



# BALANCING PROTECTION AND OPPORTUNITY

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A Strategy for Social Protection  
in Transition Economies

A WORLD FREE OF POVERTY

# Balancing Protection and Opportunity: *A Strategy for Social Protection in Transition Economies*

May 3, 2000

Social Protection Team  
Human Development Sector Unit  
Europe and Central Asia Region  
The World Bank



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# Introduction and Summary

**T**he transition from planned to market economies has created unprecedented opportunities and challenges for countries in Central and Eastern Europe and Central Asia. Guaranteed employment and retirement security have disappeared. Even though many people have benefited from the reforms, average living standards have declined, and poverty and unemployment have increased. Individuals have had to deal with income uncertainty and cope with lifetime risks on their own. In the face of these challenges, previous social protection mechanisms, focused on those with special needs—

the disabled, the elderly, families with many children—have become irrelevant, unaffordable, or difficult to administer.

In response, some transition economies—supported by the World Bank and other donors—have tried to develop new social protection systems. Others have tried to adapt old social protection systems to emerging welfare needs and fiscal realities. Reforms have focused on the three building blocks of the social protection system: labor market policies, pensions, and social assistance, including cash and in-kind benefits and services. To address misallocations of labor and foster labor market flexibility, labor mobility restrictions have been eased and labor legislation amended. Pensions have been reformed, among other things, to reduce financing problems and introduce private provision. Finally, new programs—unemployment insurance, active labor market programs to retrain or reemploy workers, targeted social assistance—have been introduced to combat poverty and unemployment.

Yet major challenges remain. Reforms have been politically difficult to introduce and sustain. Developing understanding of the need for change and building capacity to implement reforms is taking a long time. Political upheavals have disrupted progress. In countries where social protection systems have been reformed, major information, administrative, financing, and management problems remain. And in countries where macroeconomic stability has not been achieved, few efforts have been made to

develop affordable social protection systems to address emerging risks and growing poverty.

Thus a strategy is needed to address social protection issues and to inform future Bank activities. Nearly 10 years of experience make it possible to develop social protection policy in the context of a conceptual framework suited to the region. A synthesis of past efforts that incorporates emerging ideas is essential to guide the Bank's large and growing social protection portfolio in transition economies. On a more practical level, given the close links between the three building blocks of social protection policy, a strategy is needed to ensure that social protection policies are consistent and coordinated. Finally, while transition economies once appeared somewhat homogeneous, distinct patterns have emerged in economic growth and social protection policy needs. To that end, this report presents a social protection strategy for transition economies rooted in three pillars of analysis: a conceptual framework based on risk management, an understanding of the context, challenges, and choices in each country, and Bank experience in social protection in the region.

## **DEFINING A FRAMEWORK FOR RISK MANAGEMENT**

The conceptual framework for this report defines social protection programs and policies using a three-part approach to social risk management (see Holzmann and Jorgensen 1999). First, labor market policies reduce the risk faced by individuals by fostering a flexible formal labor

market that rewards labor productivity and allow labor to be allocated to its most efficient use. Similarly, active labor market policies include a variety of measures to retrain workers in accordance with labor market demands.

Second, pensions and social insurance schemes—such as affordable unemployment insurance—allow individuals to mitigate risk by smoothing consumption over their lifetimes. Finally, social assistance—including cash transfers (with built-in work incentives), in-kind benefits and services, and subsidies—are risk coping mechanisms that allow the state to reduce the impact of a negative income shock or persistent low income by providing an affordable standard of living for the poor.

### RECOGNIZING DIVERGENT PATHS IN THE TRANSITION OF THE 1990s

The social protection strategy proposed here is sensitive to each country's context. Based on the socialist legacy and recent economic developments, transition economies can be broadly characterized into one of two groups: European (all the European Union accession countries, the Baltic countries, and successor states of the former Yugoslavia) or Eurasian (countries that were part of the Soviet Union and Albania).

Relative to Eurasian transition economies, European transition economies have restructured aggressively and effectively. The declines in GDP have been smaller, and per

capita incomes are higher (Figure 1). Institutional and administrative capacity is stronger. Social protection systems, used to lay off workers and protect the poor, consume a larger share of GDP (Figure 2). Means-tested social assistance has been used for poverty alleviation purposes. Pension systems are being reformed, and multipillar systems have been introduced or are being prepared. In leading reformers, growth has resumed, real wages have increased, and unemployment is tapering off, though its persistence remains a problem.

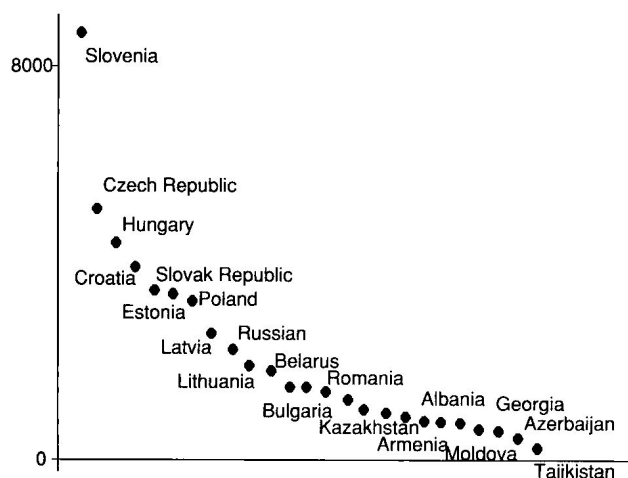
Eurasian transition economies have seen less restructuring. Real wages and output have fallen much more sharply, and in most countries growth has not resumed. The formal labor market has virtually disappeared. Many workers remain in limbo, with unpaid leaves and large wage arrears posing major social and economic challenges. Unemployment is growing. Secondary jobs and self-employment—largely informal—have become the main source of income for these workers as well as for the unemployed. The informal economy is larger relative to GDP; but the private sector share of GDP is much smaller than in European countries (Figure 3).

Pension spending remains high relative to output, but protection is insignificant in real terms, with benefit payments in arrears. Social assistance includes uncoordinated and overlapping benefits and services and is focused on subsidies for housing and utilities (rather than means-test-

**FIGURE 1. TRANSITION ECONOMIES FALL INTO TWO BROAD GROUPS**

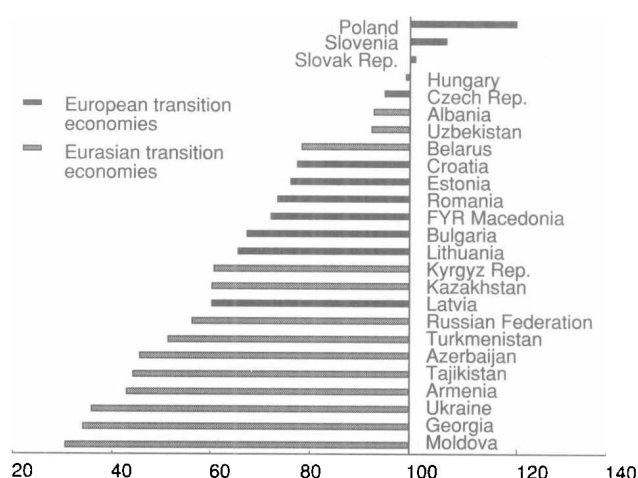
**They differ in terms of per capita income...**

(1996, US\$)



**... and economic growth**

(Real GDP of 1999, 1989=100)

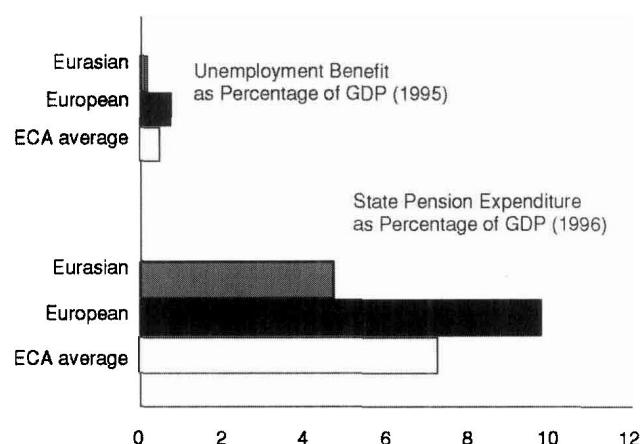


Source: Annex 1, EBRD 1999.



**FIGURE 2. SOCIAL PROTECTION SYSTEMS ALSO DIFFER**

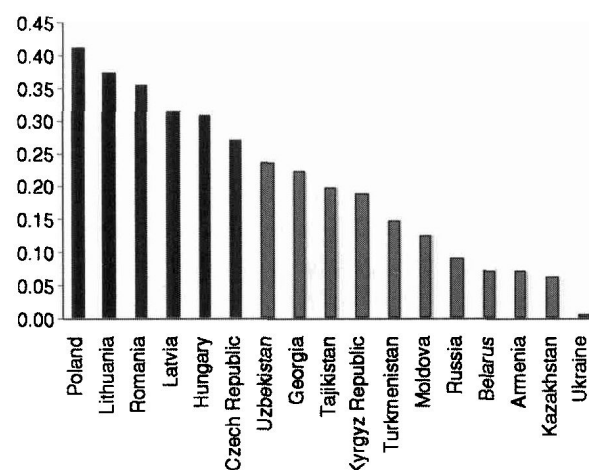
European transition economies spend more on social protection...



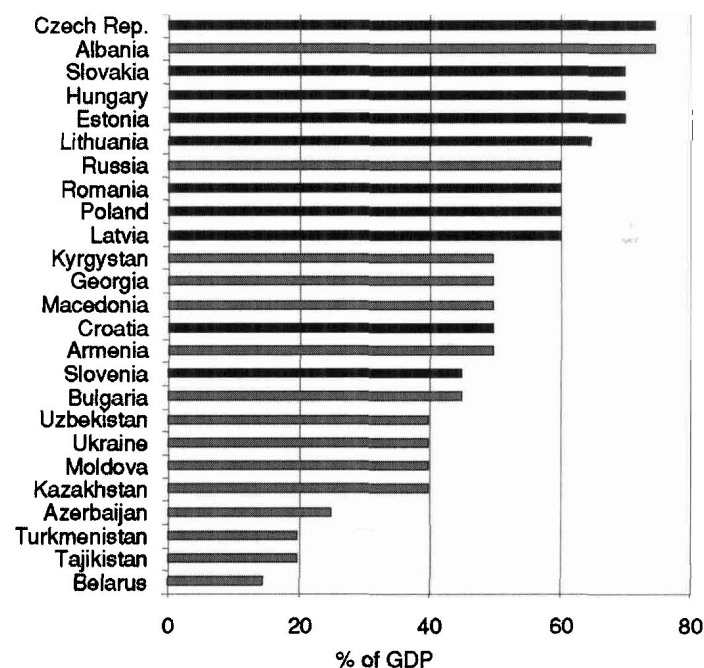
Source: Annex 1

... and labor policies such as minimum wages play a more significant role

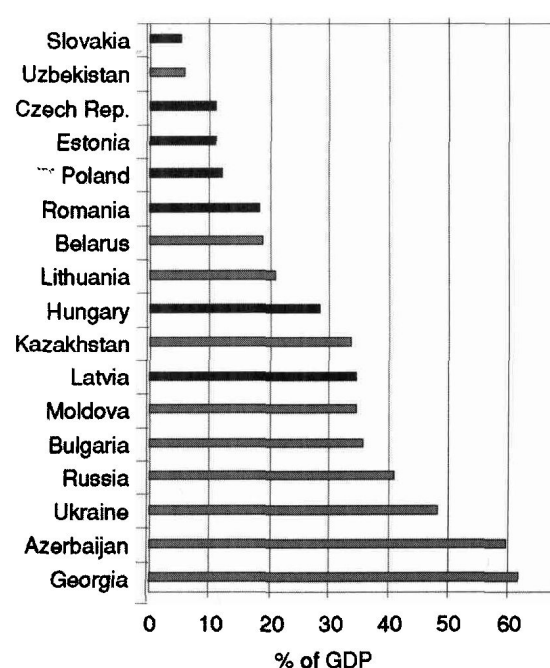
(minimum wage as % of average wage, 1995)

**FIGURE 3. PRIVATE-SECTOR AND INFORMAL-SECTOR SHARE OF GDP**

Private-Sector Share of GDP  
1996 (percent)



Informal-Sector Share of GDP  
1995 (percent)



Source: Estrin 1998; Johnson, Kaufman and Schleifer 1997.

ed social assistance) that are poorly administered and targeted.

## MAKING STRATEGIC CHOICES ON SOCIAL PROTECTION

The social protection challenge for all transition economies is to strike the right balance between promoting growth and providing protection. To that end, all countries must strive to develop competitive labor markets, foster affordable public and private systems for individuals to deal with risk, and promote equity. To ensure financial sustainability of the social protection system, tax collection apparatus needs to be strengthened. To efficiently deliver benefits and services, countries need to build institutions and administrative capacity, while at the same time promoting NGO involvement. In all countries, coordination between social protection programs should be improved. This means greater consistency in several areas: determination of minimum benefits, establishing eligibility of social assistance and unemployment benefit programs; revision of labor and pensions legislation affecting retirement conditions; ensuring coordination between pensions and other social insurance legislation; and to correctly determine a reference wage, noncontributing periods, and contributions records and transfers. In addition, both country groups need to reduce overlapping and duplicative programs.

While these long-term challenges are similar across the region, differences in initial conditions imply that strategic social protection choices differ across the two country groups. In European transition economies:

- Labor market policies should focus on increasing labor market flexibility—including reforming labor legislation to reduce hiring and firing constraints—and decentralizing collective bargaining. Minimum wages should be kept low. In countries that have seen growth, active labor market programs should be maintained to shorten the duration of unemployment.
- Pension and unemployment insurance systems should be made more affordable and focus on consumption-smoothing systems, with benefits linked to contributions. Multipillar pension schemes can be introduced to improve savings for old age and deep capital markets.
- Minimum pensions and means-tested social assistance systems can be used to address poverty. However, programs should incorporate work incentives and be fiscally affordable. Unemployment benefit reforms should be coordinated with social assistance programs.

- Social policy should also focus on deinstitutionalization and the development of social welfare and community-based services.

The social protection strategy in Eurasian countries should focus on promoting restructuring, institutional development, and poverty reduction:

- Macroeconomic stability and restructuring objectives should be pursued before attempting fundamental labor market reforms. In the meantime, in conjunction with hard budget constraints, countries could consider using severance pay to spur restructuring. Labor market legislation should be reformed to lay the ground for competitive markets. Given large informal economies and low labor demand, active labor market programs are unlikely to be appropriate.
- For the time being, until financial and administrative conditions improve, flat benefits for pensions and unemployment should be considered, with unemployment benefits coordinated with severance pay. Limited tax collections and large informal economies mean that risk mitigation and consumption-smoothing programs—unemployment insurance, multipillar pensions that link contributions to benefits—are difficult to implement.
- Social assistance should focus on simple indicator targeting, such as child allowances. A better understanding of informal safety nets should be reached before new systems are introduced. Social investment funds and community works programs can help provide temporary employment and income.

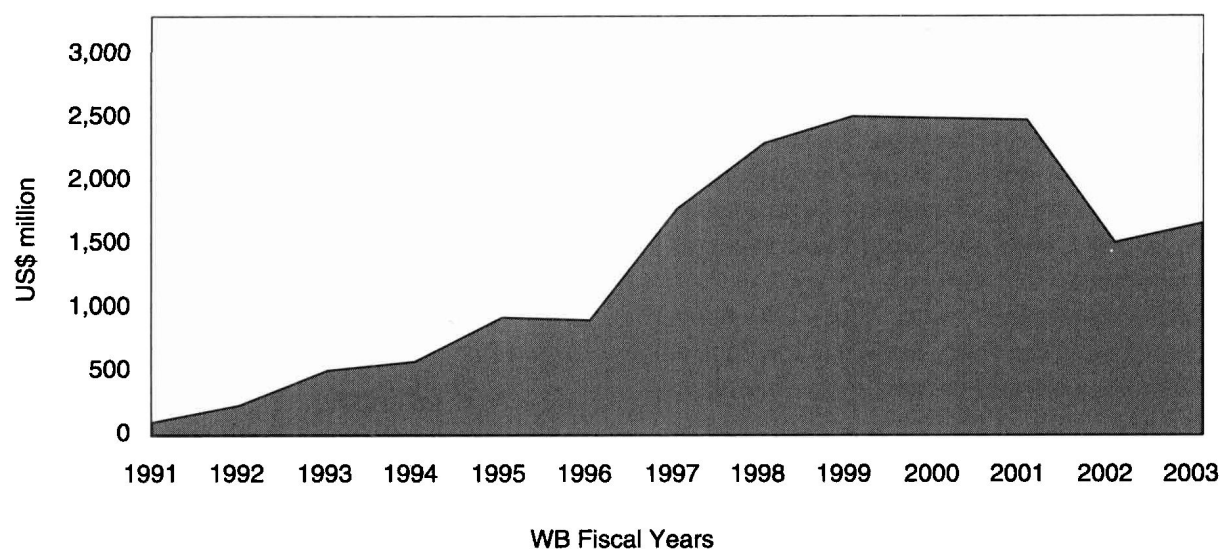
## IDENTIFYING FUTURE DIRECTIONS FOR WORLD BANK INVOLVEMENT IN SOCIAL PROTECTION

These strategic choices have been informed by—and can be supported by—Bank operations. The Bank first got involved in social protection in transition economies in the early 1990s, and since then the portfolio has grown tremendously. Bank lending for social protection in the region reached almost \$2.5 billion in Fiscal 2001, up from \$100 million in 1991 (Figure 4). Experience gained from Bank involvement suggests that future Bank support should focus on:

- *Sequencing operations under a comprehensive approach.* The Bank's social protection programs should be forward-looking and take a long-term, multiyear approach. Policy-based operations should be underpinned and preceded by sector work that provides a solid understanding of the fiscal, macroeconomic, and distributive aspects of reform, with a

## FIGURE 4. ECA SOCIAL PROTECTION PORTFOLIO

Including closed projects as of 6/30/02



*Note:* The data after 2001 is a lower bound estimate; it only includes projected HD Sector Social Protection projects, whereas prior to 2001 the data included Social Protection projects in all sectors.

participatory approach. In addition, policy-based operations should be accompanied by investment institutional capacity—particularly evaluation capacity and understanding of the need for reform—to pave the way for more comprehensive policy-based operations. Adjustment and investment operations that focus on all three blocks of the social protection system are particularly relevant in advancing more consistent social protection reforms. For Bank staff this means greater coordination among areas that are directly affected by social protection issues, including the financial sector, poverty reduction and economic management, and human development.

- *Setting priorities for policy actions through analytical work.* Analytical activities such as poverty assessments, labor market studies, and sector notes provide useful assessments of emerging economic and social conditions. Such reports are crucial for informing policy design and implementation. To ensure ownership and understanding of results, it is essential that, where possible, analytical work be undertaken with clients and other donors so that reports are jointly produced, translated, and disseminated widely within the country. In addition, two new types of analytical work should be considered: labor

market studies to inform policies that spur more competitive labor markets, and administrative reviews of social protection programs to increase their effectiveness.

- *Ensuring sensitivity to the country context.* Projects must reflect each country's context. While some countries would like to make the leap to sophisticated insurance systems, their income, factor market development, and administrative capacity mean that they may not be ready for such reforms. Still other countries may be ready in terms of economic development but not from a political perspective. These factors are critical for determining the timing and level of Bank involvement.
- *Maintaining focus on pensions.* Pensions invariably constitute the largest public transfer program with immense fiscal and poverty implications.
- *Placing greater emphasis on social assistance and labor relations.* The attention paid to social assistance has not been commensurate with its importance in coping with poverty. In labor markets, fostering more competition may require entering into a policy dialogue on industrial relations and labor legislation. Much more time has been devoted to unemployment protection and active labor market programs.

- *Developing innovative approaches.* As social risks become more diverse in transition economies, the Bank must address new areas such as post-conflict support and ethnic violence. There is a need to focus on social assistance outside cash transfer systems. In the area of social services, deinstitutionalizing children and strengthening community-based social services merit further consideration. Similarly, the Bank should use pilot projects in policy or administration when nationwide solutions are not acceptable or when evidence is not sufficient to rank one policy over another.
- *Involving stakeholders and building ownership for policy reforms.* The policy dialogue should include stakeholders within the country and be coordinated with other donors. A wide range of views can promote understanding of the complexity of reforms and how they affect different groups. Focusing on common objectives based on country-specific information as well as regional examples is one way of reaching consensus among stakeholders and generating a more constructive dialogue. Policy seminars for government officials, donors, and stakeholders are also helpful in developing acceptable and sustainable policy reforms.
- *Communicating reforms and garnering public support.* Public information campaigns should be used to increase understanding of the difficult choices facing countries. The difficulty of moving from cultural dependence on state provision of security toward more individual risk bearing requires that the public be educated on market reforms. Policymakers should also be educated on the tradeoffs among generous protection, fiscal costs, growth, and work incentives.
- *Developing an information base and enhancing evaluation capacity.* Transition economies lack adequate data for assessing individual and household welfare, evaluating policies, and forecasting the macroeconomic, fiscal, and distributive aspects of policy changes. Bank efforts should develop country capacity to gather and evaluate household, labor market, and program data to inform policy design. Where systems are already gathering information, efforts should be made to ensure that it is reaching policymakers. Emphasis should be placed on disseminating household and program data widely within the country among academics, non-governmental organizations (NGOs), and other interested parties to inspire and inform policy debates.
- *Making sure that management and information system upgrades support the policy reform agenda.* The Bank should avoid supporting changes in the administration systems, including IT, if there is no clear policy reform context. Otherwise, Bank investments can turn against the policy objectives and hinder the reform process rather than advance it.

## SOCIAL PROTECTION POLICY MATRIX

Strategies	Actions			Indicators
	Labor Markets	Pensions	Social Assistance	
1. Policies to reduce, mitigate, and cope with risk	<b>Eurasian:</b> <ul style="list-style-type: none"> <li>Further restructure labor market while maintaining stable macroeconomic environment;</li> <li>Enhance labor market flexibility: <i>review and develop labor legislation; Reduce mobility restrictions;</i></li> <li>Ensure efficient protection: <i>develop limited active labor market programs and community work; reform unemployment benefit programs, in some cases to simple unemployment assistance programs;</i></li> </ul>	<b>Eurasian:</b> <ul style="list-style-type: none"> <li>Improve financial sustainability and equity: <i>rationalize the PAYG pension system (increase retirement age, reduce or eliminate privilege pensions, adjust benefit formula, change indexation rules, etc.);</i></li> <li>Strengthen the insurance principle: <i>tighten the linkage between benefit and contribution by either changing the DB benefit formula or introducing a NDC scheme; establishing individual contribution record;</i></li> <li>In some poor countries, improve program affordability and efficiency by: <i>considering introducing flat pensions as a short-term option;</i></li> </ul>	<b>Eurasian:</b> <ul style="list-style-type: none"> <li>Ensure adequate protection for the poor: <i>consider opportunity cost of providing cash benefits in the poorest countries.</i></li> <li>Target benefits to the poorest: <i>consider indicator targeting where income is difficult to measure (e.g., child allowances if well targeted).</i></li> <li>Balance cash and in-kind provision of benefits: <i>in inflationary environments consider school feeding programs, utility life-lines.</i></li> </ul>	<ul style="list-style-type: none"> <li>Reformed social protection policies and legislation in place;</li> <li>Short-term financial situation and long-term sustainability improved;</li> <li>Coverage and targeting of programs assessed;</li> </ul>
	<b>European:</b> <ul style="list-style-type: none"> <li>Promote flexible labor markets: <i>decentralized bargaining; low minimum wages; less termination restrictions; limited severance;</i></li> <li>Invest in human capital: <i>build in evaluation practice in active labor market programs to ensure effectiveness;</i></li> <li>Unemployment insurance/assistance: <i>focus on affordable, and work incentives;</i></li> </ul>	<b>European:</b> <ul style="list-style-type: none"> <li>Ensure old age income security while diverse risks: <i>develop multipillar pension system in a conducive macro environment; further rationalize the PAYG scheme;</i></li> <li>Carry out parallel reforms: <i>prepare required financial market legislation and regulations for private pension development;</i></li> </ul>	<b>European:</b> <ul style="list-style-type: none"> <li>Strengthen targeted income transfers: <i>consider means-testing or proxy testing.</i></li> </ul>	

(Matrix continues on the following page.)

## SOCIAL PROTECTION POLICY MATRIX (continued)

Strategies	Actions			Indicators
	Labor Markets	Pensions	Social Assistance	
	<b>In all countries:</b> <ul style="list-style-type: none"> <li>• Improve tax collection;</li> <li>• Build institutions and strengthen administrative capacity of the social protection system;</li> <li>• Manage decentralization process: ensure clear responsibilities for providing and financing programs;</li> <li>• Identify and eliminate gaps in the program; reduce overlapping programs; scale back inherited privileges;</li> <li>• Protect groups with special needs: support the shift from institution-based care to community based alternatives;</li> <li>• Promote NGO involvement in social service provision; install regulatory framework for contracting of services.</li> </ul>			<ul style="list-style-type: none"> <li>• Social contribution collection rate improves;</li> <li>• MIS system developed and financial management of the programs strengthened.</li> </ul>
2. Coordination of SP programs	<b>Coordinate Minimum Benefits</b> <ul style="list-style-type: none"> <li>• Coordinate minimum benefits of pensions, unemployment, and social assistance programs, to ensure that there are no gaps in the safety net.</li> </ul> <b>Coordinate Administration of Programs</b> <ul style="list-style-type: none"> <li>• Coordinate eligibility for exemptions in education and health programs with social assistance.</li> <li>• Coordinate eligibility of social assistance and unemployment benefit programs (registration for unemployment).</li> <li>• Ensure that the pension system is coordinated with other social insurance programs (such as unemployment, health, maternity, sickness, etc.) in terms of social contribution transfer or recording, the determination of reference wage, and the account for noncontributory period in pension calculation.</li> <li>• Coordinate with tax system reform to improve social tax collection.</li> <li>• Labor with pension/social assistance legislation reforms (i.e., mandatory retirement; minimum wages).</li> <li>• Reduce overlapping and duplicative programs (e.g., family benefits).</li> <li>• Coordinate with enterprise restructuring and labor market development programs so that pension system (early retirement) is not used as a short-term solution to alleviate unemployment pressure.</li> </ul>			<ul style="list-style-type: none"> <li>• Improved policy formulation taking into account various SP linkages;</li> <li>• Improved administration of programs; and improved coordination of programs across the SP sectors.</li> </ul>
	<b>Incorporate Work Incentives</b> <ul style="list-style-type: none"> <li>• Coordinate social assistance and unemployment benefits to promote work incentives: keep benefits low relative to minimum wage, income test.</li> </ul>			
3. Improvement of information base	<b>Improve Database to Evaluate Effectiveness, Efficiency of Programs</b> <ul style="list-style-type: none"> <li>• Labor force surveys</li> <li>• Employment-based surveys</li> <li>• Household surveys</li> <li>• Registered unemployment records</li> <li>• Beneficiary assessments</li> </ul>			<ul style="list-style-type: none"> <li>• Surveys instituted and results tabulated; released to researchers in country and internationally.</li> </ul>



#### ***Improve Administrative Data to Evaluate/Monitor Programs/Clients***

- Develop information technology system that establishes individual contribution record.
- Harmonize with the database of tax authority, unemployment benefit program, and social assistance programs to enhance proactive collection and monitoring, avoid double payment.
- Use the database of financial market to ensure transparent management of funded pension system and to reduce potential risks due to lack of transparency.
- Coordinate automations systems with unemployment and social insurance systems; tax systems.
- Maintain database of NGOs active in provision of social services.

#### **4. Evaluation of programs**

##### ***Evaluate Welfare and Financing Impact of Programs***

- Assess coverage, targeting, and adequacy of cash benefits.
- Monitor outcomes of active labor market policies.
- Monitor NGO and community involvement in social assistance provision.

- Institutional capacity to evaluate own programs developed. Evaluations produced and used to guide/inform policy debate.

##### ***Monitor Economic Developments***

- Evaluate the informal sector.
- Monitor financial market performance of pension funds.

#### **5. Public information**

##### ***Build Consensus for Reforms through Public Information***

- Initiate public awareness campaigns alongside policy reforms.

- Public information campaigns mainstreamed in social protection reform.

##### ***Disseminate Information on Benefits and Services***

- Provide up-to-date information on eligibility criteria and location of services.

#### **6. Building ownership for reforms**

##### ***Engage Stakeholders in the Policy Dialogue***

- Trade unions
- Chambers of commerce and employers' associations
- NGOs
- Pensioners' associations
- Political parties

- Consultations with broad groups of stakeholders mainstreamed in the reform process.

##### ***Conduct Regular Beneficiary Assessments***

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# Social Protection Developments: Eurasian vs. European Approach

**U**nder central planning, the state provided full protection against income risks over an individual's lifetime: Employment for the working age population and pensions for retired workers were the main mechanisms for achieving lifetime income security. Social assistance was focused on individuals with special needs such as the orphaned and disabled, providing them with cash and in-kind assistance and institutionalized care. Major subsidies for goods and services, such as housing and utilities, were provided to the population. While the system promoted equity through an egalitarian wage structure, some groups, miners and teachers, for example, received special privileges such as early retirement.

As transition countries turned to the market, job security vanished. Risks of unemployment and poverty emerged. A fundamental tension in social protection policy arose. Should the state continue to use employment as the main tool of social protection? Or should it let employment adjust and use generous social protection systems to lay off workers? The choice made by transition countries to address this issue allows them to be categorized into the two distinct groups: Eurasian and European.<sup>1</sup> By and large, Eurasian countries have taken the former approach, while European countries have adopted the latter.

European countries have liberalized and restructured more aggressively and effectively. In contrast to Eurasian countries, incomes levels are higher, and countries have greater fiscal resources. Labor markets are starting to resemble those in OECD countries. Pensions, unemployment and social assistance programs provide more generous benefits and are now being reformed. Eurasian countries have restructured far less. Incomes and fiscal resources are more limited. Formal labor markets have disintegrated; and labor market institutions are weak or nonexistent. Social protection programs inherited from the socialist past provide nonexistent benefits, pay benefits in kind or not at all. Few

countries have started to reform systems to make them more affordable and better targeted to the poor.

These two approaches are reflected in each of the three building blocks of the social protection system: labor markets, pensions systems, and social assistance.

## EMERGING LABOR MARKETS

Prior to the transition, employment and wages were guaranteed. Wages were largely equitable and centrally determined. Employment rates and labor force participation rates were extremely high. The central planning system created incentives for over-manning. Labor shortages were pervasive and, with few exceptions, open unemployment was almost nonexistent. As such, there were no explicit provisions for unemployment, such as unemployment insurance. Highly protected worker rights made it difficult for employers to dismiss unproductive or incompetent individuals. Finally, worker mobility was constrained by the resident permit system and housing restrictions such as limited private ownership and lifetime occupancy (Barr 1994).

## Common Adjustment Patterns

As countries turned to the market, the remuneration and allocation of labor changed fundamentally. Wage setting became decentralized, employment was no longer

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<sup>1</sup> These categories involve broad generalizations, which in some cases hide large differences. However, this grouping is still useful to characterize the two basic approaches followed in the region.

guaranteed, and formal labor mobility constraints were eliminated. The large declines in output experienced at the onset of transition forced major adjustment in labor markets.<sup>2</sup> Real wages declined, and consistent with wage decentralization, wage inequality increased. A major *restructuring* process occurred, initially focused on labor shedding (Blanchard 1997). Employment fell in all transition countries, and open unemployment increased. However, the increase in unemployment was not commensurate with a fall in employment. Many individuals, particularly women, withdrew from the labor force (Rutkowski 1996). These developments reduced labor productivity across the region.

The transition was also accompanied by a major *reallocation* of jobs between sectors. The private sector started to play a larger role in employment and output relative to the state (Estrin 1998; Garibaldi and others 1997). The sectoral composition of employment changed. The share of manufacturing, industry, and agriculture declined and the share of jobs in services, trade, and finance rose. However, the sectoral composition still remains quite different than in OECD countries, indicating that privatization and restructuring remain major issues. In particular, employment in agriculture remains high, reflecting a lower level of economic development (vs. OECD countries), but also reflecting agriculture's role as a major coping mechanism during the transition (Jackman and Pauna 1997).

## Labor Market Developments: Two Approaches

### EURASIAN APPROACH

Despite early common trends, two divergent patterns of labor market adjustment—differentiated by the relative importance of wage or employment adjustment to output changes—have emerged in the region.<sup>3</sup> The first approach, followed by Eurasian transition economies, relied on wages as the primary mode of adjustment. Wage declines were much larger than in European transition economies (Figure

5). Wage arrears were also used to cope with declines in output, and they remain a major problem in this subregion.<sup>4</sup> In 1998, a significant share of Russian workers experienced wage arrears in Russia (Desai and Idson 1998). In Uzbekistan, 24 percent of survey respondents reported an average of two months of wage arrears (Hendricks 1999). In contrast, wage arrears are not a major problem in European transition economies.

*Over-staffing in enterprises.* Limited employment adjustment to output was reflected in low job destruction and unemployment rates in the initial transition years. Over time, job destruction rates have increased, but labor hoarding remains a problem. Employers are reluctant to lay off workers, citing paternalism, or concern for worker welfare, as a key reason (Kapeliushikov 1998). Expectations of receiving back pay, payment of wages in kind, maintaining social insurance contributions, limited job opportunities, and continued provision of services by employers (such as housing) keep employees tied to firms (Gimpelson and Lippoldt 1996; Friebe and Guriev 1999). The presence of large unstructured manufacturing firms continues to constrain the growth of small service sector firms, critical for new job creation (Faggio and Konings 1999; Konings and Walsh 1999).<sup>5</sup> Over time, the continuing collapse of output has also increased open unemployment rates, which are converging to (or in some cases, have exceeded) European transition levels (Table 2).

*Large and increasing wage disparities.* Wage inequality has increased dramatically in Eurasian transition economies. The increase in wage disparity reflects a sharp rise in the wages of high paid workers vs. wages of median workers, and a sharp decline in wages of low paid vs. median workers. The middle wage class is considerably collapsed. While increases in wage inequality are not worrisome per se, the high level of wage inequality (approaching levels in low income countries) and limited link to productivity is troubling (Newell and Reilly 1999).

<sup>2</sup> Real declines in GDP, at their peak, ranged from as high as 70 percent for Armenia/Georgia to 15 percent for Poland and Hungary. The discussion of reasons for varying output declines is not discussed in the paper. Some reasons advanced for regional variations are the large share of industrial (and most inefficient sectors) in Eurasian countries and their heavy reliance on intra-Eurasian trade. It is important to note that the decline in output may be overstated because conditions such as freedom of choice, eradication of shortages, and queuing are not included in GDP estimates (Gomulka 1998).

<sup>3</sup> Data on employment and wages from Eurasian countries (in particular) are fraught with comparability issues and also may not capture developments in the emerging private sector.

<sup>4</sup> Enterprises have also adjusted through reducing hours of work and placing workers on unpaid leaves. In some cases incorporating the decline in hours of work shows a smaller decline in labor productivity than if employment is used (Georgia, World Bank 1999c).

<sup>5</sup> In Russia, despite limited job creation and evidence of labor hoarding, the mobility of labor (within regions) is high (there is considerable hiring and firing), particularly among blue collar workers, suggesting considerable "churning" in the labor market (Gimpelson and Lippoldt 1996).