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Achieving full employment in the transition economies

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Foreword

In this paper, Geoffrey Renshaw of the University of Warwick reviews the major factors which have shaped the evolution of employment in six central and eastern European countries since they began their transition to a market economy. The countries are the Czech and the Slovak Republics, Hungary, Poland, Ukraine and the Russian Federation. Geoffrey Renshaw concentrates on three issues in explaining employment behaviour, namely overall economic stabilization, restructuring (of which the major element is the ability and willingness of previously state-owned enterprises to act in a competitive manner) and the labour market and social security system, including the financing of welfare benefits. He stresses that these three areas are interlinked in many ways. In a review of the countries' experience the differences in both their outcomes, i.e. employment and unemployment, and policies and institutional changes are brought out. Renshaw concludes that in these countries the share of government expenditure in GDP is so high as to be counterproductive; revenue raising has become increasingly difficult and at high levels of government expenditure the distortions arising from tax wedges are likely to outweigh the benefits of publicly provided goods at the margin. In particular payroll taxes at the high levels seen in the region are almost certainly having an adverse effect on employment. In many countries much remains to be done in terms of structural reform, including financial sector reforms. Such changes may well, however, lead to hidden unemployment becoming open unemployment. In such circumstances further assistance from the international community should be specifically aimed at strengthening the social safety net and maintaining the living standards of the poorest.

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Introduction

This paper aims to identify factors inhibiting employment growth in the transition economies of Central and Eastern Europe: It concentrates primarily on the Czech Republic, Hungary, Poland, the Russian Federation, the Slovak Republic and Ukraine and has some remarks on Bulgaria and Romania. The first six countries are reasonably representative of the range of experience of the twenty-six countries which embarked in 1990-92 on the transition from a centrally directed to a market driven economy. However, naturally no two countries are exactly alike. Since employment growth is the outcome of success in overall economic performance, the chapter examines economic performance under three broad heads: (i) macroeconomic stabilization and growth; (ii) privatization and restructuring; and (iii) the labour market and the social security system. Performance under these three heads influences employment.

First, stability in aggregate employment requires a stable overall balance between the production of goods and services and the demands for them by the private and public sectors. But stability alone is not enough; satisfactory economic performance requires also that employment and production be stabilised at high and growing levels.

Economic restructuring encompasses all factors contributing to microeconomic efficiency and growth: market liberalization, corporate ownership and governance issues (including privatization) and financial markets and institutions, as well as the more traditional restructuring concepts such as investment behaviour, technological innovation, and the reallocation of resources towards more dynamic enterprises and sectors. Restructuring in all these dimensions is the principal source of productivity growth, hence poor performance in this area has profound implications for employment growth.

In these areas of restructuring most transition economies have not progressed as rapidly as expected in the early 1990s, mainly because the necessary institution building and establishment of an efficient regulatory framework has proved more difficult than was initially foreseen. Moreover it has been belatedly realised that uneven progress in reform measures can lead to serious distortions and set up barriers to further reform. For example in several countries the freeing of enterprises from state control was unaccompanied by new and effective forms of control, leaving enterprise managers virtually autonomous. In some situations managers have chosen to line their own pockets and those of their cronies; in others, to attempt to preserve the status quo in terms of employment and output. The most serious consequence of this imbalance in structural reform, though, is that it has created a powerful interest group which is naturally opposed to further reform.

The third area is the labour market itself, together with the social policies which influence it. The transition process has been extremely painful for many workers and indeed for the poorer and less advantaged sections of the community in general. This is partly because successful transition inevitably entails the destruction of a great many jobs which existed under communism but simply lack viability in a market economy. Furthermore, many ordinary working people in the transition economies have also suffered from a squeeze on welfare benefits which has partly reflected governments' desperate need to bring ballooning government budget deficits under control, but also a belief (deriving from neo-liberal economic analysis) that high levels of social spending and the high tax rates thereby necessitated were damaging to individual incentives to work and to save. These same supply-side arguments have focussed attention on the structure of welfare benefits (the "targeting" issue) as well as their level.

These three areas of economic performance and policy are of course not independent of one another - though the nature of their interdependence, which is both economic and political, is often complex and controversial. Thus a recession may be so damaging to an enterprise's profitability and cash flow that it is deprived of the resources necessary to restructure and is forced

instead to focus on short term expedients aimed at survival. But a recession may also force an enterprise to implement painful measures necessary for restructuring, which in a more favourable macroeconomic environment would have been shelved. Another example concerns the role of social security benefits (the "social safety net"). In the pursuit of macroeconomic stabilization it may be highly desirable to slash the real value of social benefits and tighten eligibility conditions, but this may engender opposition on equity grounds to pushing ahead with enterprise restructuring and thus on balance prove counter-productive. Some of the more salient interdependencies are examined in this study but given space constraints the treatment is necessarily somewhat superficial.

At the outset it should be noted that the process of transition began with a fall in output everywhere broadly from 1989/90 to 1990/91. This was inevitable given that shifting to a market economy required large changes in relative prices (thus making a number of activities unprofitable) as well as a withdrawal of the state support and direction inherent in central planning. In addition the breakdown of many trading relations created uncertainties about suppliers and markets and, furthermore, some countries were already in trouble with the balance of payments. However, given the opening up of the economies and by and large sustained political changes which prevented a return to a command economy, economic recovery became bound up with making those institutional reforms which would encourage a market economy to function. In this process some countries have met fewer impediments, whether they be of longstanding or more recently virtually self imposed, than others. And the process itself necessarily imposes strains as equilibrium is sought in turn in above all public finances and the external sector.

The data in Table 1 on net material product and gross domestic product are based on 1985. They show that by 1990, the year following the fall of the Berlin wall, when COMECON was breaking up, although few liberalization and reform policies had been undertaken nationally, growth had been generally positive, if slight. In Poland, and especially Romania, growth in the second half of the 1980s was negative, and it was little better in Bulgaria and Hungary. Conversely Ukraine's expansion in the late 1980s was subsequently totally wiped out. The data could be interpreted as suggesting that e.g. Romania's policies were so poor they would be difficult to correct; that Poland had perhaps postponed actions in the late 1980s which were beneficially followed in the 1990s and that growth in the Ukraine was achieved by means that threatened future growth. But all that is speculation. The table also shows exports and imports pre capita. Trade would appear to have universally grown as a share of GDP, which partly reflects increasing capital movements. A failure of exports to rise significantly can probably be taken as an indicator of insufficient restructuring.

1. Macroeconomic Stabilization and Growth.

Russia and Ukraine, the two largest Commonwealth of Independent States (CIS) countries, have made noticeably weak progress towards establishing efficient, market driven economies. Both countries have experienced continuously falling GDP since 1990, with Russia's GDP falling by more than 40 per cent and Ukraine's by more than 60 per cent. Similarly, both Russia and Ukraine experienced hyperinflation in the early 1990s, following price liberalization. In Russia inflation peaked at 1500 per cent in 1992, while in Ukraine the peak was 5000 per cent, in 1993. In both countries inflation was reduced, painfully, to below 20 per cent by 1997 only to flare up again in the second half of 1998 (details are given in Annex Table 1).

Table 1: Real GDP/NMP and trade, transition countries

	Population (mln.)	GDP/NMP			Exports per capita US$			Imports per capita US$		
	(1997)	1985	1990	1998	1989/90	1992/93	1996/98	1989/90	1992/93	1996/98
Slovak Republic	(5.4)	100	106.3	107.7	830		1 710	770		2 210
Bulgaria	(8.3)	100	101.1	76.3	n.a.	450	560	n.a.	540	600
Hungary	(10.2)	100	102.6	101.3	930		1 790	840		2 050
Czech Republic	(10.3)	100	106.6	102..9	830		2 240	770		2 750
Romania	(22.6)	100	91.3	73.6	350		370	380		470
Poland	(38.7)	100	97.9	129.7	380		750	330		1 030
Ukraine	(50.9)	100	108.7	44.4	n.a.	150	270	n.a.	160	330
Russian Federation	(147.1)	100	106.9	61.6	n..a	290	570	n .a	240	460

Source: Economic Commission for Europe, *Economic Survey of Europe 1999/1*, Geneva 1999; and International Monetary Fund, *International Financial Statistics* various,. Washington DC

Both countries began to claw their way back from this "hyper-stagflation" in 1993-4 by cutting government spending and restricting monetary expansion. The latter squeezed enterprises, threatening their ability to meet the wage bill and maintain employment. Enterprises resorted to inter-enterprise credit and barter with their suppliers and customers, using the money saved to pay wages. Suppliers of inputs were themselves anxious to maintain output and employment, and therefore preferred to extend credit to their customers, or accept payment in kind, rather than cut off supplies. In this way employment was protected against the fall in output and squeeze on credit. Thus in Russia 1992-94 employment fell by only 5 per cent when GDP fell by 20 per cent. In the absence of a credible threat of bankruptcy, enterprises also began to fall into arrears in their tax liabilities and their interest payments to banks. They also fell into arrears of wage payments too, since many workers thought it better to work for nothing more than the hope of being paid in the future, rather than quit.

By 1998 it was possible to be cautiously optimistic about the prospects for macroeconomic stabilization in both countries. In Russia inflation was falling rapidly and the decline in production appeared to have stabilised, but many structural problems were painfully apparent. Arguably the most pressing was the need for fiscal reform. The tax code was immensely complicated, riddled with exemptions, and imposed intolerably heavy burdens on companies if fully complied with - which was seldom. The incentives to evade or avoid taxes were enormous, and some estimated that economic activity worth 40-50 per cent of GDP had gone underground to avoid taxes. The tax burden was also a strong deterrent to capital investment and encouraged capital flight. Federal tax revenue was dwindling alarmingly, to less than 10 per cent of GDP. Faced with the need to comply with IMF fiscal targets (monitored on a monthly basis) the government was forced to cut expenditure by the only available short-run means: non-payment of public employees' wages, salaries and pensions. As well as tax reform, greater tax compliance and more effective tax collection were desperately needed. The huge budgetary burden of housing and household energy subsidies also needed to be tackled, but doing so was bound to be unpopular. There was also need for urgent and decisive action to deal with the army's problems and with organised crime. The Ministry of the Interior estimated that criminals by then controlled 40,000 enterprises, including 500 banks.

In 1998 foreign confidence in Russian economic reform waned as President Yeltsin appeared to be losing the remnants of his political authority. The inflow of foreign lending which had been attracted by the large interest differential and apparent stability of the ruble went into reverse (influenced also to some extent by "contagion" from the Asian economic crisis). In August the government was forced to devalue the rouble, which quickly fell by 50 per cent, and to default on the redemption of its maturing treasury bills (GKOs), which rendered every bank in the country insolvent. Although economic policy since then has aimed at little more than damage limitation, the economy has not regressed as badly as many initially feared. GDP fell by 4.6 per cent in 1998 (having risen marginally in 1997) and may have fallen by a further 2 percent in 1999. Prices rose some 30 per cent in 1998 and by over 80 per cent in 1999, while the rouble by the end of 1998 had lost three-quarters of its 1997 value. However, by the end of 1998 the government was meeting its current wage and pension obligations, though admittedly this was achieved only by slashing capital expenditure and resorting to the printing press.[1]

In Ukraine too the fall in GDP appeared to have finally bottomed out in 1998, and the budget deficit had fallen to around 5 per cent of GDP, an improvement made possible by a huge reduction in public expenditure, which fell from around 55 per cent of GDP in the early 1990s to around 35 per cent after 1995. This reduction was somewhat illusory, however, as it was achieved

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[1.] See EBRD (1999)

in no small part by defaulting on wage and salary payments and in payments for purchases of gas. More encouragingly, government expenditure on the "national economy" (a code for subsidies to enterprises) fell from 40 per cent of government spending in 1992 to about 5 per cent in 1996.[2] A worrying feature was the expansion of Ukraine's foreign debt. From a negligible level of $450 million in 1994 foreign debt rose to $12 billion by mid-1998.[3] Foreign direct investment was low, averaging a net inflow of about $0.5 billion in the second half of the 1990s.

A new currency, the hryvna, was introduced in 1996 with a fixed exchange rate band against the dollar, but by the end of 1997 was under attack. There were three underlying problems. First, the continuing budget deficit, which now had to be financed by borrowing in the open market since Ukraine had agreed with the IMF that the Central Bank would no longer lend to the government. Second, domestic inflation was still far too high to make a fixed exchange rate credible; and third, the trade deficit was increasing rapidly.

In this situation lowering the budget deficit was seen as a key element in Ukraine's macro economic stabilization efforts. However, the Asian and Russian economic crises accentuated the difficulties and increasing cost of financing the budget deficit by borrowing abroad and in September 1998 the government was forced to follow Russia in rescheduling both its foreign and domestic debt. At the same time and as one of the main conditions of the new three year IMF programme agreed in early September the government proposed a combination of expenditure cuts and tax changes intended to reduce the deficit to 2 per cent of GDP in 1999, while also settling all payments arrears.[4]

In contrast, the four western most Central European countries have been relatively successful in achieving macroeconomic stabilization and have shown impressive rates of economic growth. Hungary and the Czech and Slovak Republics experienced severe but brief recessions in 1990-92 followed by sustained recovery in GDP to levels which now equal their 1990 levels. Poland's performance was even better**;** in 1990-92 Poland experienced the smallest falls in both GDP and industrial production, and subsequently the strongest and most sustained upswing in both, with the effect that by 1997 GDP was no less than 25 per cent above its 1990 level, and industrial production an astonishing 50 per cent higher.

These countries, unlike Russia and Ukraine, did not lose control of their price levels in 1990-92 and have since reduced inflation steadily to acceptable levels. It is noteworthy though that Poland, with easily the best growth performance, had the worst inflation record of the four countries. Several factors contributed to the performance of the four countries: tight fiscal and monetary policy, a high degree of international competitiveness, and policies which contained the domestic inflationary pressures associated with rapid growth.

In the Czech Republic, the budget deficit peaked at 3.1 per cent of GDP in 1992, falling to 1 per cent-1.5 per cent in 1994-6. Also, government expenditure as a percentage of GDP was, at around 42 per cent, the lowest of these economies (see Table 2). This made a low average tax rate possible, which among other effects probably reduced cost-inflationary pressure. Second, a high level of investment was a major factor in pulling the economy out of recession. Third, a high degree of international competitiveness was achieved through a large depreciation of the Koruna in 1990, together with a sharp drop in real wages in 1991-2. An incomes policy was in force in 1991-95 which helped to prevent the competitive advantage of devaluation from being dissipated in wage and price increases.

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2. World Bank (1997a) p.i.

3. World Bank (1998a).

4. EBRD (1998); IMF (1998)

Table 2: General Government Expenditure (% of GDP)

	1991	1992	1993	1994	1995	1996	1997
Russian Fed.	n.a.	37.2	40.7	45.9	37.0	40.1	40.7
Ukraine	n.a.	58.4	54.5	45.8	37.4	31.6	34.8
Czech R.	n.a.	n.a.	41.9	43.3	42.8	41.8	41.6
Slovak R.	n.a.	n.a.	51.0	48.0	47.0	49.0	51.0
Hungary	55.4	59.4	60.6	60.9	53.9	48.3	52.9
Poland	49.0	49.5	50.5	48.9	47.9	47.5	48.1
Bulgaria	40.2	40.6	44.8	44.9	41.0	48.1	33.5
Romania	35.4	39.9	31.5	32.0	31.8	31.4	n.a.

Data for Russia exclude transfers

Source: EBRD (1998) and IMF, *International Financial Statistics*, various

After 1995 the Czech economic miracle began to show signs of fragility. During 1995-96 imports increased very rapidly, opening up a trade deficit of 11 per cent of GDP. As this was clearly unsustainable, foreign investors became increasingly nervous, intensified in late 1996 by a major bank failure. Financial scandals continued into 1997 and in May the government was forced to float the Koruna and introduce an emergency package of fiscal and monetary measures. This experience provides yet another example of the risks inherent in a policy of pegging the exchange rate as a means of constraining domestic inflation. These shocks to the economy cut the growth of GDP to 1 per cent in 1997, while in 1998 the fall-out from the Russian economic crisis contributed to a fall in GDP of nearly 3 per cent with little prospect of recovery in 1999.
Experience in the Slovak Republic closely paralleled that of the Czech Republic. When the Slovak Republic came into existence in 1993 initial expectations of economic performance were somewhat pessimistic due to the loss of fiscal transfers from the Czech lands, the dependence of the economy on heavy industry, especially armaments manufacture, and its orientation towards the former Soviet Union.

After an initial fall in GDP however the Slovak Republic achieved one of the best growth performances of any transition economy, while inflation remained very moderate, declining from a peak of over 20 per cent p.a. in 1993 to around 10 per cent p.a. in 1994-97. As in the Czech Republic, this appeared to vindicate the policy of using a fixed exchange rate as a “nominal anchor”, but also resulted probably in no small part from strong central government influence, if not control, over wage setting (discussed further below). Monetary and fiscal policies, too, remained tight; from an initial budget deficit estimated at 13 per cent of GDP at independence, the budgetary position improved to show a small surplus in 1995, achieved primarily through expenditure cuts. However, an investment-led boom resulted in a huge deterioration in the current account of the balance of payments, from a surplus of 4.8 per cent of GDP in 1994 to a deficit of 11 per cent of GDP in 1996. This eventually forced the exchange rate peg to be abandoned in late 1998. A bright feature of the Slovak economy has been sustained rapid growth of productivity in manufacturing, associated with an overall investment ratio of around one-third of GDP.

Poland shows some similarities but also important differences. Since Poland's period of rapid growth began in 1992, fiscal policy has remained consistently tight, with budget deficits of around 3 per cent of GDP. The major difference from the Czech and Slovak Republics lies in exchange rate policy. Poland abandoned an exchange rate peg as early as 1991 and has since adopted a "crawling peg" regime. This has been associated with considerably higher inflation than in the other three CEE countries, but has not prevented Poland enjoying much superior growth

performance. Unlike the Czech and Slovak Republics, the trend of inflation remains downward. However, although the trade balance and balance of payments current account were in surplus in the mid-1990s, both subsequently slipped heavily into deficit, and by 1999 the current account deficit was projected at 5.5 per cent of GDP. Foreign capital inflows have only recently become significant.

Hungary's experience is somewhat different again. The recession of 1990-93 was mild, but growth since then has been modest. Inflation too has declined only slowly, from a peak of 35 per cent in 1991 to around 14 per cent in 1998 and a projected 9 per cent in 1999. Like Poland, Hungary adopted a crawling peg exchange rate regime in 1995, and has imposed wage restraint upon public sector workers as a means of containing the resulting inflationary pressures.

The key weaknesses in Hungary's macroeconomic performance are, first, the persistent current account deficit in the balance of payments, which after falling to a low of 2 per cent of GDP in 1997 rose to almost 5 per cent on GDP in 1998. This deficit has to be financed by inward foreign investment and borrowing abroad, and any faltering in these sources of finance would threaten a forced devaluation and default on debt servicing, which successive Hungarian governments have been extremely anxious to avoid. The second weakness is the persistent government budget deficit which, in conjunction with low levels of domestic private savings, may be seen as the underlying cause of the balance of payments deficit; in other words, a classic “twin deficits” problem, in which the budget deficit is essentially financed (directly or indirectly) by borrowing abroad. After a period of budgetary stringency in the mid-1990s, the deficit opened up again in 1997 to around 5 per cent of GDP. This was exceptionally disappointing given that GDP itself was growing rapidly at this time, though the deficit fell slightly in 1998 and is projected to be below 4 per cent in 1999.

The underlying problems of the government’s finances are two-fold. First, revenues have been stagnant and even declining relative to GDP, due to widespread tax evasion and large tax arrears. Second, government expenditure is very large relative to GDP; it was around 55 per cent in the early 1990s and remained over 50 per cent in 1997 (see table 2). This is explained mainly by the comprehensive social security system, discussed further below.

Bulgaria’s initial output fall was substantial but the period 1994-95 showed some consolidation and recovery. In that period prices rose five fold but the balance of payments current account improved as import demand was low. The government budget deficit, however, behaved erratically, after reaching 12 per cent in 1993 it fell in the next two years to around 5 per cent. The financial crisis of 1996-97 led to a doubling of the inflation rate in 1996 and a ten fold rise in 1997; the government deficit in 1996 rose to 15 per cent. The reaction was a series of austerity measures, including a very large fall in government expenditure, and the introduction or a currency board which has stabilized the exchange rate. The positive expectation flowing from this have, however, not yet had the effect of returning the country to a stable growth of output.

Romania experienced a fall in output until 1992 but then had four years of expansion. The policy and structural legacy of the 1980s needs to be stressed. This included the encouragement of extra large enterprises and the discouragement of imports (in order to repay foreign debt prematurely). Investment suffered considerably. After some initial confusion when central planning was abolished the encouragement of enterprise and a return of popular confidence in the banking system led to a revival of growth. However, this proved short lived. Even relatively low central government budget deficits could not be financed in a non-inflationary manner, the current account deficit rose to 7 per cent in 1996, and bank failures prompted large injections of special credits. Austerity policies in 1997/98 have raised interest rates and helped cause economic regression but the economic structure has not been able to reverse the large current account deficit and the economy remains very vulnerable to foreign exchange and banking crises.

2. Privatization and restructuring

In principle the antithesis of state control over productive enterprises is their privatization. In fact the situation is more complex. In Russia, a voucher scheme of privatization was pushed through in 1993-4 and more than 20,000 enterprises were privatised - a major achievement. Privatization by cash sales continued thereafter and by 1997 privatised enterprises accounted for 70 per cent of GDP. But a heavy price was paid for the speed of privatization. First, in most cases it resulted merely in the transfer of ownership titles to workers and managers ("closed privatization"), so that no stimulus to greater efficiency from outside owners ensued. This has been a key failing in the privatization strategies of other countries too. Second, in some cases a few individuals acquired control of gigantic firms for next to nothing. The strategic errors in Russia consisted in pushing forward with privatization without ensuring the separation of the enterprise's owners and employees (the "governance" issue) and without taking simultaneous steps to introduce competition.

Another pressing restructuring issue concerns land ownership and agriculture. In 1997 nine-tenths of Russian agriculture still remained as large, inefficient, under-capitalised collective farms, nominally owned by their workers but in practice run by managers and rural officials who were indifferent or hostile to market forces. Two important new laws on land registration and mortgages were passed in 1998, but the refusal of parliament to approve a proposed Land Code has inhibited the development of a market in both rural and urban land and property.

Privatization in Ukraine has been even less successful. Ukraine is heavily industrialised, containing much of the former USSR's heavy industry, including some of its largest monopolies. Initially, and reflecting the widespread view that employees and managers had ownership rights in the enterprises where they worked, around one-quarter of state enterprises were leased to their employees, on terms which gave workers the exclusive right, for three years, to buy the enterprise at its (very low) book value. This was followed in 1994 by a voucher-based mass privatization programme. By 1998 the share of the private sector in GDP had reached 50 per cent, but of the 200 largest enterprises which were offered for sale by tender, only 40 had been sold by mid-1998.[5]

The principal problem with the voucher method of privatization is that the resulting diffusion of ownership rights leads to weak corporate governance. The dominant role of "insiders" (workers and managers) in newly privatised firms, coupled with persistent weakness in financial discipline and in the enforcement of bankruptcy law, has contributed to the slow pace of industrial restructuring. In Ukraine, as in Russia, there are several indicators of continued soft budget constraints on enterprises: by mid-1998 inter enterprise arrears amounted to over 80 per cent of GDP, wage arrears were 5 per cent of GDP (excluding government budgetary wage arrears) and barter trade constituted some 42 per cent of industrial sales. In addition an estimated 50 per cent of all enterprises reported losses in the first few months of 1998. Inward foreign investment has remained low, averaging about 0.5 per cent of GDP. The development of a dynamic market-driven economy is also seriously handicapped by corruption, which is said to be omnipresent. This feeds upon a grossly over-regulated business environment. For example, 36 licences and permits are needed to operate a private business legally, and a small business receives on average a visit from a government inspector every four days.

In both Russia and Ukraine the development of the financial and banking sector has also given considerable grounds for concern. In the former Soviet Union banking was liberalised as early as 1987 and the number of banks grew to over 1,000 in the 1990s as many non-financial

[5]In mid-1998 Ukraine resolved to speed up restructuring by the sale of the very largest enterprises in telecommunications, air transport and energy; by breaking up some of the large monopolistic enterprises, especially in the gas and electricity sectors; by agricultural land reform and dismantling of the agro-industry monopolies; and, by closing down at least 20 coal mines a year between 1998 and 2001.

enterprise groups set up their own "in-house" banks, thereby forming the large financial-industrial groups which have become major players in the Russian economy. Experience has been quite different in Poland and Hungary where growth in the number of banks occurred mainly through the breaking-up of large formerly state banks. The weak regulatory structure in Russia allowed many banks to borrow heavily in foreign currencies during 1997-98 in order to lend at much higher interest rates in the domestic economy, especially to the government. When in 1998 the government defaulted on these loans and the rouble was devalued these banks became insolvent. Another problem is the poor protection of minority shareholders, permitting insiders to cream off profits and discouraging portfolio investment. This is an issue of major significance given than 60 per cent of Russia's medium and large sized companies are majority owned by "insiders" - workers and, more importantly, managers.

Privatization in what was then Czechoslovakia pioneered the voucher method, beginning in May 1992. However the state retained a significant stake in a number of companies, especially in utilities, mining, steel making, and in three of the four largest banks. Following its separation from the Slovak Republic, the Czech Republic carried through a second phase of privatization, using a voucher scheme which also allowed citizens to hold shares indirectly via financial intermediaries named Investment and Privatization Funds (IPFs). The theory was that the IPFs would effectively monitor, and enforce restructuring upon, the privatised firms that they owned, thereby exercising the function of "outside" owners.[6] In practice this did not initially occur, most importantly, because many of the IPFs are owned by banks and this has led to a conflict of interest.[7] Industrial restructuring cannot be considered in isolation from financial restructuring and the counterpart of loss-making enterprises is banks with non-performing loans in their portfolios. Banks are forced to continue financing enterprise losses because the alternative, of initiating bankruptcy proceedings, would result in these loans being written off. If this happened on other than a modest scale, the banks would become insolvent, due to their low capitalisation and large proportion of non-performing loans. In the Czech Republic about one-third of bank loans are estimated to be irrecoverable, and only about one-third of bad loans are covered by provisions.

A second undesirable feature has been that IPFs often acquire "insider" information about companies in their portfolios, which they can exploit in stock market dealings. There have been numerous cases of fraud, often involving politicians or public officials. Until very recently no independent banking and financial regulatory body existed to check this.[8] In May 1997 a string of arrests of bank officials led the government to set up a new but rather toothless supervisory and regulatory body, the Securities and Exchange Commission (SEC). These problems have hindered and delayed the essential restructuring of the Czech industrial sector. A further contributing factor has been the absence of clear bankruptcy laws; there has not been a single major bankruptcy in the Czech Republic since communism collapsed.

Privatization in the Slovak Republic began before the dissolution of the Federation. Subsequent privatization, though, was by direct sales. Prices were set very low, often below book value. The buyer needed only to put down an initial 20 per cent of the purchase price, and was

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[6] In forming expectations of the behaviour of the IPFs there appears a danger of confusing 3 or even 4 models of corporate governance: (i) IPFs as mutual funds which simply buy and sell shares but exercise no direct control; (ii) IPFs as institutional shareholders who occasionally influence firms directly; (iii) IPFs as owners with a large enough stake in individual companies to exercise frequent direct control; (iv) IPFs as being like the German banks which, as well as being large lenders to individual companies, also exercise proxy votes on behalf of shareholders.

[7] The normal assumption is that creditors will wish the enterprise to pursue less risky strategies than will shareholders.

[8] This helps to explain why the Prague stock exchange has only a small volume of dealing relative to its market capitalisation.

permitted to offset subsequent investment in the enterprise against the balance outstanding. On these terms, privatization proceeded very rapidly, and by the end of 1995 both the Czech and the Slovak Republics had far outstripped other CEE countries in the proportion of large enterprises privatised. As in the Czech Republic, the government also defined a list of 29 “essential enterprises” which were not to be privatised, including energy, water, railways, telecommunications and postal service as well as the armaments, pharmaceuticals and agro-industry. Direct sales by the National Property Fund (NPF) continued in 1997-8 but there has been criticism of the lack of transparency in the selection of buyers and the terms of sale.

In the last few years share ownership has become more concentrated, and the large privatization funds have concentrated their portfolios, often by trading parcels of shares with one another. But this concentration in share ownership also carries dangers. One such is the exploitation of minority shareholders, which is made easier by a weak regulatory regime, lack of auditing to Western standards, and few requirements to publish relevant company information.[9], [10] A second danger is simply monopoly or oligopoly in product markets. Although some of the largest state enterprises were split up prior to their privatization, the degree of product market concentration remains high. A third danger arises from the very easy credit terms which were offered to buyers of privatised assets, which carries with it the risk of default should shares tumble in value.

From the fact that unemployment has remained high despite the sustained growth of output since the end of 1993, it is evident that considerable labour shedding has occurred. The growth of labour productivity (in terms of GDP per employee) has also been impressively rapid, at around 5-6 per cent p.a., over the same period (see Annex Table 1). On the other hand it is disquieting that the gross losses of Slovak firms were 8.8 per cent of GDP in 1996, a figure that was high relative both to previous years and other CEE countries.[11] This suggests that there is much restructuring still to be done.

In Poland privatization began with the purchase or lease by employees of small and medium sized enterprises. After much political wrangling a voucher-based privatization programme was implemented in 1995. Fifteen financial intermediaries (known as national investment funds) were set up and each given a one-third stake in 30 or so companies, for which it would act as "lead fund" or controlling owner, plus 2 per cent stakes in around 400 other companies. The vouchers were issued later and were immediately traded actively. More than half of the vouchers were resold to foreign owners - another important difference from voucher schemes elsewhere. Finally, the funds themselves were offered for sale in exchange for the vouchers. However the 500 or so companies involved in the mass privatization programme accounted for only 5 per cent of GDP.[12] Looking at the success of Polish privatization as a whole, it is clear that the prevalence of sales of small and medium sized enterprises to their employees has led to "insider" ownership which is not conducive to the pursuit of profit. This is reflected in the relatively poor financial performance of the private sector in Poland.[13] Progress in restructuring

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[9] A classic form of such exploitation is "asset stripping", when the majority shareholder orders the sale of assets to another company (which it also owns) at a knock-down price.

[10] The lack of transparency in company affairs is reflected in the very low turnover on the Slovak stock exchanges; many shares are traded rarely, if ever. As noted earlier this is also true of the Prague stock exchange.

[11] World Bank (1998d), Table 3.3.

[12] The direct link between fund managers' remuneration and the fund's value was another positive feature of the Polish scheme. The managers were to get 1 per cent per year of the fund's value, plus a bonus of up to 5 per cent in 2005. The bonus was presumably to combat short-term-ism.

[13] EBRD (1998.)In May 1998 a new programme of privatization was announced which aims over three years to sell off most of the remaining 2,800 state enterprises which include about three-quarters of the largest Polish

the banking and financial sector has been slow. Successive governments have feared that free entry by foreign banks would annihilate their Polish competitors, hence have required foreign banks to take over existing state owned banks. Although some large banks have been sold, the government is trying to restructure and recapitalise the remainder prior to privatization. The banks' balance sheets have been successfully cleaned up, however, and the proportion of bad loans dropped from 28 per cent to 10 per cent between 1994 and 1997.

Hungary made a slow start on privatization and has not adopted a voucher scheme. By 1994 the relevant agency, the State Property Agency (SPA), had successfully sold about 1500 small and medium sized enterprises by means either of liquidation sales or trade sales; that is, to other firms either domestic or foreign, leaving only a rump of small and unprofitable entities. However a parallel agency, the State Holding Company, had sold only 13 of the 172 large enterprises in its portfolio and in no case has 100 per cent of the enterprise been sold. The explanation for this poor sales performance was principally the lack of political will to privatise, as many of the enterprises were potentially very attractive to buyers. The government of reformed communists elected in 1994 set itself the target of completing the privatization process within 3 years, a target it came close to achieving. By 1997, 75 per cent of GDP was estimated to be produced in the private sector. Nevertheless the government remains firm in its policy of retaining some control in enterprises it views as of strategic importance to the economy. It has taken powers to retain a 'golden share' in 27 companies, giving it veto powers over key decisions such as mergers and sell-offs. In a further 116 enterprises, the government intends to retain a long-term ownership stake.

Given both a decision against mass privatization and a desire to privatise quickly, foreign buyers have inevitably been prominent. By the end of 1996 it was estimated that foreign majority owned enterprises accounted for 16 per cent of total gross value added in Hungary and were especially prominent in utilities. This appears to have galvanised the economy. In a range of foreign-investment-intensive sectors such as machinery, computers, telecoms equipment, electrical and electronic goods, output grew by 56 per cent in 1997 and productivity by 43 per cent. Smaller companies on the other hand, where domestic ownership predominates, have had a tougher time, facing in particular problems of access to bank credit. In the early 1990s the government tried to deal with the very weak financial position of most of the banks by means of ad hoc capital injections which merely treated the symptoms of the disease rather than its cause.[14] The moral hazard problem these bailouts created was exacerbated by the very weak supervisory and regulatory regime then in place. In the mid 1990s policy was reversed and privatization of the state owned banks proceeded rapidly; the asset share of state owned banks fell from 63 per cent in 1994 to 12 per cent in 1997. As with industrial enterprises, sales at this speed without recourse to vouchers entails selling, in the main, to foreigners. By 1997 thirty of Hungary's 41 banks were foreign owned. At the same time, bad loans as a proportion of bank assets fell form 17 per cent in 1994 to only 3.6 per cent in 1997.

3. The Labour Market and the Social Security System

3.1 The Labour Market

In Russia GDP fell by 40 per cent between 1990 and 1997, yet total employment fell by less than 15 per cent and official unemployment rose to only 10 per cent. (The initial situation in Romania was similar). This pattern of labour hoarding or hidden unemployment within enterprises

companies by turnover. Large enterprises in infrastructure, heavy industry, mining and finance were particularly targeted.

[14] These bail-outs were substantial, being estimated at 7.5 per cent of GDP in 1992-94.

has been aptly described as "growthless jobs". Because of the prevalence of "closed" privatizations most firms had little interest in improving their efficiency except to the extent necessary to maintain employment and meet the wage bill. This behaviour was made possible by "soft" budget constraints. Subsidies (including tax concessions and tax arrears) and inter-enterprise credit permitted enterprises to retain on their payrolls large numbers of super-numerary workers who were either given "administrative leave" or attended the workplace but contributed little to production.[15]

In Ukraine the pattern was similar: the collapse of GDP (by 60 per cent) was even greater than in Russia, but official unemployment remained almost negligible. An important difference was the huge decline in employment in Ukraine: in 1992-95 industrial employment fell by almost one-third. But how could official unemployment remain so low in the face of such a huge fall in employment? A part of the explanation may be that some unemployed workers chose not to register.[16] But the explanation must lie mainly in the growth of the unofficial economy, which by 1998 was estimated at 40-60 per cent of GDP.[17] This explanation is also corroborated by survey data on labour force participation which showed that although the male labour force participation rate was 79 per cent in 1995, the share of male employment in the formal sector was only 51 per cent.[18] It is notable too that (official) self employment remains very limited in Ukraine. Further support lies in the fact that most of those leaving industrial employment seem to have done so voluntarily.[19] Overall, in neither Russia nor Ukraine does official unemployment appear, as yet, to play any significant part in the adjustment process.

Both open and hidden unemployment are closely linked to the evolution of productivity, real wages and investment. In Russia in 1990-97, labour productivity fell by 30 per cent. For Ukraine the available employment data relate to industry only, and show that labour productivity fell by 60 per cent (see Annex Table 1). In both countries labour hoarding was facilitated by the dramatic drop in real consumption wages in the socialised sectors of the economy. In Russia the fall was 50 per cent and in Ukraine was 55 per cent. The mechanism whereby these real wage reductions came about is not entirely clear. There may be two processes, not mutually exclusive. One is a bargaining process in labour markets in which workers accepted lower real wages in the hope of preserving their jobs. Alternatively the causation may have been a credit squeeze on enterprises, aimed at halting hyperinflation, which deprived them of working capital and thus enforced a reduction in the wage bill (in real terms) - a reduction achievable either by cutting employment or by failing to increase money wage rates in line with inflation. In Ukraine it seems likely that the fall in real wages in the formal sector encouraged workers to quit in order to work in the burgeoning unofficial economy, while in both countries many workers were doubtless

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[15] Of course, it is not axiomatic that labour hoarding or hidden unemployment occurs whenever employment falls by proportionately less than output. In most production activities it is likely that some labour is "overhead" in character, with the effect that even at peak efficiency employment does not vary in direct proportion to output. By general consensus however this phenomenon explains little, if any, of the experience of transition economies in the 1990s.

[16] Although registration was a complicated procedure involving much paper work, nevertheless it seems unlikely that this would suffice to deter many who were truly unemployed from registering, given that registration is a pre-condition for drawing unemployment benefit. For a more detailed discussion see ILO-CEET (1995c).

[17] EBRD (1998) p. 196 estimates the unofficial economy at 40-50 per cent of measured GDP, while World Bank (1998c) gives a figure of 60 per cent, quoting the Head of the State Tax Service. This latter source puts the value of unofficial activity at $13-$15 billion, about 80 per cent of it conducted in dollars. (Note that GDP in 1997 was c. $50b, so unofficial activity of $15b would be 30 per cent of GDP.)

[18] See World Bank (1997b). The figure for females was even lower, at 37 per cent.

[19] ILO-CEET (1995c) p.52

employed in both the formal and unofficial economies. Given the fall in output it is not surprising that investment fell dramatically; data are not available for Ukraine, but in Russia investment fell by 60 per cent between 1992 and 1997.

In the Czech Republic employment scarcely fell at all, and unemployment remained almost negligible. After an initial jump in 1991, official unemployment stabilized at around 3 per cent in 1992-96, an exceptionally low level by any standards. Given that relatively little restructuring of industry has occurred due to weakness in corporate governance, it is tempting to surmise that stagnating labour productivity (that is, hidden unemployment in the workplace) helped to hold open unemployment down. However this is not correct, at least at the level of the economy as a whole. Economy-wide labour productivity growth was relatively rapid in 1993-97, averaging around 2.5 per cent per year. The negative effect on employment of this growth in labour productivity was almost exactly offset by the rapid growth of GDP, with the effect that total employment remained more or less constant in 1992-96. Thus it was the growth of GDP rather than stagnating productivity which was the key factor in avoiding high unemployment in this period.

However there were also significant structural changes occurring; the service sector was expanding very rapidly at the expense of both industry and agriculture. Also in 1990-93 about 250,000 pensioners, who had also been working, gave up their jobs; and a further 250,000 took early retirement or a disability pension and left the labour force. In aggregate this was more than 10 per cent of the labour force.[20] Another important factor was the growth of self-employment; by the end of 1993 nearly one million individuals were registered as private entrepreneurs - more than one fifth of the labour force.

In the Slovak Republic the fall in employment was much larger and its recovery much weaker than in the Czech Republic, and unemployment was much higher. (This has also been the pattern in Bulgaria) This difference may be partly explained by the greater weight of industry in the Slovak Republic's economy and its dependence on eastern markets. In 1991 registered unemployment rose within six months from 2 per cent to 13 per cent and has remained at broadly that level since. The labour force participation rate also fell by about 5 per cent 1989-96, with an even larger decrease in female participation. On the other hand, since 1995 employment has been growing at around 2 per cent per annum. There is an exceptionally high degree of regional imbalance in unemployment; with regional unemployment rates ranging from 4 per cent to 24 per cent. A highly compressed wage structure, and constraints on labour mobility (housing shortage etc.) have probably contributed to this regional imbalance. The imbalance will worsen if expected employment reductions in coal mining and armaments manufacture take place. For reasons which are not apparent, self employment is only about 6 per cent of total employment.

Despite the big difference between the Czech and Slovak Republics in their unemployment experience, the path of *real wages* has been very similar in the two countries. In both, there was a sharp fall in real consumption wages in 1990-91, followed by sustained growth. The Slovak Republic experienced the bigger fall (of about 28 per cent) and a slower recovery, so that by 1997 real wages were still about 5 per cent below their 1990 level. In the Czech Republic a somewhat smaller fall and a stronger recovery put real wages in 1997 about 5 per cent above their 1990 level.

It is perhaps surprising that the high levels of unemployment in the Slovak Republic have not had more apparent effect in inhibiting wage increases. This may be because (as has been found in western economies) workers who have been unemployed for a long time, or who are geographically isolated, are not actively competing in the labour market. A further probably important factor is the centralized and strongly "top-down" wage determination process. Central

[20] See Godfrey and Richards (1997), ch. 3.

wage negotiation in a tripartite framework was introduced in 1990 to the Czech and Slovak Federation, and the federal government was able to use wage negotiation and regulation fairly successfully as an anti-inflationary device. Wage increases were centrally regulated and were adjusted to follow price increases with a three-month lag, thus in principle stabilising real wages. This central wage determination, however, did not apply to the growing private sector.

After the dissolution of the federation the government of Slovakia replicated the institutional arrangements to form the Slovak Council of Economic and Social Agreement. The new government elected in 1994 continued to use this tripartite machinery to reach agreement at the national level on the minimum wage, the wage structure or 'tariff', and even the income tax system. The government stated its general objective as being to seek to ensure that wage increases would follow productivity increases. It did not seek to re-assert any general regulatory power over wages, except in state owned enterprises where wage increases would otherwise be inflationary.

In 1996-7 it became increasingly apparent that the objective of aligning real wage and productivity increases was not being achieved; consumer price inflation was continuing to decline, but with no corresponding reduction in the level of wage settlements. At the end of 1997 the government introduced a comprehensive wage regulation scheme applying to both public and private sectors, limiting wage growth to 6-12 per cent depending on the firm's performance. While this form of incomes policy or wage restraint (whether centrally-imposed or merely centrally-agreed) may be justified as helping to avoid a wage-price spiral from developing in the early 1990s, its reintroduction in the late 1990s is a disturbing sign that there has been little reform of the labour market in the Slovak Republic. In the medium term, controlled wage bargaining and the relatively rigid and highly compressed wage structure are continuing handicaps to structural change. Wage differentials, both between occupations and regions, have remained very small, which has doubtless contributed to sustained high levels of unemployment.[21]

In Hungary, the recession of the early 1990s resulted in huge job losses; employment fell by no less than 25 per cent between 1990 and 1995 and then turned modestly upward. Unemployment peaked at around 12 per cent in 1992, since when it has stabilised at around 10 per cent. As in most other countries, as the recession lengthened there was a steady increase in the proportion of long term unemployed. Both the fall in employment and increase in unemployment appear large, given the strong performance of GDP and industrial production in Hungary. One explanation could be that a significant degree of restructuring was taking place, so that growth of production resulted from shifts to less labour-intensive products and processes.[22] The increase in registered unemployment was considerably less than job losses, in absolute terms. This can be explained partly by workers apparently leaving the official labour market to become disability or early retirement pensioners, to become students, to take maternity leave or to become careers of family members. However an unknown number also worked in the unofficial economy, either full time or part time. Presumably, those who are working in the unofficial economy will not all reveal this fact, even in anonymous survey data, which would mean that the apparent decline in unemployment and the labour force consists in part at least of people moving into the unofficial economy, which according to estimates was equivalent to 27 per cent of GDP in 1992.[23]

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[21] World Bank (1998d) p.92.

[22] Contrary to what we might expect, the fall in employment was proportionately by far the greatest in agriculture, the share of which in total employment fell from 17.5 per cent in 1990 to 9.9 per cent in 1993. In the same period the share of industry in total employment fell only marginally, from 37.7 to 36.1 per cent. The great gainer was the service sector, where the share expanded from 44.8 per cent to 53.0 per cent.

[23] See Godfrey and Richards (1997); World Bank (1995).

Real wages in Hungary have been relatively stable. They fell by about 7 per cent in 1990-91, recovered in the mid-1990s and then fell again by about 3 per cent in 1997. This stability reflects a noticeable tendency for wages in Hungary to move broadly in step with prices, which in turn helps explain why inflation has fallen comparatively slowly there. There has been no formal incomes policy in Hungary, but public sector pay increases have been constrained in the pursuit of inflation objectives, especially after 1995. The stability, or perhaps stagnation, in real wages is in marked contrast to the impressive growth in labour productivity. Overall productivity, measured by GDP per employee, grew by 3.8 per cent per year in 1991-97, while industrial labour productivity grew at the phenomenal rate of 10 per cent per year 1993-97.[24] Since real wages in terms of producer prices fell slightly in the same period, the resulting positive gap between labour productivity and real producer wage growth indicates a fall in unit labour costs. This may well have played a large part in explaining the attraction of Hungary to both domestic and foreign investors; investment rose considerably throughout the period. Using all economy data a sustained fall in unit labour costs is not found elsewhere for more than 2 or 3 years (e.g. Russia 1993-95). More common has been a lengthy rise in unit labour costs (e..g the Czech Republic 1991-97, the Slovak Republic 1991-96 and Ukraine 1993-96, after a large fall in 1992).

In Poland, following the "big bang" of 1st January 1990 the unemployment rate jumped from virtually zero to around 12 per cent in 1991, rose to a peak of 16 per cent in 1993 (by a large margin, the highest rate outside the Balkans) and fell only slowly thereafter. In addition to the increase in numbers unemployed, a roughly equal number of people of working age left the labour force. The combined effect was that between 1991 and 1994 employment relative to the population of working age fell from 78 per cent to 66 per cent. After 1994 sustained growth in the economy helped to reduce unemployment gradually but it remained over 10 per cent in 1997. With Poland having easily the best performance of all transition countries in growth of GDP and industrial production, it is scarcely surprising that total employment fell very little in 1990-92 and recovered strongly thereafter. However the level of employment in 1997 was below that of 1990, so the overall picture was one of "jobless growth". As in Hungary, sustained unemployment of more than 10 per cent despite rapid growth may be explained by structural shifts in the economy which accompanied (or more accurately, enabled) growth of total output.

Both inflation and real wage growth were influenced in the early 1990s by the excess wage tax (popiwek) which was introduced in 1989. This set a ceiling on the total wage bill of the enterprise, with only partial compensation for past inflation. If the enterprise exceeded this ceiling it became liable for additional taxes on an increasing scale.[25] The purpose of the tax was not only to restrain the wage-price spiral, but also to discourage weakly supervised state enterprises from transferring the enterprise's working capital to workers via excessive wage increases ("decapitalisation"). The tax was very unpopular with the trade unions, and after a great deal of controversy it was abolished in 1994. The effect of the wage tax was that in 1991-94 money wage growth was broadly in step with consumer price inflation, with the effect that real wages did not change very much. After the abolition of the tax in 1994, real wages in terms of consumption goods began to rise at around 5 per cent per year, which was broadly compatible with productivity growth in the whole economy. In the industrial sector, labour productivity rose exceptionally rapidly, averaging 10 per cent per year 1993-97; equal to the Hungarian rate noted above.[26]

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[24] For industrial production and employment, see OECD, *Main Economic Indicators*. Industrial labour productivity and the real product wage rose at broadly the same rate over 1990-97.

[25] One problem with this scheme was that loss-making enterprises were likely to be undeterred by the tax penalties as they would probably default on their tax liabilities in any case. Thus the excess wage tax was a binding constraint only on profitable enterprises, which appears perverse.

[26] Investment almost doubled between 1990 and 1997.

In Romania the relative stability of employment in 1990-94 was bought at the cost of the a 36 per cent fall in consumption wages. When employment subsequently began to fall real wages rebounded by about one third. But this large increase contributed to the need for a policy reversal in 1997, and another major fall in real wages occurred. In Bulgaria the fall in real wages reached 28 per cent by 1997 although the rate of decline was slowing by the end of the period

3.2 Poverty and the Social Security System

Poverty measurement in both Russia and Ukraine, where income and prices have been changing very rapidly in both real and nominal terms, is subject to large margins of error. As has been analysed elsewhere, the true decline in workers' living standards in both countries was probably substantially less than the data in Annex Table 1 would indicate, when allowance is made for the large proportion of the population able to grow some food on small plots, and also the growth of the unofficial economy.[27] Nevertheless the European Bank's poverty measure, defined as an income per person per day of less than $4 (in terms of real purchasing power) indicates that 38 per cent of the population in Russia and 41 per cent in Ukraine were in poverty in 1998.[28]

In Russia poverty occurred because money wages failed to keep pace with rapid inflation. The same was true of social security benefits. Unemployment benefit, for example, went from being 75 per cent of wages in the previous 3 months to being set at the level of the minimum wage. Furthermore, the minimum wage was the result essentially of political decision and, whereas in the mid-1980s it had been close to the average wage, by 1993 it had fallen to only 6.5 per cent of the average wage[29], less than one-quarter of the official subsistence minimum. (By 1997, however, average benefits were some 40 per cent of the subsistence minimum). The real value of unemployment benefit was indeed so low in 1991-95 that a large proportion of eligible unemployed did not bother to submit themselves to the complex registration procedures necessary to claim it. Even by 1997 the total of unemployment benefits paid out amounted to only 0.2 per cent of GDP.[30]

In general the social security system in Russia is very limited; cash transfers accounted for only about 7 per cent of GDP in 1994/95. Payments for maternity and sick leave, child allowances and emergency poverty relief amounted to about 2 per cent of GDP and pensions accounted for about 6.0 per cent of GDP (see Table 3). All of these cash transfers were financed by a 41 per cent payroll tax (in 1996). The targeting of benefits is extremely poor; it has been estimated that one-fifth of poor households, and one-third of very poor households (defined as having an income of less than half of the subsistence minimum) receive no public transfers whatever. During 1991-93 the numbers living below the subsistence minimum increased from 11 million to 46 million, or 32 per cent of the population (broadly corroborating the poverty figure of 38 per cent cited above).[31]

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[27] See for example Rutkowski (1995), Box 1.

[28] EBRD (1998). The income per person per day of less than $4 is measured in terms of 1990 US dollars converted at purchasing power parity (PPP). For alternative poverty estimates for Ukraine, see ILO-CEET (1995c), p 242, 247; World Bank (1996a). Note that World Bank (1998b) gives 32 per cent as the proportion of the population below the official poverty line.

[29] Standing and Vaughan-Whitehead (1995), p.20.

[30] Nesporova (1999). Employment and Labour market policies in transition economies, ILO, Geneva.

[31] World Bank (1996).

Table 3: Social expenditure, selected countries (per cent of GDP)*, 1996

Country (in rank order)	Total social expenditure	Of which, pensions
Hungary	22.3	9.3
Poland	26.8	14.3**
Slovak Rep.	20.9	8.3
Ukraine	19.8	9.6
Czech Rep.	18.8	8.1
Bulgaria	13.2	7.1
Estonia	17.1	7.6
Lithuania	14.7	7.3
Romania	12.4	6.8
Belarus	17.4	8.8
Russian Fed.	10.4	5.9 (1994)
Albania	10.9	5.7
EU average (12 countries)	**26.8**	**12.1****

* Note that year-to-year variation in GDP can change the values in this table substantially. For this and other reasons the data should be treated as indicative only.
**Gross of income taxes. The after-tax figure for Poland is estimated at 2-2.5 percentage points lower. In the other transition economies pensions were not taxable.
Source: ILO estimates.

Most attention focuses on pensions since they are the major expenditure component. The level of pensions is not extravagant; the average pension was 35 per cent of the average wage in 1994, which compares with an OECD average of 45 per cent. But the number of beneficiaries has increased rapidly, not because of population ageing but because of an increasing number of disability pensioners and early retirees, which in 1994 brought the total number of pensioners up to 50 per cent of the working population. And resources are threatened by the erosion of the tax base due to payments arrears and evasion. As in other countries there have been proposals to raise the retirement age, reduce reliance on payroll taxes as the source of finance, and more radically to introduce a second pension tier that would be fully funded rather than "pay as you go".

In Ukraine the same pattern emerged as in Russia. Social expenditures (including health) fell from 29 per cent of GDP in 1992 to 21 per cent in 1994, the peak year of inflation and to 20 per cent in 1996. Both unemployment benefit and the minimum wage have fallen dramatically relative to the cost of a minimum consumption basket.[32] Benefits were about one quarter of wages in 1997. The most recent EBRD data show a further decline in real wages in 1997, to less than one-third of their 1990 level. However, poverty is not solely a matter of low wages and benefits, but is strongly linked with household composition. Nearly one-quarter of poor households contain no one aged 15 - 64. Nevertheless, any attempt to reduce poverty by increasing pensions would be both costly and inefficient, because 40 per cent of pensioners are aged under 65, and only 35 per cent of pensioners are poor.[33]

The role of the social security system in poverty alleviation in Ukraine has been limited in

[32]ILO-CEET (1995c).

[33] World Bank (1996a); World Bank (1997b).

the 1990s, partly due to the fiscal crisis. The Ukrainian tax system relies heavily on payroll taxes as a source of revenue, and their resulting high rate (52 per cent of the wage bill in the early 1990s, reduced to 41 per cent by 1998) created a strong incentive to both workers and employers to switch to the unofficial sector, eroding the tax base still further. Possibly one-third of men and one-half of women were able to avoid all taxation of their labour income because they were working in the unofficial economy. In addition, it seems highly probable that payroll taxes at such high levels depressed total employment in the official economy, or reduced real wages, or both. Expenditure on unemployment benefits, training and retraining and job creation have constituted a very minor part of social security expenditure given the low official rates of unemployment experienced in the 1990s and low rates of benefit.

There is general recognition that the present pension system requires urgent reform. The dependency ratio (pensioners relative to contributors) was 0.58 in 1993 - an exceptionally high value. In the same year the replacement ratio (average pension relative to average wage) was about 0.43. The implied tax rate on earnings necessary to finance pensions was thus 0.58 X 0.43 = 0.25 or 25 per cent).[34] This figure would have been even higher, had not the government allowed the value of pensions to decline relative to earnings. Nevertheless pensions accounted for nearly 10 per cent of GDP in 1996.

In contrast with Russia and Ukraine, *poverty* in the Czech Republic appears to be very low; only 1 per cent of the population are poor, according to the European Bank's data. This difference is evidently related to the very different path of real wages in the Czech Republic. Because registered unemployment has so far remained exceptionally low funding unemployment benefits

Table 4: Pension parameters, selected countries

Country (year)	Dependency ratio	Financial ratio (replacement ratio)	Implied payroll tax rate (per cent)	Payroll taxes as share of wage bill (1996)
Hungary (1996)	0.66	0.39	26	59
Poland (1996)	n.a.	0.64	n.a.	48
Slovakia (1996)	0.6	0.41	25	50
Czech Rep. (1996)	0.5	0.42	21	49
Ukraine (1993)	0.59	0.37	22	41
Bulgaria (1992)	0.80	0.3	24	45
Latvia (1994)	0.56	0.42	24	38
Lithuania (1996)	0.46	0.31	14	31
Russia (1993)	0.49	0.42	21	41

Source: ILO-CEET (1997) and ILO estimates.

has not proved a burden; these cost only 0.13 per cent of GDP in 1997 (see Table 5). Since the early 1990s the duration of unemployment benefit has been limited to six months and is paid at a rate of 60 per cent of the worker's previous wage for the first three months, and 50 per cent thereafter, but with a maximum which may be estimated at about one quarter of the annual wage.[35]

Table 5: Expenditure on passive and active employment measures (% of GDP)

[34] A numerical example may help in understanding this calculation. If the dependency ratio is 0.5 (i.e. there is 1 pensioner for every two workers); and the replacement ratio is also 0.5 (i.e. the pension is half of earnings), then each of the two workers must pay a tax of 0.5 X 0.5 = one-quarter of their wage to finance the pensioner's pension. Thus in general the required tax rate is given by the product of the dependency ratio and the replacement ratio.

[35] Nesporova, Table A7.

Country	Year	Unemployment benefits	ALPS			
			Youth & training	Job creation & subsidy	Total - ALPS	Grand total
Russian Fed.	19921997	n.a.	n.a.	n.a.	n.a.	0.2
		0.2	n.a.	n.a.	0.1	0.3
Ukraine	19931997	0.01	0.06	0.08	0.14	0.15
		0.02	n.a.	n.a	0.13	0.20
Czech Rep.	19921997	0.18	0.01	0.2	0.21	0.39
		0.13	n.a.	n.a.	O.07	0.20
Slovak Rep.	1993	0.55	0.05	0.27	0.32	0.87
Hungary	19941996	1.63	0.12	0.26	0.38	2.01
		0.80	n.a.	n..a	0.40	1.20
Poland	19931997	1.68	0.12	0.19	0.31	1.99
		1.48	n.a.	n.a.	0.42	1.90
Bulgaria	19921996	0.59	n.a.	n.a.	0.01	0.6
		0.35	n..a	n.a.	0.15	0.5
Romania	1992	1.4	0.02	0.19	0.21	1.61
Slovenia	1992	0.85	0.26	0.68	0.94	1.79

Sources: Early years, Godfrey and Richards (1997), Table 1.6 (except Russia); later years, Nesporova, table 3.3.

The Czech Republic also has some "active" labour market programmes which although small (with an inflow of 30,000 in 1997) are apparently well-targeted. Active labour market programmes (ALPs) are normally taken to comprise (i) job counselling and placement services; (ii) retraining and relocation measures; (iii) recruitment and temporary employment subsidies; and (iv) temporary public employment or "public works" schemes. The general case for such policies is that (i) and (ii) help to reduce frictional and structural unemployment, while (iii) and (iv) help to re-attach to the effective labour force workers who have become marginalised. In these ways ALPs can permanently reduce unemployment - rather than simply inducing "churning" in which an employed and an unemployed worker exchange places.[36] Adding the cost of these "active" policies to the cost of unemployment benefits noted above, the total cost of all labour market policies was 0.39 per cent of GDP in 1994 (Table 5). Labour market expenditures have been financed, since 1993, by a payroll tax of 3 per cent on employers and 1 per cent on employees.[37] After the early 1990s programmes were reduced and some funds were unspent. With growing unemployment more funds are needed for passive benefits.

In terms of total social security expenditure relative to GDP, the figure for the Czech Republic, at 19 per cent in 1996, well below Poland and Hungary (see Table 3). The dominant component of social security spending is pensions, which account for nearly one-half of total social

[36]The Czech Republic has had a number of programmes supporting self-employment as well as job creation programmes, concentrated on disadvantaged workers such as Roma and the disabled and on areas of high unemployment. About 25,000 jobs were created in these programmes in 1994. There are also a number of small scale training programmes, offering about 14,000 training places in 1994, of whom a remarkable 70 per cent found jobs on completion of their training. Also some schemes exist to subsidize employers who offer work experience to school and university leavers, and to the disabled.

[37]See Godfrey and Richards (1997), ch. .3.

security spending, one-quarter of total government spending, and about 8 per cent of GDP. The dependency ratio in 1992 was 0.5, one pensioner for every two contributing workers. The replacement ratio was 0.42, and the implied tax rate on workers was thus 21 per cent. This figure is certainly very much higher than most OECD countries where the average in the early 1990s was 12.6 per cent. In the Czech Republic the government has attempted to gradually raise the retirement age for men from 60 to 62 years, and for women from 53-57 to 57-61. However, this has been partly offset by more generous early retirement options. A more fundamental reform has been the recent introduction of a so-called "second tier" to the pension system. The first tier is simply the pre-existing PAYG scheme, while the second tier will comprise voluntary contributions to approved private pension schemes with the "sweetener" of a state subsidy. If take-up of this optional scheme is reasonably strong, this will make it possible to stabilize contributions and benefits in the first tier and even allow them to erode in real terms via inflation. In 1997-8 there were discussions regarding a possible third tier with mandatory contributions to approved fully-funded private schemes.[38]

In the Slovak Republic poverty appears to be as low as in the Czech Republic.. The distribution of funding of welfare benefits has not fully adapted to the prevalence of long term unemployment, which tends to hit unemployed workers with young children particularly hard. Thus poverty is more common among large families than among the elderly.[39] The unemployment benefit system in the Slovak Republic is very similar to that of the Czech Republic. Unemployment benefit lasts between six and twelve months, depending on the individual's contribution record. The replacement rate is initially 60 per cent of the worker's net wage, falling after three months to 50 per cent. There is a strong government commitment to active labour market programmes (ALPS), presumably in response to the intractable pockets of regional and sub-regional unemployment and to low labour mobility. Most of the expenditure is on subsidized employment including what may be broadly described as "public works". The number of participants has been large, at over 4 per cent of the labour force in 1995 - a level matched only by Sweden. Relatively little is spent on training and retraining.

Social security spending as a whole is about 21 per cent of GDP. Pensions as a proportion of GDP were 8 per cent in 1996. The dependency ratio was 0.6 in 1992 - one of the highest in central and eastern Europe. This was offset somewhat by the average replacement rate 41 per cent. Simulations carried out by the Ministry of Labour suggest that the pension fund will move increasingly into deficit over the next two decades unless contributions are raised by the equivalent of 3-5 per cent of GDP, which may be politically unacceptable. Payroll taxes are very high; in 1996 the employer paid 38 per cent and the employee 12 per cent.

In Poland the extent of poverty is quite marked at 13 per cent of the population. Unemployment was a major cause of poverty, and poverty increased sharply with family size. In contrast, poverty among elderly people was only half the national average.[40] Since 1992 unemployment benefit has been paid at a flat rate of 36 per cent of the average wage, with a normal duration of six months. As the recession of the early 1990s lengthened, the proportion of the unemployed who had exhausted their entitlement to benefits inevitably increased, reaching 52 per

[38]See ILO-CEET (1997); EBRD (1998). Similar reforms have been adopted in Latvia.

[39]According to UNICEF 5.1 per cent of the population were in poverty in 1992-4, compared with only 0.6 per cent of the elderly; see ILO-CEET (1997), Table 7. The poverty line used is 60 per cent of 35-40 per cent of the 1989 average real wage for the country concerned.

[40]See World Bank (1994a), Box 1.1.

cent in 1993.[41] (This fell to 41 per cent in 1997.)[42] However, it is worth noting that there is an incentive to register as unemployed, because registered unemployed and their families are entitled to free health care. Poland's expenditure on active labour market programmes has become fairly high. The bulk of the funding is absorbed by unemployment benefit, due to the high levels of unemployment. The two largest components of active policies have been job subsidies and public works with at least 150,000 participating in each programme in 1997. Job subsidies are targeted mainly at the long term unemployed, school leavers, and females (for whom public works are unsuitable). Public works last six months and are targeted at long term unemployed and those who do not qualify for unemployment benefit. Training (other than apprenticeships) takes a lesser share of the budget.

The share of GDP devoted to pensions is estimated to have risen from 7 per cent in 1988 to 14.3 per cent in 1996, with further increases in prospect.[43] The increase in pension costs was the result mainly of a rapid increase in numbers eligible for retirement pensions, which can be claimed by a man after 25 years work and by a woman after 20, regardless of whether they cease work. A second important factor was that pensions lost less real value than did wages in the inflation of the late 1980s and early 1990s. Consequently the average old age pension increased from 53 per cent to 64 per cent of the average wage between 1988 and 1996.

In Hungary evidence on the incidence of poverty is mixed. The European Bank's 1998 data give a poverty incidence in Hungary of only 2 per cent. But according to a survey by the Hungarian Statistical Office, 15 per cent of the population were living in 1992 below the subsistence minimum, defined as 50-70 per cent of the average net wage. Poverty was most commonly found among single-parent families, households headed by an unemployed person, and families with four or more children. As in other transitional economies, it seems that the increased poverty associated with transition has hit families with young children to a greater degree than the elderly.[44] The duration of unemployment benefit in Hungary varies from 3 months to 1 year depending on the individual's contribution record. Benefit entitlement is based on previous earnings but with an over-riding minimum where previous earnings were very low. In 1996 average benefits were 28 per cent of average wages.[45]

Hungary has a relatively large portfolio of active labour market programmes (ALPs), comprising training and retraining; job and wage subsidies; and public works. In 1994, about 94,000 people took part in training. This was a large number, being more than double the figure in Sweden in the early 1990s, a country renowned for its commitment to ALPs. Training appears to be very successful**;** about 20-30 per cent of trainees found jobs immediately after completing training and a further 20-25 per cent after one or two months. However, training was taken up by only some 40,000 in 1997 while over 150,000 had some experience of public works. In sum, Hungary has a large ALPs programme, in which 230,000 unemployed persons participated in 1997.

Hungary devoted nearly 22 per cent of GDP to social spending in 1996, a fairly high proportion. The government derives about one-third of its revenue from payroll taxes. Payroll taxes totalled 59 per cent of the wage bill in 1996, of which the employers' component was 49.5 per cent. Thus the tax falling on employers was almost exactly one-third of total labour costs (49.5 / 149.5) - clearly, a very large "tax wedge". Pensions absorbed 9.3 per cent of GDP in 1996. The age-dependency ratio (persons aged 60 and over, relative to persons aged 15-59) was relatively

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[41]Godfrey and Richards (1997), Table 5.11.

[42]Nesporova, op.cit.

[43]It is worth noting that the figure of 14.3 per cent for Poland is gross of income taxes, whereas pensions in other transition economies are tax free.

[44]See World Bank (1995), p.28.

[45]Nesporova, op.cit.

low, at 0.36 - a figure comparable with many OECD countries. The chief problem with the Hungarian pension system is that the total number of pensioners, including early retirees and disability pensioners, is large in relation to the number of contributors to the pension fund. In 1993 this ratio was 0.66 - one of the highest in the world.[46] This, taken in conjunction with the replacement ratio of 0.39, implied that the required tax on earnings was 26 per cent.

4. Conclusions: obstacles to increased employment

This section attempts to identify and resolve the main policy issues, and consider their relevance and applicability. The first set of issues falls under the broad heading of fiscal policy. This involves not only stabilization but also labour market and social security questions. A central question concerns the appropriate share of public expenditure in GDP. There is no consensus among economists regarding the optimal size of government spending relative to GDP, nor how this should vary with the level of GDP. Therefore the premise, often encountered either explicitly or implicitly, that transition countries should aim to bring the size of their government sectors into line with other countries) with similar levels of per capita GDP (i.e. upper-middle income developing countries) cannot be uncritically accepted[47]

Nevertheless, there are three good reasons why governments of transition economies should seek to reduce this share. First, the difficulties transition economies are experiencing with revenue raising (especially the risk of the vicious circle of ever-higher tax rates and ever-shrinking tax base); second, their difficulties in funding budget deficits by tapping either domestic or foreign savings, and the danger that by doing so they will pre-empt resources which might otherwise have gone into private sector investment, which is desperately needed. Third, a public expenditure share of more than 50 per cent, as in the early 1990s in Slovakia and Hungary, was almost certainly too high. At this level the benefits at the margin of publicly provided goods, services and transfers are likely to be low, while the distortions resulting from the various tax wedges needed to finance expenditure at this level are likely to be large. For these very practical reasons transition countries in general should aim in the medium term to reduce the share of public expenditure in GDP to a percentage in the low 40s, and preferably somewhat lower. However, for twelve western European countries in 1990-92 the unweighted average of their share of government expenditure in GDP was 49.7 per cent.[48] This indicates that the transition countries are not wildly out of line with other countries where socio-political values support an active role for government both as instrument of social justice and as a provider of goods and services.

A second problem concerns the chronic inability of governments to meet their budgetary targets, which in turn is linked with on-going problems of controlling public expenditure and collecting taxes due. These problems have been at their most acute in Russia and Ukraine. Failure to collect taxes was a key factor in the Russian melt-down of 1998, because it led to a huge expansion of government borrowing abroad and thence to default. The first priority must certainly be to increase tax collections (Russian central government tax revenues in 1998 were lower than those of New York City). Achieving this is partly a political and administrative matter, but it is apparent that a new tax code to strip away the current absurd complexities and inconsistencies, and improving the professional status of tax collectors, are necessary ingredients of any solution. In

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[46] For some indicative data see World Bank (1994b), Tables A1, A11.

[47] In upper-middle income developing countries in 1989-91, central government expenditure as a percentage of GDP ranged from 8.5 per cent in Argentina to 32 per cent in South Africa, with a median value of 25 per cent. See IMF, *Government Finance Statistics Yearbook 1993.*

[48] See World Bank (1995), Table 5.4. The countries were Austria, Denmark, Finland, France, Germany, Ireland, Netherlands, Norway, Portugal, Spain, Sweden, and the UK

Ukraine too tax collections have fallen well below target due to widespread evasion and avoidance, and in both countries a serious problem has arisen of unpaid wages and salaries due to public officials, as well as pension arrears. As noted, in Ukraine these amounted to some 4 per cent and 2 per cent of GDP respectively in mid 1998. In many other transition countries budgetary control is also somewhat precarious and there are serious shortfalls in tax revenues.

Questions of tax rates and tax collection are closely linked with the size of the unofficial economy. In several countries the unofficial economy is believed to be very large; for example, an estimated 27 per cent of GDP in Hungary and 40-60 per cent of GDP in Ukraine. Clearly high tax rates are a principal factor driving the growth of the unofficial economy, but as the unofficial economy grows so the tax base shrinks and tax rates must be increased still further to maintain tax revenue, thus completing a vicious circle. For example, for Hungary it was estimated in 1995 that if even 100,000 workers (about 1.9 per cent of the workforce) could be persuaded to move from registered unemployment (while working in the unofficial economy) back to the official economy, this would improve the government's budgetary position by about 0.5 per cent of GDP - a substantial gain to a country struggling to reduce its budget deficit.[49]

To escape this, it may be tempting for governments to clamp down hard on unofficial economic activity, but this should be approached cautiously, as much (but by no means all) of unofficial economic activity contributes quite importantly to the overall health of the economy, as well as providing a valuable source of employment. The aim therefore should be not to destroy the unofficial economy but to promote its integration over time with the official economy. This is best done by keeping tax rates as low as is reasonably possible and also minimising the burden of regulation on small firms.

Payroll taxes in transition economies are significantly higher than in western economies. The unweighted average payroll tax rate in 12 transition economies in 1996 was 44 per cent, compared with an average of 20 per cent in 12 western European countries in 1992. Payroll taxes (which are typically hypothecated for financing various social benefits) are often singled out as a source of distortion - in particular, they are seen as reducing employment, at least in the official economy. The negative effect on employment arises, it is argued, as follows. With a payroll tax of, say, 50 per cent and if the worker's wage is, say, $100, it will only be profitable for the firm to hire her if she produces $150-worth of output, the difference of $50 being the payroll tax, or "tax wedge" as it is commonly known. The tax rate is therefore $50/$150, or 33 per cent.

The key question is whether this tax reduces employment. In the traditional neoclassical model of the labour market, the answer is affirmative. It is argued that if the tax were abolished, the forces of supply and demand would lead to a new equilibrium wage rate which would lie somewhere between $100 and $150; perhaps $125. At this wage, it would be profitable for firms to hire more workers, as they would now need to produce only $125 of output in order to cover their employment costs, rather than $150 as before. At the same time, workers would be willing to supply more labour since the reward has increased from $100 to $125. Thus both the demand for and the supply of labour increase, and the new wage settles at the point where the increase in demand and increase in supply are equal.

However the increase in employment in this case is not the only possible outcome. If in the long run workers feel that they simply have to accept whatever real wage the market offers - simply because "a low wage is better than no wage" it follows that when the payroll tax was first imposed, workers will have accepted a wage cut of equal magnitude in order to avoid the fall in employment which would otherwise occur due to the rise in employers' labour costs. In other words, it is possible that although the payroll tax is nominally paid by employers, it is effectively paid by

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[49] World Bank (1996b), Box 4.4.

workers. In this case, the whole process goes into reverse if the payroll tax is abolished; that is, the wage rises but employment remains unchanged. The crux is that in the neoclassical model it is, *a priori*, an entirely open question whether the effect of payroll taxes falls principally on employment or on wage levels. Some empirical support for the belief that they affect principally wages is that the share of wages in value-added is much smaller in transition countries than in western Europe. [50] The dramatic fall in real wages in Russia, coupled with a relatively small fall in employment, also supports this view.

A major criticism of the neoclassical labour market model is that it assumes that enterprises can sell as much output as they wish at its ruling market price, and workers can sell as much of their labour as they wish at the ruling market wage. Various models of the labour market explore rigorously the consequences of relaxing these rather unrealistic assumptions. Thus the Keynesian model argues that in some circumstances enterprises sales are constrained by insufficient demand. Enterprises will not hire more workers even if the cost of hiring falls, because they cannot sell the resulting increase in output. New and more complex variants of both the neoclassical and Keynesian models overall tend to show that the effect of tax changes and other shifts on employment, real wages and other variables of interest varies greatly according to the assumptions made.[51]

Payroll taxes may also affect employment through substitution in production and consumption. The payroll tax gives producers an incentive to switch, where possible, to more capital intensive methods, reducing the demand for labour associated with any given level of output. At the same time production costs and therefore prices of products which are relatively labour intensive rise relative to more capital intensive goods and services, giving consumers an incentive to switch from the former to the latter. Both of these effects reduce the demand for labour, especially unskilled, because goods and services which are labour-intensive are mostly also intensive in their requirement of unskilled labour.[52]

High payroll taxes are also more likely to reduce employment when they interact with other elements of the social security system have adverse incentive effects. For example, a relatively high level of family allowances (as is common in transition countries) weakens the relationship between work and household income in households with several children. This alone may reduce work supplied. Simultaneously a high rate of payroll tax (which perhaps finances the family allowances), may reduce labour demand. With both labour supply and labour demand falling, the likelihood of a fall in employment is great. Probably the most robust effect is the incentive for both workers and employers to move into the unofficial economy in order to escape the payroll tax (and possibly other taxes too). While this does not reduce total employment it promotes the vicious circle of ever-higher taxes and an ever-shrinking tax base. This must be combated because it threatens to destroy the whole economy (since no economy can function without government).

In sum, it is not unreasonable to claim that payroll tax wedges falling on employers as high as 30 - 35 per cent are distortionary and probably have some adverse effect on employment, and should therefore be reduced. One straightforward solution would be to switch the financing of

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[50]See ILO-CEET (1997), p.15.

[51].For example, in an influential labour market model developed by Richard Layard and others (see Layard, Nickell and Jackman (1991)), the key assumption is that real wages are set not by "atomistic" market competition between individual workers and employers but by bargaining between groups (though this bargaining is constrained by competition in the market place).Their analysis shows that a reduction in indirect taxes will temporarily reduce both unemployment and inflation, but will have no lasting effect on either. (Here "temporarily" means several years, which may be long enough to be considered worthwhile by policy makers.)

[52]These adverse substitution effects can be eliminated by switching from payroll taxes to value-added taxes, as the latter do not discriminate between labour and capital inputs.

health care to broader based income and value added taxes, provided such taxes can be collected reasonably effectively.

A vast body of theoretical and empirical research has examined whether the level and structure of unemployment benefits affect the intensity of job search by the unemployed and their willingness to accept a particular job offer at a given wage. A crucial variable is obviously the "replacement rate", i.e. the level of unemployment benefit relative to the previous (or prospective) wage-income. The duration of entitlement to unemployment benefit is also clearly important, since intensity of search and willingness to accept an offer may be expected to increase when benefit is soon to expire (to be replaced with social assistance at, typically, a much lower rate).The empirical literature has examined the effects of unemployment benefits on labour supply in western countries which have time-limited benefits and replacement rates in the 20-60 per cent range. As a broad generalization, research concludes that replacement rates in this range do not have seriously adverse effects on labour supply, though a time limit on benefits has been found to be important.[53] In transition countries (and elsewhere) replacement rates are difficult to measure accurately, can be very misleading if measured inaccurately and anyway are changing continuously due to inflation and other factors. However from the somewhat fragmentary data on replacement ratios given above it appears that lie within the 20-60 per cent range and they are also declining through time due to inflation and budgetary stringency.

Where market wage rates for unskilled workers are very close to subsistence level, the replacement rate will inevitable approach 100 per cent. In such a situation there arises the "unemployment trap", where a worker is no better off when working than when unemployed and drawing benefit (and may even be worse off when travel costs etc. are taken into account). This problem can be alleviated if benefits are subject to well-defined and administered eligibility tests, rather than being available as of right. Similarly, another finding of importance to transition countries which has already been much emphasized by the ILO and other organizations is the value of employment offices in encouraging and assisting the unemployed to continue to search actively for work. Too often this element of the social security budget is neglected.

Active labour markets programmes, comprising job subsidies and business start-up schemes ; assistance with job search, training and retraining; and public works employment, are present in transition countries in varying forms and degree. Evaluating their effectiveness is a complex task. An econometric study by O'Leary (with ILO assistance) of Hungarian data concluded training was marginally effective in raising the probability of becoming re-employed, while participation in a public works programme had no such effect.[54] One aspect of the labour market which has evidently little been studied concerns geographical mobility of workers in transition economies. Because of housing tenure conditions and other factors, workers are notoriously immobile, most notably in Russia which also has an acute regional unemployment problem. Any money to assist worker mobility would surely be well spent.

In identifying obstacles to fuller employment it is also necessary to look at *social spending as a whole*. Where this s large relative to GDP it may adversely affect employment through three broad channels, namely the high taxes necessary to finance high government expenditures; effects on economic incentives which may distort the supply side of the economy, including the effects of unemployment benefits on work incentives (another effect not pursued here could be that a generous state pension system might discourage private savings); and the deadweight losses that

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[53]See World Bank (1993); Atkinson and Micklewright (1991); Layard, Nickell and Jackman (1991); Barr (1998).

[54] See O'Leary (1997), also Rutkowski (1995). It could be argued that microeconomic or partial equilibrium approaches such as O'Leary's miss the point. In a macroeconomic model such as that of Layard, Nickell and Jackman (1991), active labour market programmes, by intensifying competition in the labour market, reduce the inflation rate and thereby permit the government to expand demand, reducing unemployment.

arise when social benefits are provided inefficiently - such as poorly targeted cash transfers or inefficient health and education systems.

Pensions are generally a heavy burden, averaging about 10 per cent of GDP in the four Visegrad countries in 1997. This is somewhat below the Western European average, but some implicitly question whether the transition economies can afford public pension provision even approaching the same scale as the OECD countries.[55] Fundamentally, the cost is high because there are many pensioners, which in turn is because retirement ages are relatively low, pensioners can often continue working, and eligibility criteria for health-related pensions have not been very demanding. Of course, a pensions contribution rate of 26 per cent of income (as in Hungary)or more is not necessarily a bad thing; society's preferences may be, indeed, to pay high taxes while working in order to retire early and/or enjoy generous pensions when retired. But the higher is the contribution rate, the more it becomes questionable whether the rate reflects society's preferences, or whether instead a better outcome might be achieved by marginally reducing contributions and benefits. But the dilemma for governments everywhere is that the pensions of many individuals are currently inadequate yet there is little willingness to pay higher taxes to improve them. The general approach to pensions reform has been to introduce a second tier, or "pillar" to the system. The existing scheme continues to provide a basic subsistence minimum pension for all. The second pillar supplements the basic pension for those with higher incomes. Its membership may be either optional or compulsory. (A third pillar is also sometimes considered, usually in the form of contributions to a funded scheme operated by private-sector insurance companies.) Implicitly, the existence of the second (and third) pillars would make it politically possible for governments to stabilise contributions and benefits in the first tier, and even allow inflation to erode them in real terms. Poland, Hungary, and the Czech Republic are indeed in the process of introducing an additional pillar. However reforms along these lines are by no means neutral in their distributional effects. Given the already marked increase in inequality in the transition economies, further steps in this direction should be approached with great circumspection.

Another way to reduce the cost of pensions is by increasing the retirement age and other measures to reduce eligibility. For example in the Czech Republic the government is gradually raising the retirement age for men from 60 to 62 years, and for women from 53-57 to 57-61. However it is by no means clear that a government can raise the effective retirement age at the stroke of a legislative pen. There are strong social and economic pressures towards earlier retirement in virtually all countries, pressures which governments find themselves having to accommodate. For example a response to raising the official retirement age may simply be that more workers are made redundant as they reach the previous retirement age, with little hope of re-employment, and thus effectively retire. Alternatively, to the extent that governments can indeed successfully raise the retirement age, so older workers remain working when previously they would have retired, this may displace younger workers and thereby increase unemployment. In sum, raising the retirement age is less straightforward as a policy measure than it may appear at first sight. It is not likely to be either effective or welfare-improving unless there is a social consensus in its favour.

As an overall conclusion on social spending there is probably some limited scope for reducing the number of benefits and the numbers eligible for some benefits. There may also be scope for improving the targeting of some benefits, for example by making them taxable so that the better off receive less. Some of these reforms, to systems that are cumbersome and inefficient, can results in savings which are pure gains to society in the sense that there are no losers.

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[55]World Bank (1997b). The average state pension spending of upper-middle income developing countries (which includes countries such as Mexico, Greece, Chile and South Africa) was 6.9 per cent of GDP in the early 1990s. See World Bank (1994b).

However, further changes are likely to impose welfare losses on people who are already relatively needy. It is then hard to justify further steps unless the reduction in taxes made possible by these measures will definitely yield tangible benefits in terms of economic growth. There is little evidence that such benefits would materialize. In this sense, there is no trade-off between inequality and economic growth that has been meaningfully identified.

Improved structural adjustment is the third leg upon which, along with macroeconomic stabilization, labour market and social security reforms, increasing employment in transition economies critically depends. Looking back on the transition experience it is now clear that the first stages of structural reform, consisting of privatization and liberalization, were comparatively easy to achieve since they required little more of government than that it distance itself from the economy. A second phase involves not just changing policies but building institutions and promoting behavioural norms. These are inherently more difficult tasks which require much time to complete. The principal goals are:

- establishing a culture in which crime and corruption, whether within government or in society at large, are exceptions rather than the norm;

- establishing strong corporate governance by "outside" owners, together with effective competition polices. Without these, privatization and liberalization tend merely to generate windfall gains for enterprise managers with little gain in economic efficiency;

- financial sector reform, including transparency, legal and accounting standards, and effective prudential supervision. Without these, liberalization of the financial sector tends to encourage speculation which can generate high profits for a few (often associates of leading politicians) without contributing much, if anything, to financial intermediation and therefore without contributing to improved economic performance.

More than any shortcomings in stabilization, labour market or social security policies, it is the failure to achieve these goals that is the chief obstacle to increasing employment in transition economies. Some countries have moved faster than others towards their achievement. The CIS countries have made slow progress, indeed their reform processes are to a large degree stalled. This is partly because they faced the additional tasks of building new nations almost from scratch, whereas countries such as Poland and Hungary have enjoyed greater institutional continuity and been able to draw on a legacy of laws and institutions from the pre-war years.
But the setbacks to reform in Russia occurred also because of new vested interests which had sprung up since the collapse of the command economy. The Russian experience serves as a salutory warning of the damaging consequences of insider ownership of the enterprise sector, especially when the insiders enjoy links with government. Indeed it is no exaggeration to say that the Russian crisis of 1998 had its origins in the failure to tackle the problem of enterprise reform.

Faster structural change along the lines indicated above would inevitably increase unemployment in the short and probably even the medium term. Previously hidden unemployment will be converted into open unemployment. To forestall the real hardship and consequent political backlash growth of new employment must be maximised. In Poland for example new private sector firms have been the principal source of new jobs, while in Hungary former state enterprises have been revitalised by sale to strategic investors. At the same time, the social safety net must be strengthened - by better targeting of benefits of all kinds - to ensure that those who bear the brunt of the necessary restructuring receive adequate support from society as a whole.

The economies of Russia and Ukraine may, however, be already so weak that the poor cannot withstand the pressure of accelerated structural adjustment. Ukraine is the only large

transition economy where GDP has fallen continuously throughout the decade.[56] Real wages collapsed in the 1990s, and although registered unemployment is remarkably low both hidden unemployment and the unofficial economy are large. Poverty is very high. Conditions in Russia are not very different. In these circumstances future assistance from the international community should be specifically aimed at strengthening the social safety net and maintaining the living standards of the poorest. This could be achieved by, for example, external donors contributing to specific lines in the government budget. Apart from its direct benefits to the needy, the great advantage of this approach is that it would reduce the political tensions arising from the reform programme and thereby permit the government to pursue reform more vigorously and single-mindedly.

[56]Moldova and Tajikistan also more or less qualify.

Table 1: Principal economic developments

Ukraine	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change		-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	0.0
GDP	100	88.4	76.3	65.5	50.4	44.3	39.8	38.6	38.6
Industrial employment			100.0	94.5	83.6	78.2	71.5	na	na
Labour productivity in industry			100.0	86.9	55.9	46.0	39.7		
Unemployment %	na	0.0	0.3	0.4	0.4	0.5	1.1	2.3	na
Inflation (CPI, annual av. % change)		91.0	1210.0	4735.0	891.0	376.0	80.0	16.0	11.0
Consumer prices	100	191.0	2502.1	120976.5	1198877.5	5706656.7	10271982.1	11915499.2	13226204.
Consumer prices (1992=100)			100.0	4835.0	47914.9	228074.7	410534.4	476219.9	
Real consumption wage level (1992=100)			100.0	53.3	44.4	48.6	46.2	45.4	
Producer prices	100	225.0	5589.0	263744.9	3280986.7	19292201.7	29324146.6	31670078.3	
Producer prices (1992=100)			100.0	4719.0	58704.4	345181.6	524676.1	566650.2	
Real product wage (1992=100)			100.0	54.6	36.3	32.1	36.2	38.2	
Russian Federation	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change	-	-5	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-5
GDP	100	95.00	81.23	74.16	64.74	62.09	59.91	60.39	57.37
Gross fixed investment % change	na			-25.8	-26.0	-7.5	-18.5	-5.0	
Total employment	100	98	95.75	94.12	88.28	88.11	87.58	86.00	
Labour productivity	100	96.9	84.8	78.8	73.3	70.5	68.4	70.2	
Unemployment %	na	0	4.8	5.3	7.1	8.3	9.2	10.9	na
Inflation (CPI, annual av. % change)	-	92.7	1526	875	311.4	197.7	47.8	14.7	40.0
Consumer prices	100	192.7	3133.3	30549.7	125681.4	374153.7	552999.1	634290.0	888006.0
Real consumption wage	100	93.5	62.9	63.1	57.2	42.9	49.6	51.8	
Producer prices (1991=100)	na	100.0	1867.9	19461.7	85125.3	286446.5	431961.3	517057.7	
Real product wage (1991=100)	na	100.0	105.5	99.1	84.4	56.1	63.5	63.5	

Slovak Republic	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change		-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	5
GDP	100	85.40	79.85	76.89	80.66	86.23	91.92	97.89	102.79
Gross fixed investment % change		-25.20	-4.50	-5.40	-4.60	5.30	39.80	14.50	
Total employment	100	85.6	85.86	85.77	84.23	86.08	86.77	86.42	
Labour productivity	100	99.8	93.0	89.7	95.8	100.2	105.9	113.3	
Unemployment (%)	na	na	na	12.2	13.7	13.1	11.1	11.6	na
Inflation (CPI, annual av. % change)		61.2	10.1	23.2	13.4	9.9	5.8	6.1	7.5
Consumer prices	100	161.2	177.5	218.7	248.0	272.5	288.3	305.9	328.8
Real consumption wage	100	72.1	76.3	75.8	79.1	83.4	90.4	95.3	
Producer prices	100	168.8	177.7	195.5	213.1	221.9	231.8	277.5	
Real product wage	100	68.9	76.2	84.7	92.0	102.4	112.4	105.1	
Czech Republic	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change		-11.5	-3.3	0.6	3.2	6.4	3.9	1	-1
GDP	100	88.50	85.58	86.09	88.85	94.53	98.22	99.20	98.21
Gross fixed investment % change		-17.50	8.80	-8.10	17.30	21.00	8.70	-4.90	
Total employment		100	97.40	95.84	96.61	99.12	99.91	98.61	
Labour productivity		100.0	99.3	101.5	103.9	107.8	111.1	113.7	
Unemployment (%)	na	4.1	2.6	3.5	3.2	2.9	3.5	5.2	na
Inflation (CPI, annual av. % change)		56.6	11.1	20.8	10.0	9.1	8.8	8.5	11
Consumer prices	100	156.6	174.0	210.2	231.2	252.2	274.4	297.7	330.5
Real consumption wage	100	74.5	80.2	82.2	86.5	93.7	101.4	106.0	
Producer prices	100	170.3	187.3	197.4	212.5	222.6	233.6	245.0	
Real product wage	100	68.5	74.5	87.5	94.2	106.1	119.1	128.8	

Hungary	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change		-11.9	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6
GDP	100	88.10	85.37	84.86	87.32	88.63	89.78	93.73	98.04
Gross fixed investment % change	-	-10.40	-2.60	2.00	12.50	-4.30	6.30	8.80	
Total employment	100	90.4	81.99	77.57	76.48	75.94	76.17	76.40	
Labour productivity	100	97.5	104.1	109.4	114.2	116.7	117.9	122.7	
Unemployment %	na	7.4	12.3	12.1	10.4	10.4	10.5	10.4	na
Inflation (CPI, annual av. % change)	-	35.0	23.0	22.5	18.8	28.2	23.6	18.3	15.0
Consumer prices	100	135.0	166.1	203.4	241.7	309.8	382.9	453.0	520.9
Real consumption wage	100	93.0	95.2	96.9	100.8	95.4	93.8	96.8	
Producer prices	100	132.6	148.9	165.7	213.6	260.2	313.3	377.2	
Real product wage	100	94.7	106.2	119.0	114.0	113.5	114.7	116.3	
Poland	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change	-	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	5.2
GDP	100	93.0	95.4	99.0	104.2	111.5	118.3	126.5	133.0
Gross fixed investment % change	-	-4.4	2.3	2.9	9.2	16.9	20.8	21.9	
Total employment	100	95.7	93.0	91.4	92.4	95.1	98.5	na	na
Labour productivity	100	97.2	102.6	108.3	112.7	117.2	120.1		
Unemployment %	na	11.8	13.6	16.4	16.0	14.9	13.2	10.5	na
Inflation (CPI, annual av. % change)	-	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.0
Consumer prices	100	170.3	243.5	329.5	435.6	556.7	667.5	766.9	
Real consumption wage level (1990=100)	100	95.8	92.9	93.0	96.1	99.8	105.6	111.7	
Producer prices	100	140.9	189.5	250.0	313.2	392.8	441.5	495.3	
Real product wage	100	115.8	119.4	122.5	133.7	141.5	159.7	173.0	

Romania	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change	-	-13.0	-8.8	1.6	3.9	7.1	4.0	-6.9	-7.3
GDP	100	87.0	79.4	80.7	83.9	89.8	93.4	87.0	80.6
Gross fixed investment % change	-	-31.7	11.1	8.2	20.8	6.9	5.7	-2.9	-18,1
Total employment	100	99.5	96.5	92.8	92.4	87.6	86.6	83.2	na
Labour productivity	100	87.4	82.3	87.0	90.8	102.5	107.8	104.6	na
Unemployment %	1.3	3.0	8.4	10.4	10.9	9.5	6.6	8.8	10.3
Inflation (CPI % change)	-	170.2	210.7	256.2	137.1	32.2	38.8	154.9	59.3
Consumer prices	100	270.2	839.5	2 990.3	7 090.1	9.973.1	13 009.9		
Consumer prices (1996=100)							100	254.9	406.1
Real consumer wage	100	83.3	73.3	63.9	64.6	71.1	85.4	78.3	75.2
Producer prices	100	320.1	911.6	2 415.8	5 815.0	7 867.6	11 801.5		
Producer prices (1996=100)							100	250.5	334.7
Real producer wage	100	70.3	67.5	79.1	78.7	90.2	94.2	79.6	91.2
Bulgaria	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GDP % change	-	-8.4	-7.3	-1.4	1.8	2.8	-10.2	-7.0	3.0
GDP	100	91.6	84.9	83.7	85.3	87.7	78.8	73.3	75.5
Gross fixed investment % change	-	-20.0	-7.4	-17.4	1.1	16.0	-21.2	-22.1	na
Total employment	100	86.9	79.9	78.6	79.2	80.1	80.2	78.1	na
Labour productivity	100	105.4	106.3	106.5	107.7	109.5	98.3	93.9	na
Unemployment %	1.8	10.7	15.7	16.4	12.8	11.1	12.5	13.7	12.2
Inflation (CPI % change)	-	338.5	91.3	72.9	96.2	62.1	123.1	1 082.6	22.2
Consumer prices	100	438.5	834.4	1 442.7	2 830.5	4 588.3	10 236.5	-	-
Consumer prices (1996=100)							100	2 082.6	2 544.9
Real consumption wage	100	62.8	76.9	69.0	54.1	52.6	46.0	48.5	na
Producer prices	100	396.4	618.8	793.9	1 263.1	1 880.7	4 320.1		
Producer prices (1996=100							100	988.1	1 213,4
Real product wage	100	69.5	103.6	125.3	121.2	128.4	109.0	92.0	na

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