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Session VI: Social Policy and Income Distribution during the Transition

Discussant: Mr. Marek Dabrowski, Vice Chairman, Center for Social and Economic Research (Poland) comments on paper by Mr. Branko Milanovic "Explaining the Growth in Inequality during the Transition"

My comments to a Branko Milanovic paper and presentation will concentrate on drawing conclusions, which can be useful for the economic and social policies of the transition countries, particularly in the Kyrgyz Republic.

Generally, I found two extremely interesting results in Milanovic's research. **First**, income inequality increased during transition period, i.e. in comparison with the pre-transition time. This is quite obvious result and easy to be explained. Development of new private sector, privatization, elimination of price control, and significant reduction in subsidies had to have consequences in increasing income differentiation. Previous communist *uravnilovka* was completely incompatible with building new market system. What is more interesting, however, income inequality in countries, which adopted fast and radical reforms (Central European and Baltic countries) is lower than in countries implementing reforms much slower and less consequently (Russia). Additionally, fast reforms are more efficient from purely economic point of view: the period of transition output decline is shorter and economic growth comes sooner and is more sustainable. Fast reformers not only distribute GDP in more equal way. They also have more to distribute than slow reformers.

This means that politicians who were against fast reforms arguing that it will bring 'higher social costs' were simply wrong. In fact persistent high inflation or hyperinflation hurts all society but mainly poor people, and contributes to bigger differentiation of income and wealth. Overregulation, trade protectionism, tax exemptions, and subsidies create source of administrative rent which not only increases inequality but also is in conflict with the common sense of social justice. Income and wealth differentiation cannot be explained in this case by influence of market forces or differences in productivity, entrepreneurship, propensity to risk, etc. Political influence, effective lobbying, personal connections, sometimes nepotism and corruption are the main determinants of income differentiation.

The same observation relates to slow privatization or its absence. In the specific transition environment state apparatus is usually seriously weakened and is not able to execute effective ownership control over the public sector. This is reason why the absence or slow pace of official privatization stimulates unofficial one where income and assets of state owned companies is illegally or semi-legally transferred to private hands, mainly of enterprise managers, their relatives and friends. It also consolidates economic power of post-communist oligarchy and limits the development of really new entrepreneurial class. Generally, slow and inconsequent reforms lead to forming distorted and corrupted capitalism with very limited growth potential but involving a lot of social inequality and social pathology. This also usually undermines political stability and weakens the legitimacy of government and its policy.

The same can be observed in many developing countries: high social inequality has its roots in distortions of economic system. High inflation, numerous regulatory and tax distortions, subsidies, weak public ownership, and lack of transparency in government actions lead to high level of income inequality and to a deep poverty of big social groups.

Second important conclusion is connected with a very low effectiveness of the social safety net in transition. As shown by Branko Milanovic in his research results, very extensive, in many cases evidently overgenerous system of social transfers have not contributed to decreasing in level of income inequality (with Latvia being the only positive exemption in this concrete research panel). Contrary to it, in countries such as Poland, Hungary, Slovenia, and Russia social transfers have even widened the scale of social differentiation. This means that transfer payments are wrongly addressed from the point of view of the efficiency of social policy.

The above finding has several important implications. Looking at social transfers from the macroeconomic point of view they are simply too high under any standards. This relates mainly to such Central European countries as Poland and Slovenia, which spend for these purposes more than 20% of GDP (see table 1). But also countries which present less impressive figures evidently spend too much taking into consideration their GDP per capita level, real revenue potential, and, what was mentioned before, very doubtful social effectiveness of this kind of spending.

Table 2 shows that public pension expenditures represent the biggest problem, again with Poland and Slovenia being the absolute leaders[1]. For these two countries (and, to lesser extent, this relates also to Hungary, Latvia, FYR Macedonia, Czech Republic, and Slovakia) high pension and other social expenditures transfers push up the overall level of fiscal redistribution of their GDP (see table 3). Even if most countries in this group can avoid fiscal deficit at all or keep it relatively low[2], such a high expenditure to GDP ratio may threaten medium and long term prospects of economic growth and create a trap of ‘post-communist welfare state’[3] [Dabrowski, 1998].

But also other countries (i.e. CIS and Balkan countries) face a challenge of excessive social, mainly pension transfers. They are in excess of their real fiscal capacity what lead in many of them to the persistent fiscal crisis. Let take example of the Kyrgyz Republic. If we look again in table 2 and 3 we will see that public pension expenditures amounted to 7.7% of GDP in 1996,

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[1] Slovenia was not shown in the table because of the lack of data fully comparable with other recorded countries. However, according to other sources [see – Golinowska, 1996, p. 21] it represents level of public pension expenditures generally similar to the Polish one (or even sometimes higher).

[2] Hungary is the only country in this group, which have experienced much serious fiscal problems in mid of 1990s.

[3] Particularly if we take into consideration long term unfavorable demographic trends in all these countries.

comparing with general government revenue to GDP ratio of 17.6%, general government expenditure to GDP ratio of 23.3%, and fiscal deficit of 5.7% of GDP. Such a level of pension expenditures is clearly unsustainable for very poor country with limited fiscal potential. Additionally, relatively young structure of the Kyrgyz society (what makes a serious difference in comparison with most of European transition countries) does not justify such a high level of pension transfers. This country has another social and economic priorities, for example, education of young generation or infrastructure investments.

If we look at this problem from the microeconomic and institutional point view we can find that pension systems and other elements of social safety net are extremely wasteful and ineffective in addressing the real support to the economically weakest groups of society. On the other hand, they also fail to generate the motivation to the employment in legal sphere and savings. This is because they are driven by the intensive rent seeking of various influential lobbies.

Basic retirement age in most of CIS countries is not high by international standards (60 for men, 55 for women). However, the effective retirement age is even much lower than the official one. Numerous sectors and professional groups' privileges of earlier retirement are one of the reasons. Another one is connected with too generous system of disability pensions. All these factors push up dependency ratio to unsustainable level. The highest dependency ratio are represented by some Central and Eastern European countries – Hungary (76.9% in 1996), Bulgaria (74.4%), Belarus (71.0%), Ukraine (65.3%), Poland (61.3%), Czech Republic (61%) [WEO, 1998, p. 114]. What is even worse, in most of these countries dependency ratio represents the increasing trend what reflects partly adverse demographic developments and partly successful rent seeking of growing number of privileged groups.

In some countries the high public pensions spending to GDP ratio is driven not only by high and increasing number of pensioners but also by too generous indexation formulas. This why the replacement rate in Poland amounted to 76.8% in 1993, and 61.3% in 1996 [WEO, 1998, p. 114]. On the contrary, most of CIS countries do not have regular indexation pension rules and period of high inflation or hyperinflation bring the replacement rate to much lower level than in Poland or Slovenia. In terms of income redistribution this means that fiscal effects of excessive expansion of population of pensioners has been partly compensated by a real depreciation of the old pension portfolio. In practical terms it means that the oldest pensioners who usually need the biggest social assistance get the lowest benefits when relatively young (for, example in age of fifty) early retired can continue work, very often in the informal sector, and get relatively higher pension benefits. Such a situation stays in clear conflict with any common sense of social justice. Thus, public pension systems in most of transition countries are not only wasteful in the fiscal sense but also socially unfair.

A very similar situation relates to many other forms of social transfers. Family benefits and social aid are also usually very badly targeted supporting in fact middle income groups instead of poor. However, the system of providing a number of goods and services for free or at highly subsidized prices to the broadly defined groups of society (so-called *social'nye l'goty*) seems to be the second biggest source (after the pension system) of excessive social expenditures. Pensioners, invalids, war veterans, single mothers, families with many children, students, military personnel, policemen, teachers, and many other social and professional groups can obtain several goods and services at lower price or for free. It relates, among others, to electricity and natural gas, housing rates, public transport and communication services, medicines. Costs of providing this goods and services by suppliers are either covered from budget or cross-subsidized by other consumers. Such a system is not only connected with significant fiscal expenditures (usually at range of few percents of GDP[4]) but also hinders attempts to demonopolize and privatize important infrastructure sectors. Its social effectiveness (in sense of supporting really poor people) is highly problematic.

As it was mentioned earlier, Kyrgyzstan represents relatively high level of public pension spending (the highest one in the post-Soviet Central Asia) despite relatively low dependency ratio (34.0% in 1996). On the contrary, the replacement rate (48.5% in 1996) is the second highest among countries of the former USSR (after Turkmenistan). However, even a dependency ratio is probably too high taking into consideration one of the youngest demographic structure of population among transition economies. What concerns other segments of social transfers they are also excessive (comparing to the real fiscal potential of the country) and very poorly targeted.

On the other hand, Kyrgyzstan needs serious fiscal adjustment if wants to avoid danger of a serious financial crisis in future [see – Antczak et al., 1997]. Recent experience of Russia and Ukraine shows that continuing large fiscal deficit must bring sooner or later serious balance of payments tensions and problems with servicing the public debt. Kyrgyzstan experienced already a kind of financial crisis in 1996 when som depreciated by approximately 50% during six months as result of huge fiscal deficit in 1995 [see – Markiewicz et al., 1997]. This should be taken as a very serious warning signal for the future.

Looking at possible ways of fiscal adjustment one may find that any significant increase of revenue collection in relation to GDP does not look very realistic, at least in the near future [Markiewicz, Mogilevski, and Cukrowski, 1997a]. Kyrgyz Republic is a low-income country, with significant role of natural agriculture, small trade and service sector what limits naturally its tax collection potential. On the expenditure side social transfers are the biggest remaining reserve of potential rationalization of public spending [see Markiewicz, Mogilevski, and Cukrowski, 1997b]. This means that reform of the existing PAYG pension system and other forms of explicit or implicit social benefits is a top priority.

What concerns the reform of pension system, it must start from increasing the official retirement age, significant cutting of opportunities of early retirement, and tightening the criteria of receiving disability pensions. All these decisions are politically extremely difficult and unpopular. However, Kyrgyzstan should follow experience of Estonia, Latvia, Georgia, Armenia, and Kazakstan, which managed to move in this direction.

During political debate concerning the increase of retirement age defenders of the status

[4] Precise assessment of the fiscal consequences of this system is not easy because of its low transparency in terms of rules and financing. Therefore, there are no comparative analyzes on this phenomenon in CIS countries, apart from few sectoral studies of individual countries. For example, Jaroslaw Kuzma [1997] from CASE tried to estimate fiscal cost of providing housing and public utilities services in the Kyrgyz Republic at concessionaire price.

quo usually present two kinds of arguments. First one is stressing that a life expectancy in post-communist countries is much lower than in developed countries. Second argument underlines that pensioners are the poorest group of population.

Both arguments are wrong. Relatively low life expectancy at birth (61.4 for men and 70.4 for women) is at least determined by the high infant and child mortality rate. As result life expectancy for men in age of 60 is 74.4 and for woman in age of 55 is 77.4 [Cukrowski, 1996]. The second argument can be easily questioned in the light of the earlier analysis. In fact making early retirement more difficult will protect economically the existing population of pensioners by creating some room for increasing the lowest benefits and guaranteeing payment of pension on time. This is extremely important for oldest group of pensioners, usually the weakest in economic sense. In the same time more tough entry criteria for the new pensioners will limit black labor market and unregistered economic activity.

Social transfers and public pension schemes are politically sensitive issues in any country, not only in Kyrgyzstan. However, a country that faces serious fiscal crisis, does not have time to postpone the necessary adjustment. Later started it will be more painful in any respect.

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Table 1: Social security transfers in selected transition countries, 1996 (in percent of GDP).

Country	Social transfers in % of GDP
Croatia	13.5
Czech Republic	12.2
Estonia	11.0
Hungary	14.4
Latvia	16.1
Lithuania	8.8
Mongolia	5.2
Poland	20.8
Slovakia	14.5
Slovenia	20.2

Source: WEO [1998], p. 112, table 24.

Table 2: Public pension expenditures in transition countries, 1996 (in percent of GDP)

Country	Pension expenditures in % of GDP
Central and Eastern Europe	
Albania	6.8
Bulgaria	9.5
Croatia	10.2
Czech Republic	8.4
Hungary	9.7
FYR Macedonia	11.2
Poland	14.4
Romania	5.8
Slovakia	8.3
Former Soviet Union	
Armenia	3.1
Azerbaijan	2.5
Belarus	8.4
Estonia	7.6
Georgia	1.7
Kazakstan	5.3
Kyrgyzstan	7.7
Latvia	10.8
Lithuania	6.2
Moldova	8.1
Russia	4.5
Tadjikistan	3.0
Ukraine	8.7
Uzbekistan	6.4

Source: WEO [1998], p. 115, box 10.

Table 3: General government revenue, expenditure and balance in transition countries, 1997 (in Percent of GDP).

Country	Revenue	Expenditure	Balance
Central Europe, Baltic countries and former Yugoslavia			
Croatia	46.8	48.2	-1.4
Czech Republic	40.7	42.8	-2.1
Estonia	39.4	37.0	+2.4
Hungary	44.9	49.5	-4.6
FYR Macedonia	42.4	42.7	-0.3
Latvia	39.0	37.6	+1.4
Lithuania	33.5	35.4	-1.9
Poland	44.1	45.8	-1.7
Slovakia	41.5	46.4	-4.9
Slovenia	45.0	46.2	-1.2
Balkans			
Albania	16.4	28.4	-12.0
Bulgaria	31.5	34.1	-2.6
Romania	27.0	31.5	-4.5
Former Soviet Union (without Baltic countries) and Mongolia			
Armenia	17.4	24.1	-6.7
Azerbaijan	17.4	20.2	-2.8
Belarus	40.9	42.1	-1.2
Georgia	10.4	15.3	-4.9
Kazakstan	23.4	27.1	-3.7
Kyrgyzstan	17.6	23.2	-5.7
Moldova	34.3	41.1	-6.8
Mongolia	29.0	38.0	-9.0
Russia	33.0	40.4	-7.4
Tadjikistan	11.6	15.0	-3.4
Turkmenistan	29.2	29.2	0.0
Ukraine	38.4	44.0	-5.6
Uzbekistan	30.2	33.0	-2.8

Source: WEO [1998], p. 98-99, table 17-19.