



**FINANCE AND DEVELOPMENT**

**DECEMBER 2018**

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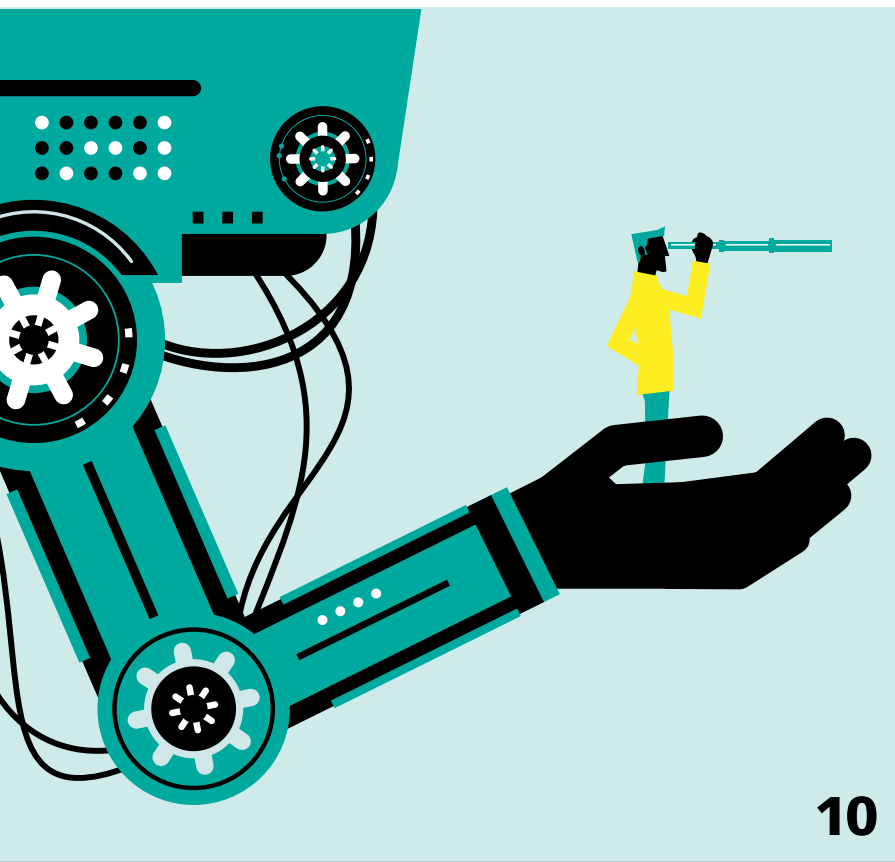
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# Age of Insecurity

**Rethinking the social contract**

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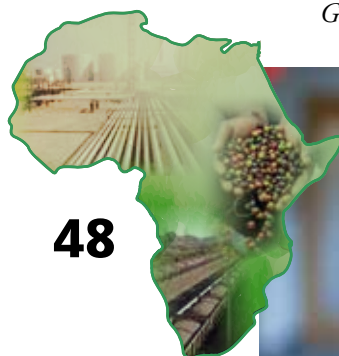
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## A New Social Contract

AS THE WORLD seeks to address the rise of populism and nationalism, it is becoming clear that economic insecurity lies at the heart of much of the discontent. In the wake of the global financial crisis, voters in wealthy countries began to lose faith in the state's ability to protect them. The profound changes sweeping labor markets, caused by the rise of technology and continued globalization, have only deepened this anxiety. At the same time, people in poor countries still have not attained even basic standards of living, with many risking their lives in search of a more prosperous future.

This has prompted many to rethink social protection. In this issue, *F&D* shines a spotlight on this work. We do so in partnership with the London School of Economics and Political Science (LSE), which last year launched a research project to redefine the welfare state.

"A new social contract is essential to restoring a sense of security and sustaining political support for open economies and societies," writes LSE Director Nemat Shafik. But what does such a contract look like in practice? In the gig economy, the responsibility for looking after workers has blurred. And as automation marches on, some workers find themselves marginalized, with no prospect for employment at all. Population aging increases the burden of caring for the elderly, while the pool of younger workers shrinks. Advances in health care mean we can all live longer. Yet even basic care remains out of reach for many poor people.

Whether through universal basic income, better targeting of existing safety nets, more investment in education and health, or a combination of all these policies, each society will need to find an answer that works for its unique characteristics. That same principle applies to the vexed issue of how to pay for social protection. Ultimately, it comes down to political choice. In this age of insecurity, we should act now to strengthen the bonds that unite us. **FD**

**CAMILLA LUND ANDERSEN**, editor-in-chief



### ON THE COVER

The changing nature of work is challenging the effectiveness of industrial-era social insurance policies. Michael Waraksa's December 2018 *F&D* cover highlights the stark difference between those who are covered and those who are left to weather the storm.

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# A NEW SOCIAL CONTRACT

Overcoming fears of technology and globalization means rethinking the rights and obligations of citizenship

Nemat Shafik

**W**e are living in an age of insecurity. Increasingly, the values of liberal democracy, liberal economies, and a rules-based international system are being repudiated—even though they have delivered progress for the vast majority of people. Discontent has been fed by fears over slowing economic progress, especially in advanced economies, flatlining productivity and social mobility, and concerns about the future brought on by shifts in demography and technology.

We see this expressed in our politics. Popular anger and distrust of elites, compounded by the financial crisis, have led to growing support for nationalist and illiberal politicians. We see it in the mounting evidence of declining perceptions of well-being and trust in many countries. While the causes of our discontent vary, they all point to the need to revitalize our politics, economics, and social contract to provide citizens with a greater sense of security and confidence in the face of impending changes.

Why are so many people in some of the more successful countries in the world so unhappy? Inequality is a major cause, as is fear about future

prospects caused by automation and aging. While the world has become more equal between countries, there have been different effects on income distribution within countries. The middle class in emerging markets and the richest 1 percent globally have benefited enormously, while the middle class in advanced economies has suffered. And parents in many countries worry about their children's prospects in the face of the high costs of education and housing, alongside low-quality jobs with poor benefits.

## Protectionist calls

Many blame globalization and technology, but I would focus more on the failure of our social contract to manage properly the consequences of both. Our social contract—by which I mean the rights and obligations of citizenship—has frayed as a result of hyper-globalization and the austerity that followed the financial crisis. The advance of automation and intensifying global competition have driven down the wages of less skilled workers. As a result, many call for more protectionism or blame immigrants. But the answer is not to deglobalize and revert to our national silos, but to





rethink our social contract to heal these tensions and help people adjust.

All this has been compounded by sluggish growth since the Great Recession. A recent study of 25 advanced economies by the McKinsey Global Institute found that 65 to 70 percent of households (or 540 million to 580 million people) experienced flat or falling incomes before taxes and transfers from 2005 to 2014. When growth is slow, people become less generous and less tolerant.

To be sure, fiscal policy reduced this decline to 20 to 25 percent in terms of disposable, or after tax, incomes, according to the 2016 McKinsey study “Poorer Than Their Parents? Flat or Falling Incomes in Advanced Economies.” Safety nets worked particularly well in the United States, turning a 4 percent drop in market incomes into a 1 percent gain in disposable incomes over time. This 5 percentage point change was helped by the Obama administration’s stimulus plan, which transferred more than \$350 billion to households in the form of tax relief and assistance to workers affected by the downturn. In France, the safety net raised median disposable income by 3 percentage points above median market income, while in the United Kingdom, transfers fully offset the decline in market incomes.

### **Future shock**

While these redistributive policies softened the blows dealt to lower-income households by the Great Recession, they also contributed to a massive accumulation of debt driven by the direct and indirect costs of the crisis. To reduce it, many countries later resorted to welfare cuts that unleashed social grievances, with communities feeling they were being left behind and individuals experiencing a loss of dignity and sense of control over their destiny. In the United Kingdom, for example, Fetzner (2018) argues that welfare cuts took the biggest toll in regions that ended up voting for the populist UK Independence Party and in favor of Brexit. The combination of globalization, the financial crisis of 2008, and the austerity that followed meant that many people faced a massive shock with a very thin safety net to support them.

Fear of future prospects is another source of discontent. This fear is largely rooted in expectations that automation will eliminate many types of routine and repetitive work while creating more demand for highly skilled labor. Compounding

the anxiety is the rise of precarious work at low wages with minimal or no benefits. While some people find advantages in these more flexible work arrangements, others experience serious economic insecurity. Precarious employment reduces both physical and mental health as individuals lose a sense of agency over their own lives.

Furthermore, there is a risk that automation will further bifurcate labor markets in favor of the highly educated. The US Bureau of Labor Statistics predicts that for every highly paid job in software development, there will be six new low-paid jobs for personal care and home health aides between 2014 and 2024.

These anxieties have found their expression in the political arena. In the United States, for example, Delsman (forthcoming) finds that 21 of the 22 states where jobs were most vulnerable to automation voted for Donald Trump in the 2016 presidential election, while all 15 least vulnerable states backed Hillary Clinton.

### **Division of responsibilities**

The backlash highlights the need for a new social contract, one that adapts to changed economic realities and better manages the social implications of globalization. The social contract includes the payment of taxes in exchange for public goods, and the way that society looks after the old, the young, the infirm, and those who have fallen on hard times. Because the social contract is fundamentally values-driven, solutions will vary across societies.

Even so, every society will have to think of who benefits from its social safety net, which is the mechanism through which we pool risk and offset, to some extent, the impact of luck on life chances. Every society will also have to make choices about the division of responsibilities between the family, the voluntary sector, the market, and the state. This is essential since the welfare state is also the mechanism for ensuring the equal standing of all citizens so that they can participate fully in public life.

There are fundamental questions to answer, which have grown more complex in more heterogeneous and globalized societies. Whom do we feel obligations to take care of and share risks with? What responsibilities go along with those obligations? How much do obligations extend beyond families to communities or other regions? What about poor people in other parts of the world? Are we obliged to leave future generations at least



an equivalent endowment of physical, social, and natural capital as we were given?

As part of the new social contract, we may need to reinstate the reciprocity and insurance element in welfare provision. There is a toxic perception that there are “hard-working people” and “welfare scroungers” when in fact, as John Hills at the London School of Economics (LSE) has shown for the United Kingdom, the vast majority take out (in the form of education, health care, and pensions) broadly as much as they put in (in taxation when they are working) over the course of their lives. The rich pay more tax but tend to live longer, so they benefit more from pensions and health care in old age.

### Universal benefits?

Perhaps we need to revisit the political and social advantages of universal benefits, which are better for getting political buy-in and ensuring quality. The founder of the welfare state in the United Kingdom, the LSE’s William Beveridge, intended it to be based on the concept of universal social insurance. That link was lost as the social safety net increasingly was funded through general taxation and some citizens opted out through private provision. Richard Titmuss, the pioneering British social researcher, noted that “separate discriminatory services for poor people have always tended to be poor quality services.” Keeping the better-off engaged with public services sustains a sense of mutual obligation and maintains pressure to uphold standards.

How would a new social contract address inequality? In the medium term, so-called pre-distribution policies are key—education, social mobility, infrastructure investments in poorer regions, and spreading productivity improvements to the frontier. Countries with greater social mobility grow faster because they more effectively match people to the right jobs, generating higher productivity. The best way to raise innovation and productivity may be to provide opportunity to the “lost Einsteins” who are disadvantaged by the circumstances of their birth (Van Reenen and others 2018). Greater investment in equalizing education opportunities and outcomes would have a high payoff and enhance confidence in the fairness of the system.

### Old and young

We also face huge issues of intergenerational fairness. Many aging societies now spend more on the old

than the young. Data from the Organisation for Economic Co-operation and Development show that as the age of the median voter rises by a year, public spending on pensions goes up by 0.5 percent of GDP (Ebbinghaus and Naumann 2018). Older people vote and are very effective at protecting their interests—the young should do the same. But older people should care, not just about their own children and grandchildren (who can be supported through bequests), but about others’ too, since they will inhabit the same society. One solution is to give young people entitlements that they can use to improve skills over the course of their lives. Under such a social contract between generations, young people would repay the investment with higher future taxes that could finance care for the elderly.

Intergenerational fairness and social mobility are issues that will take time to address; in the near term, some degree of redistribution is essential. Tax systems have become less progressive as advanced economies lowered corporate taxes and top rates on

Countries with greater social mobility grow faster because they more effectively match people to the right jobs.

personal income in the 1980s and 1990s and raised value-added taxes. This is especially problematic given widening inequality in market incomes. And because wealth has grown even more unequal than income, we should explore taxing wealth such as inheritance, land, and real estate. Recent IMF research shows that greater equality boosts growth, so such reforms may also help revive sluggish economies (Ostry, Berg, and Tsangarides 2014).

Another way to address inequality would be to put a floor under incomes, which would help ensure that even low-wage earners can enjoy a reasonable standard of living. I am not a proponent of universal basic income except in poor countries that lack the capacity to manage a welfare state or where it would substitute for an even worse policy, such as energy subsidies. In most middle-income and advanced economies, universal basic income would be expensive and inferior to a properly functioning welfare state. It also risks undermining the widespread view that anyone who can work should, and it does not take adequate account of the importance

## We must renegotiate choices we made in the past because they no longer fit current circumstances.

of meaningful work to well-being. Better solutions include wage subsidies, earned income tax credits, and higher minimum wages, combined with access to services such as education and healthcare.

### Labor flexibility

The spread of low-quality jobs with few benefits and the impact of automation are sources of insecurity that must be addressed. To make a successful transition to digital economies, governments must make it easier to switch jobs and guarantee workers a fair share of the benefits from this transition. Potential solutions include ensuring a level playing field in wage negotiations, profit sharing, and cooperatives. Otherwise those left behind will keep voting for policies such as restrictions on trade or labor mobility that thwart modernization of the economy.

Firms should have flexibility to hire and fire workers as the economy changes but then provide generous unemployment benefits, training, and job placement. “Flexicurity,” as it is called in Denmark, is just such a system. It relies on firms’ willingness to pay higher taxes and to engage with social partners on skill needs in exchange for more flexible employment rules. Unfortunately, spending on worker education and training has been declining across most countries, and firms have less incentive to spend when employee turnover is high. Investment in training and transitional support must be raised to facilitate the transition to the labor markets of the future.

As countries get richer, people work fewer hours, and automation will accelerate this trend. It will be important to use productivity gains from automation to eliminate routine and repetitive tasks and make time for more meaningful work and leisure. Giving part-time and temporary workers (who tend to be lower skilled and lower paid) more rights to pensions, paid leave, and training has been a positive reform in countries like Denmark, Germany, and the Netherlands.

### Income shift

As technology advances and populations age, working lives will be longer, and people will need to retool several times in their careers. Abolishing mandatory retirement ages and removing age limits

for student loan eligibility, as the United States and United Kingdom have done, are a good start. Linking eligibility for pensions to life expectancy, as the Netherlands has done, is an even better way to adjust workers’ expectations.

At a global level, we also must find a way to redress the massive shift in income from labor to capital. A first step would be to remove policies that tax labor more heavily, although issues of international tax competition make this difficult. An international effort to ensure that capital is taxed where the economic activity takes place, rather than in offshore havens and various “tax efficient” structures, would go a long way toward restoring a sense of fairness in the world economy.

In sum, we need a new social contract to create a sense of security in our globalized and fast-changing economy. The social contract is about how we pool our resources to provide the public goods we agree are needed and how we support those affected by adverse shocks. While different societies will make different choices, we have all arrived at a crossroads: we must renegotiate choices we made in the past because they no longer fit current circumstances, much less those of the future. A new social contract is essential to restoring a sense of security and sustaining political support for open economies and societies. **FD**

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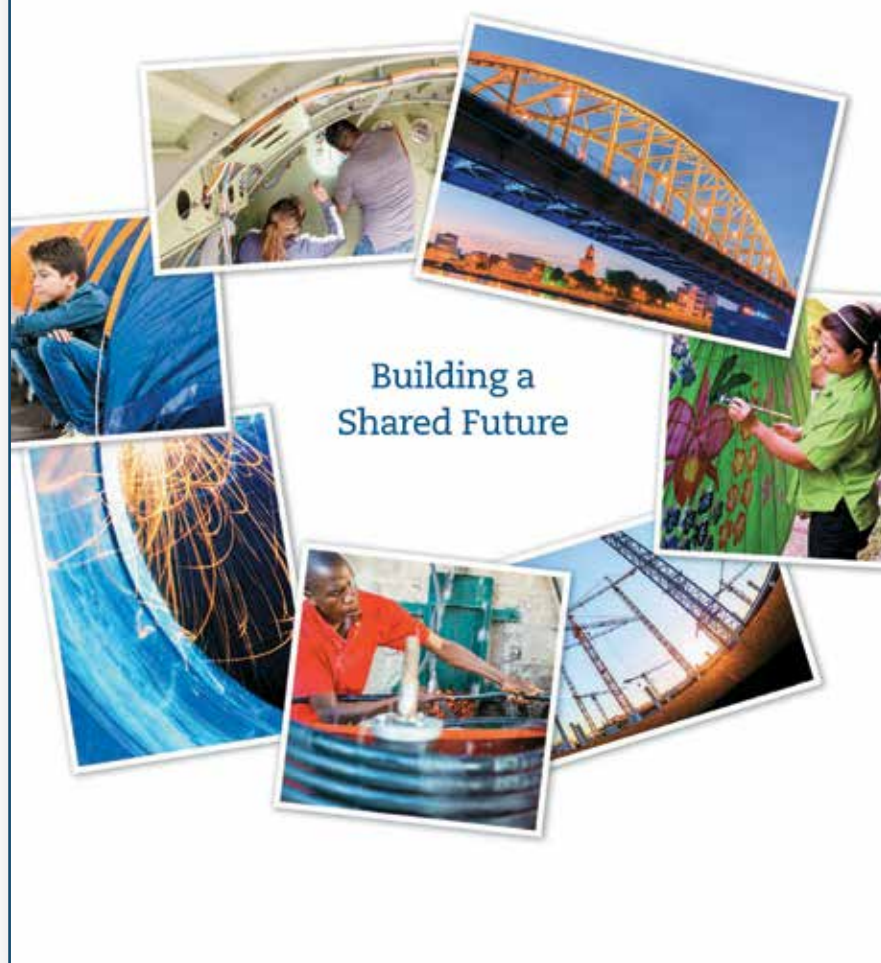
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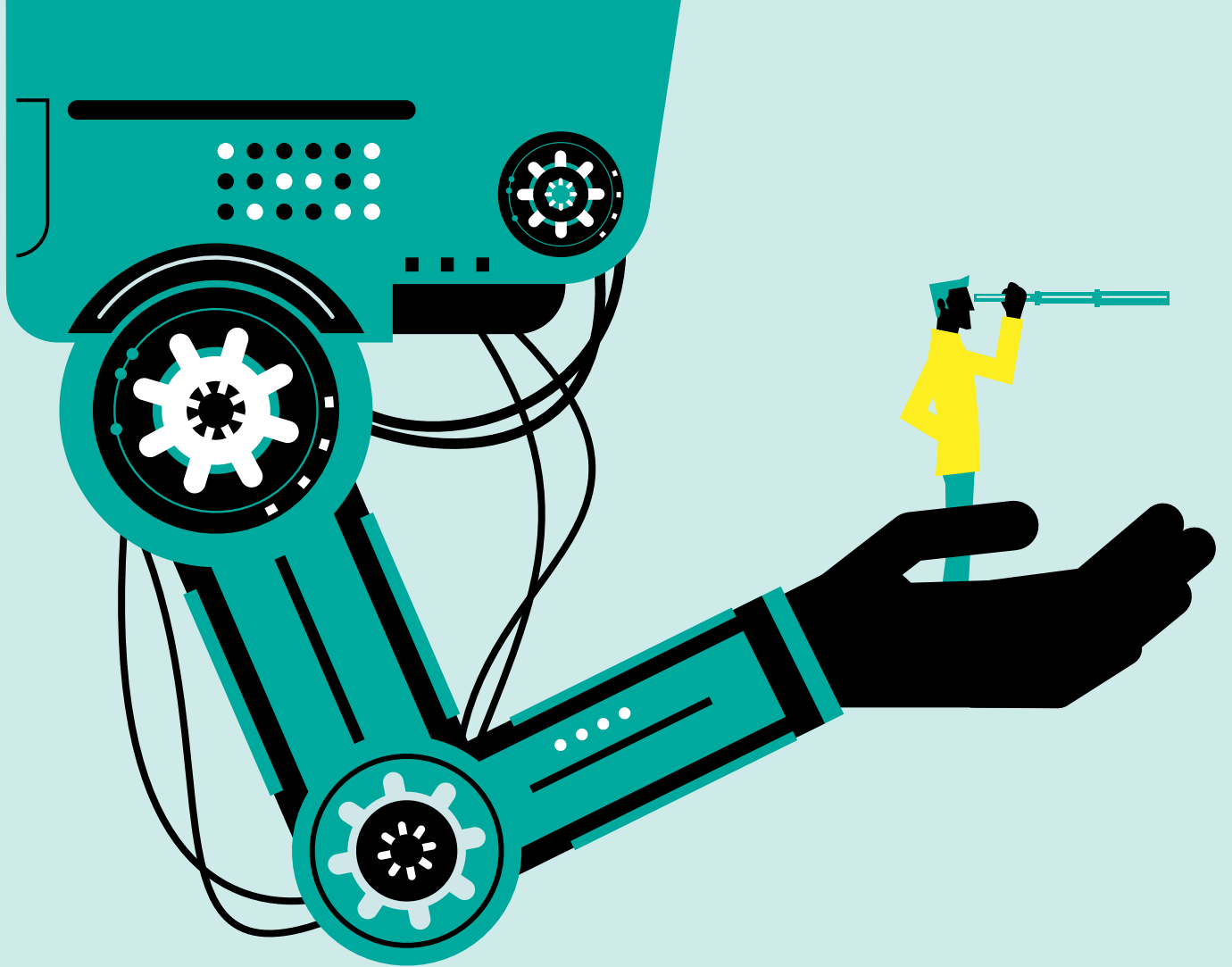


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# *Reimagining* **SOCIAL PROTECTION**

New systems that do not rely on standard employment contracts are needed

**Michal Rutkowski**



**T**he changing nature of work is upending traditional employment and its benefits. In developed economies, global drivers of disruption—technological advances, economic integration, demographic shifts, social and climate change—are challenging the effectiveness of industrial-era social insurance policies tied to stable employment contracts. Those policies have delivered formidable progress, but they have also increasingly harmed labor market decisions and formal employment.

Such systems in rich countries were developed at a time of widespread “jobs for life,” with social insurance based on mandatory contributions and payroll taxes on formal wage employment. This traditional, payroll-based insurance system is increasingly challenged by working arrangements outside standard employment contracts.

In developing economies, the world of work has mostly been diverse and fluid. Hence, the uniformity and stability of work that underpins traditional social insurance systems may not hold. In fact, social insurance participation and coverage have remained low. In Bangladesh, India, Indonesia, Nigeria, and Pakistan, which account for about a third of the world’s population, the number of people covered hovers around a single digit, with virtually no change in decades (see Chart 1).

### Technology’s impact on work

Although quantifying the impact of technological progress on job losses continues to challenge economists, estimates abound. The bottom line is that technology is changing how people work and the terms under which they work. Instead of once-standard long-term contracts, digital technology is giving rise to more short-term work, often via online platforms. These so-called gigs make certain kinds of work more accessible and flexible. More widespread access to digital infrastructure—via laptops, tablets, and smartphones—provides an environment in which on-demand services can thrive.

It is difficult to estimate the size of the gig economy. Where data exist, the numbers are still small. Worldwide, the total freelancer population is estimated at about 84 million, or less than 3 percent of the global labor force of 3.5 billion.

Informality persists on a vast scale in emerging market economies—as high as 90 percent in some low- and middle-income countries—withstanding technological progress. Because

recent technological developments are blurring the divide between formal and informal work, there is a convergence in the nature of work between advanced and emerging market economies. Labor markets are becoming more fluid in advanced economies, while informality persists in emerging markets. Most of the challenges faced by short-term or temporary workers, even in advanced economies, are the same as those faced by workers in the informal sector. Self-employment, informal wage work with no written contracts or protections, and low-productivity jobs more generally are the norm in most of the developing world. These workers operate in a regulatory gray area, with most labor laws unclear on the roles and responsibilities of the employer versus those of the employee. This group of workers often lacks access to benefits. There are no pensions, no health or unemployment insurance programs, nor any of the usual advantages provided to formal workers.

This type of convergence is not what was expected in the 21st century. Traditionally, economic development has been synonymous with formalization. This is reflected in the design of social protection systems and labor regulations. A formal wage employment contract is still the most common basis for the protections afforded by social insurance programs and by regulations such as those specifying a minimum wage or severance pay. Changes in the nature of work caused by technology shift the pattern of demanding worker benefits from employers to demanding welfare benefits directly from the state.

### A new social contract

The original purpose of social protection systems remains: to prevent poverty, cover catastrophic losses, help households and markets manage uncertainty, and ultimately provide a foundation for more efficient and equitable economic outcomes. These objectives motivated the architects of the “welfare state,” as it has come to be known, and should both motivate and guide efforts to keep social protection systems relevant and responsive.

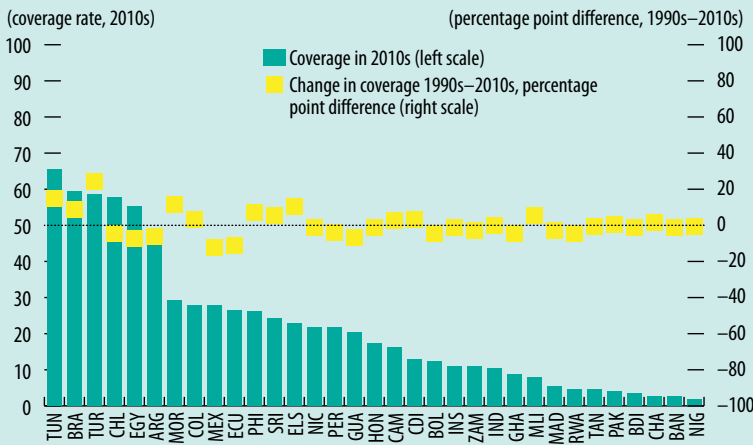
New systems are needed that serve the needs of all people, regardless of how they engage in the market to make a living. These new policies must also be more adaptable and resilient to dynamic economic, social, and demographic forces. In other words, a new social contract is needed.

As we examine the changing nature of work (World Bank 2018), we must take a closer look at

Chart 1

**(Un)covered by social insurance**

While many workers in Brazil, Tunisia, and Turkey contribute to social insurance, most developing economies exhibit low coverage of similar programs.



Source: World Bank Pension Database.

Note: “Coverage” is presented as the share of the economically active population that is contributing to a social insurance plan. Data labels in the figure use International Organization for Standardization (ISO) country codes.

how to better protect people and workers in the new economy. These are some key findings:

- *Informality, the share of the population not participating in traditional social insurance and related protections, is currently about 80 percent of the labor force in developing economies.* This is a major bottleneck to extending protection. Most workers, especially the poor, are engaged in informal sector activities with little or no access to social protection. Given the endemic nature of this challenge and minimal progress against it, most people would be better off with a social protection system that does not depend on their work situation.
- *Social assistance, which contributes to equity in societies, could be enhanced.* There are several options. At one end of the spectrum is a means-tested guaranteed minimum income program, which distributes cash to households, with benefits gradually declining as income rises. At the other end is universal basic income, with unconditional cash transfers to all, independent of income or employment. Both are distributed monthly.

An intermediate option is a negative income tax—a way to provide money to people below a certain income level—with a relatively high threshold and a gradual withdrawal of benefits. Since a negative income tax is woven into the tax declaration cycle, it tends to be paid annually. Another such option could be a smaller guaranteed minimum income supplemented with other programs, such as universal child allowances and social pensions. The cost of such an arrangement depends on the level of benefit, scale of coverage,

and shape of the income distribution graph. But increasing robotization could reduce fiscal constraints, and this type of benefit may become important for social as well as economic stability.

For informal economies, greater ability to identify individuals and households and monitor their consumption—if not income—opens new possibilities at the nexus of universal basic income, negative income tax, and guaranteed minimum income, or even a negative consumption tax. Targeting would be based on proxy indicators for unobserved income from special surveys and identified by linking administrative databases.

- *The notion of “progressive universalism” (Gentilini 2018) may help guide expansion in ways that benefit the poor and vulnerable first.* The principle recognizes that universality in itself does not necessarily make the poorest better-off than existing provisions. Hence, as countries expand social protection toward universality, the most vulnerable should be given priority, special attention, and adequate support.

In addition, the global architecture of social protection as set out by United Nations Sustainable Development Goal 1.3 aims to “implement nationally appropriate social protection systems and measures for all, including floors.” Similarly, strategic partnerships such as the International Labour Organization–World Bank Universal Social Protection Initiative help elevate universality as a strategic goal for countries and organizations supporting them.

The key issue is the need for a more neutral policy stance than many governments currently take with respect to the factors of production and to where and how people work. Once basic protections are guaranteed, people could upgrade their security with various progressively subsidized programs—mandatory contributory insurance and savings plans where feasible and an array of voluntary options where the state and markets can offer them (Packard and others 2018).

The once politically convenient mingling of social objectives—risk pooling, poverty elimination, and the pursuit of equality through wealth redistribution—calls for more explicit distinction and different risk-sharing arrangements and financing channels. To prevent people from falling into poverty, for example, the largest and most effective risk pool is a country’s national budget. Ideally, decisions about financing alternatives would follow consideration of

the appropriate policy instrument to deploy (risk pooling, saving, or prevention) and the proportionate policy response given what is privately available. A stylized package of protection against losses from livelihood shocks is illustrated in Chart 2.

The innermost core represents the guaranteed minimum support needed to cover the most catastrophic losses with the greatest social costs—such as livelihood disruption that plunges families into poverty—for which there are no viable or effective market alternatives. Ideally, but not always, these incidents are relatively rare. Interventions to cover more frequently occurring, lower-loss events—for example, structural churn in the labor market and retirement—but with obvious and substantial external social benefits, could be included in this guaranteed minimum support program. In the three remaining rings, responsibility for financing and provision gradually shifts away from purely public resources and direct provision to household or individual financing and market provision.

### Is leapfrogging possible?

Technological change, one of the global drivers of disruption in the world of work, also offers opportunities for governments to move away from, or leapfrog over, prevailing industrial-era policies and to offer more effective risk sharing to citizens and residents.

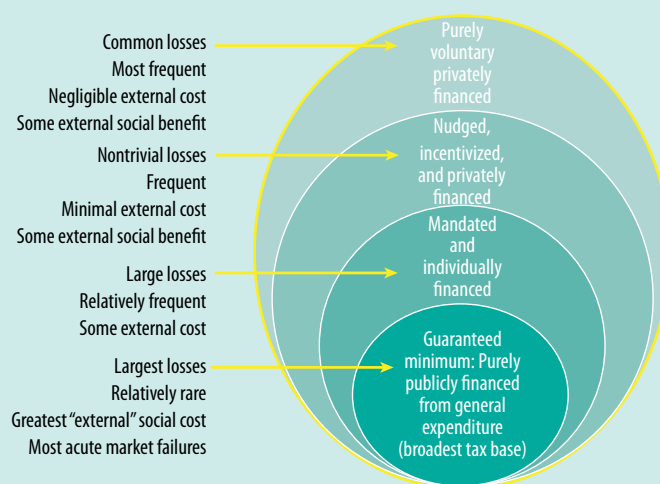
India's Direct Benefit Transfer, an innovative use of digital technology to provide direct subsidies to the bank accounts of the poorest, is a powerful example of what is already possible. In Ghana, the Labor Intensive Public Works programs digitized paper-based transactions and made wide use of biometric machines. The result was a reduction in payment time from four months to a week.

The World Bank is currently investing \$15.1 billion in delivery systems and related technology. Platforms such as social registries, IDs, and payment mechanisms are making it possible to reach excluded populations. For example, about 75,000 girls and women in rural Zambia can now choose whether to receive digital payments through a bank, mobile wallet account, or prepaid card. In West Africa, a foundational ID platform aims to cover 100 million people regionally by 2028. And in Indonesia, a cash transfer program has reached 10 million poor households, expanding to the remote eastern corners of the archipelago to meet human development goals.

Chart 2

### Rings of protection

From publicly financed to privately financed, there is a new take on ensuring social security.



Source: Packard and others (2018). World Bank, Washington, DC.

Faced with an imperative to adopt new policy models, the lowest-income countries have an advantage: low effective coverage of industrial-era risk-sharing policies means greater opportunity to leapfrog into a more modern social protection system. As with telephony and financial services, the limited coverage of legacy models makes new approaches easier for countries to embrace.

The investments by many countries to develop the capacity and systems to better identify households, assess vulnerability and poverty, and deliver cash transfers more efficiently are critical assets that make the policy ideas proposed here a real possibility.

Together we can shape the future of social protection in ways that ensure broad gains for all, and for the poorest in particular. **FD**

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# Hardly Anyone Is Too Poor to Share

*A basic level of social protection is affordable nearly everywhere*

**Michael Cichon**



PHOTO: COURTESY OF MICHAEL CICHON

**“THE WORLD DOES NOT** *lack the resources to abolish poverty, it lacks the right priorities.*” So said Juan Somavía, former director general of the International Labour Organization (ILO), in 1999.

We may have made progress in recent decades, but the world remains a miserable place for more than half of its population. Each person in that majority suffers from at least one of three human-made or at least human-tolerated societal plagues: gross inequality, debilitating insecurity, and inhumane poverty. We have known for more than a century what can be done to make things better. Social protection effectively and swiftly reduces inequality and poverty through transfers in cash and kind. A solid basic level of social protection is affordable and implementable nearly everywhere. It can be achieved now or—at least after some investment in good governance—fairly soon.

For decades, the community of nations has had a global ethical compass when it comes to social protection. Since the ILO’s 1944 recommendations on income security and medical care—and the 1948 Universal Declaration of Human Rights—social protection has been recognized as a human right. More

recently, the ILO’s 2012 Recommendation R202 concerning national social protection floors and the Sustainable Development Goals (SDGs), adopted at a United Nations summit in 2015, have given concrete content to the right to social protection.

R202 provides guidance on introducing basic social protection, defining the twin objectives of income and health security as the ability to access all essential goods and services. This requires a balance of cash and direct provision of services. The overriding objective is to achieve universal protection for all who need it.

The SDGs likewise pursue a broad agenda including social transfers, health care, education, and other essential services. The main social protection targets are to “implement nationally appropriate social protection systems and measures for all” and to “achieve universal health coverage, including financial risk protection.”

What has kept us from making greater progress toward social justice?

Publicly financed social protection transfers were often portrayed as unsustainable and detrimental to economic development. Many societies’ and governments’ economic and development strategies were based on economic myths—among them the alleged trade-off between economic performance and redistribution, and the theory that the trickle-down effect would automatically reduce poverty and inequality as economies develop. Reality and research show that these are merely myths. Virtually all developed economies have substantial social protection systems, with expenditure of 20 to 27 percent of GDP and more. There is no proof that they have sacrificed much growth as they combated poverty, inequality, and insecurity. If the trickle-down myth were true, we would not see wide variation in poverty and inequality between countries with similar per capita GDP. Markets—left to themselves—do not develop conduits for redistribution other than transfers of wealth or sharing of income within family or kinship groups.

However, the knockout myth that has often stifled progress in social protection is that it is not affordable



and not sustainable. This line of thinking claims that many countries neither have nor can mobilize the resources to finance even basic social protection. That notion is challenged by a comprehensive study from the Global Coalition for Social Protection Floors, a worldwide network of almost 100 trade union and nongovernmental organizations, and by similar studies from other groups.

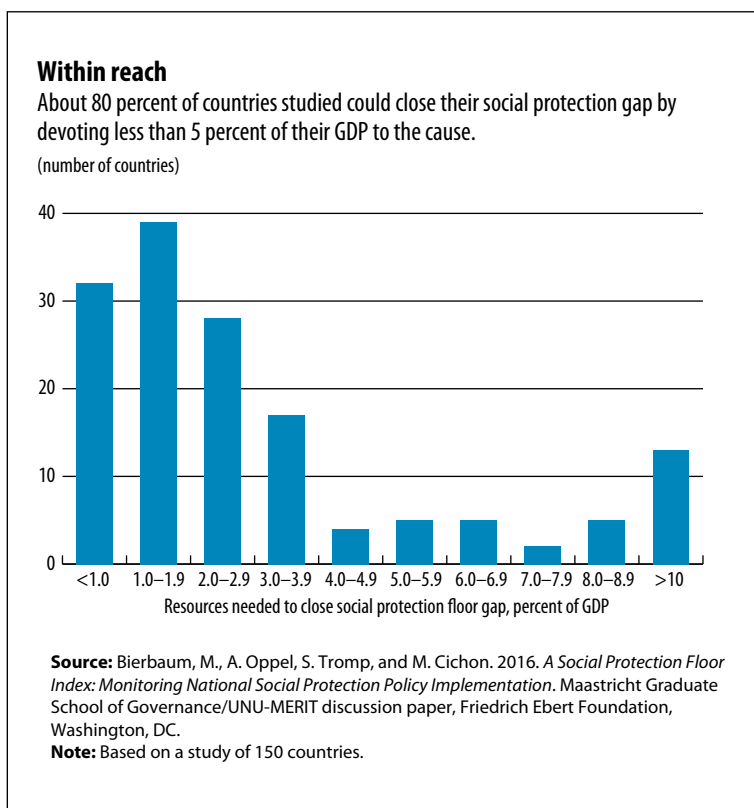
The coalition has developed an index for 150 nations that calculates the resources necessary to close their social protection gaps; that is, to achieve the minimum income and health security required under R202. About half of the 150 countries could close the gap by devoting less than 2 percent of their GDP to social protection (see chart). Eighty percent could do so with less than 5 percent of GDP. Only about 12 countries would need international assistance to finance minimum social protection. A global fund to foot about 50 percent of these countries' social protection bills would need \$10 billion to \$15 billion annually. That is equivalent to about 0.09 percent of close to \$1.7 trillion in annual global military spending, as calculated by the Stockholm International Peace Research Institute. It is a fraction of a thousandth of the global fiscal cost triggered by the worldwide financial crisis and is a level of solidarity we should be able to afford.

The chart calculates the cost of a perfectly targeted, or means-tested, social protection system. In reality there is no perfect targeting, and consequently many countries will and should resort to more universal benefits. These benefits could be combined with tax systems that claw back a part of the redistributed resources from people whose needs are less urgent. Fair and effective tax systems can help collect much more in additional resources than equally complex individual means-testing mechanisms could ever save.

Most countries not only can afford social protection, they cannot afford to neglect it. No country will be able to fully realize its economic potential without investing in the health, education, and material security of its people.

Recently, IMF Managing Director Christine Lagarde declared pursuing the SDGs a “global priority.” When it comes to reducing inequality, she said, there is an “important role for public investment in areas such as health, education, and social protection systems.”

What does it take to organize swift progress toward social protection for all? It takes political will



and the courage to align our development and governance with our globally accepted moral compass.

It takes the courage to overrule objections and mobilize fiscal resources to finance investment in social protection. An affluent state must pay for effective and efficient social transfer systems. Simply put, we need effective, fair, progressive tax regimes; sound collection mechanisms; and good fiscal governance.

Most of all, it takes the political will to make social protection a top policy priority. We cannot rely on the ruling elite to bring about such change. Civil society has the moral compass and the underlying data to show that almost no country is too poor to share.

The IMF's forthcoming social protection strategy will potentially affect the lives of many millions of people. The conscience of the community of nations, rather than the untethered promotion of often badly defined fiscal sustainability, should guide that strategy. [FD](#)

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# Shifting Tides

Dramatic social changes mean the welfare state is more necessary than ever

Nicholas Barr

**T**he world has changed in ways that affect families, work, and skills. In advanced economies in the early post-war years, most people got married and stayed married. The wife was the caregiver and the husband the breadwinner, generally in a steady job for many years, possibly a lifetime, usually with an unchanging set of skills.

Merely describing that world makes it clear how much has changed. Today, lifetime employment is no longer the norm. Labor markets are increasingly fluid. Rapid technological change requires workers to update their skills. And many more women are in paid work, more marriages end in divorce, and parenthood is less closely tied to marriage.

Over the decades, the welfare state has evolved in response to these changes in economic, demographic, and social circumstances. Those circumstances continue to change in ways that require changes in design while making a welfare state, if anything, more fundamental.

### Why a welfare state?

Before addressing specific issues, we should ask the basic question: What is the purpose of a welfare state? One well-known reason is to assist the poor. A second fundamental, but less well understood, reason is to address market failures. Markets can be inefficient for many reasons, which have been addressed by powerful literature on the economics of information, behavioral economics, incomplete markets, incomplete contracts, and optimal taxation.

These problems both explain and justify the existence of welfare states. Imperfect consumer information makes it necessary to regulate health care and pension funds. Imperfect information by insurance companies about the riskiness of different applicants explains why the state or parastatal institutions provide insurance against health risks or unemployment. Behavior that diverges from strict economic rationality is an argument for making pension saving mandatory.

For these reasons, even if all poverty could magically be eliminated, a welfare state would still be necessary to provide insurance and to assist people in planning for their life course by redistributing from their younger to their older selves.

Third, the welfare state is an element in policies to support economic growth (Ostry, Berg, and Tsangarides 2014). Investing in skills is increasingly important for growth and for sharing the fruits of that growth. Income transfers also assist growth;

for example, the ability to afford a healthy diet improves educational outcomes.

Encompassing all three reasons, the welfare state can be thought of as a device for optimal risk sharing:

- Seen as insurance at birth against unknowable future outcomes, it helps relieve poverty.
- Seen as a response to market failures, it addresses technical problems in private insurance, particularly relating to unemployment, medical risks, and social care.
- In sharing risks in these ways, it contributes to economic growth. Without a safety net, people are less likely to risk a new start-up. On the other hand, too little risk is also suboptimal: the communist system protected people against almost all risk and thus stifled effort and initiative.

A more detailed look at the welfare state's role as a device for risk sharing uncovers the starting point as the distinction between risk and uncertainty. The point is central: with risk, the probability distribution of outcomes is known well enough that the actuarial mechanism (that is, insurance premiums related to individual risk) works reasonably well. For example, the data on auto accidents by drivers of different ages and of different types of cars are good enough that insurers can calculate premiums for automobile insurance. But the actuarial model does not cope well with uncertainty, such as about rates of inflation well into the future. In contrast, social insurance can address both risk and uncertainty because a government can require everyone to be in a single risk pool and can adjust contributions over time.

What do these changes to risks and uncertainties for families, work, and skills imply for social policy?

When marriages were mostly stable, the main risk for a family was the death of the breadwinner. Today, more women are highly educated and take on paid work, and family structures are more diverse. These changes point to policies to widen choices between paid work and family obligations, including affordable childcare, and policies such as equal pay legislation to improve gender equity.

In labor markets, the main risk was once short-term unemployment. Today, people connect with labor markets in more diverse ways. They switch jobs more frequently, often with spells of part-time or self-employment, unemployment, or time outside the formal labor force. Employment is more precarious. In the future, technological change, including the spread of artificial intelligence, may make employment even more precarious. With that greater



## Good social policy requires that market and state activity be mutually reinforcing.

diversity of labor market relations, fewer workers in advanced economies have a record of continuous employment, and so organizing contributions to social security and private pensions through a worker's employer have become less effective in providing good coverage.

Postwar social welfare systems assumed that a set of skills would serve most workers for life. Today, rapidly evolving technology creates the need for a more highly skilled workforce with a greater diversity of skills, and the speed of change means that skills have a shorter shelf life. These trends require fundamental changes to education and training. There will have to be more of it; it will have to be more diverse in content and methods of delivery, including a larger role for firms; and it will have to be repeated. These activities will have to be financed on a large scale.

As well as addressing these specific risks, social welfare systems also guard against systemic risk, including the risk of a trade war or economic crisis; political instability; environmental damage caused by climate change or nuclear accidents; and a changing age structure.

Not all these issues are new; the economic and political instability of the 1930s was an important driver of postwar reform. Other risks, notably those associated with damage to the environment and technological change, have become more prominent. Critically, not only are these systemic risks, but they are also mostly uncertainties. Both aspects reinforce the centrality of the welfare state.

### Policy responses

What policies should we adopt to address these changing risks, and how will we pay for them?

Addressing income risks during working life includes providing income to the jobless and restoring and expanding earning opportunities, for example, through training and childcare. In this context, there has been renewed discussion of some variant of a universal basic income. Its feasibility depends both on the level of benefit *and* on the distribution of income. Since the distribution is skewed toward lower incomes, net beneficiaries will outnumber net contributors. As a result, the high average tax rate necessary to finance a large benefit would create major work disincentives.

On the other hand, if machines guided by artificial intelligence raised growth rates and thus expanded the tax base, fiscal constraints might ease. A benefit of this type might become important for social as well as economic stability.

Addressing income risks in retirement means moving away from reliance on contributions based on employment status. Part of the solution is a flat-rate, noncontributory pension plan financed from taxation and awarded on the basis of an age and residence test, without a contribution requirement. Such plans are spreading in more advanced economies, including Canada, Chile, the Netherlands, and New Zealand, and in developing economies. Noncontributory pensions have twin advantages: they relieve poverty and reduce the gap in retirement income between men and women. A parallel change is to increase the minimum retirement age over time as people live longer. Choices about the level of noncontributory pension and retirement age should be made to relieve poverty without discouraging work and saving.

There is no single best pension system for all countries (Barr and Diamond 2009). Earnings-related plans that work well come in a variety of guises. One example is the notional defined-contribution plan pioneered by Sweden in the 1990s. The arrangement is pay-as-you-go (meaning that this year's contributions pay for this year's benefits), but—unlike conventional pay-as-you-go plans—this one provides benefits that are closely related to a worker's cumulative contributions. This design also has been adopted in Latvia, Norway, and Poland. Individual accounts, if part of the broader pension system, should be organized through simple, cheaply administered savings plans (mandatory or with automatic enrollment) that offer limited choice and a good default for people who make no choice (Barr and Diamond 2017). In the future, electronic payments open the possibility of basing pension contributions on consumption spending rather than earnings.

Addressing health risks, it is almost universally accepted among advanced economies that intractable market failures make private actuarial insurance a bad fit for medical risks, the United States being unique among advanced economies in

its reliance on this approach. A key finding (Barr 2012) is that intervention on the scale necessary to address the slew of technical problems faced by actuarial medical insurance based on individual risk leads to an arrangement that is de facto social insurance, with everyone in a single risk pool.

Addressing the risk of skills mismatch must recognize the increasing complexity of providing appropriate education and training. The range of skills required in the job market is growing, as are ways of acquiring them; given the speed of technological change, workers will have to retrain, sometimes several times, over the course of an increasingly long working life.

Thus, what is needed is a system with at least three strategic attributes:

- Emphasis on early childhood development, given powerful research findings that early gaps in cognitive and social development are hard to make up
- Flexible choices for individuals over subject, method, and speed of skills acquisition and over pathways through vocational and academic training
- A system of financing to support such delivery methods, including a mix of taxpayer money and, where possible, a well-designed system of student loans, as in Australia, New Zealand, and the United Kingdom

What is the role for individual contributions in these new welfare systems? Earnings-related benefits clearly must be contributory. However, where the primary purpose of benefits is insurance (health care) or poverty relief (basic pensions), contributions organized through a worker's employment are not only less effective than in the past but can also discourage employment in the formal sector. So health care and similar benefits may be better financed from broadly based taxation (Levy 2008) or from a dedicated source of revenue that is unrelated to employment status; for example, from a portion of the proceeds of a consumption tax.

In all these areas, it is important to distinguish between the structure of an activity and how it is financed. Is an activity delivered more effectively by the market or the state? If there are no substantial market failures, market allocation complemented by income transfers is generally superior. How should the activity be financed? If public financing is involved, the answer will depend on a country's fiscal situation and political economy. For example, Scandinavian countries vote for higher taxes to finance more and better public services in a

way that is politically not possible in the United Kingdom or the United States.

### Why state involvement?

Finally, why should the state be involved? Good social policy requires that market and state activity be mutually reinforcing, and that policy design go with the grain of economic theory. There are many solutions that respect market failures, recognize changed labor market conditions and family structures, and draw on the findings of behavioral economics—for example, “nudging” people to save more by automatically enrolling them in a pension plan.

All pension designs involve significant state involvement in financing and regulation, and in varying degrees also in delivery. The delivery of health care can be private, as in Canada; public, as in Scandinavia; or a mix of the two, as in France and Germany. Financing of health care can be organized at a national or sub-national level or by nonprofits. In all cases, however, systems that work well are based on social insurance or tax financing, not private actuarial insurance.

Much of the debate about social policy is ideological. In the United States, public involvement in health care is often attacked as “socialism”; in the United Kingdom, private involvement is widely abhorred as “privatization.” These arguments are not helpful because they locate ideology in the wrong place. The proper (and vital) place for ideology is in setting objectives, the “what.” The “how”—or the respective roles of the market and state—should be treated mainly as a technical matter related to the extent of market failure in the face of major risks and uncertainties. **FD**

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# SEEKING BALANCE

China strives to adapt social protection to the needs of a market economy

**Ken Wills**

**T**here was bound to come a time in China's modern development—starting in 1949 with the founding of the cradle-to-grave welfare state—when the demands of the people for a better life outgrew the ability of the People's Republic to deliver.

That time could be now.

China thrived during decades of near double-digit growth since Deng Xiaoping first experimented with local markets and untethered parts of the economy from state control in the 1980s and 1990s. The country's rapid advance from developing nation to claim the No. 2 spot among the world's largest economies spawned a massive middle class and hundreds of billionaires.

But growth was uneven, leaving yawning gaps between rich and poor, between prosperous coastal cities and neglected, largely rural, inland regions.

Along the way, China sought, with mixed results, to adapt services such as pensions and health care to the demands of an increasingly market-driven economy. Today, as the government of Xi Jinping struggles to reconcile the aspirations of the rising middle class with the needs of the millions who remain in poverty, it must also contend with the challenges of slowing growth.

In an October 2017 address at the Communist Party's National Congress ahead of his second five-year term, Xi acknowledged that the government had essentially fallen short of people's expectations. He set out to redefine how the Communist Party would provide for its citizens for decades to come.

"As socialism with Chinese characteristics has entered a new era, the principal contradiction facing Chinese society has evolved," Xi told thousands of party delegates gathered in the Great Hall of

the People in Beijing, while hundreds of millions watched the national broadcast on television. “What we now face is the contradiction between unbalanced and inadequate development and the people’s ever-growing needs for a better life.”

These needs, he said, “are increasingly broad.”

Cataloging his government’s achievements, Xi boasted that China had lifted some 60 million people out of poverty in the previous five years, but he also noted that more needed to be done. He called for an end to rural poverty by 2020, a herculean task for sure, by “drawing on the joint efforts of government, society, and the market.”

Whereas other presidents who followed Deng sought to unleash the power of market forces to fuel growth and reduce poverty, Xi is reversing the trend and reasserting the role of the party and the state, some academics and political observers say.

“He is favoring the public sphere—and extending its social, political and economic reach,” China scholar Evan Feigenbaum wrote in a November 2017 paper for the Carnegie Endowment for International Peace in Washington. “The party has, quite simply, not adapted well in recent decades to the changed conditions of an aging society and growing economic inequality.”

When stock markets plunged in 2015, the government reimposed a rash of controls on capital movement out of the country and on free market trading. Xi has also increased the role of party members on private as well as public company boards.

At the same time, his government has reopened credit taps for state-owned enterprises—favoring them over the burgeoning private sector—to spur economic growth. In an effort to clamp down on financial risks from runaway debt, one of the three main “battles” cited by Xi, restrictions on corporate lending disproportionately affected private companies. The government has been stepping on the accelerator for state-owned enterprises, meanwhile, which benefit from loans freed up by recent cuts in banks’ reserve requirements. Still, experience suggests that lending to the public sector is a less efficient way of stimulating the economy and could actually add to the pile of nonperforming loans.

Under Mao Zedong, who led the Communist Party until his death in 1976, China emphasized building national strength through investment in heavy industry, and workers labored side by side for generally similar, but low, incomes. The vast

majority of people living in the countryside were organized along agricultural collectives or communes. Government enterprises and agencies together provided an “iron rice bowl” of benefits, including housing, education, health care, pensions, basic incomes, and even help with funeral costs.

As the country looked beyond its borders after Mao’s death, it began to embark on economic reforms that mirrored market mechanisms but were later dubbed “socialism with Chinese characteristics.” While Deng used incentive systems to stoke the economy—rolling out a nationwide plan in the early 1980s to let farmers reap the profits of excess production, for instance—he also started to reshape the welfare state to meet the needs of those who worked in the private sector.

Initially, the number of those venturing out to start their own businesses was limited by the uncertainty of having to forfeit benefits that went with

Once some people started getting rich, others took the leap and dove into the sea of small-scale entrepreneurship.

state employment. A few measures helped encourage individuals to become more independent, including reforms of labor contracts and prices and alternatives to collectives that shifted responsibility for profit and loss to managers. Once some people started getting rich, others took the leap and dove into the sea of small-scale entrepreneurship.

In the late 1970s, there were budding moves to shift social services from state enterprises to local governments. A thin social security system was established, though it wasn’t until 1994 that guidelines were drafted for a multitiered system of social insurance, social welfare, and an individual savings program, among other benefits. But those steps weren’t enough to provide relief to state-owned enterprises, which found it increasingly difficult to bear the costs of social welfare benefits.

“Without the support of a proper social security system, state sector enterprises bearing all the welfare burdens would find it difficult to compete in the market,” Bingqin Li, director of the Chinese Social Policy Program at the University of New South Wales in Sydney, wrote in a paper titled “Welfare State Changes in China Since 1949.”

Measures, such as the removal of employer housing provisions, were introduced to improve competitiveness. Enterprises got additional relief in the late 1990s. Unemployment insurance, living allowances, and minimum income guarantees replaced lifetime employment, while a basic pension system was introduced, and some health-care coverage was instituted, though the coverage rate was initially low.

Change accelerated as China prepared to join the World Trade Organization, a milestone in late 2001 that drew in massive amounts of foreign investment and focused Chinese companies on export markets. To compete with neighboring “tigers” Hong Kong SAR, Singapore, and South Korea, China’s state-owned enterprises had to streamline further, and government policies resulted in dismissals of tens of millions of workers.

Even for those remaining in the state sector, the reforms significantly changed the employees’ relationships with the enterprises. As part of the effort to improve efficiency, workers were turned into contractual employees, and the company’s obligations to provide a host of lifelong welfare programs were greatly reduced. Pension reforms aimed to provide a safety net for workers independent of the state firms.

By 2005, a typical retired urban worker received two distinct pensions, according to Huoyun Zhu and Alan Walker in their paper “Pension System Reform in China: Who Gets What Pensions?” published this year. One was from an account containing accumulated employer contributions, with benefits that depended on the average wage of workers, the worker’s salary before retiring, and the number of years contributions were made. The second was from an account containing individual contributions.

To complicate matters for Chinese planners, thriving new industries in China’s major cities attracted masses of rural workers seeking better-paying jobs. These migrants often found themselves in need of food, shelter, and social services, and rural areas were left denuded of working-age people.

A seismic shift in social benefits occurred in the late 2000s in response to the global financial crisis. Because China’s economy had not fully opened to the outside world, it was partially insulated from the worst of the downturn. Its stronger fiscal position also allowed it to embark on a massive stimulus program that spurred domestic and global economic growth and led to new social welfare coverage.

Investments were boosted to increase affordable housing, and taxes were reformed to be

more progressive; health care, education, and cultural spending was targeted to rural areas, which also benefited from spending on roads, rail, and power systems.

Still, the income gap between urban and rural and coastal and inland regions persisted or even continued to grow, and the Gini coefficient remained stubbornly above 0.4 (zero being full equality of income distribution and 1 showing complete concentration of income).

Big pieces of the social safety net were still missing. Many rural residents, unemployed urban residents, and jobless migrants were not covered by pension programs until 2009. Further revisions in 2015 broadened the umbrella of coverage in a transition from a state-enterprise to a state-society model, Zhu and Walker note.

As a result, most of China’s 1.4 billion people are now covered, but the uneven system exacerbates inequalities, note Zhu and Walker. “First, an important aspect of social stratification has been reshaped into five distinct pension scheme classes,” they write. “Second, the new pension model has strengthened the link between benefits and contributions, which privileges the better off.”

Meanwhile, China has substantially improved health insurance coverage. Starting in 1998, urban workers at state and private companies were covered. By late 2009, students, children, the urban jobless, and rural residents were added.

“Ten years ago, most people in China did not have access to health insurance; today 96 percent or so are covered in one way or another,” Dali Yang, a political science professor at the University of Chicago, says in an interview. “You can always say, ‘Well maybe the co-pay is too high or coverage is spotty, but in fact it’s very substantial.’”

Although the social safety net has been expanded under Xi, the government says some 30 million people—almost 2 percent of the population—linger below the poverty line, defined as earning the equivalent of about 95 cents a day. The official numbers gloss over the nearly 500 million people who live just above the poverty line, on less than \$5.50 a day, according to World Bank estimates.

One solution has been to move poor rural residents to cities, where job opportunities might be greater. In 2014, Xi’s government embarked on an unprecedented plan to shift some 250 million people to cities by 2026. That has meant redrawing municipal boundaries to encompass surrounding rural areas,



relocating rural residents, and even building entirely new cities. The plan simultaneously serves various national objectives: to increase China's percentage of urban residents in line with global developed economy standards, boost domestic consumption to rebalance the economy away from exports, and improve delivery of social services.

Poverty-reduction funds allocated by the central government budget in Xi's first term were more than double the total spending of the previous five years. That money is used primarily for infrastructure, agricultural subsidies, and discounted loans. But spending for another significant poverty-reduction program—a minimum living standard provision called *dibao*—has been declining as a percentage of GDP, according to Ministry of Finance figures.

Given the economic slowdown, Xi's goal of ending rural poverty by 2020 will be a tall order. The slowdown has led to a pause, even a reversal, in plans to further streamline state-owned enterprises.

"Xi is having none of this business about empowering private interests and 'broadening' the makeup of the Party," Feigenbaum writes. "His team views the unwinding of some of these prior policies as a necessary step toward a new and, from their standpoint, more satisfactory division of roles between the public and private spheres."

Efforts to strengthen the social safety net have also flagged as local officials focus more on restoring growth than goals such as expanding pensions, improving education, or relaxing the *hukou* system, which ties people and their benefits to a particular locale, says Mary Gallagher, a professor of political science at the University of Michigan in Ann Arbor.

"Those things I don't think have been effectively integrated into ... the system of performance evaluation for local officials," Gallagher says in an interview.

Other challenges loom. The adoption of new technologies—another national priority for Xi—has put China in a globally competitive position but has also exacerbated its social welfare needs. For instance, China's drive to invest in robotics threatens to cause large-scale unemployment in industries, from logistics to manufacturing, that provided life-long jobs in the past. Displacement of many more workers could sow discontent should China renew efforts to streamline state enterprises, throwing workers into national benefit plans that are often less generous than those provided by employers.

"A lot of times, when they do close down these firms, they'll say you'll still have a job, but it might

be as a street sweeper," Elizabeth Economy, director for Asia Studies at the New York-based Council on Foreign Relations, says in an interview. "There's a huge difference in the type of work they are getting and the type of benefits."

Xi's acknowledgment of economic shortcomings and his blueprint for solutions raise the stakes for his government when priorities fall short of expectations, Economy says.

"Economic reform, poverty alleviation, addressing environmental issues—all of those things are policy initiatives that he thinks are essential to maintaining the legitimacy of the Communist Party and moving the country forward," she says.

But the biggest test facing Xi's government may be an unavoidable demographic trend—the widening gap between pension contributions and payouts as China's population grows older.

## Given the economic slowdown, Xi's goal of ending rural poverty by 2020 will be a tall order.

The State Council, or cabinet, predicts about a quarter of the population will be over 60 by 2030. Estimates of the country's pension funding shortfall within the next few years range from \$130 billion to \$175 billion, a gap the government must fill. While Xi has vowed to improve the system, his administration has offered few specifics. Last year, the government directed a handful of large state-owned companies to transfer 10 percent of their stock to pension funds to ease the funds' asset shortfall. And the government took steps this year to remove regional disparities in benefits. One option could be to tap into the government's healthy coffers, making contributions from general revenues.

Other options—none of them easy—would focus on investing funds more effectively to boost returns; cutting benefits, which would risk alienating pensioners; or raising contribution rates for companies and individuals, which are high compared with other countries. Already running behind the rising expectations of ordinary Chinese people, the government must race just to catch up. **FD**

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# CREATING FISCAL SPACE

Enhancing domestic tax capacity is essential for strengthening social protection and developing human capital

David Coady

**A** key challenge for developing economies wishing to strengthen their social protection systems and expand access to education and health is how to raise the necessary revenue in the context of a large informal sector.

The informal sector is typically characterized by high levels of self-employment, low skill levels, and often multiple and volatile sources of income. This limits the potential to raise revenue by taxing income—especially from lower-income groups—which requires the ability to verify total individual income. In the context of social insurance, it

also means greater reliance on financing through general government revenue sources than on the contributory models emphasized in advanced economies (see “Shifting Tides” and “Reimagining Social Protection,” in this issue of *F&D*).

Recent research also finds that countries move to a higher growth path once tax revenue reaches about 15 percent of GDP (Gaspar, Jaramillo, and Wingender 2016), in part reflecting higher social spending. However, about half of low-income countries—and a third of emerging market economies—have tax ratios below this 15 percent threshold. Low tax ratios in turn result in low levels of social spending (see Chart 1).

This large variation in tax ratios within emerging market and low-income countries suggests that many have ample room for higher taxation. Some have succeeded in increasing their tax ratios in recent years, sustainably increasing tax revenues to bring them close to or above 15 percent of GDP. Georgia is a leader in this group, having increased tax revenue by 12.9 percent of GDP during 2004–08. Maldives raised revenue by 11 percent of GDP during 2011–15. Others that have made significant gains over similar periods include Dominica (7.5 percent, 2002–06), Ghana (7.3 percent, 2000–04), Mauritania (6.1 percent, 2010–14), Mozambique

## Countries move to a higher growth path once tax revenue reaches about 15 percent of GDP.

(6.1 percent, 2007–11), Guinea (5.8 percent, 2008–12), Malawi (5.7 percent, 2003–07), and Cambodia (5.0 percent, 2012–16).

These countries show what’s possible. But how can governments increase their tax capacity both equitably and efficiently?

As countries modernize their tax systems, they typically expand broad-based consumption taxes and selective excise taxes and prioritize the development of progressive income tax systems (see Chart 2).

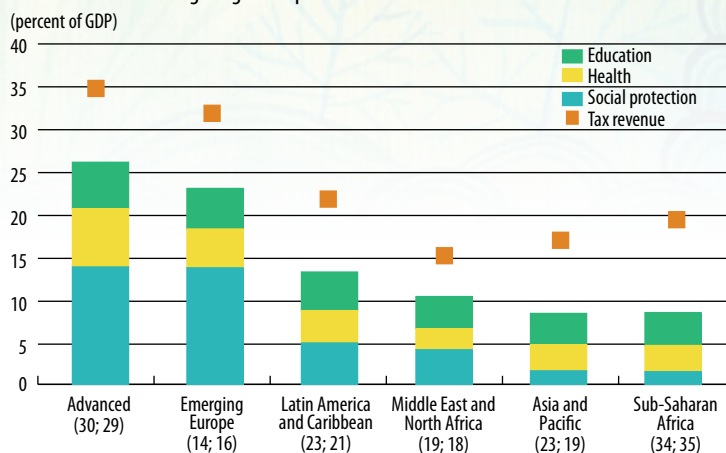
**Broad-based consumption taxes:** Increased revenue from consumption taxes, especially value-added tax (VAT), has been the main driver for most countries that have managed to significantly increase their tax ratios over recent decades.

**Greater reliance on excise taxes:** “Corrective” taxes on such goods as energy, alcohol, tobacco, and (somewhat more contentiously) sugar-sweetened beverages—levied on top of the normal VAT—can be an efficient source of revenue and help reduce the negative health impacts associated with their consumption. Along with consumption taxes, excise taxes provide an administratively feasible way of increasing revenues over the short term.

Chart 1

### Financing development

Low tax revenue results in low levels of social spending. Raising revenue could thus help countries move to a higher growth path.



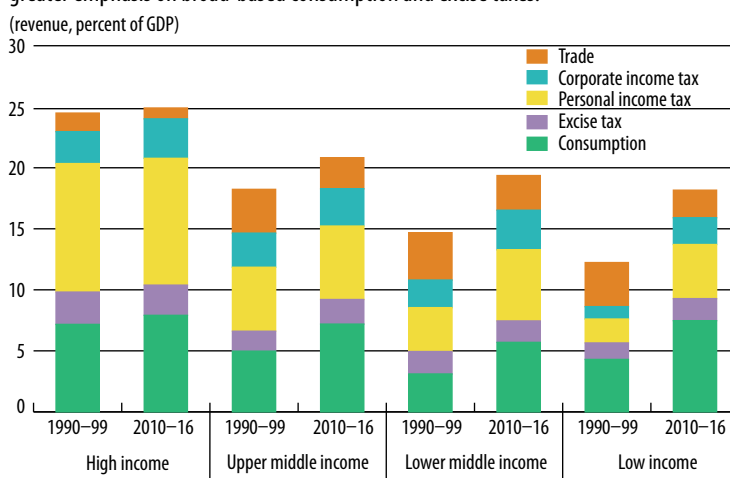
Source: International Monetary Fund WoRLD Data set.

Note: The sample size refers to the number of countries in the spending sample, then revenue.

Chart 2

### Tax levels and composition

The composition of taxes in richer countries differs from that of poorer countries, with greater emphasis on broad-based consumption and excise taxes.



Source: International Monetary Fund WoRLD Data set.

*Progressive personal income taxes:* The development of a such a system has been an important source of revenue for advanced economies and a key component of efficient systems for redistribution of income. However, high levels of tax exemption or tax evasion in emerging market and developing economies limit the short-term potential for such revenue. Even so, experience shows that countries can still raise sizable additional revenue through stronger personal income tax systems.

*Additional tax measures:* Other measures can be employed to protect and further expand tax sources. These include reforms to address corporate income tax avoidance and reduce mutually destructive international tax competition, but these may also need stronger international cooperation to be effective. Average effective corporate tax rates have

declined significantly over recent decades across the globe and are typically lower than statutory rates due to exemptions, deductions, and tax planning. Recent estimates put the long-term costs from profit shifting to lower-tax countries at about 1 to 1.5 percent of GDP for developing economies (Crivelli, de Mooij, and Keen 2016).

revenue when all consumption is taxed at the standard rate in a country. C-efficiency measures how close a government comes to collecting tax on all consumption in the economy. The revenue potential from increasing this ratio is substantial. In practice, the rise in VAT revenue in recent decades has been driven primarily by improvements in C-efficiency rather than by increasing tax rates (Keen 2013).

*Improved spending efficiency:* There is large variation in social outcomes across countries with similar spending levels, suggesting substantial room to improve spending efficiency. This is essential to ensure that additional revenue is not wasted. All spending items need to be scrutinized to ensure that they are achieving their economic and social objectives. Estimates of spending inefficiencies in the health care sector suggest that as much as

## There is large variation in social outcomes across countries with similar spending levels, suggesting substantial room to improve spending efficiency.

40 percent of spending may be wasted across all country income groups. Many countries spend significant amounts on inefficient and inequitable energy subsidies aimed at protecting domestic consumers from volatile international oil prices. A key barrier to reforming these subsidies is the absence of a strong safety net to adequately protect the poor from rising energy prices.

While broad-based consumption and selective excise taxes are efficient sources of revenue, it is important to ensure that countries have access to strong safety nets that adequately protect the poor and vulnerable from associated price increases. Absent such protection, harm to the poor can be mitigated through a higher VAT registration threshold, which determines when a firm is large enough, based on sales, to be required to charge VAT. Another possibility is reducing the VAT rate for goods consumed disproportionately by the poor. Excise tax increases can also focus first on goods consumed disproportionately by higher-income households, such as gasoline and high-end alcohol, and possibly tobacco. A gradual reform process that phases in and sequences tax

Removing tax incentives, such as tax-free zones, exemptions, and tax holidays, can lead to sizable revenue gains. There is also room in most emerging market and developing economies to expand revenue from property taxes, an efficient and equitable source of revenue, but with relatively modest potential. Finally, in many countries, natural resource revenue is an equitable and efficient revenue source that is often inadequately tapped.

*Policy and institutional reforms* must go hand in hand. For example, as administrative capacity is strengthened, VAT and income tax thresholds can be lowered. Risk-based tax audit systems can help enhance compliance and tax fairness. In the context of the VAT, the potential for such revenue gains can be explored through the concept of C-efficiency—defined as the ratio of actual revenue to potential

increases across products allows for some of the revenue gains to be allocated to strengthening safety nets over the short term, thus allowing poor and vulnerable households to be adequately protected from more comprehensive reforms over the medium term.

Strategies for strengthening tax capacity should be framed within a broader process that involves all of government (line ministries and the Ministry of Finance), citizen participation, and good governance. It is essential to embed tax reform plans within national development plans that identify priority spending needs, which are often anchored in national strategies for attaining the United Nations Sustainable Development Goals. Effective consultation on, and communication of, comprehensive spending and tax plans to strengthen the social contract with civil society is necessary as well. This could lead to adoption of a consensus-based medium-term revenue strategy, as described in the Platform for Collaboration on

Tax (IMF and others 2016). (Nobody votes for a tax hike in isolation!)

Equally important is the need for transparent and effective public financial management systems that ensure and demonstrate that tax revenues are spent efficiently and not wasted or fraudulently used. **FD**

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## CALL FOR ENTRIES

# F&D ESSAY COMPETITION



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Night scene at Malioboro Street  
in Yogyakarta, Indonesia.



# Targeting THE POOR

Developing economies face special challenges in delivering social protection

**Rema Hanna, Adnan Khan, and Benjamin Olken**



**M**any people believe that social protection generally involves rich countries aiding those that are poor. Aid is important, particularly for extremely poor countries. Bad shocks can quickly devolve into humanitarian disasters and promote conflict in fragile states, as seen with the current famine in South Sudan, the incipient famine and cholera in Yemen, and the recent Ebola outbreak in Guinea, Liberia, and Sierra Leone.

But for the 108 countries the World Bank classifies as “upper-middle” or “lower-middle” income—for example, India, Morocco, and Peru—overall tax revenue now dwarfs development assistance. Given that growth has been accompanied by increases in global inequality, it is not surprising that redistribution is increasingly taking place within countries. In these environments external

support is often important during initial program design and launch, but social protection can be funded primarily through domestic sources in the long run.

As many of these countries increasingly initiate redistribution within their own borders, they are facing challenges different from those in high-income countries. Understanding these differences is critical to grasping how social protection has evolved over time, and how it may change in the future.

### In-kind subsidies

The traditional way of providing transfers in many countries, and one that is still common today, is to subsidize particular products. Staple foods are one classic example. Energy is another.

The rationale for this policy tool is simple. In developed economies, the government can use income information from tax documents and other sources to identify who needs assistance. In less developed settings, however, substantial activity occurs in the informal sector, particularly among the poor. There is no paper trail of who is employed and how much they earn—at least none that can be easily verified. Instead, governments aim to subsidize products the poor use disproportionately so that they get a larger portion of the subsidy.

Subsidies tend to be politically popular for several reasons. The first is transparency; for example, with an energy subsidy, consumers see the subsidized price at the pump. A second is that since everyone benefits from subsidies, they may enjoy broader political support than programs that benefit only the poor. Finally, governments can claim that they influence what people consume; for example, subsidizing eggs or milk to ensure that kids get enough protein, rather than a cash subsidy the poor might waste on so-called temptation goods such as alcohol or tobacco.

These arguments have not always been borne out in practice. For the poor to receive more of the subsidy calls for subsidization of what economists call “inferior goods,” goods whose demand decreases as people get richer—cassava when everyone prefers rice, low-quality food, and so forth. Subsidizing inferior goods is often unpopular; instead, most subsidies end up being for everyday goods—things people buy more of as they have more income. This

undermines redistribution, as these programs end up benefiting mostly the middle class, or even the rich.

Picking up the tab for more popular goods also makes subsidies expensive. Energy subsidies are a classic example. Since everyone can access the subsidy, it must be quite large in order to ensure that the poor get a reasonable share, and in most cases many of the benefits accrue to the middle class, not the poor. In fact, spending is already so high for these subsidies that the amount governments would save by eliminating energy subsidies in emerging market and developing economies exceeds what many of them spend on public health.

Subsidies also have distortionary consequences. Energy subsidies, for example, have serious environmental ramifications. Subsidizing particular foods, such as rice, can backfire in terms of achieving balanced nutrition. And the idea that the poor waste cash by spending it largely on so-called temptation goods has been debunked many times, undermining much of the rationale for trying to influence what people spend the money on in the first place.

Given the cost and distortionary consequences of blanket subsidies, many countries fix the quantity of subsidized goods each household can receive, and potentially restrict them to poor households. This, however, introduces a host of other challenges, such as building a bureaucracy to distribute the goods and monitor who receives them and how much. These systems are generally subject to significant corruption and leakage, given the challenges in managing them.

### **Reaching the right households**

For these reasons, developing economies are moving away from universal (or limited) in-kind subsidies and transfers to the poor and toward targeted cash transfers of various types. Cash is neutral and thus does not distort what people purchase. Moreover, evidence suggests that the labor-supply consequences of cash transfers are small—that is, these programs do not seem to discourage work, often a concern when it comes to transfer programs. Finally, as an additional benefit, cash transfers can be used as a fiscal stimulus to smooth negative macroeconomic shocks by distributing money directly to poor households that have a high marginal propensity to consume.

Targeted cash transfer programs are already widespread in developed economies. For example, the United States provides poor working families with cash through the Earned Income Tax Credit. The US government can do this because the tax system makes it possible to verify which households are poor, and the formal banking system has effective mechanisms to ensure that the poor receive the transfers.

In contrast, many developing economies face challenges in both targeting and distribution. The informality of the workforce means that few people are captured by the tax system, so it is hard to verify income. And many households remain unbanked, so transferring funds to them is logistically difficult.

These challenges are daunting, but developing economies are finding ways to overcome them.

First, there are alternate methods to target transfers to the poor. A common approach is the “proxy means test.” Governments predict income using data from periodic, large-scale quasi censuses of the population that collect information on easy-to-verify assets (such as the material of a household’s roof and floor) and demographics. Households with a predicted income below a given threshold receive benefits for a set period of time (for example, until the next census is conducted).

These methods can be quite effective at achieving redistribution. For example, in recent work, we compared what would happen if transfers went to those deemed eligible based on the proxy means test compared with what would happen if the same budget were simply divided equally among everyone (via a universal cash transfer, also known as universal basic income) for two programs in Indonesia and Peru.

Even though targeting through proxy means testing has its flaws, we find that it yields higher overall welfare than the universal transfer, because means testing concentrates benefits among the poor. Put another way, per-beneficiary transfers would have to be much smaller for universal programs than for targeted transfers, usually because of overall budget constraints and competing priorities for government spending (for example, infrastructure development, education, and so forth). In fact, only in the case of significant targeting error would the universal transfer come out ahead.



And although the administrative costs of proxy means testing may seem high given all the data collection, the survey costs are minuscule compared with the amount they save by reducing the number of rich people who receive transfers.

Of course, there are always exceptions. When income inequality is extremely high—there is a large pool of very poor people and a small number of very rich people—a universal transfer may look more attractive. Likewise, if poverty is temporary, proxy means testing, which targets the long-term average of past income, may allow the poor to fall through the cracks. Moreover, errors in targeting that do occur with proxy means tests also generate inequality among equally poor people, and limits on subsidies to the middle class can generate political strife.

But additional methods—from including communities in the process to on-demand application—have been shown to improve targeting along various dimensions, including program satisfaction and more flexibility in the timing of identification. For example, if communities verify the final list of beneficiaries, excluded households can be added. Instead of visiting all households for the proxy means survey, households that believe themselves eligible could enroll at an office; only those close to the eligibility threshold would need home verification. Supplementing a proxy means test with these additional approaches could help resolve some of the challenges of targeting.

How can the cash be distributed? Banking systems and technology are changing rapidly in many developing economies, reducing leakage in cash distribution. Recent studies show that modern banking technology—biometric smart cards—can help dramatically reduce corruption in cash transfer programs. As mobile money continues to gain prominence, it will likely play an increasing role in delivering transfers.

### Increasing capacity

How can developing economies further improve their capacity to deliver social protection?

- *Strengthen the tax system:* Compared with developed economies, lower-income countries collect a smaller fraction of GDP and subsequently face greater budget constraints. But, without sufficient government funds, redistribution is impossible. As more people are covered by the relevant tax authority, taxation can become more progressive.

- *Develop clear identification systems:* In an example we studied, one of the biggest challenges to enrollment within a government health insurance program was a lack of a functioning identification system to track people. A clear and well-functioning identification system is an essential foundation for social protection systems.
- *Invest in effective targeting:* Identifying beneficiaries for targeted transfer programs calls for up-front investment to develop targeting that minimizes both rent seeking and the degree to which poor households are excluded. The sticker price for these systems may seem high, but it pales in comparison with the transfers being paid. Spending 1 or 2 percent of the cost of the transfers on better targeting can make a huge

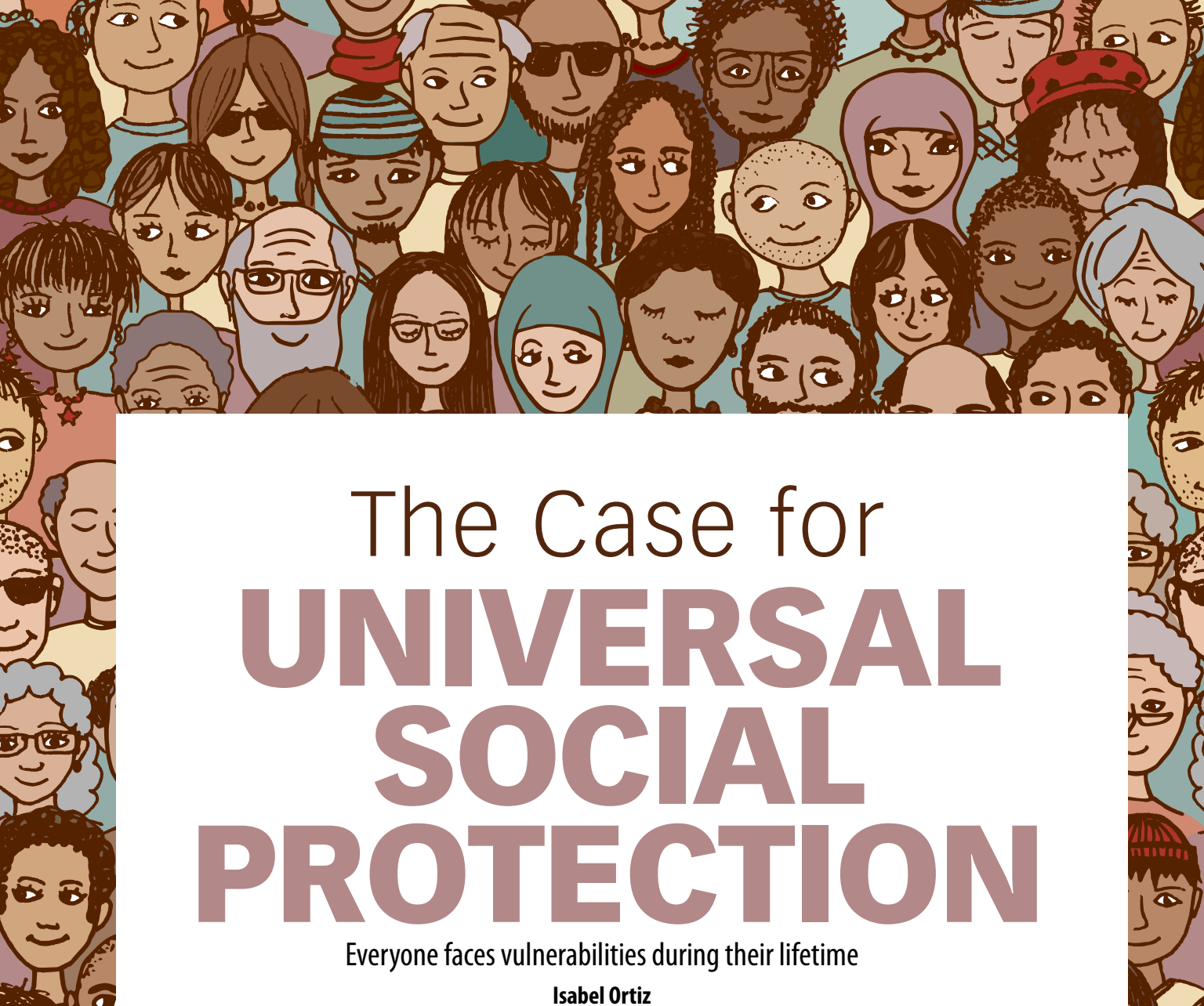
*The amount governments would save by eliminating subsidies exceeds what many of them spend on public health.*

difference in the degree to which the programs improve welfare for the poor.

- *Improve access to banking:* With new banking technology, especially mobile banking, there is an opportunity to improve the distribution of cash transfers. But it will take careful planning—from the types of technology that are feasible to ways to help the poor access and understand this technology.
- *Recognize that a variety of approaches may be needed:* Although the focus of this article is mostly anti-poverty programs, insurance programs—for example, pensions and unemployment benefits—are also an important component of redistributive systems, helping households minimize risk that could distort their behavior. [FD](#)

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# The Case for **UNIVERSAL SOCIAL PROTECTION**

Everyone faces vulnerabilities during their lifetime

Isabel Ortiz

**C**ountries across the world aim to provide social protection for all citizens or residents, generally by a combination of public social insurance and social assistance. Social protection, or social security, includes cash and in-kind benefits provided for children, mothers, and families; support for those sick and without jobs; and pensions for older and disabled persons. These benefit schemes are not only for the poor, as anyone may fall sick, lose a job, or have a child—and everyone inevitably gets old. Governments recognize the existence of *universal* needs among their citizens—reflecting vulnerabilities that all people are likely to face at least once in their lifetime.

At an international level, the United Nations Sustainable Development Goals, adopted by world leaders in 2015, commit countries to implementing nationally appropriate social protection systems for

all (universal), including floors, for reducing and preventing poverty. This commitment reaffirms the global agreement on the extension of social security achieved by the International Labour Organization's (ILO's) 2012 Social Protection Floors Recommendation, which was adopted by workers, employers, and governments from all countries (see box).

But despite significant progress in the extension of social protection in many parts of the world, only 45 percent of the global population is effectively covered by at least one social protection benefit, while the remaining 55 percent—4 billion people—are left unprotected (see chart).

Coverage gaps are associated with significant underinvestment in social protection, particularly in Africa, Asia, and the Arab states. In many countries benefits are low, keeping people vulnerable. On the positive side, many middle-income

countries are advancing fast, and a significant number of countries have achieved universal or near-universal coverage.

Universal social protection is a key element of national strategies to promote human development, political stability, and inclusive growth. Evidence shows that, in addition to reducing poverty and inequality, well-designed social protection systems with adequate benefits

- **Contribute to inclusive growth:** They increase productivity and employability by enhancing human capital, boosting domestic consumption and demand, and facilitating structural transformation of the economy.
- **Promote human development:** Cash transfers facilitate access to nutrition, education, and healthcare; encourage higher school enrollment rates; and bring about a decline in child labor.
- **Protect people against losses due to shocks,** such as economic downturns or natural disasters.
- **Build political stability and social peace,** reducing social tensions and violent conflict.

### Beware of short-term reforms

Despite significant progress in the extension of social protection globally, since 2010 a number of countries have undertaken fiscal consolidation or austerity policies. These short-term adjustments to public expenditures, including social protection spending, often undermine long-term development efforts. This is well documented for high-income countries, which have reduced a range of social protection benefits. Together with labor reforms that weakened wages and collective bargaining, these measures have resulted in a declining labor share and contributed to an increase in poverty. Depressed household income levels are leading to lower domestic consumption and lower demand, in turn slowing the economic recovery.

However, fiscal consolidation is also occurring in a majority of developing economies. Many governments are considering cuts or caps to the wage bill and reforming health and social protection systems without sufficient attention to their social impacts—for example, targeting expenditures to the poor instead of expanding social protection coverage to include the middle classes. Reforms driven by a fiscal objective tend to cut social subsidies and expenditures that benefit the majority of the population, replacing

them with a safety net for the poorest, thus punishing the middle classes—sometimes dubbed “the missing middle”—in terms of development results. In developing economies, the middle classes have very low incomes and must be supported by development policies, including by adequate social protection.

Recent calls to cut employers’ social insurance contributions, so-called labor taxes, or introduce very low ceilings for insurable earnings could destroy social security systems by constraining their resources and making them unsustainable, thus further increasing poverty and inequality.

#### UNDERSTANDING DIFFERENT SOCIAL PROTECTION POLICIES

**Universal Social Protection** is a policy objective anchored in global commitments such as Article 22 of the Universal Declaration of Human Rights, which states that “everyone, as a member of society, has the right to social security,” and other international commitments, including International Labour Organization (ILO) standards and Sustainable Development Goal 1.3, part of the United Nations Agenda 2030.

The Global Partnership Universal Social Protection (USP2030) was launched at the United Nations in 2016, led by the World Bank Group and the ILO, showcasing countries that had achieved universal social protection coverage.

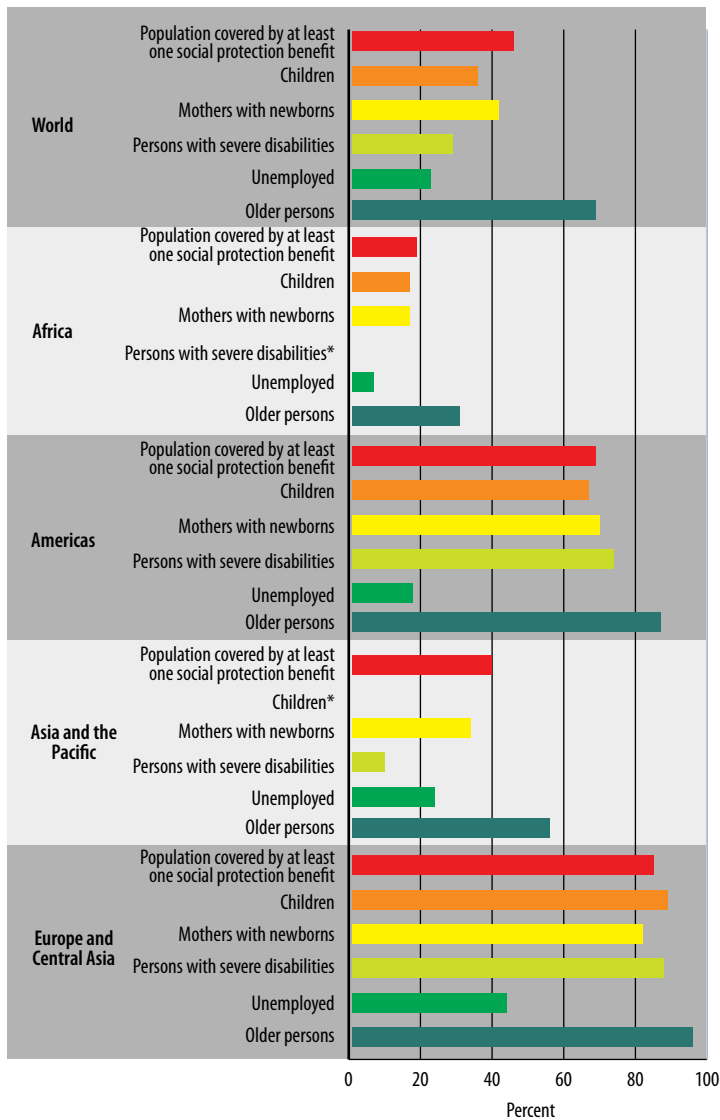
**A social protection floor** is a policy and a standard consisting of a nationally defined set of basic social security guarantees that should ensure, at a minimum, universal access to essential health care and basic income security. It should ensure adequate benefits for children, mothers with newborns, the poor, and the jobless, as well as the sick, disabled, and elderly, through a combination of contributory social insurance and tax-financed social assistance.

**Guaranteed minimum income** is a means-tested scheme of social assistance generally implemented in countries undergoing austerity or fiscal consolidation. It is not universal but rather targeted to the poor.

**Universal basic income** is an unconditional cash transfer to all residents in a country (a type of social assistance). Proposals vary considerably in terms of benefit levels, financing mechanisms, and the benefits and services offered; thus some universal basic income proposals have positive social impacts while others result in a net welfare loss. (See “Back to Basics: What Is Universal Basic Income?” in this issue of *F&D*.)

## Coverage gaps

Only 45 percent of people worldwide are effectively covered by social protection.



Sources: International Labour Organization, World Social Protection Report 2017–19; ILOSTAT.

Note: Population coverage by social protection: proportion of the total population receiving a contributory or noncontributory benefit, or actively contributing to at least one social security scheme. \* = data not available.

Social insurance is fundamental to ensure adequate levels of protection and needs to be strengthened.

Relying on individual savings does not deliver meaningful protection for the majority of people. Such proposals ignore the experience of pension privatizations, implemented in about 30 countries, which did not deliver the expected results. Full or partial privatizations underperformed: coverage stagnated, benefits decreased, gender inequalities were compounded, and administration costs proved very high. Systemic risks were transferred

to individuals, and fiscal positions worsened significantly given the high transition costs. Many countries that had embarked on pension privatization are now reversing these reforms. Private saving schemes should be a voluntary option for those able to save, but should not replace mandatory public social insurance.

## The future of social protection

Universal social protection is at the forefront of the development agenda. Over 100 developing economies are building social protection systems and fast-tracking expansion of benefits to new population groups. Expanding coverage is normally achieved by extending social insurance to the informal sector, supported by social assistance.

Building inclusive social protection systems means making them capable of adapting to demographic changes, the evolving world of work, migration, and fragile contexts. Regarding demographic change, public pension systems are constantly making minor parametric adjustments that, if well designed, should balance equity and financial sustainability, ensuring the primary objective of pension systems, to provide income security for older persons.

Social protection systems are also adapting to new forms of employment. Countries are experimenting with significant innovations that extend social protection coverage to those in the informal economy and facilitating their transition to the formal economy. For example, a number of countries in Latin America have extended coverage to tens of thousands of enterprises and self-employed people by a subsidy combined with a simplified tax and social security contribution mechanism called *monotax*.

In sum, universal social protection systems, including floors, can powerfully shape countries, enhance human capital and productivity, reduce poverty and inequality, and contribute to inclusive growth and building social peace. Despite some short-term setbacks due to fiscal consolidation and inadequate reforms, countries are advancing fast in the extension of social protection coverage, strengthening public social insurance and social assistance. The ILO and other development partners have important roles in helping countries make this developmental objective a reality for all. **FD**

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# A Helping Hand

In Japan and India, two women navigate life's transitions

Peter Langan, Reema Nanavaty

**S**ocial protection comes in various forms. In Japan, an advanced economy, retirees like Toshiko Taniuchi will make up two-fifths of the population by mid-century. Thanks to her government pension and help from her family, she remains active and independent. In youthful India, by contrast, most workers labor in the informal sector, without state-provided social protection. Jetunbibi Shirajbhi Seikh's family was having trouble making ends meet until she joined an association of self-employed women, which helped her start a business. As these two women's stories show, social protection not only shields individuals from the vagaries of life, but it helps them fulfill their potential, to the benefit of families, communities, and society.

## Keeping active in Japan

Toshiko Taniuchi participated in Japan's post-World War II economic miracle, as a growing population helped fuel a rapid expansion in output. She ran a shop in Tokyo while raising three children. Today, Taniuchi is retired, and the trend has reversed. An aging and shrinking population is weighing on economic growth.

Taniuchi, now 79 years old, has lived with her son and his family since her husband's death several years ago. She worries about being a burden on her family, so she strives to stay fit and healthy.

"I exercise and keep active to try not to cause my children too much trouble," she says. She also visits a physical therapist to recover from a back operation. "Luckily there's a bus that stops a 10-minute walk away from the rehabilitation center, and that short walk helps me stay fit."

Taniuchi keeps to a strict schedule, starting her day with exercises from a radio program at 6:30 a.m. She goes to karaoke three times a month,

calligraphy on the first Saturday of every month, drawing on the third Tuesday, and ground golf—a type of croquet—once a week. Then there are community events, like local disaster drills and neighborhood cleanup drives.

"I try to do these things and exercise to avoid getting dementia," she says. "I make sure I'm doing different things instead of sitting watching TV, cleaning, and doing laundry."

Japan famously has the world's oldest population, with people 65 and older accounting for about 27 percent of its 127 million people, according to government estimates, up from 9 percent in 1980. The proportion of elderly people is forecast to rise almost to 40 percent by 2050.

The demographic shift is putting pressure on Japan to improve productivity and expand the labor force, which could be done by bringing in more women and older workers. That would require eliminating disincentives to full-time and regular work and

Toshiko Taniuchi



PHOTO: SEAN LANGAN

## Taniuchi keeps to a strict schedule, starting her day with exercises from a radio program at 6:30 a.m.

making childcare and eldercare more widely available to free people from domestic duties, according to the IMF's July 2017 country report on Japan.

Taniuchi was born in Fukushima, a prefecture about a two-hour-plus drive northeast of Tokyo known for excellent mountain hiking and centuries-old *onsen*, or hot-spring baths. She moved to Tokyo in 1954, married, and opened a grocery store. Today, she shares a three-story home with her son, an office worker, and his wife and children. She rents out the ground floor to a local business.

Taniuchi maintains an active social life, helping her friends avoid the loneliness and isolation of many elderly Japanese. About 15 percent of men over 65 and 5 percent of women say they go as long as two weeks without talking to anyone, according to a nationwide survey conducted in August. More than 30 percent of men and 9 percent of women in the same age group said they have no one to rely on in their day-to-day lives.

"If I'm alone at home I like to go visit my friends who are also at home alone," she says. Recently, she visited a female friend who is confined to a wheelchair and cannot leave the house. Her friend hadn't spoken to anyone all day.

Finances are a concern for many older people in Japan, as they are for other age groups. Among those in the national survey who said living circumstances were somewhat difficult, difficult,

or very difficult, 40-year-olds were the biggest group, at 38 percent. The 60-year-olds were next, at 37 percent.

Taniuchi's expenses are high: there's medical insurance, fire insurance, and mortgage payments on her house, which aren't covered by the rental income from the ground floor.

Still, "I can get by in my current circumstances," she says. "I get help from my children."

**PETER LANGAN** is a freelance journalist based in Tokyo. He was formerly Tokyo bureau chief for Bloomberg News.

### A tailor's tale

Jetunbibi Shirajbhi Seikh, a home-based informal worker from Ahmedabad in the western Indian state of Gujarat, got married when she was 18 years old. At the time, her husband was the sole breadwinner, earning less than Rs 1,850 (\$25) a month doing odd jobs. With six family members relying on her husband's income, daily life was demanding and difficult.

Then things got even worse. Seikh's mother-in-law was diagnosed with tuberculosis, and because her family didn't have health insurance, they mortgaged some of their few possessions, including wedding jewelry, to pay for her treatment. Without substantial assets, they could not get a loan from a formal bank,



Women line up for various applications at the SEWA Cooperative Bank for Women.

PHOTO: WILLIAM ALBERT ALLARD

so Seikh was forced to borrow from local lenders at absurdly high interest rates—trapping her and her family in a vicious cycle of debt and poverty.

Seikh's story is far from unique. More than 90 percent of India's working population is in the informal sector. Among these people, more than 50 percent work in agriculture and allied trades, and more than 20 percent work in low-end manufacturing and services. Employment opportunities in the informal economy are always changing because of fierce competition, market trends, and changing economic policies. It is common, then, for informal workers to pursue more than one trade. A street vendor during the day may also work as a bidi (Indian cigar) roller at night and a kite maker during the kite festival. Informal workers rarely have any kind of insurance, health care, childcare, or access to formal banking. The lack of social protection is one of these workers' major hurdles to escaping from debt and poverty and to living a decent, dignified life.

One day, Seikh's neighbor introduced her to the Self-Employed Women's Association (SEWA), a trade union of more than 1.5 million low-income, informal sector women workers. SEWA promotes work, income, and social security for its members by offering direct access to loans and by facilitating access to health insurance, life insurance, home insurance, and crop insurance for rural workers, among other services. Its membership includes

workers from more than 125 trades, including tailors, waste pickers, street vendors, home-based workers, animal husbandry workers, and artisans.

Seikh signed up and immediately opened an account with SEWA Bank and began saving Rs 5 (\$0.07) a month. She then enrolled her children in SEWA's childcare center and entered a tailoring program. After six months, Seikh took out a loan for Rs 10,000 (\$135) and launched her own tailoring business from home. What began with small repairs and alterations grew to T-shirts, shorts, vests, and other apparel. Before long she was earning more than Rs 11,000 (\$150) a month, and she was also producing her own ready-made garments.

Now 51 years old, Seikh has had her tailoring business for more than a decade. Her family earns more than Rs 55,000 (\$750) a month. When she was an informal worker, she and her family were vulnerable to the ups and downs of daily hardship, unable to rely on a steady income or plan for their future. Today, she runs a thriving business, has health insurance, life insurance, and—most important—home insurance covering her place of work and source of income. In short, Seikh has beaten the cycle of poverty. **FD**

**REEMA NANAVATY** is director of the Self-Employed Women's Association (SEWA), in Ahmedabad, India.

# What Is Universal Basic Income?

Proponents hail simplicity and equity; skeptics worry about fiscal cost and incentives

Maura Francese and Delphine Prady

**MANY GOVERNMENTS PAY** pensions to elderly people, or unemployment benefits to those who lose their jobs, or child benefits to families. Cash transfers to households are common in most countries. What is a universal basic income, and how is it different from these programs?

Universal basic income is an income support mechanism typically intended to reach all (or a very large portion of the population) with no (or minimal) conditions.

Discussions around universal basic income can be heated, both in a scholarly context and in public discourse, and there is no established common understanding. Very different income-support programs are often labeled “universal basic income,” even when they have little in common or do not aim at the same goal.

Many ongoing and prospective experiments with universal basic income around the world refer to very different interventions. Examples include cash transfers to a selected group of unemployed people for a short time in Finland, to adults for 12 years in Kenya, and to randomly chosen households in California. This diversity reflects the absence of a unified definition and assessment methodology in both the literature and policy discourse.

Programs typically grouped under the universal basic income umbrella have a mix of key features (see chart). Does it replace or complement other social protection programs? Is the recipient an individual or a household? How is the pool of beneficiaries defined? What is the timing of the payment? Are there conditions attached?

Depending on how these key features are chosen and combined, scholars have proposed various forms of universal basic income (see chart).

Thomas Paine’s (1797) “ground-rent” resembles a categorical capital grant (for example, a one-time endowment to a specific group of people) aimed at fighting the transmission of poverty from one generation to the next. Milton Friedman (1968) saw the “negative income tax” as a way to replace the entire American welfare state to overcome administrative inefficiencies. Philippe Van Parijs (1992) advocates a regular, universal, unconditional, and generous cash transfer. Anthony Atkinson’s



(1996) “participation income” complements existing social programs and the minimum wage and is conditioned on a form of “social” participation—contributing to society through employment, education, childcare, or other activities. Across this broad spectrum, however, two common traits characterize and differentiate universal basic income-type programs from others:

- **Universality**—or very large—coverage of individuals in society
- **Unconditionality**—or very broadly conditioned provision—as is the case of Atkinson’s “participation income”

Proponents and opponents of universal basic income have highlighted several aspects, and arguments in its favor mirror those opposed. Some advocates point out that it does a better job of reaching the poor than means-tested programs—that is, programs that determine individual or family eligibility for government assistance based on an income or asset test. Many factors can keep means-tested programs from reaching the intended recipients—for example, administrative capacity, high information and administrative costs, poor performance of targeting mechanisms, and social stigma.

In principle, simple universal basic income programs could save administrative costs and increase



the transparency of transfer systems, making them less subject to administrative discretion and corruption. Advocates also tout its usefulness as a strategic instrument to support structural reforms such as removal of inefficient programs like energy subsidies (Coady and Prady 2018). Universal basic income programs can improve efficiency by avoiding sharp withdrawal of benefits as earned income increases, a common problem in many means-tested programs, which tends to discourage labor market participation.

Opponents tend to focus on sustainability—high fiscal costs since all households—including middle- and high-income households that do not need income support—receive the benefit. Skeptics worry about efficiency issues—warning against the undermining of work ethics—and opportunity costs—the risk of diverting scarce resources from other priorities such as health, education, and investment.

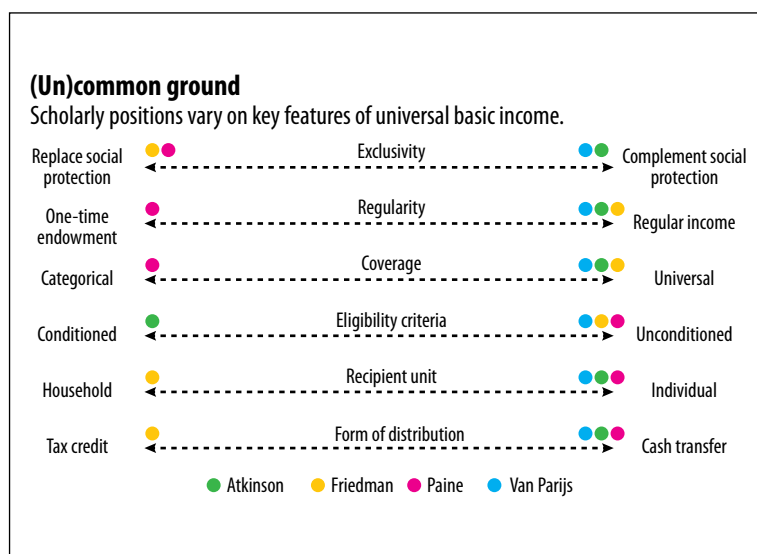
Assessment of the merits of such programs must take into account country-specific characteristics and societal preferences. It should also be anchored in a thorough understanding of the trade-offs when choosing one type of design over another.

Empirical analysis can shed light on the relative redistributive performance of existing social safety nets, a universal basic income, and potential alternatives. Given that both the spending and the tax side of the budget shape distributional outcomes, a comprehensive analysis should evaluate both to ensure progressivity—that is, gradually increasing net burden on more affluent households and larger benefits for more vulnerable households. Such an analysis must also consider fiscal sustainability. Typically, policymakers face trade-offs along the following key dimensions:

- **Coverage at the bottom** of the income distribution versus leakage to richer households
- **Generosity of transfers** versus incentives and economic distortions, such as those related to the decision to enter the labor market and the number of hours worked
- **Fiscal cost** versus alternative use of scarce fiscal resources

Policymakers must also consider a fourth aspect: how to reconcile objectives and implementation challenges, such as the government’s capacity to raise resources equitably and sustainably and roll out a complex transfer program.

Scholars disagree on whether a universal basic income is more appropriate for countries with limited



and ill-functioning safety nets or for rich countries that can afford it. Limited administrative capacity argues for a shift toward more universal transfer programs in developing economies. But displacement of other priorities (such as education and health) where revenue mobilization is problematic—particularly in the short term—is a concern.

In advanced economies, universal basic income is often used as an instrument to address inadequate safety nets (and ensure inclusion) and a way to tackle the challenges of technological and demographic changes. Country authorities must assess the relative merits of universal basic income including its financing through rechanneling resources already used in other ways or through higher taxes and contributions. **FD**

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*This article draws on the authors’ forthcoming IMF Working Paper “Universal Basic Income: Debate and Impact Assessment.”*

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# TIME TRAVELER

Peter J. Walker profiles **Claudia Goldin**, who pioneered the study of women's role in the economy

**F**or those who are dismayed at the depth of political and economic division in the United States today, Harvard University economics professor Claudia Goldin has a simple reminder: there is nothing new under the sun.

“Deep political divisions arose in the past ... particularly in periods of rising and high income and wealth inequality,” Goldin says in an interview with *F&D*. She fondly cites the prediction that an income tax would be the beginning of “a war of the poor against the rich,” made by Associate Justice Stephen Field as the Supreme Court struck down the 1894 income tax law. (The 16th Amendment in 1913 cleared the way for today’s income tax.)

The 72-year-old economic historian, labor economist, and gender expert draws lessons from the past to better understand the present. In a career spanning more than four decades, Goldin has studied the economic effects of technological change, inequality, education, water pollution, and corruption. She is best known for her research and insights into the role of women in the US economy and for developing a sophisticated, nuanced understanding of the reasons for the well-documented gender pay gap.

She is a media regular on Equal Pay Day, which marks how far into each year American women must work to match men’s earnings in the previous year. (It will be April 2 in 2019.) Goldin’s research covering 200 years of economic history shows that unequal pay isn’t so much about discrimination, but rather reflects the high cost of workplace flexibility and combining work with family, as she explains to interviewers on the air every year.

Goldin is frequently cited as one of the 10 most influential female economists in the world. She pioneered the study of women’s role in the economy 40 years ago, inspired new generations of female economists, and helped bring gender economics into the mainstream. Goldin won the IZA Prize in Labor Economics in 2016 and the Society of Labor Economists’ Mincer Prize for lifetime contributions in 2009. She was president of the American Economic Association in 2013–14 and was the first woman to receive tenure in economics at Harvard and the University of Pennsylvania.

Born in 1946 in the Bronx, a borough of New York City, Goldin recalls an early fascination with investigation and intellectual discovery, immersing

herself in the wonders of Manhattan’s museums as she fell in love first with archeology, then bacteriology. She went to Cornell University initially to study microbiology but came to embrace the humanities and social sciences, especially history and economics, which became her undergraduate major. She completed her doctorate in industrial organization and labor economics in 1972 at the University of Chicago.

Goldin explains why history is important to economics, citing the book *The Race between Education and Technology* (2008), which she wrote with fellow Harvard labor economist Lawrence Katz, who is also her husband.

“Larry Katz and I looked at changes in income inequality post-1980 versus pre-1980 and investigated the theory that inequality has risen more post-1980 because of skill-biased technological change,” Goldin says. “History allowed us to understand that skill-biased technological change is not new but has been around for a very long time and to identify the longer-term forces at work.”

The earnings gap between more-educated and less-educated workers was also wide in 1915, then narrowed until the 1950s, and then expanded again in the 1980s, Goldin and Katz found. By studying the whole century, they saw that changes in the supply of and demand for college-educated workers explain most of the fluctuation in wage premiums for better-educated workers. These ups and downs reflect a race between education and technology as the education system keeps up with evolving technologies’ changing demands for skills.

### Making her mark

As the feminist movement unfolded in the 1970s, Goldin discovered where she could make her mark: in studying women’s participation in the economy. She was living through a period of significant social change and a transformation of perceptions about the role of women.

“I realized that something was missing,” she wrote in “The Economist as Detective,” her 1998 autobiographical essay. “I was slighting the family member who would undergo the most profound change over the long run—the wife and mother. I neglected her because the sources had. Women were in the data when young and single and often when widowed. But their stories were faintly heard after they married.”

Starting in the late 1970s, Goldin conducted a series of studies examining how various dimensions of women's participation in the US labor force evolved over 200 years. In the book *Understanding the Gender Gap: An Economic History of American Women* (1990), she noted how the history of gender wage gaps is characterized not by steady progress but by distinct spells when the gaps narrowed, including in the early 19th century with mechanization, in the early 20th century with the rise of clerical work, and in the 1980s with gains in women's educational attainment.

In her 2006 paper "The Quiet Revolution That Transformed Women's Employment, Education, and Family," Goldin identified four phases going back to the late 19th century that shaped women's role in the US economy. She found the first three phases to be "evolutionary," identifying them as "independent female worker," up to the 1920s; "easing the constraints on married women in the labor force," 1930s–1950s; and "roots of the revolution," 1950s–1970s. Then came the "quiet revolution" starting in the late 1970s.

While important advances were made through the evolutionary phases, women in those periods were more likely to view their working lives as intermittent and a means to put food on the table, Goldin wrote. Women also had limited control over key decisions affecting their employment. By

beyond explanations built on sexism. She showed that most of the wage gap reflects the high cost of "temporal flexibility"—or women working fewer or more flexible hours to allow them to raise a family. Consequently, narrowing the gap will depend on restructuring jobs to incorporate greater flexibility for all workers, thus reducing the costs associated with flexibility. While such a fundamental change may sound like a tall order, Goldin has pointed out that the shift has already taken place in areas including technology, science, and health care. This benefits both women and men, she says.

"If it's only the women who are putting pressure on firms to provide more flexible jobs in a less expensive manner, not that much is going to happen," Goldin says.

As extensive as Goldin's work on gender has been, her academic contributions extend even further. In their 2006 edited volume, *Corruption and Reform: Lessons from America's Economic History*, Goldin and Harvard economist Edward L. Glaeser studied the significant decline in American public corruption between 1870 and 1920. She identifies a vigorous, independent, free press as the fundamental driving factor.

"The Fourth Estate, in informing the public what was really going on, in reporting and doing the very best investigative journalism, was extremely important," she says. "Our research showed how

## The ratio of undergraduate men to women majoring in economics has been stuck at 3-to-1 for 20 years, suggesting that many young women are put off by the field.

contrast, women of the quiet revolution generally viewed their careers as a significant part of their personal identity and made their own decisions about their working lives. Goldin found that this latest phase was triggered mainly by increased availability of contraceptives and a rising divorce rate.

### Equality's final frontier

The quiet revolution did not, however, close the gender wage gap. In a 2014 paper, "A Grand Gender Convergence: Its Last Chapter," Goldin identified narrowing the gap as one of the final challenges for workplace gender equality in the United States and other advanced economies. This is where Goldin's research broke new ground and moved the discussion

the more neutral and apolitical free press emerged in the US in the late 19th and early 20th century."

In their paper "Watersheds in Child Mortality: The Role of Effective Water and Sewerage Infrastructure, 1880 to 1920" (2018), Goldin and the Stanford medical school's Marcella Alsan suggest a central focus for low-income countries trying to reduce deaths among children. Analyzing data from Boston between 1880 and 1920, they found that a third of the decline in child mortality resulted from efforts to provide clean water and effective sewage systems. Developing economies could achieve better results by building clean water and sewage systems than by pursuing other piecemeal policies, Goldin told *F&D*.



*Claudia Goldin and her golden retriever, Pika.*

In 2014, Goldin started the Undergraduate Women in Economics Program, an initiative to encourage more female economics majors. The ratio of undergraduate men to women majoring in economics has been stuck at 3-to-1 for 20 years, she says, suggesting that many young women are put off by the field because they don't envision pursuing careers in finance or banking.

"If they understood that economics is an extremely broad and helpful discipline, they would realize that they could do an economics major and be more competitive in a range of areas," Goldin says. The program focuses on a randomly selected group of 20 US universities and colleges from among those that produce about 25 economics majors a year. These include the University of California, Berkeley; Colorado State University; Princeton University; Washington and Lee University; and Williams College. It offers small grants of about \$12,500 to encourage women to pursue economics degrees. ("That's a lot of pizza!" she says.)

### Building a legacy

For 28 years ending in 2017, Goldin was director of the Development of the American Economy (DAE) Program at the National Bureau of Economic Research (NBER). Over the past two decades, economic historians have published a rising number of papers on economic history in top economics journals.

"Claudia shaped the program into a productive research environment, combining economic theory

and historical evidence," says Princeton's Leah Boustan, who is the program's current codirector, along with Vanderbilt University's Bill Collins. "Under Claudia's leadership, the DAE became a nurturing setting characterized by constructive criticism and openness to new ideas."

For her part, Goldin points to her broad view of the scope of economics as a major contribution to the NBER's work.

"I think that the legacy is that I expanded the group to include a host of fields not considered in the original conception," she says. That included "researchers from other parts of the NBER who were using historical materials and understood the special methodology of economic history."

The 98-year-old NBER, based near the Harvard campus in Cambridge, Massachusetts, is where Goldin and Katz met as they pursued research projects.

"It's a joke of ours that we call it the National Bureau of Economic Romance," she says. Besides economics, they share interests in bird watching, hiking, and walking their eight-year-old golden retriever, Pika. Goldin maintains a section on her Harvard web page documenting Pika's achievements as a competitive scent dog, including a photo of him covered with his prize ribbons. It's perhaps a faint echo of her childhood investigative pursuits in museums around New York in search of clues about the world around her. [FD](#)

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PHOTO: IMF

## Cleaning Up

*Countries are advancing efforts to stop criminals from laundering their trillions*

**Rhoda Weeks-Brown**

**AL CAPONE HAD A PROBLEM:** he needed a way to disguise the enormous amounts of cash generated by his criminal empire as legitimate income. His solution was to buy all-cash laundromats, mix dirty money in with clean, and then claim that washing ordinary Americans' shirts and socks, rather than gambling and bootlegging, was the source of his riches.

Almost a century later, the basic concept of money laundering is the same, but its scale and complexity have grown considerably. Were Capone alive today, he would have to run his washers and dryers around the clock to keep pace with demand; the United Nations recently estimated that the criminal proceeds laundered annually amount to between 2 and 5 percent of global GDP, or \$1.6 to \$4 trillion a year.

### **Threat to stability**

Money laundering is what enables criminals to reap the benefits of their crimes, including corruption, tax evasion, theft, drug trafficking, and migrant smuggling. Many of these crimes pose a direct threat to economic stability. Corruption and tax evasion make it difficult for governments to deliver sustainable and

inclusive growth by diminishing the resources available for productive purposes, such as building roads, schools, and hospitals. Criminal activity undermines state authority and the rule of law while squeezing out legitimate economic activity. And money laundering may create asset bubbles in markets like real estate, a common vehicle.

A recent example illustrates the point. A Guinean minister helped a foreign company obtain important mining concessions in exchange for \$8.5 million in bribes. Falsely reporting that money as income from consulting work and private land sales, the minister transferred it to the United States and bought a luxury estate in New York. But his effort to turn ill-gotten gains into a seemingly legitimate asset was ultimately unsuccessful; last year, he was convicted of money laundering.

In some ways, expensive homes are the modern mobster's collection of laundromats. A public advisory issued by US authorities last year indicated that over 30 percent of high-value, all-cash real estate purchases in New York City and several other major metropolitan areas were conducted by individuals already suspected of involvement in questionable dealings. The governments of Australia, Austria, Canada, and other countries have concluded that their own real estate markets could also be used to invest and launder dirty money.

### **Terrorism financing**

More worrying still, dirty money—along with clean—may be a source of funding for terrorism

and the proliferation of weapons of mass destruction. Terrorist groups need money, lots of it, to compensate fighters and their families; buy weapons, food, and fuel; and bribe crooked officials. Similarly, proliferation does not come cheap. For example, North Korea has reportedly devoted a substantial portion of its scarce resources to developing nuclear weapons.

Countries with weak anti-money laundering and combating the financing of terrorism (AML/CFT) regimes could be called out by the Financial Action Task Force (FATF), a global standard-setting organization. Once countries come to be viewed as vulnerable to illicit financial flows, their banks may face long-term reputational damage, costly demands for additional documentation on the part of international business partners, and the loss of correspondent banking relationships. This may marginalize already fragile economies, threaten remittance channels and foreign direct investment, and drive financial flows underground. So ignoring AML/CFT or delaying related reforms is no longer an option.

Thankfully, this message is starting to resonate. Under the leadership of the FATF, and with the support of the IMF, United Nations, World Bank, and other stakeholders, almost every country has criminalized money laundering and terrorism financing and established a legal framework to freeze terrorist assets.

But this work is far from finished. Whether because of lingering legal and institutional loopholes or innovation on the part of criminals (or both), there is no shortage of money laundering scandals in the news. As a case in point, investigators are currently probing the possibility that the better part of \$233 billion in payments was laundered through the Estonian branch of Danske Bank from 2007 to 2015.

### Financial technology

Rapidly developing financial technology has further complicated the picture. Mobile money transfers, distributed ledgers, and virtual currencies have legitimate and productive uses but can also be used to conceal or facilitate criminal activity. Put another way, nearly cost-free consumer payments and nearly untraceable ransom payments are two sides of the same (Bit)coin.

So how should countries prioritize their response to this evolving and globalizing challenge?

First, they should heed the FATF's call to understand and address the threats that stem from changing technology, but should do so without stifling financial innovation and inclusion. The objective should be to increase transparency—to know who

is behind financial transactions, where, and for what purpose—without unduly increasing transaction costs or driving financial flows underground.

Second, they should remove legal and practical barriers to international cooperation. Detecting money laundering and terrorism financing requires both safeguarding and sharing financial intelligence, and deterring criminals requires following the trail of dirty money or money intended for nefarious purposes, wherever it leads.

Finally, they should continue to strengthen the effectiveness of their efforts to mitigate identified risks. Whether national AML/CFT laws are perfect or not, beyond laws on the books, consistent (and persistent) implementation is critical to achieving durable results.

### Ukraine, Libya

Given its mandate to preserve economic stability and financial integrity, the IMF maintains an extensive AML/CFT program, which includes active participation in international efforts to raise awareness of the threat and generate effective responses, along with the provision of advice and know-how to over 100 of its members—and counting.

What are some examples of these efforts? To name just a few, in Ukraine, we are working with national authorities to prevent banks from being misused by corrupt officials. As a result, regulatory sanctions for AML/CFT violations are increasing and the reporting of suspicious transactions is on the rise, yielding a significant number of corruption investigations and prosecutions of high-level public officials.

In Libya, we helped the authorities craft a new AML/CFT law that criminalized terrorism financing and established the legal basis for the imposition of sanctions against recognized terrorists.

And in the Caribbean, where the withdrawal of correspondent banking relationships is a critical concern, we convened international banks and their local counterparts to foster bilateral cooperation in addressing information gaps and meeting regulatory expectations. One global bank that had left the region has now decided to reestablish ties with some local banks.

The IMF is committed to helping its members identify today's dirty money laundromats—and close them down. The stakes have never been higher. **FD**

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**RHODA WEEKS-BROWN** is general counsel and director of the Legal Department of the IMF.



## MOVING THE NEEDLE

Maurice Obstfeld discusses his tenure as the IMF's chief economist

**R**etiring as chief economist of the International Monetary Fund at the end of 2018, Maurice Obstfeld shares his thoughts on trade tensions, widening inequality, the importance of education, and relations between United States and China in an interview with *F&D*'s Gita Bhatt. Obstfeld plans to return to the University of California, Berkeley, where he was a prominent academic economist for 24 years and cowrote two leading textbooks on international economics. His successor at the IMF will be Harvard University's Gita Gopinath.

**F&D:** What worries you most on the macroeconomic front?

**MO:** The worries are clearly set out in the *World Economic Outlook*: trade tensions and adjustment to differential financial conditions in an environment of much higher private and public debt than we had in the past.

Longer term, wage and productivity growth is an issue. How do we spur innovation?

We need a big rethink on educational investments everywhere. Human capital investments very early in life have been shown to be critical to future success. But even later in life, they can promote greater flexibility of workers, prolong working lives, and offset effects of aging populations.

That will also help mitigate some of the adjustment issues that might be related to technology and trade. It will make economies more resilient and better able to deal with the critical, long-term problem that we just haven't seen working people share in the gains from growth. There is now a sense in a lot of countries that incomes of working people have stagnated, that social mobility is lower, that opportunity is lower, that one's children will not be better-off and may indeed be worse off. These trends poison our politics.

**F&D:** The United States and China are the world's largest, most dynamic economies. How do you see the economic relations between the two playing out?

**MO:** Their disagreements go way beyond economics. They go fundamentally to the issue of global leadership. If you are a country like the United States, which has been a global leader and has shaped the global governance structure, how do you manage this relationship, which at once offers opportunities for cooperation but also hazards of conflict?

Moreover, how do you do it dealing with a system that is very, very different from yours politically? If you look at the approach the Obama administration took to the trade relationship with China, one important element was the TPP [Trans-Pacific Partnership agreement], which excluded China but which included the flexibility for countries (including China) to join if they subscribed to the rules. This was a strategy for maintaining US influence and potentially influencing through soft power the way China conducted trade.

Now the relationship seems to have become more confrontational, certainly in trade. I'm not sure confrontation is ultimately going to be productive



because it puts front and center the idea that one country has to “win” and be dominant, as opposed to creating a structure within which countries can coexist and conflicts are contained.

**F&D:** In your three years as the IMF’s chief economist, what were some of the more surprising global economic developments?

**MO:** When I came in, China had recently devalued the yuan and changed its exchange rate regime, and asset markets were in turmoil. It set off a period of worry about China’s growth and stability, which affected global asset markets through the first half of 2016.

The next surprise was the Brexit vote, which came in the middle of 2016 at a time when we thought markets were still a bit shaky and we were worried about possible downsides.

Very soon thereafter, we had the US presidential election, the outcome of which was also a surprise and set up a new dynamic, where on one side there was the prospect of more US fiscal stimulus supported by a booming stock market. But, on the downside, there was a lot of noise about trade and possible renegotiation of fundamental trade relationships, which after a bit more than a year turned into action.

This was all happening against the backdrop of the Federal Reserve gradually normalizing monetary policy. In December 2015 the Fed started raising US interest rates, and as it has kept at it, we have gotten into a period of much tighter financial conditions for emerging markets.

**F&D:** Do you feel the responsibility of your research’s impact on policy?

**MO:** You always want your research to be as solid and as credible as possible. If that’s the case, then I don’t worry about it. One worries more about giving the right advice in a crisis situation, where you might make a severe mistake and a lot of people might suffer as a result.

I first understood this responsibility in August 2015, just before I assumed this role. China devalued its currency that month, and global markets were melting down. Some distinguished economists were putting out alarmed—and alarming—tweets. The chair of the US Council of Economic Advisers, Jason Furman, was on paternity leave, and as a member of the Council, I was therefore the macroeconomist in charge. President Obama called me in to the Oval Office along with the secretary of the treasury, Jack Lew.

The president seemed calm about all of this. He looked at me and asked, “Should I be worried?” I said to myself, “I have never been in this position before, but I will probably be in this position a lot at the Fund.” I had a couple of seconds to consider my answer. And I said, “No. The markets will find their footing, and for now I don’t think the world is coming to an end.”

The president next looked at Secretary Lew. “Jack, what do you think?” He replied, “I agree.” “OK, thanks,” the president said. “Can we ask these folks to stop tweeting?” End of meeting.

**F&D:** Where do you think you have moved the needle the most?

**MO:** Trade was not historically a big focus at the IMF, but we have really stepped up in that area. Consideration of inequality and the inclusiveness in growth has been much more mainstreamed. And

“You always want your research to be as solid and as credible as possible.”

there has been more work on climate issues. When I came into the Fund, there was skepticism as to whether climate was something we should study. We talk about macrocritical, but this threat is truly “macro macro.” It is in the Fund’s DNA to worry about global coordination failures, and climate change is the biggest and most consequential one that we face. If I have had any impact on the thinking about this in the Fund, I will be very happy.

**F&D:** What do you see as the evolving role of the IMF?

**MO:** We have to incorporate a longer-term perspective into our surveillance. We tend to look intensively at the short or medium term, but there has to be more long-run thinking, so that we can better challenge authorities to think about the distant future, far beyond the political cycle. And that may require us to think somewhat more broadly, too.

We need to realize that we have a unique position as a long-lived institution with a good degree of independence from day-to-day politics. I think we need to keep in mind how special that position is, and learn to exploit it more effectively. **FD**

*This interview has been edited for length and clarity. A longer version of this article is available on [www.fandd.org](http://www.fandd.org).*



PHOTO: ISTOCK/WANGANI ALAMY/ANDREY GUDKOV, ALAMY/BARRY IVERSON, ALAMY/PETE TITMUS



# A Competitive Africa

Economic integration could make the continent a global player

**Hippolyte Fofack**

**A**frica ranks near the bottom when it comes to competing in the global economy, held back by fragmented markets that inhibit efficiency and constrain economic growth.

Now a new player is emerging with the potential to defragment Africa and boost the productivity of its economies: the African Continental Free Trade Area (AfCFTA). In March 2018, 44 African heads of state signed a framework to establish a single continental market for goods and services, with free movement of capital and business travelers. Five additional countries, including South Africa, joined in July. The AfCFTA still needs ratification by the parliaments of at least 22 countries; seven have done so thus far.

In addition to increasing market efficiency and reducing the cost of doing business by offering opportunities for economies of scale, the AfCFTA could ease trade and investment flows and shift the composition and direction of foreign direct investment flows into Africa.

The big question is whether this effort will also elevate the competitiveness of African economies. Competitiveness—the set of institutions, policies, and factors driving productivity—is a key determinant of sustainable growth and provides a path for effective integration into the global economy.

The Global Competitiveness Index, a performance indicator generated every year by the World Economic Forum to benchmark countries, shows large variations in national competitiveness rankings. These have to do with the stage of economic development, the gap

in physical and technological infrastructure between developed and many developing economies, and the inability of a number of developing economies to undertake the critical economic and institutional reforms needed to raise their market efficiency.

The few African countries that have emerged as the fastest-growing economies in the past decade have also been on an upward trajectory on the global competitiveness ladder. Increasingly, these countries (most notably Côte d'Ivoire, Ethiopia, and Rwanda) are drawing on their improving competitiveness and macroeconomic environment to diversify their sources of growth and trade and, in the process, expand their share of the global market pie. However, most African countries are probably latecomers in the race to boost competitiveness. Lately, the global economic environment has been dominated by the rise of beggar-thy-neighbor nationalism and creeping protectionism. Leading economies are moving away from the rules-based system that has governed global trading arrangements for decades toward a new mercantilist system that measures a country's economic performance by its trade surplus.

In this new reality, competitiveness is perhaps even more important for emerging market and developing economies. In Africa, the push to deepen economic integration and boost intra-African trade under the AfCFTA is also likely to mitigate the costs of adverse global shocks. A larger effective domestic market acts as insurance against disruptions to global trade associated either with global volatility or with contraction in global demand.

### Active versus passive globalizers

In a zero-sum trading landscape, more and more countries are vying for the same market. Only the most competitive—those with strong economic fundamentals and policy frameworks and diversified sources of growth—are likely to expand and sustain the growth of their share of global trade. These “active globalizers” are arguably the best positioned to mitigate the risks associated with global economic and financial integration and therefore to take full advantage of the benefits of globalization. The least competitive economies have been “passive globalizers,” or impotent victims of globalization that have consistently acted as feedstock, supplying the raw materials and natural resources required to expand manufacturing output in more actively globalizing nations (Fofack, forthcoming).

Not surprisingly, passive globalizers have been more vulnerable to the risks of globalization. These include faster global transmission of negative shocks, swings in commodity prices, long-term deterioration in the commodity terms of trade, and lower global

factors—technological readiness, market size, and efficiency of goods and labor markets. In addition, market fragmentation has held back growth by discouraging large-scale and long-term investment.

Despite lower import duty within the continent’s various regional economic communities, a range of nontariff and regulatory barriers continues to raise transaction costs and limit the movement of goods, services, labor, and capital across borders. These barriers include border delays, burdensome customs and inspection procedures, multiple licensing requirements, and increasingly the requirement that importers secure national transit bonds along key routes. Trading across borders in Africa is still more costly and time-consuming than in any other region of the world—and African countries trade more with the rest of the world than with each other.

The average cost of importing a container in Africa is about \$2,492 compared with \$935 in East Asia and the Pacific and \$1,488 in Latin America and the Caribbean (Brenton and Isik 2012). Not surprisingly, intraregional trade, though on the rise, is still

### Africa has been labeled as a continent full of potential—yet realizing this potential has been one of its main challenges.

demand triggered by either creeping protectionism or synchronized downturns. These risks have stifled the aspirations of lagging nations, most of which have found themselves locked into vicious cycles of excess growth volatility and structural balance-of-payments crises. This perhaps suggests wide-ranging macroeconomic implications of competitiveness.

Competitiveness goes hand in hand with trade performance, and therefore with economic growth. And the largest single determinant of GDP growth in both developed and developing economies is innovation. Africa’s fastest-growing economies are also making the greatest strides toward diversification of exports. The degree of innovation and efficiency in production processes may well be the fault line between developed and developing economies, as well as between active and passive globalizers.

Africa faces a host of hurdles to competitiveness and trade. Steps to improve the economic infrastructure and reforms to boost innovation have been stifled by institutional resistance and heavy costs associated with infrastructure development and technological catch-up. Progress has been equally slow on efficiency-driven competitiveness

relatively rare, accounting for only about 15 percent of total African trade, compared with 68 percent in Europe and 58 percent in Asia (Fofack, forthcoming; Afreximbank 2018). In addition to nontariff barriers, the state of governance, the structure of production, the direction of trade inherited from the colonial model of resource extraction, and supply-side constraints are at play. Supply-side constraints include a low manufacturing base, costly trade financing, limited access to information, and trade-enabling infrastructure that is either lacking or costly.

The process of defragmenting Africa under the AfCFTA is therefore the first step toward boosting competitiveness and integrating African economies into the global economy as active globalizers. The continental free trade area will establish a market of 1.2 billion people with a combined GDP of \$2.5 trillion and combined consumer and business spending of more than \$4 trillion. Basic simulations that assume expanded and increased efficiency of goods and labor markets under the AfCFTA point to a significant increase in Africa’s overall ranking on the Global Competitiveness Index in both the short and the medium term.

Over the long term, the average ranking for Africa could rise even further. This could happen if the continental free trade area begets a more dynamic trade and economic environment that expands manufacturing bases, sustains the growth of agro-processing industries fit for value chain integration, and accelerates the development and integration of financial markets. Such financial progress could, for instance, enable cross-listing of firms in different stock markets and promote the development of nonbank financing and the establishment of credit reference bureaus to reduce information asymmetry and credit risk. Ultimately, these measures could ease access to credit in a region where more shallow financial intermediation and fragmented financial markets have put the kibosh on competitiveness and private sector growth.

Establishing one of the largest free trade areas in the world could boost competitiveness through other channels as well: technology transfer, industrial development, diversification of sources of growth, and expansion of intra-African trade. A recent review of the African competitiveness landscape blames limited progress in these areas for stalled productivity growth and competitiveness and singles out relatively low regional trade and integration as a major bottleneck (WEF 2017). The same review also highlights overlapping regional economic communities as a major constraint to the kind of business-friendly environment entrepreneurs need to take advantage of growth opportunities.

Preliminary estimates of the expected benefits of the AfCFTA, in terms of trade performance and regional integration, are positive and significant. The United Nations Economic Commission for Africa estimates that intra-African trade, largely dominated by industrial products and manufactured goods, could increase by more than 50 percent and even double about a decade into the implementation of the AfCFTA, if the envisioned reforms are fully carried out and complemented by robust trade facilitation measures.

The requirement that participating countries remove tariffs on at least 90 percent of goods would drive this increase. Economies of scale as a result of a larger continental market could lower overall production costs, which remain very high; stimulate cross-border trade and investment within Africa; and attract additional foreign direct investment to the region while also shifting it toward the production of industrial and manufactured goods. This would boost intraregional trade in intermediate and

capital goods. Attendant benefits include technology transfer and development of regional value chains in which African businesses add value as they turn raw materials into finished goods.

### “Factory Africa”

These regional value chains could help integrate African economies into the global economy, whose manufacturing processes are driven increasingly by the globalization of supply and value chains. Despite the rise in outsourcing production to several countries, much of the value-added distribution in global value chains remains within regional blocs. Hence the increasing references to “Factory Europe,” “Factory North America,” and “Factory Asia”—the continents where these value chains are concentrated (Stöllinger and others 2018). The rise of value chains in regional blocs and their continued relevance in the face of entrenched globalization reflect their many inherent benefits, most notably lower transit costs and shorter supply chains associated with either sourcing or manufacturing closer to target export markets.

The AfCFTA could eventually give birth to “Factory Africa.” In time, the emergence of “Factory Africa”—and ultimately, the connection of Africa-based factories and production chains to global value chains—would link production networks from all continents.

For decades, Africa has been labeled as a continent full of potential—yet year after year, realizing this potential has been one of its main challenges. If the AfCFTA succeeds in inspiring these reforms, the new free trade area could unleash forces for African dynamism and position the continent as a global competitor. **FD**

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**HIPPOLYTE FOFACK** is the chief economist at the African Export-Import Bank.

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# ON THE MOVE

Migration, with its upsides and downsides, is increasing globally.

**MODERN TRANSPORTATION** and digital technologies make it easier for people to move across borders. Around the world, 258 million people, or 3.4 percent of the global population, live outside their country of birth. The international migrant population is now triple its 1970 level. International migration takes different forms: economic migrants voluntarily leave in search of work, while refugees are forced to flee due to conflict and violence. Migration can be an economic boon, but it can also be a critical policy and political challenge.

Work is the main motivator. Migrant workers comprise two-thirds of all international migrants, and most move to high-income countries. For these individuals and their families, migration can bring considerable gains in income, education, and health. For their home countries, emigration can reduce unemployment and foster knowledge transfer. The remittances migrants send home—\$613 billion in 2017—provide financial flows and a stable source of income. For destination countries, immigration can increase labor supply, enhance productivity, and ease pressures on pension systems.

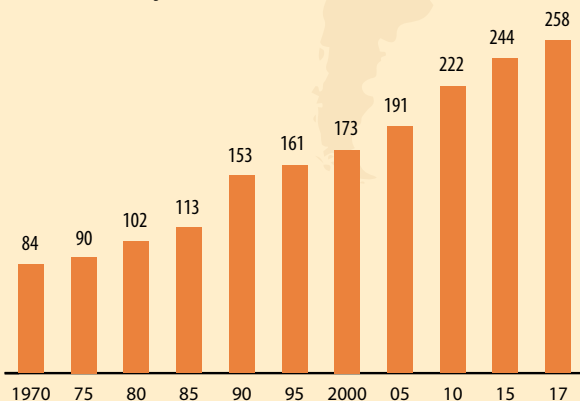
Not all migration occurs in positive circumstances. Conflict and persecution uprooted 68.5 million people by 2017—including 25.4 million refugees, 3.1 million asylum seekers, and 40 million people displaced within their countries—a level not seen in decades. More than half the refugees were children, many unaccompanied or separated from their parents. A third of all refugees fled to the least developed economies, where the capacity to accommodate and integrate them often falls short.

Migration matters to economic prosperity, human development, and security, and ensuring safer and better-regulated migration has become a global priority. The United Nations, for example, is set to adopt two global compacts to improve the governance of migration. One thing is clear: no country can manage migration issues on its own. Cross-border challenges require cross-border solutions. **FD**

Prepared by **JIA FENG**, communications officer, IMF Communications Department

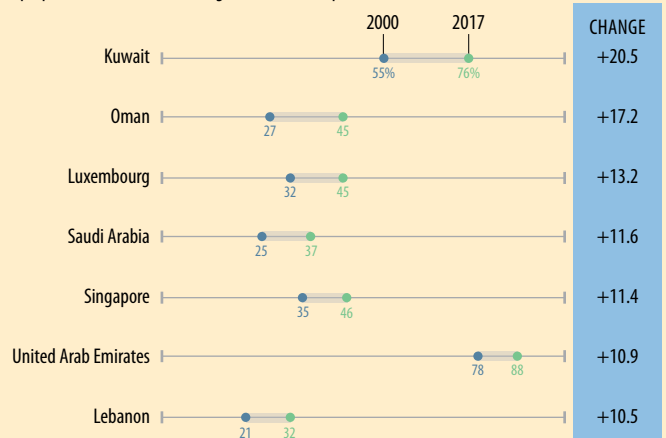
## International migration on the rise

A steady increase worldwide  
(number of international migrants, millions)



Source: World Migration Report Update 2018.

Dramatic changes, particularly in the Gulf  
(proportion of international migrants, 2000–17, percent)



Source: United Nations.

# Migration can be a boon . . .

After moving to a developed economy, migrants from the poorest countries experienced:



a **15-fold** increase in income

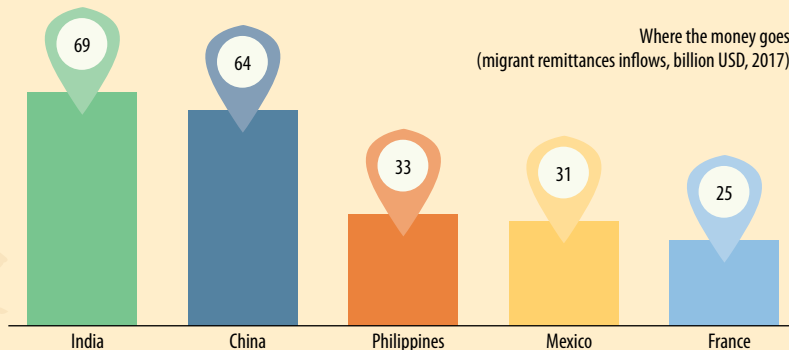


a **doubling** of school enrollment rates



a **16-fold** reduction in child mortality

**\$466 billion**, or **76 percent** of global remittances flow to developing economies, almost **three times** as much as official development assistance in 2017



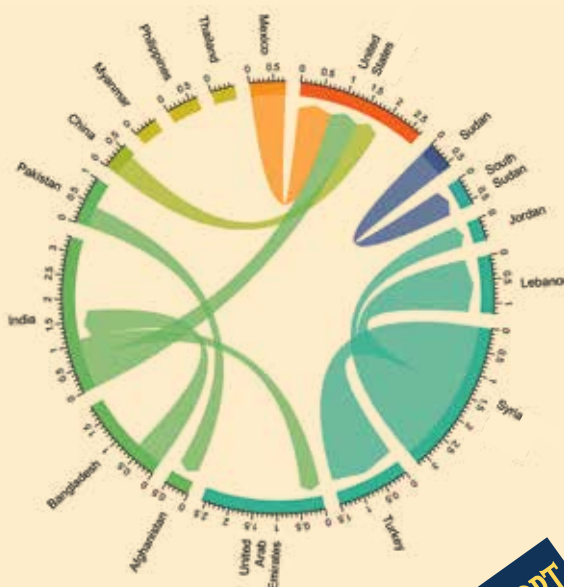
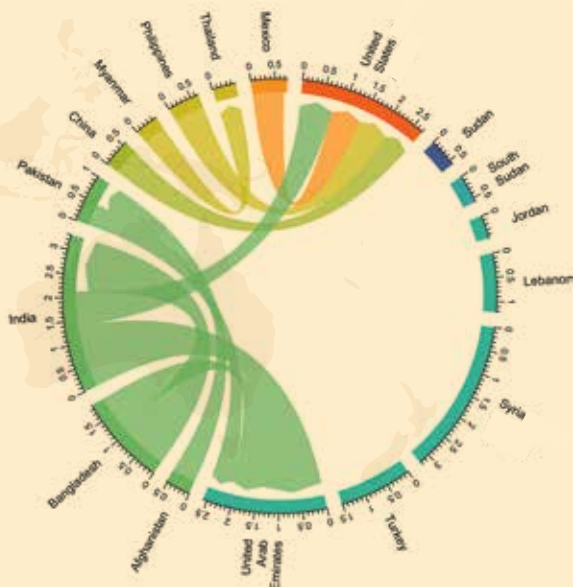
Source: World Bank.

# . . . but it can also be a challenge

Refugee crises in Syria and Sudan created four of the world's top 10 migration flows during 2010–15. Many refugees who fled from Afghanistan to Pakistan during 2005–10 were repatriated during 2010–15, resulting in a reverse flow.

Top 10 migration corridors, 2005-10 (number of migrants, millions)

Top 10 migration corridors, 2010-15 (number of migrants, millions)



Source: Data visualization and estimates by Guy J. Abel.

Note: Some countries lack data because they were not in the top 10, but are kept to show a comparison.



**68%** of all refugees in 2017 came from just five countries: Afghanistan, Myanmar, Somalia, South Sudan, and Syria.

**85%** of all refugees in 2017 fled to developing economies, including Iran, Lebanon, Pakistan, Turkey, and Uganda.



*Timothy Geithner, Zeti Akhtar Aziz, Andrew Metrick, and Agustin Carstens on the Yale University campus.*

# CRISIS ACADEMY

Veterans of the global financial crisis pass their wisdom on to the next generation

Chris Wellisz

It happened again and again in a career punctuated by upheavals: the peso crisis of 1994, the Asian crisis of 1997, and finally, the big one—the global financial crisis of 2008.

Each time he started a new government job, Timothy Geithner hoped to find a letter from his predecessor, explaining what to do and whom to call if things fell apart. The desk drawer was always empty.

“Financial crises are probably the most devastating economic events that can happen to a country,” says Geithner, who fought the last conflagration as president of the Federal Reserve Bank of New York and later US Treasury secretary. “I’d like our successors to have a better base of knowledge.”

So every summer, Geithner takes time off from his job as president of Warburg Pincus, a private equity firm, to help teach a two-week crisis management workshop for regulators from around the world. It’s one part of the Yale Program on Financial Stability, which also offers a master’s degree and is undertaking an ambitious project to create, on a very large scale, what Geithner never found in that desk drawer—a manual for crisis managers.

“A lot of times we’ve made the same mistakes in fighting financial crises over time simply because there was no body of knowledge that people had jointly studied and debated,” says Andrew Metrick, a professor of finance at Yale who founded and runs the program. “It’s almost like you show up at the emergency room and the doctor says, ‘It looks like a broken arm. I think I’ve seen someone once do something for a broken arm.’”

## Reviving housing

Metrick was one of those emergency room financial doctors. Six months after the collapse of Lehman Brothers in September 2008, he got a call from the Obama administration. They desperately needed a financial economist. So Metrick moved to Washington to work for the Council of Economic Advisers. There, as chief staff economist, he helped develop programs to revive housing and financial markets. When it came time to propose legislation, he discovered that academic research wasn’t very useful.

“There was no real great connection between academic knowledge, economic intuition, and



what we actually could put in the law because there just wasn't a good body of research there," Metrick says. "I was determined that when I came back to the academy I would try to be part of something that would help to fill that gap."

That was the genesis of the Yale Program on Financial Stability, which got off the ground in 2014 with donations from organizations including the Alfred P. Sloan Foundation. Geithner joined soon after, teaching, raising money, and chairing the advisory board, which includes former central bankers such as the Federal Reserve's Ben Bernanke, Mexico's Agustín Carstens, and Malaysia's Zeti Akhtar Aziz.

### Practical focus

Geithner brought a practical focus to what became known as the New Bagehot Crisis-Response Project, named for Walter Bagehot, a 19th century British economist and author of *Lombard Street: A Description of the Money Market*, a bible of sorts for the guardians of financial stability. The project's 14 researchers compile case studies of responses to the global financial crisis and the euro crisis that followed it. Eventually, they plan to study manias and panics going back to the South Sea Bubble in the 18th century.

## Their plan is to create an online tool that crisis managers can turn to in real time, in case they need to recapitalize a bank.

While the global crisis spawned countless books, articles, and memoirs, the Bagehot project seeks to analyze it in a systematic way—and determine what kinds of government actions worked, what kinds didn't, and why. The architects of crisis-fighting programs in various countries are consultants on the project.

"Our focus is really on the technical details of the interventions," Metrick says.

Their plan is to create an online tool that crisis managers can turn to in real time, in case they need to recapitalize a bank, say, or set up an emergency liquidity facility. They will also learn what to avoid, like Ireland's decision to guarantee the liabilities of its banks, which transformed a bank run into a far more serious sovereign debt crisis.

"Because the classic panic happens pretty rarely in the same country, even though it happens around the world with pretty appalling frequency, there's not actually that much institutional memory, and there certainly wasn't at the Treasury or the Fed, about how you deal with a systemic financial crisis," Geithner says in an interview.

### Learning from history

The summer symposium—Geithner calls it a "war college"—is a two-week workshop for central bankers and regulators. The central banks of China, Europe, Japan, and the United States have all sent participants, along with agencies like the Bank for International Settlements and the European Stability Mechanism.

Another piece of the Yale program is the two-day Financial Crisis Forum, where veterans including former Treasury Secretary Henry Paulson offer their insights on subjects from capital injections to frozen money markets.

"For the current generation of officials, especially the younger ones who attend the conference, learning from history is vital," says Paul Tucker, deputy governor of the Bank of England from 2009 to 2013. "Going forward, current officials also need to learn from the crises that, believe it or not, were averted or successfully contained."

Finally, there is Yale's one-year master's degree in systemic risk, which offers early career professionals a chance to hone their skills and develop new ones. A recent graduate is Özgü Özen Çavuşoğlu, who returned to her job in the financial stability division of Turkey's central bank and is now researching an early-warning system for the country's economy.

Just as important, she says, was the opportunity to forge bonds with colleagues from across the globe.

"We are living in an interconnected world," Özen Çavuşoğlu says. "That's why the network of people with the same understanding will play an important role in having a stable global economy." **FD**

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**CHRIS WELLISZ** is on the staff of *Finance & Development*.



PHOTO: ALAMY/MIALL CARSON

## Breathing Space

*Patrick Honohan explains how the IMF helped Ireland overcome its financial crisis*

Steve Dorst

**PATRICK HONOHAN** took over as governor of the Central Bank of Ireland in 2009, as the country's financial meltdown deepened. As one of Ireland's chief financial firefighters, he directed efforts to rescue the country's banks and had a leading role in negotiations on a lending program with the IMF, the European Central Bank, and the European Commission. Honohan retired from the central bank in 2015, when the country's recovery was well underway. He previously worked at the IMF and the World Bank and was economic advisor to Irish Prime Minister Garret FitzGerald. He has taught at the London School of Economics, University College Dublin, and Trinity College Dublin.

**F&D:** What were the origins of the crisis in Ireland?

**PH:** The economy became overindebted as part of a price bubble and the construction boom. And when the global economic turndown came—in fact a little bit before that—there was a general realization that the Irish construction sector was too big, the prices had moved too high, and there was a loss of international confidence. The construction boom stopped suddenly. Irish tax revenue, which had been heavily dependent on the construction boom, also collapsed, leaving a big hole in the government's accounts. And as the banks realized that many of their borrowers wouldn't be able to repay, especially the property developers and construction companies, they found difficulty also in financing themselves.

**F&D:** How quickly did the government react?

**PH:** The Irish government's reaction was quite prompt. Already in 2008, the minister for finance started to bring in the corrective measures—fiscal measures, tax increases, spending restraint. By 2009, the government had laid out a multiyear program of fiscal adjustment, which encouraged the markets. But during 2009, and especially in 2010, the markets' confidence in the adequacy of these measures fell away. The markets realized that the banking failures were going to cost the government enormous sums of money—the government had guaranteed all the liabilities of the banks—and that the underlying fiscal situation was also much weaker and was going to remain weak. So, by 2010, there was a loss of market confidence in the government's plan and its ability to turn things around.

**F&D:** When did the government realize that outside help would be needed?

**PH:** During the autumn of 2010, yields on Irish government securities in the secondary market rose and rose. The banks were unable to finance themselves. It was clear that something had to be done, or else the Irish economy as a whole would get into a kind of doom loop of higher financing costs and loss of access to the markets.

**F&D:** Was there any alternative to international assistance?

**PH:** If we had kept going on our own, trying to turn this around in the face of financial market turbulence and very high interest rates, it would surely have been more costly than going into the program where we had assurance for three years of adequate funding at what in the end was an adequate, sufficiently low interest charge.

**F&D:** What was the IMF's role in communications with the public?

**PH:** The IMF captured the confidence of the nation to a surprising extent. They spoke plainly, sensitively, and directly. And people said, "Ah, these guys are actually here to help us."

Something had to be done, or else the Irish economy as a whole would get into a kind of doom loop of higher financing costs and loss of access to the market.

**F&D:** Were there any areas of disagreement?

**PH:** I would like to have seen it start with lower interest rates. That was not possible at the time of negotiation, but it became possible seven or eight months later. I would have liked to see the banks strengthened by a direct infusion of capital or by some kind of insurance mechanism. But both the IMF team and the Europeans said this was impractical.

**F&D:** What was the Irish government's role in designing the recovery program?

**PH:** This was substantially an Irish government program. There was that tension between the lenders and borrowers as to how long the adjustment would take, but having set the amount of adjustment, it was the Irish government's decision as to how that adjustment was to be divided between tax increases and spending cuts. And then within

taxation, what taxes. And within spending, what spending adjustments.

**F&D:** How quickly did the economy recover?

**PH:** We saw no real pickup in employment or in economic activity until 2012. It was a very, very severe slowdown. And the employment loss was severe.

**F&D:** How did you explain the program to the public?

**PH:** The way I put it at the time, when speaking to the public, was that the IMF was going to provide protection for Ireland against the vagaries of the international financial markets, which were now asking very high interest rates for Ireland to borrow, and Ireland needed to borrow a lot of money to keep public services going. What was on offer gave the breathing space for the adjustment of the public finances, the economy generally, and the banking system to take place to an extent that by the end of 2013, three years later, we were able to stand on our own two feet, and so was the banking system.

**F&D:** How did the public react?

**PH:** I saw three waves of political attitude. Firstly, I think that a lot of people in Ireland had a sense that they were having a period of "too good to be true," that this was an inevitable adjustment, and a sense of "Oh, we should have realized that this was too good to be true." And that was succeeded by a different wave of political attitude, which was saying, "Somebody is to blame and it must be the banks, and it must be the developers, and it must be the government"—or some mixture of all three. Subsequently, after a couple of years, I think that shifted away towards a search for outside blame, blame to be placed on the European Union, on trends in globalization, on international financial markets. **FD**

**STEVE DORST** is a documentary producer who has created a series of videos about the IMF's work in Colombia, Ireland, and Vietnam.

*This interview has been edited for length and clarity.*

## Return of the Bond Vigilante

*Will markets coerce fiscal policy again?*

**Ramana Ramaswamy**



PHOTO: ONUR PINAR PHOTOGRAPHY

**BOND MARKET VIGILANTES** are a vanishing species. The label refers to bond traders who are averse to fiscal profligacy but also captures politicians who are wedded to small government. They wielded significant influence over global fiscal policy for two decades until 2008 but are feared no more. The bond market has been unable to assign risk premiums—higher yields—to countries with unsustainable fiscal policies in recent years. The customary political forces arrayed in support of small government have also fallen silent. The recent reticence of the fiscal hawks in the US Congress, for instance, has perplexed many.

What happened? Has the economic structure in advanced economies changed to accommodate a larger public debt than reckoned previously? Does the Republican support for fiscal expansion in a full-employment economy reflect political exigency, or is it an indicator of deeper changes in the economy? Will bond markets ever pressure governments again? Getting a handle on these questions is critical for both policy and markets.

It is no great revelation that quantitative easing (QE)—large-scale purchases of government bonds by central banks—fundamentally changed the relationship between debt and bond yields. Having a big new buyer of bonds invariably pushes yields down. What is less obvious is that the sensitivity of bond yields to inflation is much higher than their sensitivity to fiscal sustainability. And QE did not drive inflation up as quickly or as much over time as was envisaged initially. This combination of direct bond buying under QE, its failure to rev up inflation given the scale of the bond purchases, and bond yields' strong sensitivity to inflation proved a powerful cocktail in keeping bond yields low for years.

Low bond yields transformed the politics of debt and deficits radically. There is less crowding out of noninterest government spending when yields are low. That decreases pressure on politicians to make hard choices between competing spending objectives. There is simply less of a reason to antagonize anybody with spending curbs when there is more to go around. It gets close to a free lunch; railing against free lunches would be somewhat quixotic. The silence of the political forces favoring small government and balanced budgets reflects mainly this coexistence of high debt and low yields.

The reticence of small-government politicians could, presumably, also reflect a more sophisticated understanding of fiscal policy—that in demand-deficient economies where monetary policy cannot get traction, fiscal expansion is needed to prevent a deep contraction. I doubt, somehow, that this epiphany muffled the fiscal hawks. Persistent low yields are a more credible explanation for a shift in the politics of fiscal policy.

Changing perceptions about sovereign default are also at play. The Japanese and euro area experience with QE fundamentally changed how the market perceives default today. Japan and Italy have deeper challenges with debt sustainability than the United States. There are significant differences between

## Low bond yields transformed the politics of debt and deficits radically.

Italy and Japan, but essentially their debt is large, their growth is slower, and their populations are aging faster. That is an onerous combination for debt sustainability.

As in the United States, the stated objective of QE in Japan and the euro area is to push inflation higher. But its unintended effect—some might say its “unstated intent,” even though central banks deny it vehemently—has been to remove default premiums from the bond market. When a country with a debt ratio of 240 percent of GDP, as in Japan, manages to lock in 10-year bond yields close to zero, it makes it hard for bond markets to price default probability elsewhere. So, as QE becomes an integral part of the central bank toolkit, it fundamentally alters the market’s perception of default—and its capacity to price it. Fiscal profligacy imposes minimal costs on governments.

It is this factor—the inability of the bond market to price risk premiums—rather than changes in the structure of the economy that allowed higher debt with little collateral impairment. The political process simply gobbled up the free lunch. If anything, the structure of advanced economies may warrant lower debt levels today. Aging populations imply larger future spending on health and pensions, along with a lower capacity to grow.

The layering of QE on the strong disinflationary forces of technology, globalization, and labor’s weakened position neutered the bond vigilantes. While QE is being gradually withdrawn from a stronger US economy, it continues in both Japan and the euro area. With low inflation and the implicit fiscal support it offers, the bar to withdrawing QE in both places is high. A global bond market will therefore continue to feel the effects of QE despite its gradual withdrawal in the United States.

Inflation is key to resurrecting the bond vigilante. We don’t know quite how long the structural disinflation trend of the past two decades will last. It is unlikely to persist if globalization goes into retreat. We may be at one such inflection point as the backlash against free trade and the cross-border movement of labor gains traction. Policy could also force greater so-called onshoring of production

through tax incentives and could make it costly to rely on international supply chains.

If the disinflation trend morphs into inflation, it would force global QE withdrawal. And that would peel away the implicit fiscal support that has been an unstated but nevertheless powerful feature of QE. The entire chain of events that pushed the bond vigilantes close to extinction would reverse. Google searches would start spawning reports about the bond vigilante, and fiscal hawks would emerge from Congress’s woodwork. Governments would then feel the pinch, and it would profoundly transform the politics of fiscal policy. **FD**

**RAMANA RAMASWAMY** is a distinguished academic visitor at Queens’ College, Cambridge University.



# Finding Success

**ASSAF RAZIN'S** *Israel and the World Economy* shows that globalization can be a powerful force for economic progress in the case of a country with the institutions and policies to take advantage of the possibilities of an open economy. As depicted in this comprehensive and accessible book, Israel's strong growth since its stabilization from high inflation in 1985 owes much to an international economy in which capital, labor, and ideas are mobile and in which trade and investment flow readily across far-flung international borders.

Razin explains that where other countries have experienced problems with globalization, Israel has found success. Large capital inflows are understandably viewed as dangerous in emerging markets living with memories of recent currency crises: in Israel foreign capital provided crucial funding for investment in the country's showcase technology sector. Israel is now solidly established as a high-tech powerhouse—a place

Similarly, immigration is a hot-button issue in the United States and in some countries in Europe but a source of growth in Israel. This is because a massive influx of skilled immigrants from the former Soviet Union starting in 1989 led to a surge in productivity, propelling Israel to medium- to high-income status, capped by membership in

**Israel is now solidly established as a high-tech powerhouse.**

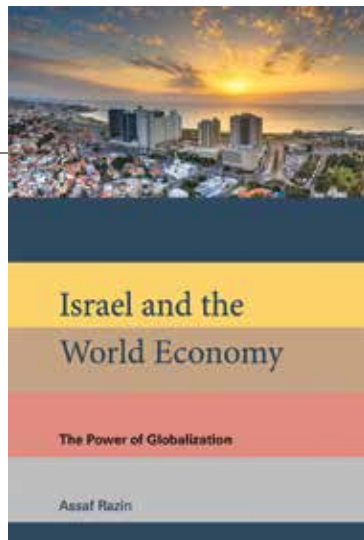
the Organisation for Economic Co-operation and Development in 2010. And Razin shows that this productivity boom translated into higher wages even for domestic workers who might otherwise have been harmed by the increased labor supply.

There is a sense in which this is three books in one. First, Razin explains the intuition and policy implications of a more globalized world across a range of topics, including migration, inequality, capital flows, currency crises, international trade, and more. The book then connects each topic to developments in the Israeli economy, portraying both successes and challenges in light of the underlying theory. Last, each chapter includes self-contained technical expositions of key models with which to analyze these economic phenomena, making this a text to be considered for a rigorous course on international economic policy.

It is not that Razin thinks Israel has done everything right—far from it. He covers rising inequality within Israeli society, the low participation rates and levels of skills among the fastest-growing segments of the population, the problem of brain drain as highly educated Israelis move abroad, and the costs associated with Israel's security challenges, including a chapter on the "Rising Cost of Occupation."

Still, even with Razin's frankness about the potential pitfalls, his book is an ode to the potential benefits of good economic policy, to economic models through which to examine policy, and to Israel's astonishing economic success. **FD**

**PHILLIP SWAGEL**, professor of international economic policy, University of Maryland



Assaf Razin  
**Israel and the World Economy**  
MIT Press, Cambridge, MA  
2018, 232 pp., \$40

where budding venture capitalists from emerging market countries flock to learn how to develop an innovation ecosystem. But the domestic market alone is far too small and homegrown capital formation insufficient to foster that innovation. Globalization has been essential.

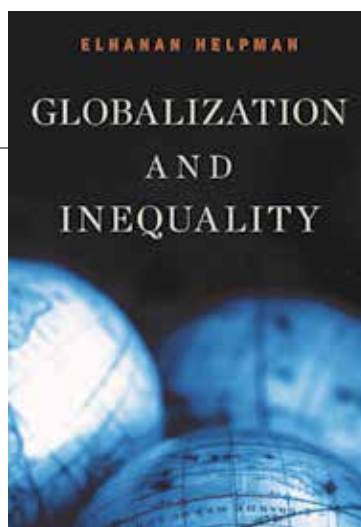
## Grounding the Debate

**THE RISE OF GLOBALIZATION** and income inequality are two defining trends of our time. Since the beginning of the 19th century, the volume of global trade has increased dramatically, and in the past few decades several firms have globalized their production processes through offshoring and outsourcing. At the same time, within-country inequality in income has risen substantially in several countries, and particularly in the United States. Are these trends linked? Indeed, the recent backlash against globalization and international trade is to some extent based on the presumption that they have caused job losses and higher income inequality.

Not so fast, argues Elhanan Helpman in *Globalization and Inequality*. Although globalization may have affected inequality through a variety of channels, the overwhelming finding of recent research, he argues, is that this impact has been quantitatively small, meaning that we have to look elsewhere for the chief culprit in rising inequality. Helpman develops this point in a highly readable book that traverses three decades of theoretical and empirical research on international trade.

### The available evidence does not support the view that globalization is to be blamed for the increase in inequality.

The book starts with a review of studies based on the factor proportions theory, the traditional lens economists use when thinking about the effects of globalization. According to this view, the progressive removal of barriers to international trade in developing economies has raised the price of goods whose production relies more on highly skilled labor, resulting in larger wage gaps between high- and low-skilled workers in rich countries. While this mechanism is plausible in theory, the empirical evidence suggests that the magnitude of



Elhanan Helpman  
**Globalization and Inequality**  
Harvard University Press, Cambridge, MA, 2018, 232 pp., \$26.95

the effect is rather small and that other subsidiary implications of the theory are not supported either.

In response to this failure, recent research has considered other mechanisms linking globalization and inequality. Helpman illustrates in a rigorous yet accessible way how the matching process between workers and firms, the survival and growth of different types of firms, and technological change may have been affected by international trade, therefore shaping inequality. The studies reviewed in this book are extremely rich and diverse in terms of theoretical sophistication, data, and empirical methodology—and their systematic categorization and discussion are perhaps the most valuable contribution of the book. Many of these lines of work are in their infancy, and Helpman acknowledges that conclusions are inevitably tentative at this point. However, the available evidence does not support the view that globalization is to be blamed for the increase in inequality.

The recent policy debate on the labor market consequences of international trade is ideological, vague, and ill-informed. In such an environment, economists have the important mission of disseminating key findings from rigorous research and helping to ground the debate on data and logical reasoning. This book, written by one of the most prominent globalization scholars, is one essential attempt in that direction. **FD**

**FEDERICO ROSSI**, assistant professor of economics, University of Warwick

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—Barry Eichengreen, University of California, Berkeley



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