wage. The actual benefit amounts could be lower and the actual payroll tax compliance higher (e.g., Russian Federation and Ukraine) than displayed in Table 6.

The results are revealing. With the assumed levels of tax compliance and benefits, payroll taxes would clearly be insufficient to finance both pensions and unemployment benefits. If payroll taxes were also used to pay some child allowances, the imbalance between available resources and needs would be substantially greater. A lowering of average benefits through incomplete indexation, elimination of special pensions, or a raising of the retirement age for pensioners would reduce pension outlays. For instance,

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1/ As most countries are using payroll taxes to finance pensions and unemployment benefits, the simulations reported here link outlays on these programs to payroll taxes. It is not necessary for a country to finance social programs from payroll taxes; general taxation can also be used for this purpose.

Table 6. Simulation of Social Protection Resource Requirements, 1994

(As percent of GDP)

	Payroll Tax Revenue 1/	Payroll-Tax Financed Benefits			Child Allowances 4/	Social Assistance 5/
		Total	Pensions 2/	Unemployment Benefits 3/		
Baltic countries						
Estonia	4.8	9.2	8.2	1.0	2.8	0.9
Latvia	7.5	13.9	12.7	1.2	4.0	1.3
Countries of the former U.S.S.R.						
Armenia	4.1	5.5	4.9	0.6	3.5	0.8
Kyrgyz Republic	5.6	6.1	5.6	0.6	6.9	1.2
Russian Federation	3.9	6.3	5.6	0.7	2.0	0.6
Tajikistan	6.8	7.4	7.1	0.3	13.9	2.1
Ukraine	4.3	7.8	7.8	--	2.3	0.8
Eastern Europe						
Albania	6.1	8.1	5.4	2.7	5.2	1.1
Former Yugoslav Republic of Macedonia 6/ 7/	9.4	16.7	12.4	4.3	6.5	1.8
Poland	5.7	11.6	9.1	2.5	4.0	1.1

Source: Authors' estimates.

1/ Assuming an effective payroll tax of 13 percent of the wage bill. The base for payroll taxation is typically the wage fund, which is narrower than the wage bill. Furthermore, the wage bill is derived by multiplying the average wage by employment. The latter is an overestimate because many workers are being placed on administrative leave and are not receiving wages. This has been taken into account by lowering the effective payroll tax.

2/ Based on population above the age of 55 and 40 percent of the average wage.

3/ Based on 30 percent of the average wage.

4/ Based on 15 percent of the average wage.

5/ Based on 20 percent of the average wage and assuming the poor equal 5 percent of the total population.

6/ As percent of GSP.

7/ 1993.

if pensions were limited to the population above the age of 60 through a benefit restructuring, with the average benefit amount held at 40 percent of the average wage, these countries would save between 1.2 percent of GDP and 3.6 percent of GDP (Table 7). 1/ 2/ For instance, pension outlays for Estonia would decline from 8.2 percent of GDP in Table 6 to 6.2 percent of GDP in Table 7. If payroll tax compliance (including coverage of in-kind income in the payroll tax base) were to be improved by one percentage point, payroll tax revenue would expand by up to 0.7 percent of GDP. For instance, Latvia's payroll tax revenue would increase from 7.5 percent of GDP in Table 6 to 8.1 percent of GDP in Table 7. The impact of increased unemployment, a higher level of child allowances, and increased demand for social assistance, is also shown in this table.

IV. Summary and Conclusions

The efforts of transition countries to help households with vulnerable members of society are being stifled by severe financial and administrative constraints that have recently surfaced. In a number of countries, the formal sector is shrinking, and unemployment and underemployment are rising rapidly. The fast-contracting revenue base is threatening the ability of pension systems to provide even basic pension benefits. Increasing informal

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1/ Given the comparative static nature of the simulation, some caution needs to be exercised in interpreting this result. The retirement age is typically raised gradually (e.g., Estonia and the Former Yugoslav Republic of Macedonia) and consequently, the financial savings would be realized only over a period of time.

2/ It is argued by some that raising of the retirement age may not be appropriate in view of declining life-expectancy in many transition countries. However, it is important to note that life-expectancy in these countries has been affected by rising infant mortality rates; what is relevant for pensioners is life-expectancy at the time of retirement.

Table 7. Resource Requirements for Social Protection Under Different Scenarios 1/

(As percent of GDP)

	Increased Payroll Compliance 2/	Payroll-Tax-Financed Benefits				Increased Demand For Social Assistance 6/
		Total	Reduced Pensions 3/	Increased Unemployment 4/	Increased Child Allowances 5/	
Baltic Countries						
Estonia	5.2	7.3	6.2	1.1	3.0	1.1
Latvia	8.1	11.0	9.6	1.4	4.3	1.5
Countries of the former U.S.S.R.						
Armenia	4.4	4.4	3.7	0.7	3.7	1.0
Kyrgyz Republic	6.0	4.9	4.2	0.7	7.3	1.5
Russian Federation	4.2	4.9	4.1	0.8	2.2	0.7
Tajikistan	7.4	5.7	5.2	0.5	14.9	2.5
Ukraine	4.7	6.1	5.9	0.1	2.5	0.9
Eastern Europe						
Albania	6.5	6.7	3.8	2.8	5.6	1.3
Former Yugoslav Republic of Macedonia 7/	10.1	13.4	8.8	4.6	6.9	2.1
Poland	6.1	9.5	6.9	2.7	4.3	1.4

Source: Authors' estimates.

1/ The baseline for the simulations is given in Table 6.

2/ Assuming that the effective payroll tax increases to 14 percent, in comparis with 13 percent in Table 6.

3/ Based on population of age 60 and above, and 40 percent of the average wage in comparison with population of age 55 and above in Table 6.

4/ Increase in one percentage point in unemployment in comparison with Table 6, and benefit equaling 30 percent of the average wage.

5/ Increase in one percentage point in child allowance with benefit equaling 16 percent of average wage, in comparison with 15 percent of the average wage in Table 6.

6/ The proportion of the poor in the population is assumed to increase to 6 percent from 5 percent in Table 6, with the benefit equaling 20 percent of the average wage.

7/ As percent of GSP.

sector activity is also complicating the task of targeting different social benefits and providing adequate social protection to the vulnerable.

These countries need to respond quickly to these challenges. This is necessary to both ensure macroeconomic stabilization and to sustain the reform process. The remaining generalized subsidies, particularly for housing and communal services, would have to be better targeted to reduce their budgetary costs and to correct price distortions.

The simulations presented in the paper indicate that transition countries must both restructure social benefits and take steps to improve compliance with payroll taxes. They should also develop ways to target social benefits to the truly vulnerable without taxing their limited administrative capacity. These tasks are not easy but are essential, nevertheless. More broadly, they must achieve improvements in tax policy and administration and in all public spending programs, not merely social programs.

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