

*INNOCENTI WORKING PAPERS*

*No. 91*

**POVERTY IN THE TRANSITION:  
SOCIAL EXPENDITURES AND  
THE WORKING-AGE POOR**

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United Nations Children's Fund  
Innocenti Research Centre  
Florence - Italy

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Social Expenditures and  
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***¾ March 2002 ¾***

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### ***Acknowledgements***

*This paper was written for the EBRD 10<sup>th</sup> anniversary conference, 13-14 December 2001. We thank the EBRD for financial support for the research. We are grateful to Simon Commander for suggestions and very useful comments on a draft, to Radha Seshagiri for valuable assistance, and to Asad Alam and Sergei Shatalov for advice. Gyula Nagy kindly provided information on labour market flows and institutions in Hungary. Helpful comments were made at the EBRD conference, at a University of Padova workshop, and at seminars in Syracuse and Cornell. In particular we thank discussants Richard Layard, Michael Mareese, Mario Nuti, and Ugo Trivellato.*

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*Cover design: Miller, Craig and Cocking, Oxfordshire – UK*

*Printed on recycled paper by: Tipografia Giuntina, Florence, Italy*

*ISSN: 1014-7837*

*Readers citing this document are asked to use the following form of words:*

**Klugman, Jeni, John Micklewright and Gerry Redmond (2002), ‘Poverty in the Transition: Social Expenditures and the Working-Age Poor’. Innocenti Working Paper No. 91. Florence: UNICEF Innocenti Research Centre.**

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## Abstract

A combination of economic growth and committed revenue-raising should give most governments in Central and Eastern Europe and the former Soviet Union considerable scope to devote increased resources to tackling poverty. We review the extent and nature of poverty across the transition countries, emphasising the phenomenon of the working-age poor. We consider governments' fiscal positions and revenue raising tools, including the issue of whether some countries now have levels of external debt servicing that are so high as to hamper social sector expenditures. We analyse whether the introduction of credible unemployment benefit schemes in the CIS would aid labour market reform and hence help solve the problem there of in-work poverty (we first review experience in Central and Eastern Europe). We focus on the case of Russia, and simulate a simple scheme with 2000 household survey data. The paper concludes by considering the role of improved wages for public service workers and the targeting of categorical benefits.

*Keywords:* transition, poverty, social expenditures

*JEL Classification:* H5, I3, P2

## 1. Introduction

Poverty remains a major problem in much of Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS). Whether measured in the narrow sense of low income or expenditure or in broader terms involving other dimensions of well-being, the existence of widespread poverty in the transition countries challenges both policy makers in the region and the international community outside.

Reducing poverty involves policies to stimulate economic growth and to ensure that its benefits extend firmly to the poor (through both 'pro-poor' growth and redistribution). In this paper we consider the role of public transfers and the taxes that fund them. Almost all economies in the region are now growing and a combination of further growth and, in some cases more committed revenue-raising, should give most governments considerable scope to devote resources to tackling disadvantage in the years ahead. Although we comment on the record of the 1990s and hence on how the current situation has come about, our focus is on the future not the past: what can be done from this point on to use tax and transfer policy to reduce poverty?

Our analysis is selective. We do not provide a comprehensive review of possibilities for action across the range of available instruments, and still less give detailed policy prescriptions for different countries. Rather we aim to explore issues in just a few selected areas of social spending. We do however cover both CEE countries and the CIS. Economic strength and institutional capacity differ both between and within these two groups of countries, and our analysis tries to take this heterogeneity into account.

Section 2 outlines the problem: how much poverty is there and who are the poor? We draw on data for more than 20 countries and compare the situation with that in the EU. The data show the main burden of poverty in both CEE and the CIS to be shouldered by *people of working age* and their families, the group that is the principal focus in the rest of the paper. This leads us to review poor households' access to education in the region, a key issue in combating long-term disadvantage in the labour market and the intergenerational transmission of poverty.

Section 3 looks at governments' room for manoeuvre in terms of their ability to spend on transfers in cash and kind. We consider the size of social expenditures, including those on education and health for which we provide benchmarks from low and middle income countries elsewhere. We then ask whether some transition countries now have levels of external debt servicing that are so high as to hamper social sector expenditures, an issue that has seen a lot of recent discussion in other parts of the world. Finally we consider whether the forms in which tax revenue is raised to finance spending are conducive to an objective of reducing poverty.

The next two sections focus on the issue of unemployment benefit. This is an obvious element of social spending in an environment of economic change. But CIS countries typically have little or no serious income support for the unemployed. One hypothesis is that the introduction of proper unemployment benefit would aid restructuring of CIS labour markets. This – some commentators contend – would liberate people from jobs paying poverty-level wages and hence, eventually, would lower poverty rates. Section 4 examines the arguments, including some of the lessons from the experience with unemployment benefit in the CEE countries. Section 5 illustrates the possibilities in Russia through use of 2000 household survey data to simulate the impact of an unemployment benefit scheme on poverty.

Even with a well-functioning unemployment benefit system that achieves the effect that its advocates seek – and Section 4 argues that those in CEE countries illustrate many problems – there will always be a need for some form of cash transfer to help working age households on low incomes, something true in both the CEE and CIS countries. Again using survey data (from Russia and Hungary), Section 6 discusses (and costs) the possibilities, ranging from better wages in the public service sector, through universal family allowances, to targeted support to low income households. Section 7 concludes, summarising our broad policy messages for the future.

## 2. A Picture of Poverty

At its trough, measured GDP per capita had fallen by a third on average in CEE relative to 1989 levels and by more than a half in the CIS. Despite growth in most countries in the second half of the 1990s, by the end of the decade income per head was still on average 13 per cent down in CEE and 45 per cent down in the CIS, with complete recovery only in Central Europe. Eight CIS members are currently classified as ‘low income countries’ by the World Bank with national annual income per head below \$755 at market rates.<sup>1</sup> At the other extreme, half a dozen CEE countries are in the ‘upper middle income’ band (\$3000 or more).

The national cake also became more unequally divided in the 1990s, especially in the CIS. The average Gini coefficient for household income per capita in CEE countries rose from 0.25 in the late 1980s to 0.30 in late 1990s and from 0.26 to 0.43 in the CIS (UNICEF 2001, Figure 2.1). These figures may be compared with an average for OECD countries of 0.31. By this yardstick, many CIS countries have become very unequal places indeed.

### ▪ 2.1 *How many poor people?*

Lower average income and more unequally distributed income have resulted in large numbers of people beneath conventional international benchmarks of absolute poverty: 50 million persons in households living on less than \$2.15 per person per day (in purchasing power parity terms) in the late 1990s, including nearly 18 million children, the great majority of them in the CIS.<sup>2</sup>

These figures for absolute poverty are perhaps most relevant to the international donor community deciding where to allocate its aid. But for national policy makers it is figures using national benchmarks that are more important and, especially, information on the characteristics of the people found below the poverty line.

Governments or statistical offices in many CEE/CIS countries calculate national poverty lines, often called ‘subsistence’ or ‘social’ minima. Obviously these do not give results that can easily be compared across countries. For this we need a common definition of the poverty threshold. Figure 2.1 shows the percentage of persons in the late 1990s living in households with expenditure beneath two conventional national benchmarks for poverty: half and two-thirds of the national median. This graph and Table 2.1 are based on the detailed analysis of poverty in 22 of the 27 countries in

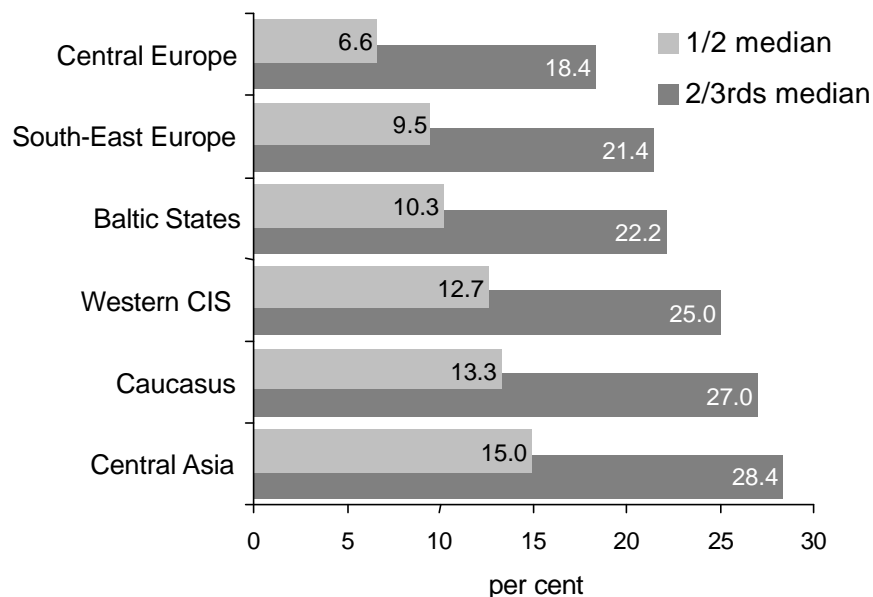
<sup>1</sup> The low income countries are Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kyrgyzstan, Tajikistan and Uzbekistan. See <http://www.worldbank.org/data/databytopic/class.htm>.

<sup>2</sup> This figure is obtained by applying the poverty rates given in World Bank (2000, Table 1.1) to population totals for each country, with estimates made for the few countries with no rates available. See UNICEF (2001, Table 2.1).



the region in the appendix of World Bank (2000), the most up-to-date source of comparable data that is available.<sup>3</sup>

Figure 2.1: *Poverty rates with median-based thresholds, late 1990s*



*Source:* World Bank (2000, Appendix D).

*Note:* The diagram shows percentages of persons living in households with equivalised household expenditure beneath half or two-thirds of the national median. Expenditures are equivalised by household size to the power 0.75. Figures for each sub-region are unweighted averages of the country rates (see UNICEF (2001) for sub-region definitions).

On average about 1 in 10 persons lived in households with expenditures beneath half the national median, a poverty line that is typically seen as a pretty modest one in the poverty literature and one far below many national subsistence or social minima in the transition countries. The figure varies substantially across the sub-regions: lowest in Central Europe and highest in Central Asia (reflecting differences in income inequality between these two groups of countries). There is also considerable variation within regions, not shown in the diagram. For example, within the Western CIS the rate varies from 6 per cent in Belarus to 19 per cent in Russia.<sup>4</sup>

These numbers may frequently seem ‘too low’. Is it really the case that as few as 14 per cent of the population in Moldova and 11 per cent in Tajikistan for example can be considered poor? These countries are in the World Bank’s ‘low income’ group where even average living standards are very modest. On the \$2.15 a day criterion, the poverty rates would be 55 per cent and 68 per cent respectively. But the relative line serves a different purpose: to measure

<sup>3</sup> Of course comparability is never anywhere near perfect but our focus on averages for sub-regions may help iron out differences.

<sup>4</sup> By contrast, the poverty rate based on the official Russian poverty line for the same year (1998) in the same household survey was 39 per cent (Mroz et al. 2001, Table 8).

poverty *conditional on* national average living standards. For policy makers deciding how to allocate scarce public resources, it is not much use to be advised that two-thirds or more of the national population is poor.

Figure 2.1 shows that the more generous threshold of two-thirds of the median typically doubles the poverty rate (almost tripling it in Central Europe) reflecting the fact that many households above the half-median line are not far above it. Likewise, if the line was drawn at a lower level the numbers would fall sharply (the World Bank source on which we draw also gives results for a threshold of one-third of the median).

It is important not to become fixated on the poverty *rate*, the so-called 'head count'. Whatever threshold is selected there will always be people just above it whose living standards are only slightly better and there will always be a distribution of people below it. As far as the latter is concerned, various formal measures have been proposed in the literature for assessing the depth of poverty. We do not use them here but it is clearly important to look beyond the headline poverty rate when assessing the impact of policy. For example, in our simulations in Sections 5 and 6, we show the percentage of the poor who gain from a policy reform (even if they are not lifted out of poverty entirely) and the average amount by which their consumption could increase. It is quite possible for the depth of poverty to be reduced significantly even if the headline rate shows little change.

We should make clear that our use of the World Bank relative poverty data does not imply that we believe a relative measure to be superior to an absolute one defined in the national context. A pure relative measure of poverty has the disadvantage that equi-proportional increases in expenditures (or income) leave poverty unchanged. This contradicts the view of the impact of evenly-shared economic growth on poverty in the transition countries that the great majority of people would subscribe to, i.e. that growth shared by all reduces poverty. Surely the expectation is that the resumption of growth would offset the deprivation that the 1990s have brought about? We agree, and in our simulations in this and later sections of the paper, we therefore hold fixed the (pre-simulation) relative poverty lines in nominal terms. Hence the relative line merely serves to distinguish in a consistent way those people who have the lowest income or expenditure in a country. Any policy reform that improves their income or expenditure will reduce their poverty, whether it partially fills their poverty gap or whether it actually pushes them up over the (fixed) line.<sup>5</sup>

<sup>5</sup> Atkinson and Micklewright (1992, chapter 7) discuss the choice of poverty lines in transition, including forms of indexation over time. See also Lanjouw (1997).

## ■ 2.2 Who are the poor?

How does the risk of poverty vary across the population and which groups make up the bulk of the poor? Table 2.1 shows poverty rates for different groups of people, expressed as a ratio to the overall rate. We distinguish between the CEE countries and the CIS and take the EU average as a Western benchmark.<sup>6</sup> Of course, there may be more suitable benchmarks for some countries, especially those in Central Asia where demographic composition is quite different (many more children and fewer elderly).<sup>7</sup>

Table 2.1: *Risk of poverty relative to the average*

	EU	CEE	CIS
<i>Age of individual:</i>			
0 to 15	1.27	1.37	1.09
16 to 64	0.87	0.85	0.92
65+	1.26	1.00	1.09
<i>Work status of household head:</i>			
Working	0.69	0.79	0.84
Unemployed	2.38	3.31	1.32
Retired	1.29	0.91	1.20
<i>Number of earners in household:</i>			
0	1.51	2.07	1.43
1	0.91	1.31	1.10
2+	0.59	0.55	0.84

*Source:* World Bank (2000, Appendix D) and Hagenaars et al. (1994, Appendix Tables A2.1 and A4.1, excluding Luxembourg).

*Note:* The poverty line is 50 per cent of the median in CEE and CIS countries (67 per cent in the Czech Republic) and 50 per cent of the mean in the EU (60 per cent in Denmark and the Netherlands). Expenditures are equivalised by household size to the power 0.75 in the EU and by the OECD scale in the EU. The youngest age group is 0-13 in the EU. The EU figures refer to the late 1980s.

<sup>6</sup> The EU figures refer to the late 1980s and (like those for the transition countries) are based on household expenditures (only income figures are published for more recent years). The equivalence scale is very close in practice to that behind the results we focus on from the World Bank study. The EU rates however are based on a half mean, rather than median, poverty line, a threshold that comes some way between half and two-thirds of the median. The average EU poverty rate is 15 per cent.

<sup>7</sup> The relative risk may be expected to vary between the CEE countries and the CIS (and within each group) in part merely because poverty is much more common in some countries than in others. The relative risk will also vary due just to differences in demographic composition. Ideally one might look at the relative risk of being in a group of fixed size across countries, e.g. below the bottom quintile. Comparable data providing this information are not available but we check the sensitivity of results to changing the threshold from half to two-thirds of the median. In the case of the Czech Republic we focus on the latter only since the overall half-median rate is so low: 2.8 per cent, compared to 10.8 per cent with the two-thirds line (and for the same reason we take a threshold of 60 per cent of the mean in Denmark and the Netherlands).

Poverty has a well-known relationship to the life-cycle in Western countries with a higher risk in childhood and in old-age. The EU figures in Table 2.1 show this clearly, with children and the elderly one and a quarter times more likely to be poor than the average person. The pattern is rather different in the transition countries: the elderly tend to do better. Only in the Western CIS – Belarus, Moldova, Russia and Ukraine – is the ratio of their rate to the average up at the EU level. In Central Europe, the Baltics and Central Asia the poverty risk of the elderly is actually lower than that of the average person. Only 1 in 8 of all poor people are aged 65 or over. Children, on the other hand, do better in relative terms in the CIS than in the EU and worse in CEE, especially in Central Europe where the figure is as high as 1.5.

This age profile of poverty is significantly affected by the method chosen to adjust for differences in household size (but very little by the chosen threshold, half or two-thirds median). The results from the World Bank study that we focus on embody only moderate economies of scale within the household – the elasticity of needs to household size is set at 0.75. If greater scale economies are assumed, small households move down the expenditure distribution and large households move up. With an elasticity of 0.5 (a figure often used in analyses of OECD countries), the elderly have a poverty risk one and a half times the average and the average ratio for children drops to 1.05. However, the average *share* of all poverty accounted for by those aged 65 and older is still less than a fifth.<sup>8</sup>

The lower poverty risk for the elderly in CEE/CIS compared to the EU is reflected in the results by head of household's work status: people in households where the head is retired in CEE have the same poverty rate as the average person while these households have a notably higher risk in the EU. The elderly are particularly advantaged in Central Europe where the ratio to the average risk is only 0.69, lower than that where the head works (0.78).

Unemployment is a well-established cause of poverty in industrialized countries, reflected in the relative risk in the EU when the head is unemployed of almost 2.4. Unemployment appears to have even graver consequences in CEE. The opposite seems to be the case in the CIS, which is surprising given the lack of unemployment benefit in this part of the region. This may reflect various factors, in particular supplementary incomes in the informal economy and more extended families (increasing the probability that an unemployed person lives with other people who work). It may also be due to the average risk of poverty being higher in the CIS, which in part is due to a higher risk when in wage employment (see below). If being employed

<sup>8</sup> The sensitivity of the relative risk by age to the equivalence scale applies of course to official poverty lines as well. The Russian government's subsistence minimum assumes a pensioner's needs to be 30 per cent less than those of a working age adult but a child's needs to be only 5 per cent less. The rights and wrongs of these assumptions can be debated, but the fact is that compared to a line that makes no adjustment for household composition, use of the official Russian subsistence minimum will lead to more children and less pensioners being deemed to be poor.

means less in terms of avoiding poverty, being unemployed means less relative to the average. We return in Section 4 to what this finding implies for the case in favour of introducing genuine unemployment benefit in the CIS.

Work (as measured by an employed or self-employed head) reduces the poverty risk throughout the region – but nowhere by as much as in the EU. The difference between CEE and the CIS is small but the gap widens if we focus on wage employment only, excluding the self-employed. With a household head in waged-employment, the poverty risk in CEE falls to 67 per cent of the average compared to 81 per cent in the CIS. With the wider definition (including self-employment), *half the poor are in households where the head is in work*, a figure that varies little between CEE and CIS.

If work does not pull a household out of poverty it must be because work is poorly paid, or because there are not enough people working in the household, or both. The bottom half of Table 2.1 sheds light on this. One earner in the household is sufficient in the EU to reduce the poverty risk to below average but this is not the case in either the CEE countries or the CIS. One reason for this is that both CEE and the CIS are characterised by widespread low pay. Taking a conventional threshold of two-thirds of median earnings, 22 per cent of full-time workers are low paid in CEE and as many as 31 per cent in the CIS, the results of a sharp widening in the distribution of earnings. This compares with a much lower incidence in the EU: only 11 per cent.<sup>9</sup>

Low pay is so common in the CIS that even with two or more earners in the household the poverty rate on average is still nearly 85 per cent of the overall rate, compared to about 60 per cent in the EU. On average, as many as half the poor in the CIS countries are in households where two or more people are earning income (compared to 30 per cent in the CEE). Only a quarter of the poor in the CEE and a third in the CIS are in households where nobody earns.

Another factor behind the situation in the CIS is the phenomenon of wage arrears. Russia is a well known example. In 1998, 64 per cent of Russian workers were owed wages by their employers; the situation had improved sharply by 2000 with the figure down to 30 per cent (Mroz et al. 2001) but the problem is clearly still a very serious one and is not restricted to wages – state benefits are often subject to serious delays.

It would be a gross exaggeration to say that the problem of poverty in CEE and the CIS is easily described. But the brief review we have given shows that most poverty is found in households of working age and that in many such households someone does actually work; these observations hold right across the region.

<sup>9</sup> Unweighted averages of figures for 10 CEE countries and 7 CIS countries in 1999 (UNICEF 2001, Figure 2.4) and 8 EU countries in the mid 1990s (OECD 1996, Table 3.2).

### ▪ *2.3 Poverty in the short and long-term: the role of education*

Reducing working-age poverty requires measures to tackle long-term disadvantage in the labour market as well as more short-term efforts to boost employment and to supplement incomes directly. The maintenance and development of educational systems is central to this task. The aim should be that poor children do not grow into poor uneducated adults, perpetuating poverty across the generations.

The educational record of the planned system was one to be proud of when compared with that of other countries at similar levels of economic development. True, various reforms were needed for a market economy (and some still are). But the inheritance of high enrolment rates and what was often high quality education should have been an important base from which to combat long-term disadvantage in the labour market.<sup>10</sup>

Sustained economic growth allows more resources in real terms to go into education and fuels demand for qualified labour, while the reverse is the case where economies have shrunk severely. Enrolment rates at the upper secondary level (age 15-18) have typically risen in Central Europe, while parts of South-East Europe and all of the CIS have seen falls (UNICEF 2001). On average, upper secondary enrolment rates in the CIS fell by a third over 1989-99.

The impact of change has not been randomly distributed. Some systematic survey findings and a lot of anecdotal evidence indicate children from poor households in the transition countries to have markedly less access to quality education. In the worst cases, the situation risks becoming akin to that in poor developing regions of the world where access is far from universal and quality tends to be low for many.

One factor affecting quality is public expenditures on education. Levels of state spending are discussed in Section 3 and are a concern in the low income CIS countries in particular. Households in many countries now face significant private costs and these of course bear most heavily on the poor. The result is either that poor households reduce consumption of other goods and services, or that their children are priced out of adequate educational provision. Charges faced by households include legal fees, especially at the tertiary and pre-school level, textbooks, 'complementary inputs' such as school clothes and shoes (a serious barrier for poor households in some CIS countries), and informal charges levied by teachers, schools and universities. The last of these is the most disturbing. There are numerous reports from

<sup>10</sup> Evidence from a range of CEE and CIS countries shows an increasingly healthy return to education in the region, both in terms of earnings and avoiding unemployment (although some public sector jobs requiring a lot of education and training are even more under-rewarded than before). See UNICEF (2001, chapter 4). Viewing its impact more broadly, education of course also helps determine various capabilities in the Sen sense other than economic well-being.

many CIS countries in particular of state schools and universities giving places to children whose parents make a substantial donation, of private tutoring of children by their own teachers, and of bribes to teachers and lecturers for good examination marks.<sup>11</sup>

Low (and late) salaries are presumably the main factor driving teachers to demand bribes. More than two-thirds of those employed in education in Russia in 1999, for example, had wages below the official subsistence level – compared to only a quarter in manufacturing (UNDP 2001, Annex Table 3-11). As these figures highlight, low public sector wages in education also have an immediate direct effect on poverty, as well as an indirect one through the demands some teachers then make of poor households to supplement their income. Quality in any case suffers when honest teachers devote less time to teaching and preparation while they struggle to make ends meet through second jobs, subsistence agriculture etc.

## ▪ ***2.4 Inequality and poverty***

We finish this section where it began, with the effect of inequality on poverty. We noted earlier that higher income inequality has been a major driver of poverty and here we try to give some feel for the relationship between the two in arithmetic terms.

What would be the effect on poverty rates if some combination of pro-poor growth and redistribution could reduce income differences appreciably in the coming years? (Note that we do not assume redistribution alone.) It is worth noting that current levels of income inequality in the transition countries are greatly resented by many people in the region. Opinion poll data from 1999 for six CEE countries and Russia show nearly two-thirds of people strongly agreeing that income differences are ‘too large’ in their country, which is twice the OECD figure (Suhrcke 2001, unweighted country averages).

We use the example of Russia, one of the transition countries with the greatest measured dispersion in incomes. The Gini coefficient of per capita income in the 2000 wave of the Russian Longitudinal Monitoring Survey (RLMS) was 0.43. We simulate reductions in this level of income inequality by changing each person’s income so that its new value is a weighted average of the recorded value and average income (the mean is therefore left unchanged), the weight being chosen so as to produce a change in the Gini of a given amount. We fix the poverty line as half the median of pre-simulation per capita income. (The focus on income rather than expenditure and the use of the per capita equivalence scale are not important to the results.)

<sup>11</sup> For example, focus groups of secondary school students and graduates interviewed by UNICEF in 2000 in Russia, Ukraine and Uzbekistan all mentioned this problem (these reports are available from [www.unicef-icdc.org](http://www.unicef-icdc.org)). See also social sector reports for different countries from the World Bank.

Imagine the Gini were to fall by a tenth. This would give Russia a level of income inequality below that of the USA (the per capita Gini in the US in 1997 was 0.41) but still well above the OECD average (0.31).<sup>12</sup> Table 2.2 shows poverty falling by a third, from 17 per cent to 11 per cent. With a 20 per cent fall in the Gini – to a level still above the OECD average – poverty falls by almost two-thirds to 6 per cent.

How does the impact of lower inequality compare with that of an across-the-board percentage increase in incomes, an increase experienced by all households rich and poor (i.e. equi-proportional growth)? This type of growth leaves the inequality of incomes unchanged. Growth of 20 per cent reduces poverty by nearly a third. A ten per cent increase in incomes reduces poverty by only 2 percentage points, although the nature of these simulations is that all the poor do gain something (although the reduction in the poverty gap is smaller the greater the depth of poverty).

Table 2.2: *Poverty rates in Russia, 2000 (per cent): the impact of growth and of reducing inequality*

Reduction in inequality	Growth in incomes		
	None	10 per cent	20 per cent
None	17	15	12
10 per cent	11	9	7
20 per cent	6	4	3

*Source:* RLMS round 9 microdata, per capita incomes (zero, negative and missing values excluded).

*Note:* The poverty line is fixed as half median pre-simulation income. Growth is simulated by increasing each person's income by the amount concerned. Reductions in inequality are simulated by changing each person's income so that its new value is a weighted average of the recorded value and average income, the weight being chosen so as to result in a change in the Gini coefficient of a given amount.

The message of the table is *not* that 'growth is less good for the poor than redistribution'. (Indeed, the pattern of growth is a key determinant of the distribution of income.) It is not surprising that the significant reductions in inequality simulated in the table have a larger impact on poverty; they involve big increases in income for people at the bottom of the income distribution (and big falls for persons at the top), much greater than those given by the across-the-board growth in incomes. Nevertheless, the table does illustrate the fact that in a country like Russia where income inequality is high, a significant reduction in income disparities would have a big impact on poverty (both the headcount and depth). Such a reduction could hardly happen overnight – and policy makers would be unwise to try to bring it

<sup>12</sup> US figure and OECD average calculated from microdata in the Luxembourg Income Study (OECD average based on 1990s data only).



about abruptly. But moving to substantially lower inequality over a period of say 10 years should be a feasible goal.

The best outcome of all, of course, is a big increase in incomes coupled with a significant reduction in their dispersion. A 30 per cent increase in incomes across-the-board coupled with a 30 per cent reduction in inequality – not shown in the table – eradicates poverty defined on the pre-simulation benchmark. (The fixed nature of the poverty line must be borne in mind – a large rise in average incomes should arguably lead to the poverty line being revised upwards.) Imagine a more modest ambition: a 20 per cent growth in incomes and a 20 per cent reduction of inequality, taking place say over six years (this implies income growth of little more than three per cent per year). Table 2.2 shows that poverty in Russia would fall to 3 per cent – the number of poor would be cut by some 20 million people, a major achievement. Without the reduction in inequality the six years of growth would only reduce poverty to 12 per cent. In countries where disparities in incomes are large it will be difficult to substantially increase the incomes of poor families in the short- to medium-term without some reduction in those income differences.

### 3. Financing Poverty Reduction

The state budget is a critical lever of poverty reduction, in both low income and advanced market economies alike. In this section we illustrate the potential for state spending and tax design in combating poverty in the transition countries. We examine trends in aggregate levels on both sides of the budget, allocations on the spending side, the increasing pressure imposed by debt servicing obligations, and the distributional implications of how revenue is raised.

#### ▪ **3.1 *Expenditure levels and patterns***

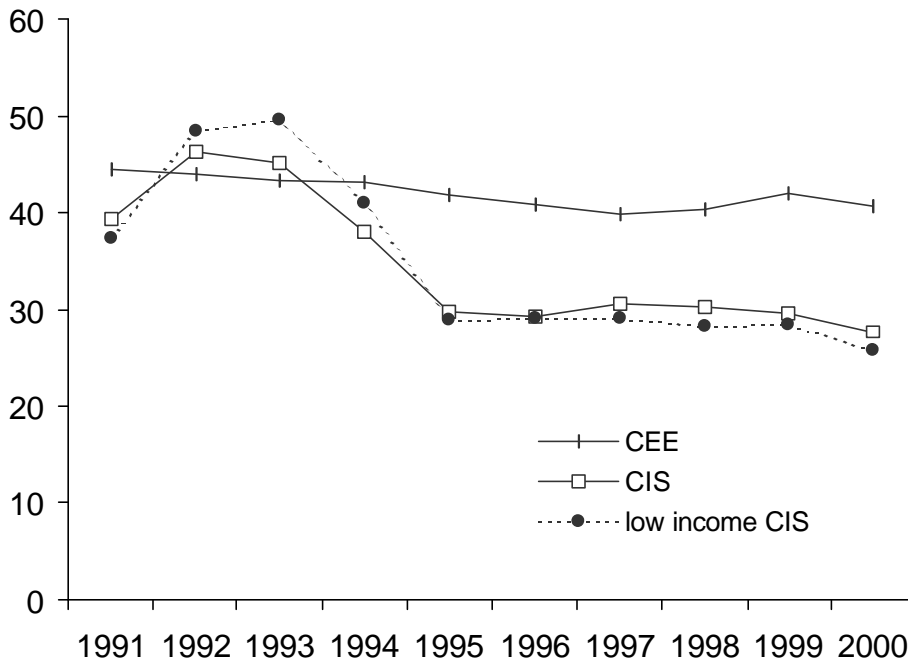
The major adjustment in expenditure levels associated with the transition in many countries is well known. The decline in government spending as a per cent of GDP over the 1990s was largest in the low income CIS countries with the average fall in the CEE being much more modest (Figure 3.1).

Even this conceals major falls in the real value of public expenditures given the large declines in output. In a number of countries the erosion in the level of state spending per capita was immense, for example, by an estimated 90 per cent in Tajikistan over the decade and by two-thirds in Ukraine.

For a subset, it has nonetheless been argued that spending as a share of GDP remains unsustainably high (see e.g. Alam and Sundberg 2001). Croatia topped the list in 1999 in the CEE (Bosnia-Herzegovina excepted) and Belarus in the CIS, both spending about half of national income. On the other hand, at least among those countries that have achieved significant economic restructuring and appear to be on a reasonable growth path, like Poland and

Estonia, a large role for the state may be consistent with domestic preferences for tax-financed redistribution via transfers and social services, as reported in surveys of public attitudes toward inequality – see Section 2.

Figure 3.1: *Government expenditure (as a % of GDP), 1991-2000*



*Source:* UNICEF TransMONEE 2001 (drawing on EBRD data) and EBRD Transition Report 2001.

Among some of the remaining countries, spending is arguably unsustainably low – or at least inconsistent with adequate investments in educational systems and other basic social services vital to the poor. Compare, say, Tajikistan with Zambia, a highly indebted country in Africa with a per capita income of about \$300 (at market exchange rates), similar to that in Tajikistan and its Central Asian neighbour Kyrgyzstan. In 1999, Zambia was directing about 2.5 per cent of GDP to education, and only half of all primary school-age children actually attended school. Even for those who do go to school, a recent national assessment concluded that the system yields pupils who can scarcely read or write (World Bank 2001a). In the same year, Tajikistan spent only 2.1 per cent of national income on education (also the average annual figure for the second half of the 1990s), suggesting that its historical record in terms of enrolment and learning achievement will be difficult to preserve. Indeed, enrolment rates at the upper secondary level more than halved in Tajikistan over 1989-99 (UNICEF 2001). The level of public expenditure is not the only factor affecting quantity and quality of education but it is certainly one influence.

Table 3.1 gives the average shares of GDP going to public expenditure on education, health and social protection (essentially cash benefits) across the region. Both CEE and the CIS averaged around 5 per cent both on education and on health at the start of the 1990s. While CEE has maintained average spending at this level, the CIS has seen some big falls. The average shares towards the end of the decade for the low income CIS group are still above those for low income countries worldwide but they vary considerably from country to country: Armenia and Georgia both spent only 1.8 per cent of GDP on education in 1997-8, and like Tajikistan were therefore well below the worldwide low income average, despite their having a far larger educational system to protect. (Georgia was even spending below one per cent in 1993-5.)

Table 3.1: *Public social spending as share of GDP (%), 1997-8*

	Education	Health	Social Protection
CEE	4.8	4.9	13.3
CIS	4.2	3.4	7.4
Low income CIS	3.8	2.7	5.5
Low income worldwide	3.2	1.2	n.a.
Middle income worldwide	4.6	2.6	n.a.

*Source:* CEE and CIS data for health and education from UNICEF (2001, Annex Tables 6.10 and 7.6, averages of 1997 and 1998 figures). Social protection data are for 1998 and are from IMF Government Financial Statistics (2001). Low and middle income worldwide figures taken from World Bank (2001d) World Development Indicators Table 4.10 p80.

*Note:* Social protection spending includes benefits for sickness, disability, unemployment, old age, and maternity, veterans and survivors' benefits and family and child allowances, and housing allowances.

In practice, declining government allocations have required larger contributions from households. As in much of the developing world, formal and informal payments for education are commonly demanded, a particular problem for the poor as noted in Section 2. The same applies to health. A senior government minister recently noted that household expenditure on education in Russia is estimated to be between \$2 and \$5 billion per year, compared to public expenditure of \$1.7 billion.<sup>13</sup> Looking ahead, given fiscal constraints, much of such 'user-fees' are likely to continue to be an important source of revenue in both the health and education sectors. But the informal payments will need to be formalised, and administered in order to take into account ability to pay so as not to exclude the poor. (One promising example of where this has been done is a textbook subsidy scheme in Uzbekistan.)

Countries that spend less on education and health also have lower spending on cash benefits. The low income CIS countries allocate less than half what CEE countries spend on social protection as a share of national

<sup>13</sup> Associated Press, Moscow, 29 August 2001.

income. Indeed, their lower expenditure on cash benefits is even more striking than that on education and health – social protection takes considerably more than education and health together in CEE, about the same in the CIS as a whole, and about a quarter less in the low income CIS countries.

Cash benefits are not always well targeted to poor households. In some cases one would not always expect them to be, for example pensions are paid on the basis of employment record and not current need. But the lack of targeting to the poor is also found for ‘last-resort’ social assistance. In Russia and Ukraine, only 6 per cent of social assistance spending went to the poorest fifth of the population in the mid-1990s, and the average across eight transition countries was 28 per cent, well below the 42 per cent for market economies (Milanovic 1998, Table 5.9). In Moldova, the poor comprise nearly half of the population on one definition, yet in 1997 they received less than a fifth of old age pensions and only a third of child allowances respectively. In Tajikistan in 1998 over half of eligible beneficiaries did not receive their pension, while only two out of ten families received the assistance payments to which they were entitled.

Social protection includes unemployment benefit but we delay discussion of expenditure under this heading until Section 4. We will see that formal unemployment benefit is nowhere a big item. Pension benefits, on the other hand, typically comprise about half of total social protection spending – this may be the reason that, as Section 2 notes, the elderly are not most at risk of poverty (hence thinking of robbing Peter to pay Paul may not be too helpful). The conventional approach to pension financing in the region, ‘pay-as-you-go’ funding from current social insurance contributions, came under considerable strain in the 1990s due to tax evasion and higher dependency ratios (on account of both demographic shifts and incentives for early retirement). Some countries have made progress toward fiscal sustainability on the pension front by raising retirement ages, decreasing the minimum pension benefit, or introducing multi-pillar pension schemes. Poland is widely regarded as successful in introducing complex pension reforms; Hungary and the Czech Republic also have undertaken effective reform packages.

Looking ahead, spending on social protection programmes should typically have a clear justification along poverty reduction lines. (Poverty reduction should be interpreted in a broad sense – we are certainly not advocating that all access to health and education be means-tested nor do we argue that social insurance pension systems be completely discontinued.) General price subsidies (such as in the energy sector) are typically both expensive and not well-targeted (World Bank 2000). Using means-tests to restrict eligibility for cash and near-cash benefits has obvious fiscal and equity attractions, and has frequently been recommended (for example by IMF staff, see Heller and Keller 2001). However the associated information

and administrative needs are substantial – and possibly insurmountable in many of the poorer countries in the region – and there is also the issue of the poverty-trap disincentive they create (see Section 6).

Comparing Figure 3.1 and Table 3.1, the question naturally arises as to what else governments are spending money on? Governments in even the low income CIS countries spend on average over a quarter of national income but their spending on education, health and social protection comes to only about a half of the total. This leaves some 10-15 per cent points of GDP on average to account for, and getting on for 20 points in the CEE. This includes repayment of debt (see below), and spending on public goods that one would not want to see squeezed. For example, rural transport infrastructure is of considerable benefit to the poor. But public goods aside, could some of these sizeable expenditures be diverted to reducing poverty?

A key item to consider here is the major subsidies that some countries pay to enterprises. IMF data show the total of subsidies to firms and transfers to households to average 40 per cent of all public spending in the CIS in 1999 and 56 per cent in CEE.<sup>14</sup> Some of this money no doubt keeps in jobs some people who would otherwise be unemployed so in this sense it performs the role of an unemployment benefit and could be seen as a ‘social expenditure’. (Some part of the subsidies however merely increase the incomes of enterprise managements.) But the argument can certainly be made that it would be better to get this money channelled towards the poor explicitly. Expenditure on formal unemployment benefit may be such a route and one that we explore in Sections 4 and 5.

### ■ **3.2 *The debt threat***

Evidence is mounting that a number of countries will face difficulties in servicing their external debt over the next decade, and that the fiscal burden of servicing external debt is large in relation to key expenditures that have direct linkages with the well-being of the poor, raising the possibility that these expenditures are being crowded out.<sup>15</sup> In Moldova in 1999, for example, public debt service obligations amounted to over one third of central government revenue. In Georgia, debt service represented a quarter of the state’s revenue in the same year, compared to a share going to education of just five per cent.<sup>16</sup>

Only a few countries had high external debts at the onset of the transition and these were concentrated in the CEE group. The early 1990s witnessed a

<sup>14</sup> IMF, *Government Financial Statistics 2001*.

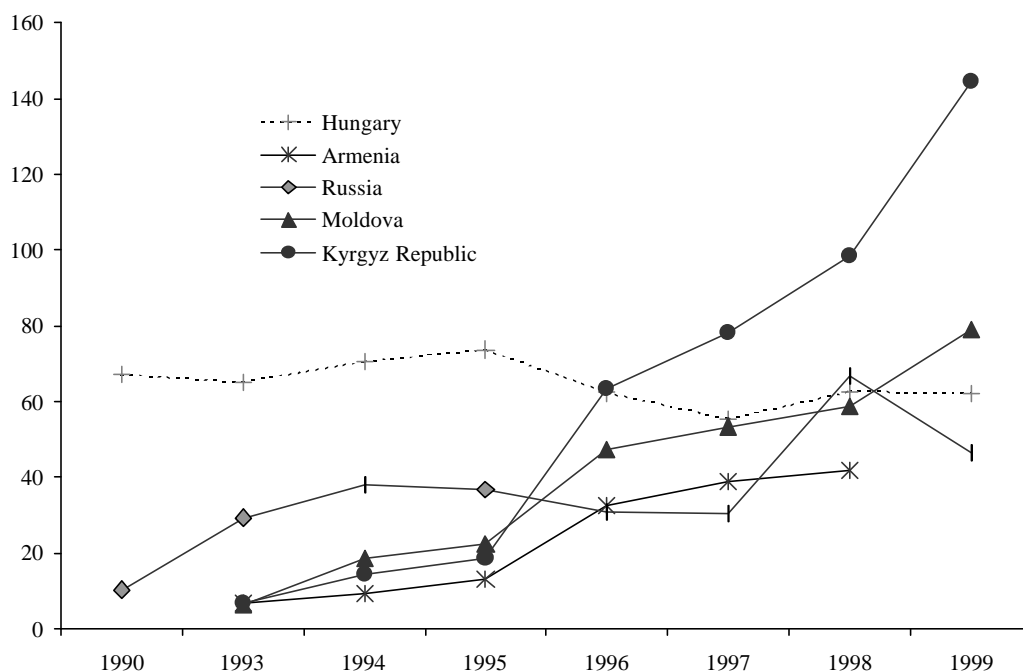
<sup>15</sup> We should recognise that debt servicing may in part relate to loans taken to support social expenditures (such as the World Bank’s \$800 million loan to Russia in 1997 for example). Hence in this sense debt and social protection can be directly complementary rather than debt being seen just as a dead hand on the poor.

<sup>16</sup> *World Development Indicators 2001*. The Georgia education spending figure refers to 1998.

number of national governments accumulating large stocks of external and publicly guaranteed debt as they sought to maintain spending levels despite significant declines in revenue and output. This was especially marked in low-income countries which had formerly benefited from transfers from Moscow (see below). By 1999, the regional picture of external debt had changed markedly, with total public (and publicly guaranteed) debt in some countries approaching the levels faced by the HIPC group of ‘Highly Indebted Poor Countries’ (most of which are in Africa and Central America), that are now applying for debt relief. This situation is partly due to the fact that stabilisation and adjustment programmes implemented in the early 1990s assumed growth and revenue projections that were too ambitious (a fact now recognized – see IMF and World Bank 2001). External debt denominated in hard currencies obviously worsened in the wake of the Russian financial crisis of 1998 and the associated exchange rate depreciations.

Ten countries in the region are currently classified as ‘moderately’ or ‘severely’ indebted by the World Bank: Hungary, Estonia, Russia, Moldova, Armenia, Georgia, and Turkmenistan (moderately), and Bosnia-Herzegovina, Bulgaria and Kyrgyzstan (severely). Trends in the stock of debt are depicted for five of them in Figure 3.2.

Figure 3.2: *External debt as per cent of GDP, 1990-99*



*Source:* World Bank (2001e), Global Development Finance 2001.

*Note:* The diagram shows the net present value of future repayment obligations (principal and interest, and taking into account the degree of concessionality of the loan).

To whom is the money owed? A large portion of the debt has been incurred to multilateral institutions, including the IMF, the World Bank and the Asian Development Bank. The ratio of concessional debt (loans with interest rates at below market rates) to total external debt is as high as 60 per cent (in Tajikistan), and exceeds 40 per cent in Bosnia, Kyrgyzstan, Georgia, Armenia and Albania. (The data in Figure 3.2 adjust for differences in concessionality.) But in retrospect it is clear that the financing terms in the early 1990s to support stabilisation and adjustment were insufficiently concessional.

Table 3.2 summarises levels of debt and debt service for the region as a whole. HIPC countries in 1999 spent one fifth of government revenue on debt service, whereas the CIS average (expressed relative to total spending rather than revenue) was almost one third. The low income CIS countries averaged 9 per cent of GDP in debt service, well ahead of their total spending on education and health shown in Table 3.1 of 6.5 per cent (and almost three times the level of the HPIC countries). Nor are debt problems and the implied squeeze on public spending restricted to the poorest countries in the region. Hungary entered the transition with a substantial amount of public debt (see Figure 3.2) and by the end of the 1990s had debt service obligations exceeding one-third of public spending and a massive 16 per cent of GDP. (Unlike Poland, for example, Hungary did not seek debt forgiveness and rescheduling in the early 1990s.) Russia's debt service figure of 3.6 per cent of GDP in 1999 was exactly equal to its public spending on education that year.

Table 3.2: *Annual debt service ratios, 1999 (per cent)*

	Annual Debt Service		
	to exports	to public spending	to GDP
HIPC countries	14	21	3
Low-income CIS	15	33	9
CIS	14	33	8
CEE	17	18	7

*Source:* World Bank (2001d), World Development Indicators, and World Bank HIPC website ([www.worldbank.org/hipc](http://www.worldbank.org/hipc)).

*Note:* Unweighted averages. The HIPC figures refer to data on the 22 decision point HIPC countries. The HIPC country figures for debt service are as a share of revenue, not spending.

Looking ahead to assess whether debt servicing will continue to constrain social sector spending is fraught with difficulty. Any judgement depends on predictions for the path of GDP and exports, future exchange rate movements, real interest rates and the state's likely ability to collect revenues. It is nonetheless useful to highlight the results of recent work by the World Bank

and IMF that considered the implications of alternative growth and fiscal scenarios in five low-income CIS countries (IMF and World Bank 2001). It is in these countries, rather than in the richer indebted countries, such as Hungary, where prospects on all fronts are least favourable.

One scenario assumed average annual growth in GDP of 4½ to 6½ per cent for 2000 to 2010, and better fiscal performance than to date. Under these conditions, the debt burden would improve after five years in every country that was considered except Kyrgyzstan. However, World Bank-Fund staff concluded that public expenditures would likely remain seriously constrained by debt service in all countries because the ability to raise additional revenues is limited. Under a scenario of lower average annual growth of 2 to 3 per cent, which is more in line with recent estimates (World Bank, 2001b), debt as a share of government revenue rises in excess of 250 per cent for all the countries, and to a remarkable 400 per cent for Georgia, Kyrgyzstan and Tajikistan.<sup>17</sup> Annual debt service would represent one half of government revenue for Moldova and Tajikistan and over two-thirds in Georgia. This outlook suggests that the salience of the debt issue will increase in the coming years.

Servicing external public debt involves both an internal transfer (between domestic households and firms, and the government), and an external transfer (between the debtor economy and the rest of the world). The distributive impact of the domestic transfer obviously depends on the incidence of taxes discussed in the rest of the section.

### ▪ ***3.3 Revenue trends and composition***

The transition has been associated with large negative shocks to government revenue, although their extent has varied across the region. In general this can be traced to the combined effects of recession and taxes premised on a planned economic system.<sup>18</sup> The end of the Soviet Union entailed the loss of large fiscal transfers from Moscow at the outset of transition for many of the CIS countries. For instance, both Uzbekistan and Kyrgyzstan lost transfers equivalent to about 18 per cent of GDP in 1991 (Alam and Sundberg 2001). Trends in overall expenditure shown earlier in Figure 3.1, and hence trends in social expenditures, have naturally been heavily influenced by these changes in revenues. The alarmingly low levels of social expenditure in some countries reflect in large part an inability to collect the money needed to finance spending.

Tax collection has been characterized by weak enforcement in many countries. Arguably the poor suffer more as a result than other groups given

<sup>17</sup> At the time of writing the World Bank forecast growth of 3.2 per cent for 2002 for the CIS, 3.5 per cent for 2003 and 2.6 per cent for 2004-2010 (World Bank 2001b, Table A1.4).

<sup>18</sup> See Cheasty and Davis (1996) on the causes of the revenue decline. Gray (1998) discusses under-use of energy revenue potential in the CIS and Baltic countries.



their greater reliance on state expenditures. Tax evasion is widespread, especially among firms and individuals in the informal sector. Bringing the grey economy into the tax net will require various reforms that reduce the incentives and ability of firms to escape tax.<sup>19</sup> Foregone revenues from ad hoc tax exemptions and offsets are pervasive. In Kyrgyzstan, the World Bank has estimated that exemptions amount to 5-7 per cent of GDP. Related to this is the serious revenue loss from non-payments for services. Russia is probably the worst example, since implicit subsidies to enterprises through arrears on utility payments are estimated at over 7 per cent of GDP over 1995-97, contributing to chronic revenue shortfalls as energy monopolies passed on revenue losses to the budget (Pinto et al. 2000).

But the transition has also been characterized by substantial shifts in the *composition* of revenue. While the feasible extent of redistribution via the revenue side of the budget may be limited, the prevailing tax mix in the region is important to note and it raises distributional concerns. We summarise these concerns below and then note the implications for poverty relief of the fiscal decentralisation that has often been extended to sub-national governments.

The major instruments being relied upon at the end of the 1990s included value-added tax (VAT), various trade taxes (excises, customs duties and, for example in the case of Azerbaijan, a levy on “strategic exports”), personal income tax (PIT) on individuals, and taxes on enterprises’ incomes.<sup>20</sup> In addition, in most countries, a major part of social expenditure – notably that on pensions – is still financed out of payroll taxes maintained in extra-budgetary funds: the share of central government revenue being collected via social security contributions in 1998, 30 per cent, was well above the world high income countries average of 20 per cent and the middle income countries figure of 12 per cent (but just below the average for EU countries of 32 per cent).<sup>21</sup> The incidence of these taxes is generally assumed to be borne by workers in the form of lower wages but it may also dampen labour demand. The already high level of payroll taxation is one reason for considering more

<sup>19</sup> Removing foreign exchange restrictions in Uzbekistan, for example, is likely the most effective measure to reduce informal sector transactions (Alam and Sundberg 2001).

<sup>20</sup> Previously, the tax system was organised in a fairly straightforward way, given the state plan and associated reporting, the dominance of the state sector in economic activity, and the processing of payments through the state bank. Most tax revenue was collected directly or indirectly from state enterprises, via three instruments – the turnover tax, the enterprise tax, and the payroll tax. See Tanzi and Tsibouris (1999), Ebril and Havrylyshyn (1999) and Martinez-Vazquez and McNab (2000) on the tax reforms in transition countries.

<sup>21</sup> *World Development Indicators 2001* (Table 4.13 p244). The EU figures are for the 11 countries that had joined the single currency by January 2001. Another way of looking at the importance of social security taxes is to consider their (legislated) level as percentage of the average wage: an average of 40 per cent in the transition countries compared to 32 per cent in the OECD and 21 per cent in Latin America ([www.worldbank.org/pensions](http://www.worldbank.org/pensions); data are mostly for 1995).

progressive forms of financing an expansion of social protection, for example increases in income taxes on high earners (see Sections 5 and 6).

The share of revenue collected through taxes on goods and services in the transition countries is sizeable: 40 per cent in 1998, compared to 28 per cent for high income countries. Taxes on incomes, profits and capital gains (of both individuals and enterprises) averaged 14 per cent, below the middle income country average of 17 per cent and exactly half the high income country level.

Some countries moved early with major tax reform with an eye to EU accession. On the other hand, until 2001, Russia had failed in its attempts to introduce a comprehensive tax code in the absence of broad-based support for reform (Martinez-Vasquez and McNab 2000). The recent tax reforms in Russia had the well known objectives of simplification, reducing the tax burden and broadening the tax base. Key elements included reduced and consolidated social fund contributions and sharp reduced turnover taxes. A flat-rate personal income tax (of 13 per cent) was introduced, reducing also the average rate, while the rate of taxation on profits was cut to 24 per cent (from 35 per cent for most enterprises) and exemptions eliminated. The flat-rate PIT is intended to reduce the incentive to evade tax and hence it is hoped revenue collection rates will increase. Against this argument is the loss of ability to redistribute via the tax system. For example, taxing universal cash benefits (as we propose in Section 6 for Russia) serves little purpose unless some people pay higher rates of income tax.

In general, there has been a shift from direct towards indirect taxes, and, within direct taxes, a reduced emphasis on firms relative to individuals. Taxation on consumption could be argued to hit the poor hard, since they consume a larger share of their income, whereas the tax-free allowance in a typical PIT means that many of the poor do not pay income tax. Available evidence suggests that progressive statutory PIT schedules are also progressive in reality: in 1999, the share of gross income paid in tax in the top decile of the income distribution in eight CEE countries averaged about three times that in the bottom decile.<sup>22</sup> For example, 20 per cent in the top decile and 6 per cent in the bottom decile in Lithuania. However, in some countries the progression was much less (e.g. the Czech Republic, Slovakia and Lithuania) and in others the tax take was so low that the fact it was progressive seems rather immaterial (e.g. Bulgaria). In practice, personal taxes are less progressive than the nominal structure would imply because of evasion as well as the mismatch between the rate structure and the actual distribution of gross income (as documented for example by Jarvis 1995 for Hungary, and Hassan 1998 for Bulgaria). It is also possible to meet equity objectives through design features of VAT – for example, turnover thresholds

<sup>22</sup> Information from household budget surveys, MONEE project database, UNICEF Innocenti Research Centre.

can be set which protect lower income people given they typically buy from small shops and traders. And essential goods can be zero-rated (e.g. some foods and selected medicines).

In contrast to a typical reform package that would cut personal income taxes in return for introducing or increasing VAT (as in Australia in the late 1990s and the UK in the early 1980s, for example), the relative importance of PIT in revenue concurrently rose in various transition countries during the 1990s, while the average revenue yield on corporate taxation steadily decreased. Current tax rates on enterprises are moderate and often below Western norms. For a sample of nine FSU countries (including Russia and Ukraine) for which trend data were available from the IMF, corporate tax revenue as share of national income fell on average, from 8.6 to 1.7 per cent between 1993 and 1998 (with some notable exceptions, like Uzbekistan, which managed to maintain the corporate tax take).<sup>23</sup> Some form of selective higher corporate taxation might be one way of recouping money from ‘robber barons’ who have been allowed to strip the public sector of its assets in Russia.<sup>24</sup>

The distributional implications of the revenue picture are complicated by changes in inter-governmental relations. In several countries expenditure responsibilities have been devolved to sub-national governments, as noted above. However, many central governments have been reluctant to give up commensurate control over revenues, and instead share revenues with provincial authorities, typically on a derivation basis, with the rates subject to annual re-negotiation. The proportion of local revenue coming from shared taxes exceeds 80 per cent in Estonia, Kazakhstan and Ukraine (Wetzel 2001). Tax sharing based on derivation – whereby a fixed share of the revenue raised in a local government’s geographic area is given to (or retained by) that local government – obviously hampers regional redistribution on the expenditure side of the budget. This has particular significance for social expenditures to combat poverty since responsibility for much of this spending – on education, on health and on social assistance – is often devolved to the local level. Transfers from central government may be inadequate to sustain local governments with weak revenue bases (see Stewart 2000 and Martinez-Vazquez and Boez 2001 on the case of Russia). If policy measures of the sort discussed in Sections 5 and 6 are to be successful, then a stronger system of centre-regional transfers may be necessary.

<sup>23</sup> Authors’ analysis based on published IMF staff reports.

<sup>24</sup> The example of windfall tax on profits of former nationalised industries in the UK may be worth mentioning in this respect, a tax instituted to finance a scheme to help young unemployed people into work (<http://www.ifs.org.uk/corptax/windfall.shtml>). Even re-nationalisation is another possibility in Russia. As Mario Nuti has put to us, alleviation of poverty could involve redistribution of wealth from robbers to law-abiding citizens as well as redistribution of income.

## 4. Poverty, Unemployment Benefit and Labour Market Restructuring

“[Country X] will announce new initiatives to strengthen the unemployment safety net in order to cushion the impact of corporate restructuring on the labour market.”  
(Financial Times, 19 June 2001)

Country X is Japan, a somewhat different case of transition. But the example is clear: industrialized countries look to unemployment benefit to facilitate economic change.

The huge fall in output in the CIS has been accommodated more through lower wages than through lower employment. Employment certainly has fallen sharply and unemployment on the ILO criteria of search and availability is substantial: 11-14 per cent in Russia, Ukraine, Moldova and Georgia for example.<sup>25</sup> But the reduction in employment has typically been much smaller than that in GDP. Whereas employment fell on average by 4 per cent more than GDP in the CEE countries over 1989-99, in the CIS employment fell by 35 per cent less than output.<sup>26</sup> This contrast is reflected in the higher proportion of low-paid jobs in the CIS (see Section 2). As Gimpelson (2001) argues in the case of Russia, the government implicitly agreed to restrain the decline in employment and the increase in unemployment as the price to be paid for reduced social and political conflict.

The CIS countries in general lack proper unemployment benefit schemes (or indeed, means tested social assistance schemes) that can act as a reliable safety net for people out of work. For example, only 1 in 8 of the (ILO) unemployed in the 2000 wave of the Russian Longitudinal Monitoring Survey (RLMS) reported receipt of any unemployment benefit. The question is whether genuine unemployment benefit would encourage layoffs by firms – and their acceptance by workers – allowing people in unproductive low-wage jobs to move (via a period of unemployment) to productive higher-wage jobs, thus lowering the overall poverty rate.

On one view, unemployment is such an evil that it needs to be avoided at all costs. This leads to the conclusion that CIS governments made the right choice in accepting widespread in-work poverty in order to keep down unemployment. We think this argument takes too static a view of the trade-off between unemployment and poverty. Part of the rationale for unemployment benefit – and hence unemployment – is that in time it may produce a substantial fall in poverty as a result of economic growth following labour market re-structuring. Of course, whether this occurs in practice is another

<sup>25</sup> ILO LABORSTA website (<http://laborsta.ilo.org>), 1999 rates.

<sup>26</sup> UNICEF (2001, Annex tables 10.1 and 10.6, unweighted averages). The employment changes are those in total employment as a per cent of the population aged 15-59.

matter but as it stands we feel the ‘avoid unemployment’ view risks missing the point.

We start by considering the CEE experience with unemployment benefits. Our aim is less to assess how much benefits have allowed labour market restructuring in the CEE countries (something that evidence is hardly conclusive on) and more to highlight a number of issues that would have to be faced in the CIS. We then turn to the CIS. How much of the problem of working-age poverty could unemployment benefit help solve, even in principle? Much of our empirical analysis focuses on Russia, which in many ways typifies the CIS experience. The focus on Russia continues in Section 5.

#### ▪ **4.1 *The CEE experience***

Overall poverty rates in CEE are certainly lower than in the CIS and work brings households a greater degree of insulation against poverty. But CEE poverty is not trivial and Section 2 showed that its burden is often borne by working-age people, including many with jobs. We noted there to be a great deal of low-wage employment in CEE, twice as much as the OECD average (although a lot less than in the CIS). Unemployment benefit has clearly not caused the phenomenon of the working poor to disappear in the more advanced transition countries – the first obvious lesson from the CEE experience.

We also showed that poverty rates are high relative to the average among the CEE unemployed. The argument that unemployment benefit could drive out low-wage jobs in the CIS is clearly one that focuses on wages in new jobs in relation to those in jobs lost, rather than on living standards during any interim unemployment. Nevertheless, the poverty rates among the unemployed in CEE are a salutary warning, especially when the expected duration of job loss is taken into account – more on this below.

Has unemployment benefit speeded restructuring in CEE and ensured that an even longer tail of low paid employment has not emerged? Vodopivec et al. (2001) conclude from a review of CEE unemployment benefit schemes that there is little concrete evidence one way or the other to take us beyond the crude observation at the start of this section of CIS and CEE differences. Echoing Blanchard (1997, pp.113-4), they argue that any positive impact on job destruction may be confounded by disincentive effects that benefits have on job creation by firms (via their effect on a wage floor) and on the behaviour of the unemployed.

Vodopivec et al. contrast Slovenia’s modest restructuring with the higher rate in Estonia and point to generous support to the unemployed in the former

compared to the meagre benefits in latter.<sup>27</sup> But *ceteris paribus* comparisons are clearly hard to achieve. Other institutional differences that should impact on the speed of restructuring need to be taken into account, for example employment protection laws. Rather more evidence exists on the search behaviour of the CEE unemployed. Several studies find that their probability of moving into jobs is in fact fairly inelastic with respect to marginal changes in benefits (levels or duration), as in the OECD.<sup>28</sup> However, this type of evidence does not really tell us much about the impact on the labour market of introducing a completely new scheme in a situation where nothing (or virtually nothing) was present before.

It is important to note that most labour market restructuring in CEE has involved direct job-to-job changes, something that obviously calls into question the importance of unemployment benefit as a restructuring tool. One corollary of this pattern of job changing has been a low turnover in the unemployed stock given the extent of reallocation of labour that has taken place. Although unemployment rose sharply in the first half of the 1990s in CEE this was the result of only modest inflows, coupled with very low outflows. Since 1995 the share of long-term unemployment (search for more than a year) has accounted for almost one-half of all unemployment.<sup>29</sup> This depressing situation is something that proponents of the 'avoid unemployment' view would (very reasonably) point to. The large number of exits from unemployment to inactivity would also be cited.

The structure of unemployment that has emerged in CEE is vital to understanding the coverage of unemployment benefit. Here we need to distinguish unemployment insurance (UI) from unemployment assistance (UA). The former provides benefit related typically to past earnings and linked to employment history, the latter pays benefit on the basis of a household income test. UI is almost invariably time-limited while UA is often not.<sup>30</sup>

<sup>27</sup> Nevertheless, the relative risk of poverty with an unemployed head of household in Slovenia shown in the World Bank study we draw on in Table 2.1 is slightly above the CEE average and not far below that in Estonia: 3.6 compared to 4.5.

<sup>28</sup> See for example Lubyova and Van Ours (1998) for Slovakia, Micklewright and Nagy (1999) for Hungary, Ham et al. (1998) for the Czech and Slovak Republics and the papers cited in Vodopivec et al. (2001).

<sup>29</sup> Figures for ILO unemployment for the 10 EU applicants from OECD-CCET Labour Market Database 1997 (excluding Estonia and Lithuania) and Eurostat (2001, p22).

<sup>30</sup> We also need to consider alternative payments that may be available to unemployed persons, for example, social assistance, disability and other pensions. These payments may come with or without a work test, and, in the case of pensions, with or without a means test. Their availability, and the conditions under which they are paid, will inevitably influence the labour force decisions of some people, either when they initially leave employment, or when their entitlement to time-limited UI payments expires. Certainly in Central Europe, there have been increases during the 1990s in the number of working age people in receipt of a pension. Presumably, in the absence of an adequate pension system, some of these people would be defined as unemployed.

Low outflow rates from unemployment, together with reductions in entitlement periods as governments cut support in the face of mounting costs, resulted in sharp reductions in the coverage by UI of the unemployed stock during the 1990s. By 1995, only half or less of the registered unemployed were receiving UI in Poland and Hungary and a quarter in Slovakia and Slovenia, compared to figures of around 75-80 per cent in 1991 (Micklewright and Nagy 1999). In Hungary, exhaustion of entitlement became the most common way for an entrant to the UI register to leave it, rather than exiting to a job! Entitlement is also eaten up by repeated spells of unemployment without sufficient time spent in work in between to generate new entitlement. As in OECD countries many people in CEE leave unemployment for unstable or short-term jobs and then return to the unemployment rolls; 40 per cent of men entering the UI register in Hungary in 1996 had been there at least once before in the 1990s and this figure had risen to 60 per cent by 2000.<sup>31</sup>

UA has picked up part of the slack and in several CEE countries it became more widely received than UI in the late 1990s. However, not all the unemployed receive one or other benefit. For example, a quarter of the ILO unemployed received UI in Hungary in 1998 and another quarter received UA, so about a half had no support at all. As few as only 15 per cent of ILO unemployed men had UI in the Czech Republic and Slovakia in 1994, while about a quarter and a half respectively had UA; in Slovenia the figures in 1995 were 45 per cent with UI and 12 per cent with UA (Bardasi et al. 2001).

Should we be indifferent to the mix of UI and UA from the point of view of labour market restructuring and poverty alleviation? UA often pays less on average but as Vroman (2001) points out, examples can be found in the OECD of both high cost UA (Australia) and low cost UI (USA). However, aggregate cost is an imperfect guide to likely poverty impact – here, targeting is important. For example, UA in Hungary has a simple per capita household income test, no tapering of the flat-rate benefit with rising income, and no additions for dependants – in short, a very crude scheme. Moreover, it imposes a disincentive to the labour supply of household members via the household means-test, creating a potential poverty trap.

One issue that has received little attention in CEE is the differences in financing and administration of the two types of benefit. UI is a national scheme, financed by payroll taxes or social insurance contributions and is typically administered by the local offices of a national organ. UA is typically administered and paid out by local governments, which either raises principal-agent problems or threatens horizontal equity. If payments are made with central government funds then local officials have little incentive to conserve the money. If locally raised revenue is used then administrations in

<sup>31</sup> Information provided by Gyula Nagy. Figures refer to the Spring inflow in each case.

poorer areas – exactly those where demand is greatest – are least able to finance the scheme and may be less likely to make awards. This is an example of the drawback with fiscal decentralisation mentioned in Section 3.

The Hungarian UA scheme provides an example. This is administered by local governments, three-quarters of which encompass fewer than two thousand inhabitants. Central government support is intended to help ensure adequate resources but maintain financial discipline: only half of benefit expenditure can be re-claimed from central funds. Encouragingly, a sample of decisions on UA claims in 1995 shows no evidence of any significant variation in the probability of an award with the level of local government revenue, controlling for other factors (Micklewright and Nagy 1999). Nonetheless, very small local authorities will always have limited capacity to judge claims and to facilitate adequate job search. As in other OECD countries, the problem of maintaining the contact of the long-term unemployed with the labour market is a serious one.

One such contact may be with the informal labour market. On the one hand this may be welcome, meaning that the unemployed are not lost from the world of work, with informal jobs acting as a stepping stone to formal employment (for evidence from Russia, see Guariglia and Kim 2001). On the other hand this leads to fears of ‘double-dipping’, where income from informal work is not declared to the benefit authorities.

Concern with benefit fraud may be one reason for instituting a work test of the ‘workfare’ type, with benefit paid only to those who have done, or say they are willing to do, public works. The idea is that the truly needy households will ‘self target’ as a result. The Hungarian UA scheme has now gone down this road. Since Summer 2000 a UA claimant must be prepared to work a month on a public works scheme before benefit is paid (although they may not be called upon to do so). Like UA itself the public work is administered by local governments. Evidence on the pattern of claims around the time of the change suggests that the introduction of this work test had a considerable impact: the number of claims dropped by about a quarter.<sup>32</sup>

Finally, what has been the cost of CEE unemployment benefit schemes? Table 4.1 shows expenditures as a per cent of GDP for two years, 1993 and 1998, in Central Europe, comparing them with EU and OECD countries. We standardise the figures for differences in the unemployment rate, expressing them as expenditures per 10 per cent points of (ILO) unemployment. (We are thus taking into account the impact on the spending totals of variation in the amount of unemployment.) Spending on benefits alone (‘passive policy’) in Central Europe is very modest by EU or OECD standards: only 0.55 per cent of GDP on average compared to three times this figure in the EU and nearly four times in the OECD as a whole. Note that expenditure on unemployment

<sup>32</sup> Information provided by Gyula Nagy. Some of the drop in claims may be due to the rather more stringent means-test and lower level of benefit that accompanied the change.



related benefits does not fully capture social expenditure on people who become unemployed. As noted earlier, some take early retirement, and others claim disability payments. In this sense, the expenditure figures for Central Europe are perhaps lower than they might otherwise be, had alternatives to unemployment payments such as disability pensions not existed (although our standardisation by the level of unemployment should be noted).

Table 4.1: *Expenditure on labour market policy as percentage of GDP per ten per cent unemployment*

	Total		Active		Passive	
	1993	1998	1993	1998	1993	1998
Central Europe	1.57	0.92	0.44	0.37	1.13	0.55
EU	3.39	2.83	1.06	1.08	2.34	1.75
OECD	3.79	3.23	1.18	1.23	2.61	2.00

Source: OECD *Employment Outlook* 2001, Table 1.5 p24 and Table A p208. Central Europe data are for Czech Republic, Hungary and Poland only.

Note: Passive expenditure represents expenditure on unemployment benefits (both UI and UA) and the administration of the employment service.

The difference between Central Europe and Western countries for ‘active policy’ (which includes the administration of the benefit system) is also large. And the reduction in generosity in the Central European benefit schemes in the 1990s noted earlier is clearly reflected in the figures (expenditure on active policy also declined, in this case in contrast to both the EU and the OECD).<sup>33</sup>

To summarise: CEE saw the rapid emergence of a large amount of long-term unemployment that time-limited UI is not well-equipped to cover. UA has come to play a major role (although many unemployed people receive no benefit at all) raising issues of equity and efficiency in finance and administration. Among those who do receive it, payment levels are generally low. All this helps explain why the CEE unemployed have a high risk of poverty relative to the average. On the positive side, unemployment benefit at the current Central European level is a relatively cheap policy.

## ▪ 4.2 *The CIS problem*

We now examine the case for unemployment benefit as an agent of labour market restructuring and poverty reduction in the CIS. Unemployment benefits do exist already in a number of CIS countries, but coverage is low as

<sup>33</sup> Vodopivec et al. (2001) cite levels of average benefit to average earnings in CEE countries of around 0.2-0.25 for 1999, down from about 0.3-0.35 in 1992, and argue that these are low by the standards of most OECD countries. (It is unclear whether these refer to just UI or not. The ratio of average UI to average wages was 26 per cent in Hungary in 1998 but that for average UI was only 16 per cent.)

the example of Russia, given at the start of the section, illustrates. Total expenditure on both active and passive labour market policy in 1999 came to just 0.3 per cent of GDP in Russia and 0.4 per cent in Ukraine. This is despite ILO unemployment rates of 12-13 per cent, implying that expenditure in these two countries was only one quarter to one third of that in Central European countries shown in Table 4.1. In Belarus, unemployment benefit recipients represented less than one per cent of the labour force in 1999, and little over 2 per cent in Kazakhstan. Kazakhstan has even abandoned the attempt to provide a national unemployment benefit scheme and local governments have been given responsibility to provide for the unemployed as they see fit.<sup>34</sup>

The argument in favour of proper unemployment benefit has been stated in broad terms at the beginning of the section but we need to see whether various conditions in the CIS are conducive to the hypothesised effect. Most of our empirical analysis applies to Russia, but the issues are generally relevant in other CIS countries as well.

The first issue is the current level of poverty among the unemployed. Section 2 showed the risk of poverty relative to the average risk to be much lower in the CIS than in the CEE (and the EU). Is unemployment benefit really needed in the CIS in these circumstances? We discussed in Section 2 the possible reasons for the pattern found – which include the impact on the average risk of the low wages that unemployment benefit would force up – but we have not quantified their importance. The effect of the extended family in supporting the living standards of the unemployed will vary from country to country, presumably being more important in Central Asia than it is in Russia or Ukraine for example. The insurance role played by the family is one reason why less developed countries in other parts of the world in general lack unemployment benefit and it could be argued that it makes formal income support for the unemployed a low priority in the lower income and more rural parts of the CIS.

The second question relates to the nature of low pay. Are the low-paid jobs all ones that we should be happy to see go, helped on the way by a wage floor set by a widely available unemployment benefit? The answer is clearly no. In particular there is a lot of low wage employment in public services – health, education, public administration etc. – services that the transition economies should be trying to retain. Sustaining the education sector should be a major plank in the fight against poverty. Some downsizing of employment in such public services is certainly needed (e.g. see UNICEF 2001) but not by as much as the extent of low pay that is found there.

Table 4.2 shows the situation in Russia, using the 2000 data from RLMS. About a third of employees are low paid on the conventional definition and 12 per cent are very low paid with wages less than one-third of the median in

<sup>34</sup> Information in this paragraph is from IMF (2000a, p76), IMF (2000b, pp15 and 106), IMF (2000c, p74) and IMF (2001, p29).

their region (regions here being a much wider definition than the individual oblast).<sup>35</sup> Low pay is most widespread in the public sector with the incidence reaching over 40 per cent among public service workers. Other sources appear to corroborate this picture – see the comment in Section 2 on the extent of subsistence-level pay in education in Russia compared to that in industry. Public service workers probably make up at least 1 in 5 of all the low paid (around 1 in 6 workers in RLMS do not report their occupation and the public service classification is narrowly defined as ‘professionals’ only).<sup>36</sup>

This leaves many low paid people elsewhere, including in the private sector where about 1 in 4 workers are low paid. (Even the foreign-owned sector exhibits a low-pay rate at the OECD average.) Taking into account the problems of classification, we can conclude that only about 40 per cent of the low paid (around 1 in 10 of all workers) are in public sector jobs that are *not* public service jobs. These are jobs that one might hope to see destroyed in a process of labour market restructuring that shifts workers from the public to the private sector.

Table 4.2: *Low pay in Russia, 2000*

	% all employees	% who are low paid	% who are very low paid	% with no pay
Wholly government owned	48.5	39.9	14.5	18.4
Public service workers	(13.3)	43.9	11.4	15.8
Private/joint venture	36.2	24.6	8.2	14.3
Foreign owned	(4.1)	15.0	3.5	7.3
Don't know/won't say	15.3	29.4	10.5	18.8
All employees	100.0	32.6	11.6	17.0

*Source:* RLMS microdata.

*Notes:* (1) ‘low paid’ is defined as earnings of less than 2/3 median earnings (46 per cent mean earnings); (2) ‘very low paid’ is defined as earnings less than 1/3 median earnings; (3) Public service workers in the government-owned sector are identified in the Annex; (4) the table is restricted to employees in current job who have worked in the last 30 days.

<sup>35</sup> Sampling methods and sizes mean that the RLMS is not ideally suited for regional analysis. In calculating regional median earnings, and below, regional poverty lines, we take the lead from Mroz et al. (2001), who divide Russia into eight regions: (1) Moscow – St Petersburg, (2) Northern and North Western, (3) Central and Central Black Earth, (4) Volga-Vaytski and Volga Basin, (5) North Caucasian, (6) Ural, (7) Western Siberian, (8) Eastern Siberian and Far Eastern.

<sup>36</sup> Total employment in public services broadly defined in other data totals 27 per cent of the workforce in Russia and 22 per cent in the CIS on average (CIS-STAT 2000-5). These are the totals of the employment shares in (a) housing and communal services and public utilities, (b) public health services, physical culture and social security, (c) education, culture and art, and (d) general administration. As such, the definition is probably wider than we would like.

These results for Russia seem likely to be not that unrepresentative of the situation elsewhere in the CIS in the case of public service workers. For example, average earnings in ‘education’ and ‘public health and social security’ in the CIS averaged 72 per cent and 61 per cent respectively of the all-sector average in 1999, compared to 58 per cent and 64 per cent in Russia (CIS-STAT 2000-5).

The next issue is the link with poverty. To what extent are the low paid also the poor? Table 4.3 shows the overlap between the two, again using RLMS 2000. (Our definition of poverty is as in Section 2, equivalised household expenditure beneath half the median, but here medians are calculated on a regional basis.) Only 1 in 5 of the low-paid are in fact in poverty. Even among the very low paid the poverty rate is only 26 per cent. The low paid also represent just 1 in 5 of all persons of working age who are poor, while the unemployed represent 1 in 4. And for every 20 poor persons of working age who are low paid there are another 13 who are employed but with earnings above the low pay cut-off. On the other hand, 15 per cent of persons who were employed were not paid in the month prior to interview (a third of these did not work). Many of this group could be considered low paid too in the broad sense. Clearly, however, the overlap between low pay and working-age poverty is far from complete. This shows that action to tackle the former is not going to solve entirely the problem of the latter.<sup>37</sup> We return to this issue in Section 6.

Table 4.3: *Poverty among working-age people in Russia, 2000*

	Incidence (%)		Concentration (%)	
	poverty rate	not in poverty	in poverty	all
<b>Not Employed</b>				
Not in the labour force	19.5	11.5	14.6	12.0
Unemployed not searching	22.4	13.1	19.9	14.2
Unemployed and searching	26.1	7.5	13.9	8.6
<b>Employed</b>				
Not worked in last month	13.3	5.3	4.3	5.1
Not paid in last month	21.7	9.4	13.6	10.0
Pay below regional median	25.5	5.0	9.0	5.7
Pay to of regional median	17.2	10.2	11.1	10.3
Pay above of regional median	6.3	36.9	13.0	33.1
Self-employed	8.3	1.0	0.5	1.0
<b>All</b>	<b>16.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

*Source:* RLMS microdata.

Note: The sample is all persons of working age. ‘Unemployed and searching’ is roughly equivalent to the ILO definition of unemployment. Persons are classified as self-employed only where they own more than 5 per cent of the enterprise in which they work (otherwise they are classified as employees). Poverty is defined as household expenditure, including the imputed value of consumption of home production, below half the national median (equivalising by household size to the power 0.75). The regions for the purpose of regional median earnings used to define low pay are the 8 main regions identified in RLMS.

<sup>37</sup> Nolan and Marx (1999) argue the same for the EU where the pattern of overlap is similar.

We now turn to the key issue of labour flows. As noted, real wage cuts have to a large extent replaced employment cuts in the CIS. On the one hand there has been a reluctance to downsize workforces. Broadman and Recanatini (2001) cite, among other things, a 'socialist' corporate culture as responsible in Russia – many enterprise managements have been unable, or unwilling, to restructure or to shed staff.<sup>38</sup> Other factors include labour law, although Boeri and Terrell (2002) argue that this is not in fact a major constraint to layoffs in Russia, citing a variety of evidence to support their view.

But this is not to say that labour turnover has been low. Turnover in Russia has in fact been high. There is a great deal of movement between jobs, as noted by various authors (e.g. Broadman and Recanatini 2001, Brown and Earle 2001). The 2000 EBRD *Transition Report* shows a turnover rate for Russia in 1998 of 17 per cent that exceeds those in Hungary and Poland of 13-14 per cent.<sup>39</sup> Many Russian employers have been unable to retain staff because of the poor wages and conditions they offer, and are therefore continually hiring new staff (Clarke 1999). The result is a mixture of 'low quality' labour mobility – workers moving from one low wage dead end job to another – and a high degree of immobility. We deal with each of these in turn.

Is 'low quality' mobility purely a public sector phenomenon? Table 4.4 suggests that this is far from being the case. (The table is not conclusive since we have information only on the current and not any previous job.) Nearly 1 in 5 public sector workers in 2000 had been in their current job for less than a year, compared with a quarter in the private sector. While a half of recent recruits in the public sector are low paid, the figure is also as high as a quarter in the private sector. What is needed is more job destruction and job creation, and not just labour 'churning'. Brown and Earle (2001) show that in most industrial sectors job creation accounts for only a small fraction of new hires in Russia, with an average for all sectors of only 13 per cent for large and medium-sized enterprises in 1994-99.

<sup>38</sup> Clarke (1999) refutes the suggestion that Russian enterprise managers are reluctant to fire employees, and argues that 'most were only too glad to devolve or close down their social and welfare facilities despite the fact that this entailed large scale loss of jobs.' (p.76)

<sup>39</sup> Percentage of workers that joined their employer in the previous 12 months (EBRD 2000, Table 5.4). Russia may be an outlier in the CIS with regard to levels of labour mobility. The CIS statistical office reports 'newly employed persons' in 1999 as being 16 per cent of total employment in Russia whereas the figure averages only 8 per cent for nine other CIS countries (CIS-STAT 2000-5).

Table 4.4: *Tenure, low pay and poverty in Russia, 2000*

Tenure in current job	% all employees	average earnings (% regional mean)	% who are low paid	% who are very low paid	% with no pay	% in poor households
<i>Wholly government owned</i>						
Less than one year	19.3	73	51.1	22.8	25.2	16.3
One to less than five years	31.1	76	39.9	17.9	18.4	14.3
Five years or more	49.6	86	36.0	9.7	15.7	13.9
Total	100.0	80	39.9	14.5	18.4	14.5
<i>Private/joint venture</i>						
Less than one year	24.5	119	27.2	8.9	21.3	8.9
One to less than five years	32.7	125	21.5	6.8	9.6	10.7
Five years or more	42.8	114	25.8	8.8	13.9	10.5
Total	100.0	127	24.6	8.2	14.3	10.2
All employees (including those where sector is not known)	100.0	100	32.6	11.6	17.0	13.6

*Source:* RLMS microdata.

*Note:* The table is restricted to employees in current job who have worked in the last 30 days.

Why do some workers appear to be immobile? Clark (1999) suggests that some older workers may prefer to serve out their careers with their present employer, first to build up pension rights (which are sometimes enhanced by dangerous or dirty work) and second, because they are afraid that if they leave their current job they will not find another. Friebel and Guriev (2000) propose an alternative argument that focuses on firms' rather than workers' behaviour. They posit that enterprises not only have an incentive to restrict the mobility of workers, but the means to do so. By paying workers in kind, they can prevent them from building up the resources necessary to be able to move to another region in search of alternative work.

Yet many commentators have argued that more labour mobility from declining to prosperous regions is precisely what is needed if Russia is to restructure. Regional disparities in the labour market are notable. Median wages by region in RLMS 2000 vary from 1.5 times the national figure in Moscow and St Petersburg to 0.71 in the North Caucasus and in Volga-Vaytski and the Volga Basin. Unemployment varies sharply. The coefficient of variation of the ILO unemployment rate across 88 Russian oblasts (or their equivalents) was 0.42 in 1999 (and 0.34 excluding Ingush in the North Caucasus). This may be compared with a figure of 0.27 across US states in the early 1980s when US unemployment approached 10 per cent (although

we must recognise that the US labour force has tended to be more mobile than most).<sup>40</sup> Regional variation in Russia reflects a variety of factors including the geographical specialisation of economic activity inherited from the Soviet period.

Restructuring the Russian labour market should clearly involve significant internal migration. There has certainly been significant migration, particularly from the Far Eastern and Arctic regions of the country (see e.g. IMF 2000a, World Bank 2001b). This has largely been driven by a collapse in state-run economies, and the lack of alternative economic possibilities in these inhospitable climates. Research by Brown (1997) shows a high level of migration in the early 1990s out of as well as into high wage areas and she argues that this reflects the importance of the ability to build up savings to finance a move. Many commentators have argued that the lack of a properly developed private housing market is a barrier to regional labour mobility in Russia. Clarke (1999) actually disputes some of the supposed constraints to moving. Rather, he argues that the high level of forced migration in the Soviet era meant that many people have good connections in distant places “which give them more opportunity for geographical mobility than most workers in established market economies” (p41). However, bureaucratic constraints on mobility are also an issue. Residence permits for some of Russia’s more prosperous cities (for example, Moscow) are not always easily acquired (although the rules are not always applied).

Despite all these complications there is clearly potential for an unemployment benefit scheme to remove some of the constraints on labour re-allocation. Enterprises would be unable to pay wages below the floor provided by the benefit level, and thus would have to restructure, retrenching some workers and raising the wages of others, or close down. Public services such as health care and education, which are currently overstuffed but where employees are poorly paid, could also rationalise their employment levels to some extent. And unemployed workers would be able to rely on a measure of financial support while they looked for alternative employment.

Is this what would actually happen if an unemployment benefit scheme were implemented? This depends on the level of benefits offered, coverage among the unemployed and the efficiency of administration. We return to these points in Section 5.

But any benefit scheme would clearly have limitations, even if we put aside such issues as the overlap of poverty with low pay. First, experience in the CEE countries suggests workers who are laid off are at high risk of long term unemployment. Some older workers will never find another job. This is

<sup>40</sup> Oblast unemployment rates for Russia taken from Broadman and Recanatini (2001, Table 4) and for US states from [www.bls.gov](http://www.bls.gov). If all the North Caucasus oblasts are excluded from the calculation the CV for Russia drops to 0.28. The North Caucasus is therefore both a high unemployment and low wage area.

clearly a political as well as an economic problem, and some imaginative solutions may be necessary. Second, while benefit may help subsidise job search costs for unemployed people, it will not overcome difficulties that they currently face in hearing about jobs – most vacancies are filled through word-of-mouth and within specific social networks, particularly family members of employees. The role of public media (including employment agencies) in connecting employers with searchers may have to be enhanced. Third, unemployment benefit may hasten job destruction and aid workers' search (including perhaps geographically) but it is unlikely to do much for job creation. Indeed, by setting a wage floor it should lower creation, *ceteris paribus*, as noted earlier in the section. The impact of an unemployment benefit scheme is therefore likely to depend on the state of the economy in general, contributing most during an upswing.

## 5. An Unemployment Benefit for Russia?

What might a workable unemployment benefit scheme in Russia look like in the light of the CEE (and OECD) experience and how much would it cost? We provide an illustration in this section with some simple simulations using the RLMS 2000 data.

### ▪ *5.1 The current Russian system*

As noted in Section 4, few of the unemployed in Russia receive any unemployment benefit. Why is the current scheme, a form of UI, ineffective? The answer is not entirely clear. Long durations of unemployment may be one reason but the method of finance, leading to low benefit levels, seems to be another.

The Russia UI scheme is locally financed and administered, and while in theory the scheme is financed by a payroll tax on local employers and topped up as needed from federal and local governments (Social Security Administration 1999), in practice, it appears to be paid for almost solely by the levy on employers. Regions with high unemployment and low activity have therefore few funds to distribute among a large number of individuals. Not only is the average level of benefits exceedingly low but payments arrears are substantial, averaging 9 months in March 1998 (Standing 1996, Grogan and Van den Berg 1999). Needless to say, long arrears for unemployment benefit run completely counter to the whole principle of providing income support during unemployment.

Reliance on UI is likely to be ineffective in terms of coverage, as with the 1990s experience of unemployment benefit in the CEE countries. A categorically targeted or means-tested UA scheme seems to offer more possibilities for supporting those in need. Yet a UA scheme would also be difficult to implement. We consider three issues that policymakers in the



region face in designing an effective UA scheme – the work test, the means test and national versus local schemes.

## ▪ ***5.2 Work test, means test and national v. local standards***

All unemployment benefit schemes require a work test designed to establish whether people are genuinely looking for work. It can also deter fraudulent claims by people who are already employed. One extreme form of work test is workfare, where the claimant is obliged to perform work in return for benefits. The recent experience in Hungary was noted earlier. Australia provides another example of a worktest: claimants moving to an area of higher unemployment (especially one with sand and surf) can be denied benefit for several months. Benefit is therefore tied to geographic mobility, in this case negatively. One possibility in Russia might be to provide a positive link, although this would clearly complicate the administration.

The Federal Employment Service (FES) is one obvious entity to administer a worktest, although we note that the workfare element of the Hungarian UA scheme is run by local governments. The FES is nationally organised with over 2,300 labour exchanges and 30,000 staff (IMF 2000a). It is currently responsible for registration of the unemployed, payment of unemployment benefit and activity to support job search. However, there are two caveats. First, if only those who are currently unemployed claimed a new UA benefit (even without any acceleration in lay-offs), the FES's workload would increase at least six-fold. (Not only do the majority of the ILO unemployed fail to receive benefit but the vast bulk are not even registered as unemployed either.) Expansion in staffing with associated training costs would be inevitable because despite the large numbers just cited the FES is arguably understaffed.<sup>41</sup> Second, the FES has a poor reputation among both employers and the unemployed alike (not an uncommon complaint about state employment services) and efforts to reform it have been made before.<sup>42</sup> The FES would have to substantially improve its service to both client groups (e.g. see Clarke 1999, Grogan and Van den Berg 1999).

Means-tested transfers that provide wide coverage to target groups have proved difficult to implement in Russia (as in the rest of the CIS). One reason is that social assistance functions in Russia (both funding and delivery) have been devolved to regional and local authorities. Regional equalisation

<sup>41</sup> There are about 2400 persons in the Russian labour force per FES employee (the 30,000 FES staff in this calculation do not include the 5,000 persons engaged on collecting payroll tax (IMF 2000a, p77)). This may be compared with a figure of between 1300 to 1800 in Hungary, Poland, the Czech Republic and Slovakia in 1993 (Boeri 1996, Table 3) and about 900 in the UK (OECD 1992, Table 3.1). The number of offices compares more favourably. For example the UK has about 25,000 persons per office compared to 31,000 in Russia.

<sup>42</sup> For example, the FES was the subject in 1992 of what was only the second World Bank loan made to Russia.

mechanisms negotiated between federal and regional authorities have proved inadequate (see Section 3), and local programmes (as well as Federal programmes that are locally administered, such as child allowance) have varied greatly among the regions, with better off regions providing better payments and services (Alexandrova and Braithwaite 2000).<sup>43</sup>

This suggests that an equitable and uniform means-tested UA scheme would have to be federally funded, with federal guidance and rules to ensure equity. The reasonably fair implementation of UA by local authorities in Hungary discussed earlier in this section perhaps gives hope. But the principal-agent problems will be far larger in an ethnically diverse and vast country like Russia. Gimpelson et al. (2000) argue that regional authorities use Federal funding to expand public employment in order to buy votes prior to elections and to redistribute to ethnic minorities. There is a danger that Federal funding for locally administered UA could be used in a similar fashion.

Administration costs associated with means-testing can be substantial. The evidence in Russia is quite mixed. Experimental social protection schemes in three oblasts in the late 1990s showed estimated costs ranging from 6 to 13 per cent of the total value of benefits disbursed which does not seem too bad (Smirnov 2000). On the other hand, Mikhalev (1997) reports on a scheme in the city of Krasnoyarsk where the value of benefits disbursed amounted to only 20 per cent of total programme costs. While administration costs should fall in the long run, it seems prudent to expect that they would add significantly to the overall costs of a UA program.

Is a national and uniform UA scheme the most appropriate in the Russian context? If effectively administered, it would ensure equity between individuals and regions. On the other hand the cost of living varies considerably across the country so some regional differentiation in benefit levels might well be sensible. In this way the wage floor set by unemployment benefit would be broadly the same across regions in real terms. People in low wage areas would have an incentive to move to high wage areas (which clearly only makes sense if labour demand is highest where wages are highest). Further variation could be introduced if the aim was to limit the amount of job destruction in low (real) wage areas. The UA scheme that we model below is a national one, but with rates which vary according to median earnings in different regions. Thus, benefit is higher in Moscow than in Volgograd for example.

<sup>43</sup> This is because nearly all programmes rely on an element of local funding. Hence in poorer regions, which cannot afford their contribution to programme costs, benefit payments are often not made. See also Section 6.

### ▪ *5.3 Modelling a UA scheme*

We use the 2000 RLMS data to model replacing the current UI system with a simple UA scheme. We show its first round effect on poverty and the incentives it would give to quit into unemployment. We show how the costs of the scheme could be met. We stress this is an illustrative exercise and to take it at all seriously one probably has to assume that other labour market institutions change too, including the administrative ability of the FES, employment protection law, and the incidence of non-wage benefits in work. We deal explicitly with regional mobility later.

We assume a flat-rate benefit equal to one third of regional median cash earnings, our definition earlier of ‘very low pay’, given to all households containing unemployed persons of working age that have total net per capita cash earnings and publicly provided benefits and pensions below the benefit level. This is a very crude form of UA, though the approach is similar to the Hungarian scheme described earlier. As in that scheme, there is a large discontinuity in the household budget constraint at the benefit level (since there is no taper in the benefit amount as the threshold approaches). The per capita income test favours large households. Unlike in a standard unemployment benefit scheme we assume no sanction for voluntary quitting – the idea is to encourage quits from low wage jobs. We assume this UA is only available to unemployed persons aged between 21 and retirement age (55 for women, 60 for men) who are seeking work and who have a work record: they must have been employed at some point during the 24 months prior to claim. Benefit can only be claimed for a total of two years. The income test is restricted to formal sources of income simply because that is all we can assume that the benefit authorities could reasonably observe.

As in Table 4.3, our definition of unemployment includes two types – the ‘ILO unemployed’ and other unemployed. We include all those reporting that they are ‘unemployed’ (for whatever reason) as well as unemployed people who report search and availability for work (the ILO definition). We assume that if an effective UA scheme were to be introduced, a large number of people would then begin a more active search if this were to be a condition of benefit receipt. Among those who are unemployed according to our definition, six in every ten are either aged under 21, or have no employment record, or have not been employed in the previous 24 months. (These include many people who are unemployed on the ILO definition.) We exclude all these people from UA eligibility, resulting in a total of 7.5 per cent of the labour force who are eligible to claim UA. The UA means-test then denies benefit to about half of these people. Therefore fewer than 1 in 25 of the labour force initially qualifies for a UA payment.

The first column of Table 5.1 shows the results of introducing such a scheme on poverty levels and on incentives to work. The base-line position is a working-age poverty rate of 17.1 per cent among those living in households

with persons of working age.<sup>44</sup> The direct impact (assuming no change in anyone's behaviour) is to reduce this headcount by less than one percentage point. This may seem a fairly modest impact but it is the case that household income rises for nearly 1 in 6 people in poor working-age households. That is, their poverty gap is partially filled. If one were to equate their gains to a typical person's monthly food expenditure in the bottom half of the distribution, then households that received UA would on average be able to feed one extra person. In total, one third of UA expenditure goes to households below the poverty line.

Cost? We estimate an additional marginal tax would be needed on higher income households at the rate of 2.8 per cent of all formal cash incomes above the median. This includes administrative costs of UA (assumed equal to one fifth of total payments) but excludes fixed set-up costs associated with expansion of the Federal Employment Service for example. Of course, in practice the cost might be borne by additional taxes on the corporate sector rather than the household sector, and the introduction of a higher rate band would return the Russian PIT to the type of progressive structure that has recently been done away with (see Section 3).<sup>45</sup> We estimate that this first round cost would be a little under 0.7 per cent of GDP, although this is inevitably a pretty rough estimate (see the notes to the table).

These are the first round effects but the whole aim of the UA scheme would be to shift some people out of low paid work by setting a wage floor. Table 5.1 shows that about 14 per cent of all employed workers would be little or no worse off were they to quit work. Among those employees who report not receiving any cash pay in the last 30 days, the proportion who would be better off unemployed rises to over 50 per cent.<sup>46</sup> Given the current incidence of low pay, more employees in the public sector, including those in public service jobs, than in the private sector would have an incentive to quit. Nonetheless, the impact on private sector earners could also be significant – 1 in 10 of them would be no worse off if they quit and claimed UA.

<sup>44</sup> Poverty is again defined as equivalised household expenditure below 50 per cent of the national median. See the note to Table 4.3 for more details. Simulated changes in income are then added to or subtracted from consumption.

<sup>45</sup> If the PIT were used, then the additional revenue would clearly have to be part of the federal rather than the regional (derived) share.

<sup>46</sup> Note that the group who report being employed but receiving no pay in the last 30 days includes some (a fifth of the group) who have been with their current employer for 2 months or less, and therefore might reasonably be expected not to have received any pay yet. Moreover, 68 per cent of the group report being owed wages. It is likely that some of this group, when they got their pay, would not be worse off in work than unemployed and claiming UA.

Table 5.1: *Cost and impact of simulated unemployment assistance, public service minimum wage and child allowance in Russia, 2000*

	UA	UA + public service minimum wage	UA + minimum wage + child allowance
<i>Impact on poverty and consumption</i>			
Percentage point reduction in people living in poverty	-0.5	-1.0	-1.4
% people in households with working age members who gain			
- all	7.6	15.3	57.2
- poor households	15.7	24.6	71.3
% unemployed people living in households that gain	21.6	24.4	
Extra mouths that gaining households could feed (average)	0.99	1.05	0.64
% of expenditure to households below the poverty line	34	29	25
Gini coefficient (pre-reform value = 0.429)	0.423	0.418	0.413
<i>Cost and targeting (no behavioural change)</i>			
Marginal PIT rate on formal incomes above median that would cover cost (%)	2.78	5.22	7.65
Cost of measures as % GDP	0.68	1.27	1.9
<i>Incentives</i>			
% workers no worse off unemployed			
-all	14.1	12.4	12.4
-no pay	53.6	47.3	47.3
-very low pay	30.7	27.9	27.9
-low pay	18.3	14.0	14.0
-public sector	16.1	13.0	13.1
-public services	14.3	6.6	7.0
-private sector	10.5	10.2	10.2
Percentage point increase in unemployment if all 'no worse off' workers become unemployed	10.9	9.7	9.7
<i>Total costs if all 'no worse off' workers become unemployed</i>			
Marginal PIT rate on formal incomes above median that would cover cost (%)	4.9	7.3	10.0
Cost of measures as % GDP	1.2	1.78	2.43

Source: RLMS microdata.

Notes: Extra Mouths: the calculation of extra mouths that could be fed takes as its yardstick the average per capita food consumption in households in the bottom half of the distribution of total (equivalised) consumption.

Gini: the Gini coefficient is of the distribution of all individuals (not just those in working households) by household income. The simulated values adjust the recorded income by the calculated income gains and losses.

Cost of measures as % GDP: this figure is estimated from weighted RLMS data and National Accounts data as follows. First, the cost of the measures is calculated as a proportion of total earnings reported in the RLMS. The answer is multiplied by earnings in National Accounts as a proportion of GDP (taken from CIS-STAT 2000-5). Thus, if earnings in the RLMS were perfectly representative of earnings in National Accounts, the calculation would be correct. If earnings in the RLMS understate earnings in national accounts, then the estimate would be high, and if it overstates, the estimate would be low. In determining the direction of error, the following two important factors need to be taken into account. First, National Accounts earnings data are gross of taxes and include employer social security contributions, while RLMS earnings are net of taxes and do not include employer contributions. This would suggest that RLMS earnings should be lower than those in National Accounts. On the other hand, RLMS earnings include income that is unlikely to be included in the National Accounts definition, including income from informal sources. This would suggest that RLMS earnings should be higher than those in National Accounts. On balance, we believe that the effect of the latter is likely to be larger than that of the former. Therefore our estimates of the cost of the schemes modelled as a proportion of GDP are more likely to be under-estimates than over-estimates.

Workers 'no worse off unemployed': those who live in households where total income of the household would decline by less than 10 per cent or by 1/3 of the median wage, whichever is less, if they decided to become unemployed.

Unemployment could therefore increase greatly. However, not all of those who would be no worse off were they on UA would in fact choose to quit their jobs and enter unemployment. In some cases, employers would raise wages as a result of the new wage floor. In other cases, workers on low wages would have an expectation of higher wages (through performance, promotion, etc.) in the near future. And some people actually like their jobs. Nonetheless, some workers would surely quit. If *all* workers who we estimate would be no worse off on UA were to quit, unemployment would rise by 10 percentage points and the costs of the scheme would rise to 1.2 per cent of GDP. In practice one would not expect that upper bound to be reached.

What can be done to accelerate the impact of UA on restructuring via increasing internal migration to areas of labour demand? One possibility would be to offer unemployed people in high unemployment regions part of their projected UA as a lump sum (for example, 3 months' payment) on the condition that they move to a low unemployment region. We conceive of this as a non-returnable relocation grant. A World Bank loan has recently been extended to facilitate this type of migration from the Northern to the Central regions of Russia, with provision for direct assistance payments to migrants (World Bank 2001c). This active labour market measure would be more effective still if supported by a national employment service capable of bringing together unemployed people and prospective employers in different regions.

How quickly can we expect the initial surge in unemployment to diminish? Russia is now growing again and formal employment even rose over 1998-99. What if economic growth were to continue (as is forecast), with employment also growing? Consider the CEE experience where growth has been positive for several years. Between 1993 and 2000, Hungarian GDP grew at an average 3 per cent per year (this includes a period of negative growth in 1993-4). This is not dissimilar to the forecast growth rate for the CIS region from the World Bank, of 'somewhat below 3 per cent' for 2001 to 2010 (World Bank 2001b). What happened to unemployment flows in Hungary between 1992 and 2000?

During this period of (mostly) economic growth, the unemployment rate declined in Hungary from 11.9 per cent of the labour force in 1993, to 6.4 per cent in 2000. Unemployment fell partly because many people withdrew from the labour force altogether during the 1990s. But as Table 5.2 shows, the average quarterly flow of people from employment to unemployment declined each year – a smaller proportion of the labour force became unemployed. Moreover, the average quarterly flow from unemployment to employment began to overtake that in the opposite direction from 1994 onwards. In 1992, an average 1.7 per cent of the labour force flowed from employment to unemployment each quarter, while an average 1.5 per cent moved from unemployment to employment, causing unemployment to

increase. But in 1994, while 1 per cent of the labour force flowed into employment from unemployment, 1.4 per cent moved in the opposite direction, helping the unemployment rate to fall. This pattern was repeated in every year to the end of the decade.

Table 5.2: *Unemployment rate and flows between employment and unemployment, Hungary 1992-2000*

	1992	1994	1996	1998	2000
Average ILO unemployment rate (per cent labour force)	9.8	10.7	9.9	7.8	6.4
Average quarterly flows (per cent labour force)					
..from employment to unemployment	1.7	1.0	0.9	0.6	0.5
..from unemployment to employment	1.5	1.4	1.2	1.1	0.9
Difference	-0.2	+0.4	+0.3	+0.5	+0.4

*Source:* Hungarian Labour Force Surveys, 1992-2000. Information provided by Gyula Nagy.

This is the sort of decrease in unemployment that Russia needs. After an initial surge in unemployment in Hungary in the early 1990s (which could be analogous to what might happen with the introduction of UA in Russia), employment creation began to help force down the unemployment rate, and continued to do so throughout the decade. Continued withdrawal by many people from the labour force also contributed to declining unemployment, but increased *employment* was clearly one important driver of the decline in unemployment in Hungary.

Is this a realistic scenario for Russia? Yes, the scenario is optimistic in the sense that Russia has proved to be more sclerotic than Hungary. Even if an average of 3 per cent growth in GDP is achieved over the first decade of the millennium, it may not be broad-based enough to generate significant employment growth. In addition, evidence from other countries suggests that a more expanded role for the private sector would be necessary if GDP growth were, first, to be sustained, and second, to be turned into major increases in employment. Therefore we must be cautious. The long-term impact on *poverty* as opposed to unemployment depends on the types of jobs people move off the unemployment register to, and on the extent to which flows from the register are indeed to jobs rather than to inactivity.

## 6. Returning the Focus to Poverty

Unemployment benefit might help the pace of restructuring in the CIS – and more generous unemployment benefit would certainly help reduce poverty among the unemployed in CEE. But unemployment benefit is never going to end all the problems of working age poverty in either the CEE or the CIS countries.

In the first two parts of this section, we examine two policies that would serve to reduce both short-term and long-term disadvantage: a minimum wage for workers in vital public services such as education and health care; and universal child benefit. Both are in fact complementary to a UA scheme, as we explain. In both cases we continue with simulations for the case of Russia. Neither of these proposed schemes is particularly well targeted on poor households. We then end the section with a Hungarian example, again based on microsimulation, to argue that this is not necessarily a bad thing.

### ▪ **6.1 *A minimum wage for public service workers***

Earlier sections of the paper noted the importance of tackling funding shortages in public education and health systems in, especially, the CIS. This should reduce poverty over the longer term to the extent that the future earnings capacity of poor families, and particularly of children in poor families, is improved through more money in the educational system (better paid staff should produce higher quality education). Similar points can be made about access to health care and future health status. In both cases inequities in access are exacerbating long-term disadvantage.

Increases in teachers' and medical workers' salaries are not all that is required to 'fix' these vital public services. But they are part of a solution alongside other measures designed to improve access to quality public services for the poor. Moreover, since a high proportion of public service workers experience low pay levels (Table 4.2), raising their wages forms part of an effective anti-poverty strategy in the short-term as well.

We use the RLMS data to model the short-term impact on poverty of a minimum wage for Russian public service workers. (There is notionally a minimum wage in Russia at present, but set at such a low level that it is effectively meaningless.) The modelled minimum wage would pay all public service workers at least half the median in the region where they are employed. As with our UA simulation, we show how this could be paid for by an increase in income taxes for workers with earnings above the median but we stress again that the money does not have to necessarily be raised through the PIT or from the household sector.

Wages need to be improved in the education and health sectors but evidence suggests that employment in both can be cut (see Section 2). We therefore assume that 1 in 10 public service workers are retrenched. However,



we do not assume any savings in the short term from this reduction in staffing. Rather, the saved salaries would be used to fund wages owed and severance payments (which could also act as mobility grants to encourage retrenched workers to move to where new employment opportunities exist).<sup>47</sup>

The second column of Table 5.1 shows the impact of such a scheme (in conjunction with the earlier simulation of UA) at one third of regional median earnings. As with UA alone, the impact on the poverty head count is very small: another half percentage point reduction. But 1 in 4 of the working-age poor gain (with gaining households on average able to feed one extra mouth). The share of total expenditure going to households in poverty is now a little lower. The cost doubles to 1¼ per cent of GDP, which could be financed by a 5¼ per cent higher tax rate on above-median earnings. Unemployment would increase by a percentage point as a result of the retrenchment of a tenth of public service workers.

A substantial number of workers would still have little incentive to carry on in employment: 1 in 8. Even with the proposed minimum wage, 7 per cent of public service workers would still have some incentive to quit although it should be noted that this is half the previous level.<sup>48</sup> If all workers who were no worse off claiming UA did leave their job, unemployment would jump by almost 10 per cent and the tax bill would rise by another half percentage point of GDP.

To summarise, a minimum wage for public service workers, while affordable in terms of the additional taxes required to pay for it and even necessary in the context of the introduction of UA (to limit incentives to quit), would produce little in the way of a reduction in the poverty headcount in the short term (if introduced at the level assumed). However, the poverty gap would be partially filled for a sizeable proportion of the working poor and it is also important to keep in mind any long term impact (which we are unable to measure): a reduction in intergenerational transmission of economic disadvantage brought about by having better paid teachers.

## ▪ ***6.2 Enhanced child allowance to support families with children***

The incidence of poverty among families with children is high in many transition countries (UNICEF 2001), and children are at notably higher risk of poverty than the rest of the population.<sup>49</sup> Tackling child poverty should be central in any anti-poverty strategy, not least due to the impact this should

<sup>47</sup> Therefore, the increased income taxes raised to pay for this minimum wage are also effectively used to increase social services spending.

<sup>48</sup> These are mostly in households with sources of income other than cash earnings or social security payments.

<sup>49</sup> This result holds unless significant economies of scale are assumed in the household.

have on future poverty levels. (The UK is one example of an OECD government that has placed a great deal of emphasis recently on this.)

One method of supporting the incomes of families with children is through child allowance payments. There is a long tradition in most CEE countries of using this policy, typically with benefits paid on a universal basis, and a number of them still have high coverage and relatively generous rates by OECD standards.<sup>50</sup>

Russia too has a system of child allowance.<sup>51</sup> However, it is not well resourced, and has not been updated to compensate for inflation. The universal system introduced in 1991 to compensate for price liberalisation was, by 1995, equal to only 0.13 of the minimum subsistence level for one child (UNICEF 1997). Moreover, the system has been plagued by problems of equity. RLMS rounds from the mid-1990s show half or more of families with children not receiving what was meant at that time to be a universal allowance. Due in some measure to the system of local financing for the benefit (and until 1997, payment through employers), not only did a diminishing proportion of families with children receive any allowance, but most was going to non-poor families. Arrears have become very common. De facto means-testing for the benefit was progressively introduced in many local areas during the late 1990s (and was formalised by federal law in 1998). Moreover, in most regions payment in kind became the norm, where families could get their entitlement in food in certain stores, which would in turn offset the stores' outlay against tax liabilities. Denisova et al. (2000) conclude from their analysis of 1996 and 1998 RLMS data that the ability of the schemes applied in different regions at that time to correctly identify the poor is "rather limited" (p11).

What if this entire system in Russia were to be swept away: no more central-local funding issues and no more weakly administered means-tests? Besides the obvious attractions of simplicity a universal scheme might also help promote national solidarity (we note for the sceptical reader that we discuss a means-tested option below). We simulate the impact of a national universal allowance that really does pay benefits in respect of every eligible child (where eligibility is not linked directly to family means.) There are some arguments in favour of such a system not just for Russia, but for other CIS (and industrialized) countries as well. The goal of uniformity is to ensure equity between regions. The rationale for universality is to ensure simplicity in administration and horizontal equity between families. Like UA, this scheme would have to be nationally financed with a degree of federal oversight in its administration.

<sup>50</sup> Details of coverage are given in UNICEF (2001 chapter 2).

<sup>51</sup> In this paragraph we draw on an excellent analysis by Denisova et al. (2000)

We use RLMS 2000 to model the impact of a scheme which would pay 5 per cent of the (national) median wage in respect of the first child in a family, and 10 per cent in respect of subsequent children. In the case of the second and subsequent children this is at the sort of level that child allowance is paid in several CEE countries. Payments of children's allowance are assumed to go to the mother (an important principle) and are added to the mother's taxable income. We assume they are ignored however for the purpose of a UA income test.

The third column in Table 5.1 gives the results from this simulation exercise, which is grafted on top of the UA and public service minimum wage schemes discussed above. The reduction in the poverty headcount among people in working age households is again small – the number of people in poverty is reduced by about another half percentage point on top of the one percentage point achieved by UA and the public service minimum wage combined (see column 2). The proportion of total expenditure (on all three schemes taken together) that now goes to households below the poverty line is down to a quarter. But among people living in households with two or more children, the reduction in poverty is larger. For example, among households with three or more children, the poverty rate falls nearly four percentage points (from 28.8 to 25.0 per cent), which is suggestive of the likely impact of schemes such as this in countries with a younger age structure.

Total cost now rises by another 0.63 per cent of GDP and if funded by the PIT this translates into a marginal tax increase of nearly 8 per cent on formal economy incomes above the median. If all the 'no worse off' workers as a result of the introduction of UA were to take up the option to become unemployed, total costs would rise to 2½ per cent of GDP.

While the headcount figure falls relatively little, 7 in every 10 people in households with consumption below the poverty line would gain. This gain would on average be worth the equivalent of almost two thirds of a typical monthly food bill for a person living in the bottom half of the distribution. Moreover, inequality would fall. The relationship between inequality reduction and poverty reduction was noted in Section 2. When financed through a higher rate of PIT in the way we have described, the cumulative impact of UA, the public service minimum wage and child allowance would be to reduce the Gini coefficient from 0.43 to 0.41.

### ▪ **6.3 *The disincentives problem with targeting***

Is a reduction in the headline poverty headcount (on which public debate so often focuses) of about 1½ per cent the best that can be managed through a combination of UA, a floor to public services wages, and an expansion of child allowances? We have emphasised the need to look also at the reduction in the depth of poverty as well as at the change in the number of poor people

– the majority of the working-poor gain something from the package of policies – and at the medium and long-term impacts of these measures coming through the restructuring of the labour market, the promotion of better education and other vital public services, and the guaranteed support to incomes in childhood. Nevertheless, the policymaker who insists on an emphasis on the short-term impact on the headline poverty count may want a better bang for his or her rouble. In particular, viewed from this standpoint our proposed reform of child allowance may well be seen as ‘poorly targeted’ and relatively ineffective.

Would more targeting of support to families give a better result? Yes and no. Uniform and equitable means testing has proved difficult to implement in a country such as Russia. Nonetheless, we propose the establishment of a means test for UA, so we do not believe it is impossible, despite the evidence cited above on attempts to date. Why not means test child allowance as well, and target it more directly on the poor?

Consider the experience of Hungary. Some observers have raged against what they see as the profligacy of the universal child allowance in this country. A scheme of means testing the allowance was tried in Hungary in the mid 1990s (it has since been discontinued) and although only relatively few high income households were excluded, it was seen by some as a way of psychologically preparing people for an extension of means-testing (Csaba 1998). Here we make that extension, drawing on household budget survey data for Hungary from 1995.<sup>52</sup> What if a heavily means-tested scheme, such as that applying in the UK, were introduced in Hungary?

In terms of targeting benefits at the poor, the results would be quite marked. Table 6.1 shows that 40 per cent of benefit payments would accrue to those below the poverty line (taken here as two-thirds of median pre-simulation income), compared with 28 per cent without means-testing.<sup>53</sup> The number of people living in poverty would in fact be reduced only very slightly, which shows that even a more firmly targeted benefit may fail to shift the headcount much. The price to be paid with the UK-style system can be seen in the effective marginal tax rates. For each extra forint a person in a poor Hungarian household would earn under the UK-style scheme, he or she would forfeit over three-quarters of it in PIT, social insurance and lower benefits. Under the then existing Hungarian scheme he or she would lose only a third of each extra forint earned in deductions. UK-style targeting and poverty reduction is better, but the price is a much bigger poverty trap. That

<sup>52</sup> See Redmond (1999) for a fuller explanation. The UK scheme that is modelled is the one prevailing in the mid-1990s which has subsequently been modified. The simulation involves a slight reduction in cost compared to the existing universal scheme.

<sup>53</sup> For the most part, state benefits were not means tested in Hungary in 1995. Exceptions included Child Raising Allowance and Social Assistance. Together, they accounted for 6.7 per cent of total social security expenditure in 1995 (HCSO 1996, Table 5.3).

means lower incentives to poor people to improve their incomes which may result in poverty being perpetuated rather than reduced.

Table 6.1: *Targeting, poverty reduction and effective marginal tax rates in Hungary, 1995*

	Poverty rate (%)	% total benefits targeted below poverty line	Average effective marginal tax rate for poor households with 2 children (%)
Hungary 1995 system	16.2	28	34
UK-style system	15.6	40	77

*Source:* Hungarian household budget survey microdata.

*Note:* The poverty line is two-thirds median income (income equivalised by household size to the power 0.75). For details of methods and data see Redmond (1999).

There are no easy solutions here. Policy makers in each country will have to make their decisions on how to target taking into account all the factors involved, including societal attitudes about solidarity and tolerance for higher taxes more generally to finance higher transfers. Some countries will certainly develop their means-tested family support.<sup>54</sup> What we have been concerned with in this section, as in the rest of the paper, is to illustrate some of the parameters of the problem.

## 7. Conclusions

It is impossible to address comprehensively all the factors associated with poverty in an increasingly diverse set of transition countries in a single paper. Instead, we have focused on one group of poor people – those of working age and their families – and have looked at a small selection of issues of current and longer term disadvantage as they relate to this group. Here we briefly sum up our main findings and some possibilities for future action.

Poverty is pervasive in the region, particularly among people in working age households. This is partly a problem of lack of work, but in the CIS especially, it is also caused by low wages – although the case of Russia suggests that the association of low-pay with poverty is not as large as one might think. Low expenditure on education and other public services, especially (but not only) in low-income CIS countries, increases the danger of present-day poverty being perpetuated in the future. Economic growth is one important factor in poverty reduction, but it is also important that inequality, particularly in the CIS, declines (to which end pro-poor growth would contribute).

<sup>54</sup> Uzbekistan is an example, where the system of administration of a new targeted social assistance (via local community groups, the Mahallas), has now been extended to child allowance (Coudouel et al. 1997, Coudouel and Marnie 2000).

Income redistribution and investment in public services require government intervention. Since public services are typically provided by local governments, it is important that transfers of resources between central and regional authorities are both transparent and predictable. Many countries in the region, particularly the low income countries, are especially constrained on the financing front. Yet there is some room for manoeuvre, depending on the country. Where the revenue share in GDP is low and collection is very inefficient, there should be scope to raise revenue through more concerted administration. On the expenditure side, the scope for expanding spending to address poverty depends in part on cutting unproductive expenditures. Reforms to cut enterprise subsidies and to downsize the public sector could release substantial resources for potential redistributive purposes.

We showed that several countries now face a heavy debt burden, which can severely constrain social spending. This is an issue that Western countries and the highly indebted countries involved need to co-operate more closely on.

Higher tax revenues, and increased resources for public expenditure, should also follow from economic growth. Arguably, positive growth will be aided by accelerated labour market restructuring. Could an unemployment benefits system help in achieving this goal in CIS countries? The evidence from CEE is inconclusive, perhaps inevitably. Our review of CEE unemployment benefits and poverty among the poor showed that the former are notably low by EU standards and the latter is notably high. Microeconomic evidence from CEE does not suggest that somewhat more generous benefits would have much impact on the duration of unemployment spells.

Our analysis using Russian data shows that a relatively cheap unemployment benefit system could give large numbers of low paid workers the incentive to quit their jobs and search for alternative employment (or at least they would be no worse off doing so). Such a system would support a higher wage floor, and employers would have to pay higher wages (to perhaps fewer staff) or close down. Thus 'high quality' labour mobility might grow (we documented the current extent of low paid work among recent recruits in both public and private sectors). However, we identified various caveats that call this hypothesised effect into question. These include the need for job creation to match the job destruction generated by unemployment benefits, the CEE experience of widespread long-term unemployment, the complementary nature of reforms to employment law, the importance of strengthening the employment service, and the problem of regional immobility.

A package in Russia of a modest unemployment assistance benefit, a minimum wage for public service workers and a truly universal child allowance would raise the incomes of most of the working poor in Russia.

These schemes are affordable. We cost them in terms of increased income taxes on earners in the top half of the earnings distribution, but they could also be paid for by taxes raised outside the household sector. But we stress that these schemes are just some among an array of policy choices that can lead to reduced poverty. One very obvious one that we have not considered explicitly is to simply pay workers each month what they earn. The phenomenon of wage arrears has no place in a reformed labour market. Since the public sector is the single biggest sinner in this respect, eliminating arrears and paying wages on time should be high on its list of spending priorities.

We have not dealt with a range of other issues that are relevant to poverty among working age people. In one sense, this is because we have mostly focused on longer term issues – financing investment in education and health, and labour market restructuring. But while restructuring may result in greater prosperity in the medium term, it will also produce losers – people who do not have the skills demanded in the restructured market. Some form of social assistance will be needed to support the incomes of such people as their unemployment becomes long-term. Alternatively, it may be sensible to maintain enterprise subsidies where no real employment alternatives exist. Where subsidies to failing enterprises are withdrawn, they could be redirected into funding early retirement programmes for older workers, and to retraining younger workers. The list of problems and possibilities is long. This paper highlights just some of both.

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#

# **POVERTY IN THE TRANSITION: SOCIAL EXPENDITURES AND THE WORKING-AGE POOR**

Poverty remains a major problem in much of Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS). This paper reviews the extent and nature of poverty across the transition countries and emphasizes the phenomenon of the working-age poor. Governments' fiscal positions and revenue raising tools are considered, including the issue of whether some countries now have levels of external debt servicing that are so high as to hamper social sector expenditures. The paper concludes by considering the role of improved wages for public service workers and the targeting of categorical benefits.

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