WHILE making the move toward a market-oriented economy, the states of the former USSR must deal with the transitory adverse effects of reform measures on vulnerable groups. Social safety nets—a critical component of a reform program—rank among the most complex yet urgent tasks in the transition.

As the states of the former USSR struggle to establish a market-oriented economy, their first steps are marked by disquieting cuts in incomes and jobs—the results of a disruption in interstate trade and consequent reductions in output reinforced by reform-induced adverse effects. Even more disturbing are indications of reductions in real incomes of the existing poor groups and the emergence of new poor groups. Particularly vulnerable are families with workers earning minimum wages, pensioners, workers who are either unemployed or about to be unemployed, and children.

For market-oriented reforms to be politically viable, adverse impacts on vulnerable segments of society must be mitigated. The key issues, therefore, are whether the most vulnerable can be shielded during the transition period from an unacceptable decline in their living standards and how existing social protection arrangements can be reformed to help tide them over the transition period. While the socialist legacy provided for an overly generous level of benefits to some, these social protection arrangements cannot be sustained without destabilizing budgetary positions. Hence, reform requires designing cost-effective safety nets—from the range of existing social protection tools in these countries—to accommodate market and budgetary realities. The challenge ahead is not only of an economic but also of a political and social nature.

Social safety nets, in this instance, are instruments to help the poor avoid getting poorer as a result of reform measures. They are not necessarily permanent social security...
What Poland can teach

The Eastern European experience—particularly of Poland—can provide some useful lessons for the states of the former USSR. The Polish experience stresses the importance of:

**Ensuring that safety nets are an integral part of a reform program.** Large due to ease of access, the brunt of the reform-induced increases in social expenditures in Poland was borne by pensions and unemployment compensation, rather than by social assistance schemes targeted to the vulnerable. So far, reforms of social expenditures have largely assumed a reactive character, and measures have been taken when existing policies became unsustainable. This approach has been disruptive as policy measures were frequently perceived as revoking or eroding entitlements.

**Targeting social expenditures.** During 1989–92, a rationalization and targeting of subsidies helped to reduce budgetary outlays: overall subsidies—including, for example, subsidies for foodstuff, coal, housing, transport, and to private farmers—were cut by more than 10 percent of GDP. This reduction enabled the government to expand other social programs.

**Formulating an efficient unemployment compensation scheme.** During 1989–92, unemployment increased from virtually zero to close to 14 percent of the labor force, largely because of labor shedding. However, liberal eligibility criteria and attractive benefits also contributed to a surge in registration of new entrants (e.g., housewives and school leavers) as unemployed. This problem was addressed by introducing flat benefits and by limiting their duration, and by expanding emergency support programs for the long-term unemployed.

**Reforming pensions.** During 1989–92, pension expenditures increased from just over 8 percent of GDP to close to 15 percent of GDP, partly because the retirees were allowed to continue close to full-time work without loss of pension. Together with liberal disability provisions, this meant that the average retirement age dropped by about two years. While pensions for early retirees were somewhat limited by legislation in 1991–92, it has been generally difficult to reform pensions. This is mainly because the issue of pension reform has often been discussed in isolation from the general task of reforming the social safety net in a way that would provide adequate provisions for life-cycle and other contingencies.

**Adopting administratively simple benefits.** The Polish experience shows that the ratio of cash benefits to wages can be volatile, suggesting administrative difficulties in appropriately timing changes in cash benefits in an unstable financial environment. This points to having a simple benefit structure during the transition period.

Gerd Schwartz

Institutions, such as those in Western societies, typically aimed at addressing normal life-cycle and other contingencies (old age, unemployment, and sickness). Reform-induced changes in real incomes can dominate those arising from normal contingencies. Consequently, permanent social security institutions—although they need to be developed over time—may not be a realistic solution to addressing the transitory effects of reform policies.

**Impact of reform measures.**

Budgetary realities require that, inter alia, unsustainable public expenditures—for example, costly consumer subsidies and transfers to enterprises—be reduced. Besides helping establish a stable financial environment by reducing the budgetary deficit, reducing subsidies and transfers will allow increased public outlays on productive investments. There is a price to be paid, however. Reducing consumer subsidies implies an increase in consumer prices of major staples. Reducing transfers will inevitably force many enterprises—particularly inefficient ones—to cut back production and employment.

The implications of reform measures can be particularly severe in these economies because socialism and central planning had maintained grossly unrealistic relative prices. For example, in December 1991, just before the states instituted major price increases, the official price of a loaf of bread in Moscow was less than half of one US cent at the free market exchange rate, compared with nearly one dollar in the United States. This unrealistically low price was maintained through budgetary subsidies and implicit taxes on farmers who received artificially low prices and, hence, few incentives for production.

The need to institute market-oriented social protection, stressing the role of private initiatives and responsibilities, clashes with the tradition of social protection (e.g., guaranteed employment and small wage differentiation), which features government intervention at the expense of economic efficiency, making the reform difficult.

**Socialist legacy.**

All the states have inherited an elaborate system of social protection, which comprises food and nonfood consumer subsidies and cash benefits that include pensions, newly established unemployment compensation, sickness and maternity benefits, and family allowances that mitigate the cost of raising children. Expenditures on social protection are financed partly from the government budget (subsidies and some family allowances) and partly from payroll taxes, paid by employers (pensions, unemployment benefits, and maternity benefits). These benefits are channeled through the Pension Fund (family allowances and pensions), the Employment Fund (unemployment benefits and retraining allowances), and the Social Insurance Fund (sickness and maternity benefits).

Even excluding health and education expenditure, these benefits are extensive, often duplicative in their coverage, and, therefore, demand large budgetary resources. In addition, high payroll taxes have forced enterprises to raise prices, reduce wages, and curtail employment. For example, in Ukraine, these benefits accounted for about 30 percent of GDP in 1992, with almost one third financed through the government budget, of which more than half was subsidy expenditure. The combined payroll tax burden exceeded 50 percent of the wage bill.

**Consumer subsidies.** Consumer subsidies often have two components: budgetary, or explicit, subsidies that represent the difference between official producer and consumer prices and implicit subsidies, borne by producers—that represent the difference between market-determined and official producer prices.

These subsidies distort production and consumption patterns. For instance, low milk prices relative to meat prices in Kyrgyzstan at the end of 1992 prompted producers to slaughter cattle, with longer-term consequences for the supply of both milk and meat. A generalized subsidy for bread in Kyrgyzstan increased the consumption of bread during 1992 at the expense of other unsubsidized grain.
products. In most instances, subsidized goods and services are available to all, irrespective of any criteria of need. Since high-income households often consume more of these subsidized products than low-income households do, subsidies provide more benefits in absolute terms to high-income than to low-income households.

**Cash benefits.** Unlike consumer subsidies, cash benefits in general are targeted to vulnerable groups—pensions to the old and disabled; unemployment benefits to the unemployed; and family allowances to the very young. However, their eligibility criteria are generous, and benefit levels high, considering available financing.

In Ukraine, one of every four persons is a pensioner, imposing a heavy burden on the working population for payroll contributions amounting to 10 percent of GDP to cover the cost of pensions in 1992. In contrast, around 40 percent of the population in Kyrgyzstan is 16 years old or younger, imposing a heavy burden on the budget for financing family allowances of 4 percent of GDP in 1992.

Special pensions and low retirement ages—55 years for women and 60 years for men—have increased pension expenditures. Many pensioners continue to work on their pre-retirement job while drawing full pensions, creating inequities among working and nonworking pensioners. In 1992, in Armenia, the Russian Federation, and Ukraine, such pensioners accounted for some 25 percent of all pensioners.

Relatively generous unemployment benefits—in some cases combined with allowances for each dependent and including those for both first-time labor market entrants or reentrants—are potentially expensive and may not encourage unemployed workers to search for jobs actively. Sick leave and maternity benefits are in excess of international norms. In addition, workers often can obtain virtually free vouchers to visit vacation resorts.

The structure of family allowances is complex and duplicative with different rates for different age groups and categories (e.g., children in military families and of single mothers). There were 17 such allowances in Ukraine in mid-1992. Family allowances have generally not been limited to families considered poor, thus increasing resource requirements.

**Establishing safety nets**

Clearly, the level and coverage of benefits is financially unsustainable over the foreseeable future in these economies, especially where revenues have contracted sharply. The heavy reliance on bank credit in some countries to finance expenditures has only worsened the plight of vulnerable groups by fueling inflation, while the existing payroll taxes remain a heavy burden on enterprises. Imbalances are further increased in some cases as payroll tax bases shrink with the reductions in real wages, while real social benefits—at levels close to minimum requirements—cannot be reduced.

In view of these prospects, reform will inevitably entail streamlining some of the existing benefits. Indeed, fundamental reform of the existing system has become an urgent task for ensuring the medium- to long-term sustainability of the system and, more immediately, adequate protection during enterprise restructuring and price liberalization to those who need it most. Foreign financing of social safety nets could be considered, but should be aimed at covering only the transitory component of social expenditure needs that arise from reform measures. Stronger reform would inevitably increase the need for such financing during the transition, but should eliminate it in the long run.

**Target groups and targeting methods.** To be financially sustainable, benefits should be commensurate with available resources. To this end, benefits should be limited to families with low per capita incomes. In practice, however, targeting benefits on the basis of household incomes or assets poses difficulties in identifying eligible households. This is particularly so when incomes of the majority of households are clustered together around the poverty line—the income level that is used to distinguish the poor from the nonpoor. In such a situation, many of the officially designated nonpoor may not be significantly better off than the poor. Even if a mechanism to monitor household incomes is devised, these benefits can create work disincentives.

Administratively easier alternatives are targeting benefits to specific geographical regions or socioeconomic groups. For example, food subsidies could either be targeted to urban areas (usually food-deficit regions) or to certain easily identifiable vulnerable categories of the population (for example, elderly, children, and the unemployed).

**Assessing living standards**

The states are diverse in living standards and demographic profiles, although for all of them life expectancy is fairly long (Table 1). In 1991, per capita GNP ranged between $1,100 and $3,800. Since 1991, however, outputs and incomes have been declining. It is not easy to measure changes in living standards because, while formal sector activities have been declining, informal sector activities have been increasing. Snapshots as of June and December 1992 for two states indicate that the proportion of the minimum wage is used in purchasing three basic consumption items—bread, milk, and meat—ranged between 30 and 50 percent (Table 2).

It should be noted that typical households may also receive informal sector incomes, in-
kind wages, as well as family allowances and subsidies on heating, housing, and transportation. For example, in Kyrgyzstan, the real average wages are estimated to have declined drastically in the past few years. Statistical surveys, however, do not suggest significant reductions in the consumption of basic foodstuffs even for low-income groups. This could mean that households have reduced nonfood expenditures drastically. It could also reflect increased informal activity, such as weekend work on the family plot by urban dwellers and moonlighting by formal sector workers. It is thus essential to conduct periodic household expenditure surveys.

**Minimum consumption.** In targeting benefits, the concept of a minimum consumption requirement (for example, in calories) can play an important role. In most states, the “minimum consumption basket” covers a wide range of goods and services, extending sometimes to silk blouses, with excessive per capita consumption norms used in determining the basket compared with actual consumption patterns of low-income groups. What is needed is a narrowly defined basket containing a minimum set of basic necessities and services.

**Transfer instruments.** Social benefits could be provided either in cash or in kind. An intermediate instrument, such as coupons, could also be used. Cash is an efficient means because beneficiaries are free to use it in accordance with their specific needs. At the same time, cash payments require less administrative costs than in-kind transfers, say, distributing bread. Providing vulnerable households with cash, however, may be problematic. When food prices increase rapidly, the nominal amount of cash must be adjusted frequently. With the present difficulties in supply and transportation in a territory as vast as the Russian Federation and some other states, monitoring price developments in different regions is a difficult task. Providing cash may not achieve its objective unless the government ensures adequate supplies of the commodities. In-kind transfers of some items, such as milk and preventive health care through schools and health clinics, can be very effective.

**Reform options**

The exact mix of social safety nets for a country should depend on the type and sequencing of its economic reform policies, the socioeconomic and demographic composition of the poor, its administrative capacity, and financing availability. A number of general considerations must be taken into account in reforming subsidies and cash benefits.

**Consumer subsidies.** In the short run, two options are available with respect to subsidies. First, they could be eliminated altogether. This, however, will require at least partial compensation in the form of increased wages and cash benefits. Unless the financial policies are tight, higher wages can trigger a chain reaction of price increases and further wage increases. Second, subsidies may be retained for a few essential foodstuffs (e.g., bread) and selected services (e.g., heating) for a short period, and then gradually phased out. This latter approach has been followed by many states, but without much effort to improve targeting. The scope for financial savings, even in the short term, is immense if subsidies are targeted to the vulnerable groups with the objective of ensuring their minimum consumption.

**Cash benefits.** In the short term, the states need to restructure the eligibility, benefits, and duration of benefits along the following lines:

- For both the unemployed and pensioners, the average benefits should be modest. It may not be possible to set the average benefits far above the minimum benefits. Under the circumstances, and taking into account financial and administrative factors, a flat-rate (uniform) benefit structure may have to be adopted. This may appear inequitable, for it breaks the link to beneficiaries’ past earnings. But in the short term, there may not be any other alternative.
- Pensions for working pensioners should be limited.
- To induce active job search, the duration of unemployment benefits should be short. Chronically unemployed should be retrained or supported through public works programs and other social assistance mechanisms. New entrants and re-entrants should also be assisted in a similar manner.

- Family allowances should be simplified by instituting a flat allowance for all categories of children. The amounts for the second and third child could be lower than that for the first.
- User charges should be levied for the use of resort facilities for vacations.

Over time, two additional measures should be implemented. First, the official retirement age for both men and women should be raised. Second, a part of sick leave should be shifted to enterprises and the duration of maternity benefits reduced.

**Concluding remarks**

While the sustained reform process will eventually lead to positive gains, it is optimistic to suppose that all of these gains will arrive early on in the transition. Hence, social safety nets should be integrated into the economic reform program to mitigate the adverse transitory effects of reform on the poor. The states already have a range of social policy instruments. However, these instruments need to be streamlined to accommodate budgetary and market realities. This demands political and administrative skills, as well as patience.

**Table 2**

<table>
<thead>
<tr>
<th>Goods</th>
<th>Kyrgyzstan (as of December 1992)</th>
<th>Ukraine (as of June 1992)</th>
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<tbody>
<tr>
<td>Beef (1 kilogram)</td>
<td>97</td>
<td>80.1</td>
</tr>
<tr>
<td>Milk (1 liter)</td>
<td>18</td>
<td>16.0</td>
</tr>
<tr>
<td>Bread (1 kilogram)</td>
<td>14</td>
<td>3.0</td>
</tr>
<tr>
<td>Monthly minimum wage (rubles)</td>
<td>1600</td>
<td>900</td>
</tr>
<tr>
<td>Monthly cost of three items (rubles)</td>
<td>456</td>
<td>475</td>
</tr>
</tbody>
</table>

Source: Authors’ estimates based on data provided by government officials.
1 Latest available actual monthly consumption of low-income groups.
2 includes other meat products.
3 Includes other dairy products.

**Ke-young Chu**

from Korea, is Assistant Director in the IMF’s Fiscal Affairs Department. He holds a PhD from Columbia University.

**Sanjeev Gupta**

from India, is Deputy Division Chief in the IMF’s Fiscal Affairs Department. A graduate of Oxford and Simon Fraser Universities, he has previously worked in Germany and India.